VILLANOVA LAW REVIEW
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Introduction

OFFSHORE ACCOUNTS, CORPORATE INCOME SHIFTING, AND EXECUTIVE COMPENSATION

Leslie Book

I. INTRODUCTION

The articles that follow arose out of the Villanova Law Review Norman J. Shachoy Symposium hosted at Villanova Law School on September 23, 2011. The symposium brought together some of the nation’s leading academics, practitioners, and journalists to discuss issues relating to the taxation of offshore individual offshore accounts and offshore operations of multinational corporations (MNCs), as well as the role of the tax laws in regulating executive compensation. As I discuss in this introductory essay, all of the articles implicate at some level essential questions of fairness, including questions of both vertical and horizontal equity.

This topic is very timely. The image of millionaires hiding money in undeclared offshore bank accounts has triggered unprecedented administrative and legislative reactions to detect those accounts and deter that type of evasion. Moreover, the fact that some of the largest American MNCs pay no or little tax raises questions about our corporate and international tax policy, and executives’ high pay, at companies implicated in

* Professor of Law and Director, Graduate Tax Program, Villanova University School of Law. The author is grateful for the excellent research assistance of Catherine Mock, LL.M. in Taxation Candidate 2012, J.D. 2011, Villanova University School of Law. I wish to acknowledge all of the participants at the symposium, including those who did not present papers but whose participation made the symposium a huge success. The participants (apart from those whose articles I mention in this essay) were Tamara Ashford, John McDougal, Bryan Skarlatos, Rosanne Altshuler, Ed Kleinbard, Fritz Foley, Joseph E. Ronan, Jr., and Lee Sheppard. I am grateful to the Shachoy family for its support of the Law School, and to Villanova Law School for its financial support of my research. I wish to thank Leandra Lederman, Keith Fogg, Joy Mullane, Dick Harvey, and Valinda Garcia Latoff for comments on an earlier draft.

1. A useful summary of the essential role that fairness plays (and has played) in tax policy debates can be found in Joel Slemrod & Jon Bakija, Taxing Ourselves 57–98 (4th ed., 2008). Vertical equity considers the appropriate level of tax burdens on households of differing levels of income, and horizontal equity considers tax burdens across households of similar income or well-being. Id. at 59–60
corporate scandals and the near meltdown of the financial sector, has contributed to federal legislation meant to influence corporate governance.

Faith in public institutions matters a great deal for those who care about tax administration. This past year has provided a rich real-life case study of the effects on global markets of a country that has a tax system that is riddled with corruption, and a society that has as one of its national pastimes the underreporting of income and differing (though unstated) rules for those with means and those without. The Greek culture of systemic underreporting of income, and the Greek tax authorities’ difficulties in detecting and prosecuting tax cheats exploded into the popular media.2 The failure of the Greek tax system contributed mightily to that country’s fiscal woes. Greece is not alone in its tax troubles: other countries too have significant tax compliance issues,3 issues that threaten fiscal stability and raise challenges for tax administrators who generally rely to some degree on voluntary compliance to ensure the integrity of their tax system.4

It is common knowledge that those with certain kinds of incomes have an ability to benefit from tax advantages that others do not, and that tax policy has contributed to greater concentration of wealth in the past decade. The Occupy Wall Street movement has highlighted an increasing concentration of wealth among the top earners.5 In addition, news articles have detailed how the largest and most profitable American MNCs,


3. For example, the pope took up the cause of worldwide tax evasion, with some linking his efforts to the significant tax compliance problems Italy faces. See Pope to Denounce Tax Evasion, ACCOUNTINGTODAY (Aug. 20, 2007), http://www.accountingtoday.com/news/25103-1.html.

4. ERICH KIRCHLER, THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR 160 (Cambridge University Press 2007) (discussing various models of tax compliance and noting that behavioral models that implicate “psychological and sociological variables such as demographic characteristics (e.g., education, income level, income source, occupation) social representations and attitudes (e.g., tax ethics, and social norms, fairness perceptions), and structural characteristics (e.g., complexity of the system, audit probability and detection probability, sanctions, and tax rates) contribute to understanding tax compliance across cultures).

like GE, pay little or no corporate tax. But concerns about the nation’s richest individuals and largest corporations and their taxes highlight a concern beyond that of just class envy or questions regarding the effects of income inequality—even if that inequality is greater now than at almost any other time in our country’s history. For example, Mitt Romney’s 2010 tax return drew attention to ways that our country’s wealthiest can take advantage of “perfectly legal” mechanisms to reduce effective tax rates to below what many middle and upper-middle Americans pay.

It is not that GE or Romney achieved low tax rates through illegal means—as far as we know, they did not—but that they can do so through legal means when others cannot leads to the conclusion that perhaps some are more “equal” than others when it comes to our tax system. In particular, the knowledge “that Romney can pay such a small share of his income in taxes and be safely within the law . . . vexes.” As one perceptive observer noted, “[m]any Americans—whether they are of the Tea Party or Occupy Wall Street persuasion, or somewhere in between—increasingly sense that our public institutions do not treat us as equals.”


10. Id.
It would be an overstatement to say that the American tax system is in danger of becoming like the Greek tax system: while the tax gap (the difference between what is properly due and what is paid on time) is significant, our compliance rate is holding steady at about 83%. For items of income where there is information reporting and withholding (like wages), compliance is extremely high. Yet, tax administrators and academics know that the seeds of discontent, and potential deep-rooted problems with tax compliance, lie both in opportunity and perceptions. Administrators wish to minimize opportunities for tax cheaters to avoid detection, and squelch a perception that our tax system is unfair, either in design or application. There is a sense of unfairness that arises both when some taxpayers successfully evade taxes through illegal means, and when those or others gain access to tax preferences through legal means that are increasingly unavailable to people without certain kinds of income or business opportunities. It is these issues that the first tranche of papers in the Shachoy symposium address.

II. OVERSEAS ISSUES: HIDING MONEY FROM THE TAX COLLECTOR AND CORPORATE INCOME SHIFTING

The first set of articles in the Norman J. Shachoy Law Review Symposium address the cat and mouse game of wealthy Americans hiding assets and income in previously undeclared offshore bank accounts. This is not a new problem; as John McDougal, Special Trial Attorney at IRS Office of Chief Counsel, recounted in his presentation at the symposium, in 1937, then-Secretary of the Treasury Henry Morgenthau, in a letter to FDR, blamed the lack of income tax receipts in part on the use of offshore accounts and dummy corporations—evidencing both legal avoidance and outright evasion.

For decades, the IRS has had little systemic ability to track this form of cheating. Hiding behind bank secrecy laws and layers of byzantine entities obfuscating beneficial ownership, Americans with the means and will to hide money offshore could do so, largely immune from detection. That has changed dramatically in the past decade. In his article, Go West: How the IRS Should Foster Innovation In Its Agents, Professor Keith Fogg identifies and describes in great detail the pioneering work of Joe West, an IRS revenue agent whose doggedness and creativity in the 1980s and early

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1990s jump-started the current efforts to detect and deter taxpayers seeking to hide their income overseas. The article is remarkable in its efforts to show how a determined and resourceful IRS employee could gather facts from credit card companies, promoters, bankers, and others to help begin the systemic chipping away at the previously walled-off world of offshore banking. Drawing on interviews and review of underlying court documents, Professor Fogg pieces together how a 1980s audit of Wheaton Industries, a New Jersey-based specialty glass manufacturing company, led to the detection of the use by Frank Wheaton, Jr., that company’s CEO, of offshore bank accounts to conceal money and income from the IRS in at least three tax haven jurisdictions. What started as an examination of a corporation turned into an almost decade-long effort to gather information about individuals and the shadowy world of tax havens and undeclared bank accounts.

The article not only provides an important historical narrative, it also includes a prescription: Professor Fogg urges the IRS to “continue to adopt innovative techniques such as the one designed by Revenue Agent Joe West” and suggests “that the IRS must find a way to encourage its agents to approach their jobs with the same inventiveness [West] brought to the offshore project.”

15. Id. at 442.


17. See generally J. Richard Harvey, Jr., Offshore Accounts: Insider’s Summary of FATCA and Its Potential Future, 57 VILL. L. REV. 471 (2012). Professor Harvey notes that one of FATCA’s goals was to enhance participation in the voluntary compliance programs, in that its implementation heralded a greater likelihood that the U.S. would detect previously noncompliant taxpayers, thus incentivizing participation. See generally id.
Following her description of this series of voluntary disclosure programs in the 2000s, Professor Lederman evaluates the government’s approach to voluntary disclosure of offshore evasion in light of the literature on optimal tax amnesties (including insightful work by Dean Craig Boise), identifying the costs and benefits of those amnesties. Applying Dean Boise’s analysis, she describes an optimal amnesty as one that will (1) be accompanied by reform that will discourage evasion in the future; (2) be accompanied by greater enforcement; (3) be offered only once; (4) minimize perceptions of unfairness by not being offered to known tax evaders and waiving few penalties—ideally only criminal prosecution; and (5) not be relied on principally to raise revenue. Professor Lederman then applies that framework to current IRS efforts and concludes that the offshore tax amnesties meet some but not all of the optimal amnesty elements. She convincingly argues that there are likely to be diminishing returns unless the government continues to emphasize and publicize criminal prosecutions as part of its overall enforcement strategy.

Next, in his article, Offshore Accounts: Insider’s Summary of FATCA and Its Potential Future, Professor J. Richard Harvey, who was heavily involved in the IRS’s efforts to address offshore accounts, describes the origins of the Foreign Account Tax Compliance Act (FATCA), including prior efforts to address the longstanding problem surrounding the use of offshore accounts to evade detection. Professor Harvey describes efforts such as the adoption of the qualified intermediary withholding regime, the use of John Doe summonses to ferret out U.S. accounts at foreign financial institutions and the IRS’s adoption of voluntary disclosure initiatives to incentivize compliance. FATCA’s architects, including Professor Harvey himself when he was the Senior Advisor to IRS Commissioner Doug Shulman, knew full well that the existing regime was inadequate due to the IRS’s inability to identify foreign source income and determine an account’s beneficial ownership (rather than legal ownership). Moreover, prior efforts fell short of requiring foreign financial institutions to review all customer accounts within the affiliated group in order to identify U.S. taxpayers. FATCA, as Professor Harvey describes, addresses these deficiencies, but creates major compliance costs for foreign financial institutions, which will face the threat of withholding tax on U.S.-source payments, including gross sale proceeds.

Professor Harvey proceeds to describe some technical issues that the IRS and financial institutions are grappling with (including the challenges associated with potentially burdensome due diligence requirements that

19. Harvey, supra note 17.
20. See I.R.C. § 7609(f) (2006) (explaining that IRS has broad powers to seek “John Doe summons” for information from third parties on unknown taxpayers if the IRS determines there is a significant pocket of non-compliance that warrants an investigation on such taxpayers). See also Fogg, supra note 14.
may apply irrespective of how few U.S. accounts are held by a foreign financial institution, and then raises the important questions as to whether FATCA will achieve its intended general goal of making it more difficult for Americans to hide assets offshore. Professor Harvey notes that the FATCA regime was adopted unilaterally, and that “the major weakness of FATCA is that the U.S. is attempting to unilaterally require [foreign financial institutions] to report information to the U.S. When FATCA was being conceptualized, it was this author’s hope that the U.S. would aggressively market the FATCA concept to other major countries. It is not clear whether this has been occurring.”21 To enhance the chances of broader adoption, Professor Harvey counsels the Treasury to balance its desire to craft tight due diligence rules and restrictive rules regarding the ability of U.S. taxpayers to indirectly invest in U.S.-source assets with an understanding that its efforts to make matters airtight may minimize the chances for broader adoption. Thus, underlying Professor Harvey’s recommendation is that when it comes to sniffing out tax cheaters, “the best is the enemy of the good,”22 and that proceeding unilaterally may jeopardize the entire endeavor.

Professor Susan C. Morse’s article, Don’t Go It Alone, Uncle Sam: The Future of Global Tax Reporting,23 also analyzes FATCA but focuses on how to enforce it. She describes the U.S. approaches to the problem of offshore accounts and cross-border information reporting, and compares our efforts with European approaches. Professor Morse details how American efforts to combat offshore evasion arose from an increased understanding following the unraveling of UBS and other banks’ efforts to assist wealthy Americans in avoiding detection under existing laws. The FATCA regime has quickly brought “remarkable innovations,” namely withholding penalties, disclosure requirements, due diligence requirements, and an expanded beneficial owner concept.24

Like Professor Harvey, Professor Morse identifies the deficiencies of unilateralism in FATCA’s implementation, and highlights the importance of gaining non-U.S. government cooperation to ensure FATCA’s success.25 Identifying specifically how FATCA lacks a good enforcement mechanism (because, for example, the U.S. lacks jurisdiction over the non-U.S. banks and other foreign financial institutions), Professor Morse recommends that the U.S. (1) keep FATCA’s diligence and reporting requirements simple, (2) seek cooperation through reciprocity, and (3) consider the European approach of incentivizing foreign governments through the use of side payments.

21. Harvey, supra note 17.
24. Id. at 535.
25. Id. at 542–49.
The final paper in this set shifts the focus from individuals to corporations. In *Some Suggestions For Tax Reform*26 Michael C. Durst considers the ways that American MNCs have legally shifted their incomes to low-tax or no-tax overseas jurisdictions. Unlike the wealthy individuals described in the first series of papers in the Shachoy symposium, some of whom have shifted assets outside the U.S. in order to intentionally evade taxes while avoiding the detection of American tax authorities, American corporations’ income-shifting actions, while aggressive, are within the letter of the law. Yet, Durst identifies how these actions, while legal, can undermine the trust and respect that tax systems depend upon to succeed:

[T]he most serious harm from our current international tax rules, I think, is not a tendency to erode the tax base, or to skew investment and employment away from the United States. The most serious harm is not economic at all. The income shifting that I have described is “perfectly legal,” as the phrase goes, but the image that it presents to the public—an image that has been made available to the public by leading journalists—is, I think, deeply harmful. The public sees our most important business corporations, and policy-makers in Congress and elsewhere in Washington, colluding, albeit legally, to shift hundreds of billions of dollars of income to mailbox companies in countries where the companies perform little if any business activity. Institutions in our society which should be among the most worthy of respect appear to be engaged in a kind of behavior that typically would be associated with society’s least savory actors. This spectacle cannot possibly be failing to contribute to what is already an unhealthy erosion of public respect for governmental and business institutions.27

Durst, a former advisor for the IRS and now a columnist for *Tax Notes*, sketches a way out of our current mess, suggesting a combination of international tax reform and a substantial reduction in corporate income taxes. Mindful of the net revenue effects of such a proposal, Durst notes the reform that he suggests will have to be accompanied by sources of additional revenue, linking his ideas to reforming our international tax system to an overall, comprehensive, reform.

III. EXECUTIVE COMPENSATION

While the first group of papers address challenges in offshore taxation and international taxation, the second group of papers touch on a different set of issues: excessive pay of executives, and Congress’ interest in curbing certain types of pay and limiting salaries. Specifically, the follow-

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27. Id. at 436.
ing articles principally address the use of the tax system to tackle issues of corporate governance. These authors tackle the use of our tax system to control pay that Congress, for various reasons and at different times, has regarded as excessive or improper.

In her article, *Perfect Storms: Congressional Regulation of Executive Compensation*, Professor Joy Sabino Mullane takes an historical approach, and examines the factors that have triggered legislation regulating executive compensation following the expansion of federal powers at the time of the New Deal. In examining the myriad efforts, Professor Mullane argues “that legislation regulating executive pay is enacted when three factors coalesce: economic turmoil (i.e., a recession), rising unemployment, and an executive pay controversy.” The explanation sheds light on how economic turmoil, on its own, is generally insufficient to drive additional congressional action, and how Congress, at certain times (and in light of a coalescing of opinions calling for federal action to control pay), is compelled to “do something” about executive pay, but typically legislates deeply flawed provisions. Drawing on the deep bench of criticism of Congress’ actions in this area, Professor Mullane suggests that, in light of the inevitability of Congress injecting complexity and unintended consequences, its attempts to regulate pay should be accompanied by sunset provisions. These provisions will provide a shelf life for the legislation, and also provide opportunities for Congress and the public to cool off and dispassionately examine the consequences of the legislation.

In *The Use of Federal Law to Curb Excessive Executive Compensation: Lessons in Past Failures and Lessons for the Future*, Professor Kathryn J. Kennedy discusses the use of tax law and, in recent times, federal securities laws, to curb excessive compensation. After describing how state laws typically address only the process by which boards set pay, and not the amount of pay, she concludes that it is not surprising that Congress “dabbles” in the area of corporate governance. She details the panoply of tax provisions meant to curb pay, and notes both their complexity and unintended consequences and how Congress tends to legislate by reacting to specific news events.

For example, Professor Kennedy describes the Code’s limits on golden parachute payments following a bevy of mergers and acquisitions in the early 1980s. Congress attended to what it thought were excessive severances and byzantinely complex limits on deferred compensation following news of Enron executives dipping into their deferred compensation arrangements at the same time that the firm itself was spiraling

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29. Id. at 591.

30. Id. at 628–31.

toward bankruptcy. Professor Kennedy also explores the relatively recent push toward the use of federal securities laws to address governance issues relating to pay, including more robust disclosure rules and shareholder “say-on-pay” provisions. While noting that the full measure of some of these provisions is not clear (due mainly to their relatively recent vintage), she anticipates continued corporate backlash and is skeptical of the provisions’ ability to control or meaningfully influence pay.

Professor Andrew C.W. Lund, drawing on a longstanding strand of critical scholarship, argues in Tax’s Triviality As a Pay-Reforming Device that when it comes to executive compensation, tax interventions of the kind that Professor Kennedy catalogues (such as the limitation of Section 162(m) on the deductibility of certain compensation) “have trivial effects on board decision making regarding executive pay.” He argues that, compared to gains associated with hiring the perceived best executives, the tax interventions are minor. Accordingly, corporations and their boards will accept the penalty and compliance costs associated with Congress’s efforts to use the tax law and pay what they wish to compete for perceived managerial talent and value. To have real effect, the use of the tax system to regulate compensation would have to be connected with far more serious and adverse consequences than currently structured. Yet, Professor Lund suggests that coercive regulation through the tax system is too blunt and ill-fitting in a diverse world, and suggests that using the tax system to try to attain corporate governance outcomes is ill-advised.

In his article, Fixing Section 409A: Legislative and Administrative Options, Professor Gregg D. Polsky takes aim at the legislative effort in Section 409A to curtail a type of executive pay, deferred compensation. That section penalizes deferred compensation arrangements that do not meet its numerous technical requirements. Professor Polsky argues that Section 409A is an “unqualified mistake,” noting that Section 409A “simply provided more hoops to jump through to get the tax benefit of deferred compensation and everyone is jumping through them rather than opting out.” Detailing the additional complexity and costs (and great potential for inadvertent noncompliance) added by Section 409A, Professor Polsky argues that Congress should repeal the provision and, in the absence of overall reform in the area, grant the Treasury explicit authority to promulgate rules and regulations based upon doctrines of constructive receipt and economic benefit. If Congress does not act, Professor Polsky urges the IRS to take matters in its own hands and administratively limit its appli-
cability to compensation paid by public companies to their employees or directors.

Concluding this series of articles is Professor David I. Walker’s article, *Who Bears the Cost of Executive Compensation (And Other Agency Costs)?* 37 Professor Walker discusses how many “commentators and analysts believe that executive pay at U.S. public companies reflects systematic market failure, and, as a result, executives receive more compensation than they would in a well-functioning market.” 38 Professor Walker analogizes the excess pay to an additional corporate tax on publicly traded companies, and argues that in light of recent research on the incidence of corporate tax, the “cost of systematically excessive executive pay is likely to be shifted from shareholders to other investors, labor, or both.” 39 The implications of this insight are significant, with, for example, differences in progressivity depending on the incidence of the cost. That is, to the extent costs are borne by parties other than shareholders, it is likely that these costs are more regressive than traditionally identified in the corporate governance literature. 40 Professor Walker extends his insights beyond incidence analysis, however, noting the social costs of the inefficiencies, including how, under various models, excessive executive pay may distort the allocation of capital both between the corporate sector and the domestic non-corporate sector and between domestic and foreign investments.

The implications of Professor Walker’s insights are far reaching; for example, the incidence and effects of executive compensation may justify additional regulation because the stakes are perhaps “greater, or at least different” 41 if labor and non-corporate capital may bear some of the burden of excessive compensation. To the extent that the cost of excessive pay is borne solely by shareholders (which Professor Walker’s insights suggest not to be the case), regulatory responses aimed at increasing shareholder power vis-à-vis management, such as mandating shareholder “say on pay,” may be reasonable and effective. 42 But shareholder-centric approaches to improving pay processes may be less compelling to the extent that shareholders are able to pass the costs on to other stakeholders.

IV. Conclusion

The implications of Professor Walker’s paper bring us back to questions of fairness directly addressed in the first series of articles in the symposium, which dealt with offshore tax noncompliance. That those in


38. *Id.* at 654.

39. *Id.*

40. *Id.* at 670–71 (stating that costs are more regressive when shifted to labor than when shifted to shareholders; thus, costs are more regressive as they are not borne entirely by shareholders).

41. *Id.* at 670.

42. *Id.* at 671.
positions of power, through legal or other means, can continue to perpetuate advantages not generally available contributes to dissatisfaction with institutions. When institutions that should be among our most respected can exacerbate and perpetuate inequalities, especially at times of economic uncertainty, there is bound to be both a public and legislative backlash. While there is a great deal of disagreement in tax policy about how to calibrate the trade-off between limiting incentives to create wealth on the one hand, and the ill-effects of income and wealth inequality on the other, there is general agreement that those with positions of power should not abuse that power by extracting rents from the market or hiding assets in an undeclared bank account so as to evade taxes.

Likewise, when some of our most profitable MNC’s or richest Americans have an effective tax rate below that of many with modest incomes, those trade-offs inherent in the discussion about the degree of vertical equity become visible, and likely to generate political attention. How our tax system will address these questions in the future remains to be seen. There is no doubt, however, that policymakers and academics interested in issues of offshore evasion, international income-shifting, and executive compensation will find the series of articles that follows essential reading.
Articles

SOME SUGGESTIONS FOR TAX REFORM

MICHAEL C. DURST*

I. INTRODUCTION

This Article is written at a time when the U.S. political process seems largely stalled as a result of fundamental disagreements concerning the desired role of government in national economic affairs, and hence the desired level of tax revenues. The stalemate has slowed, at best to a crawl, legislative movement toward comprehensive tax reform. This article is intended to convey a modest collection of ideas that, it is hoped, might be useful for consideration when the current legislative situation becomes more fluid. The article focuses most specifically on international issues, but as discussed below, for a number of practical reasons such issues cannot be addressed in isolation from broader questions of tax reform. Therefore, this article essentially works outward from a discussion of problems in the sphere of international taxation and suggests the kind of overall reform in which currently vexing issues—not only in the international field, but elsewhere—might be addressed in what is hoped can be seen as a politically and economically moderate manner.

II. SOME INTERNATIONALLY FOCUSED OBSERVATIONS

I will start with a brief—and admittedly somewhat argumentative—diagnostic review of the history of the rules that govern the international taxation of U.S.-based companies. Following the discussion of international rules, I will expand the focus to a brief consideration of how the different components of a reform—domestic as well as international—might fit together in a comprehensive and coherent package.

I think that our current international tax rules are, to a large extent, the result of historical accident. Soon after World War II, with the development of the new generation of wonder drugs by U.S. companies, pharmaceutical companies began to transfer patent licenses to what came to be known as “base companies” in low-tax countries. By the early 1960s, the Kennedy Administration thought that the revenue leakages from the use of base companies were excessive, and the Administration sought to eliminate the ability to shift income to low-tax jurisdictions. Many saw this as a

* Mike Durst is a columnist for the publication Tax Notes. This Article summarizes remarks that Durst made at the Villanova Law Review Norman J. Shachoy Symposium. Portions of this Article are adapted from a column published in Tax Notes on November 28, 2011, and are published here by permission of Tax Analysts, Inc.
move toward an economically unwise *de facto* tax increase on key U.S. businesses, and in any event the attempt to eliminate deferral proved politically infeasible. Accordingly, starting with the Revenue Act of 1962 and continuing over the course of the 1960s—with, of course, many modifications since the 1960s—Congress and the Treasury developed a system of rules that continued to allow deferral through income shifting, but sought to limit income shifting to some extent.

Then, as new intangibles-intensive industries, such as the electronics and later software industries, developed alongside the pharmaceutical industry, and as tax practitioners developed greater expertise in working with the applicable rules—with the controlled foreign corporation rules of subpart F and the transfer pricing rules—the practice of income shifting to low- and zero-tax countries grew. The introduction in the 1990s of the check the box rules, and of today’s cost sharing rules, accelerated the expansion of income shifting. I think it is fair to say that today, the extent of income shifting by U.S.-based companies, to low- and zero-tax countries, extends far beyond what Congress and the Treasury could have envisioned during the 1960s.

I believe as well—and I know some may in all sincerity disagree—that the expansion of income shifting reflects some basic failures of policy-makers in the 1960s to foresee some of the substantive implications of the system they were creating. First, I think that the policy-makers of the 1960s didn’t foresee that the courts would hold that the Treasury does not have the power to tax the transfer by a U.S. company of the right to conduct a potentially profitable business outside the United States. That is, I don’t think it was foreseen, in the 1960s, that the transfer of a so-called “business opportunity” would be outside the reach of the transfer pricing rules.

When a U.S. company gives a subsidiary the right to try to replicate a proven business model overseas, the parent company has an expectation that the subsidiary probably will succeed in its efforts—that is, the expected return at the time of the transfer is positive. Yes, there is a chance that the subsidiary’s efforts will fail, but the overall statistical expectation is that the subsidiary’s efforts will succeed, and that the subsidiary will end up generating profits. If that expectation were not present, the company would not make the transfer.

Because of the statistical expectation of success, companies would not transfer business opportunities to unrelated companies without requiring substantial compensation. Our transfer pricing laws, however, do not require U.S. companies to receive arm’s length compensation when they transfer business opportunities to related companies. The result is that our transfer pricing laws permit the tax-free transfer of huge amounts of income-generating potential overseas, without a requirement that arm’s length consideration be paid.
I think, in addition, that the architects of our international corporate tax system failed to appreciate the consequences of permitting the sourcing of business income to be determined by the terms of contracts, including both contracts for the license of intangibles and other contracts that allocate risks and rights to income, that are made between members of commonly controlled groups. The related companies that are party to such contracts all have precisely the same owners—precisely the same ultimate shareholders. These contracts therefore involve no genuine adverse bargaining and do not apportion risks and rewards in any real economic sense. Market forces impose no discipline on the terms of such contracts; instead, the parties are free to draft such contracts with the sole objective of moving anticipated income to the lowest-tax jurisdiction. Not surprisingly, permitting taxpayers to rely on intragroup contracts for tax purposes has amounted to an open-ended invitation to shift income to low- and zero-tax countries.

I have listed only two central errors that I think policy-makers made in the 1960s, and which have been perpetuated until the present time. More could, I think, be said along these lines, but I am not sure that offering a more detailed bill of particulars right now would be useful.

So I will move on to the question of whether the income shifting which currently occurs inflicts damage that should be redressed as part of tax reform. Again, opinions may differ, but I am personally convinced that the shifting of income under our current tax rules has serious adverse consequences for the United States.

First, it seems apparent to me that the current rules—particularly by allowing the tax-free transfer of business opportunities from the United States—have drained off a large chunk of our corporate tax base. This erosion of the tax base has, I believe, led to chronic shortfalls in revenue collections from the corporate income tax. These shortfalls have in turn contributed to the maintenance of a statutory corporate rate that is much higher than is consistent with adequate levels of corporate investment and employment in the United States. Every tenth of a percentage point in the corporate tax rate directly reduces the expected after tax rate of return from business investment. No other component of the tax system so directly and predictably diminishes incentives for business investment. By tending to push corporate tax rates higher, income shifting discourages investment and employment in this country.

A second economic problem raised by income shifting does not directly involve transfers of property out of the United States, but nevertheless inflicts economic harm on this country. Our current international rules, particularly the rules of subpart F, make it easier for U.S. multinationals to shift, to low- and zero-income countries, income that is earned from manufacturing outside the United States than it is to shift income from manufacturing inside the United States. Ed Kleinbard explains this
problem well in his recent writing.\(^1\) The relative ease of shifting foreign-
earned, but not U.S.-earned, manufacturing income to low- and zero-tax
countries creates an incentive for U.S.-based companies to shift their mix
of investment and employment away from the United States.

I am not in a position to know the quantitative significance of this
apparent bias toward non-U.S., as opposed to U.S., investment. I am, fur-
ther, not sure that economic science is capable of measuring the effects of
this bias with any degree of confidence. I will say, though, that in practice,
I have seen U.S. businesses choose to locate substantial operations over-
seas rather than here, predominantly for tax reasons. I think this is unfor-
tunate and, indeed, unacceptable.

But the most serious harm from our current international tax rules, I
think, is not a tendency to erode the tax base, or to skew investment and
employment away from the United States. The most serious harm is not
economic at all. The income shifting that I have described is “perfectly
legal,” as the phrase goes, but the image that it presents to the public—an
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corporations, and policy-makers in Congress and elsewhere in Washing-
ton, colluding, albeit legally, to shift hundreds of billions of dollars of in-
come to mailbox companies in countries where the companies perform
little if any business activity. Institutions in our society which should be
among the most worthy of respect appear to be engaged in a kind of be-
havior that typically would be associated with society’s least savory actors.
This spectacle cannot possibly be failing to contribute to what is already an
unhealthy erosion of public respect for governmental and business
institutions.

III. THE SHAPE OF COMPREHENSIVE REFORM?

I would like now to sketch out my own very incomplete thoughts
about where reform might be headed. These thoughts are intended to
reflect what I think are two important principles: (i) that reform, if it is to
be effective, needs to involve many different parts of the tax system, not
just the corporate income tax; and (ii) that especially given our stressed
economy, we need to be mindful of the need to minimize disincentives for
investment and employment by U.S. businesses.

In particular, while I believe that the income shifting that is now ram-
pant among U.S. companies causes unacceptable damage to this country, I
also believe that income shifting opportunities should not be ended with-
out dramatically reducing the statutory corporate tax rate. To eliminate
income shifting without substantially lowering the statutory rate would im-
pose a large additional tax burden increase on many important U.S.-based

\(^1\) See Edward D. Kleinbard, Stateless Income’s Challenge to Tax Policy, 132 TAX
NOTES 1021 (2011); Martin A. Sullivan, Economic Analysis: “Stateless Income” Is Key to
International Reform, 131 TAX NOTES 1315 (2011).
corporations, including companies involved in valuable technological innovation. I think this would be very inadvisable.  

The combination of international tax reform with a substantial corporate rate reduction, though, will plainly be a net revenue loser. Responsible fiscal policy will, I believe, require us to make up that revenue, and indeed generate additional revenues, from other components of the tax system. This is why we cannot reform our international tax system without a comprehensive reform that extends beyond the corporate tax.

Now, in broad outline, what might a reformed system look like? Well, that’s a large question, and I cannot pretend to offer anything even close to a comprehensive answer. In various installments of the column that I write for Tax Notes, I have tried to offer a broad list of features that a reformed system might include  

Specifically, key components of my admittedly far from complete picture of reform include: (i) eliminating income shifting opportunities through a revitalized subpart F, and also probably eliminating other provisions that narrow the corporate tax base; (ii) dramatically reducing the corporate tax rate—I have suggested a rate as low as 15 percent; (iii) the recovery of revenue, and the generation of additional revenue for deficit reduction, through increased rates and some curtailment of deductions for the highest-bracket individual taxpayers; (iv) technical measures to prevent the reduction of the corporate rate from inviting high-bracket individual taxpayers to use corporations as vehicles for tax deferral; and (v) a “superdeduction” for employee compensation paid by businesses that are operated as sole proprietorships or in passthrough form, since these businesses will not benefit from a reduction in corporate rates but should, I think, receive incentives for the creation of jobs.

I am aware that the goal of raising additional revenue through rate increases on individual high-bracket taxpayers poses particular political problems in the current environment. It may well be preferable on some grounds—both political and economic—to raise that revenue through a value added tax (VAT) or another new consumption tax, rather than from the individual income tax. I believe, however, that attempts to institute a

2. The personal skepticism toward corporate income taxation as an institution, which this Article displays, reflects thirty years of work within the corporate tax system during which the defects of the tax have become progressively more evident. For a comprehensive bill of particulars against the corporate income tax, on economic as well as political grounds, see Yariv Brauner, The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy, 2008 Mich. St. L. Rev. 591. Although I do not, alas, consider it desirable, on fiscal grounds and other grounds, to eliminate the corporate tax entirely, I believe that the economic case for minimizing it is overwhelming.

new consumption tax are likely to be more problematic, politically, than increased rates on high-income individuals. Further, a new consumption tax might be difficult to implement without adversely affecting the progressivity of the tax system. Moreover, my own admittedly approximate computations suggest that high-bracket rate increases under the individual tax can raise the additional revenues that are needed while still keeping maximum rates very low by historical standards—that is, significantly less than fifty percent. I may be unduly pessimistic about the prospects for a VAT or other consumption tax, and I may be overly optimistic about political prospects for raising additional revenue from the individual income tax. The main point, though, is that effective corporate and international tax reform will cost revenue, and that unavoidably, the lost revenue and more will need to be recovered from other components of the tax system.

IV. SEEKING POLITICAL BALANCE

By coupling the elimination of international income shifting practices with a dramatic decline in the corporate rate, my proposals combine elements that respond to traditional Republican Party concerns, and others that respond to traditional Democratic Party concerns. That mix is important, since I do not think there is any route to comprehensive tax reform that does not involve political tradeoff and political compromise of the traditional kind.

Of course, the short list I have offered provides at best only the barest framework for comprehensive reform. Every item on the list poses significant problems of feasibility and implementation, and every item on the list is likely to be highly problematic to one or more political constituencies. Building an effective reform package will involve a large amount of technical work, as well as political creativity in crafting trade-offs and compromises.

And so we come back to the problem with which these remarks started—namely that right now, the formal legislative process is unable to make much progress toward solving the many problems, especially the problem of political compromise—that comprehensive tax reform presents. Therefore, it is necessary for non-governmental experts, the “government in exile,” to move the processes of technical refinement and political compromise forward until the legislative environment opens up once again.

V. TWO SUGGESTIONS

Given the complexity of the task ahead, are there any nuggets of advice that I might offer as finishing touches to this article—as, perhaps the dessert course to the luncheon at which these thoughts originally were presented? Any such attempted nuggets will, of course, reflect my own preconceptions, but with that caution in mind, let me offer two suggestions.
First, because I believe that effective tax reform will require a political willingness to reduce the corporate rate, I think that successful reform will require willingness among some constituencies, which historically have supported relatively high levels of corporate taxation, to reconsider that position. High corporate tax rates are at least as inimical to the interests of American labor as they are to the interests of corporate shareholders and management. I think that a vigorous but self-disciplined public debate, showing the effects of high corporate tax rates on all sectors of our population, could, perhaps more than any other single factor, help make comprehensive tax reform feasible.

A second prerequisite to an effective tax policy debate is that those who hold leadership roles within, and who advocate on behalf of, companies that today benefit from international income shifting opportunities, and from other means of obtaining greatly reduced effective corporate tax rates, refrain from the posture that the status quo is the only acceptable outcome of debate over comprehensive tax reform. Yes, there are many reasons why promoting the status quo might appear to be in the interests of the corporations' shareholders, from a short-term perspective. Tax reform is a risky business, and some companies that now enjoy low effective rates will risk seeing those rates increased. Therefore, there may well be an incentive to try to forestall the entire process of tax reform. This incentive imparts to the tax system its own internally generated tendency toward stasis, in addition to the stasis produced by the broad political logjam that we face today.

In the long and even intermediate terms, though, retention of our tax regime, without fundamental and comprehensive reform, is a recipe for growing economic and even social harm that will hurt everyone. I am not suggesting that those who represent corporate interests refrain from advocating the perceived financial interests of shareholders. But the advocacy of shareholder interests needs to be leavened by a recognition that the well-being of those shareholders depends on the country's overall economic and political well-being.

Now, there may be substantive arguments that our current international tax system, with all its ramifications for the rest of the tax system, is an optimal system, so that tax reform would be counterproductive per se. In my own judgment, though, the defects in our current tax rules are glaring, and the harm that those rules cause is serious. I will even go so far as to say, and I know some will disagree, that some attempts to defend the status quo have become so strained, intellectually, as to have lost credibility. I think it important that instead of falling into the trap of arguing for stasis, corporate leadership instead devote its considerable energy and skill toward promoting a re-designed tax system that will promote the country's economic and social well-being far better than the current system.

To sum up, the task of tax reform is, for the moment, stalled, and once restarted it will face substantial obstacles. I am confident, though,
that those with expertise in tax policy in this country have the intellectual
and technical skills, the commitment to the country’s overall well-being,
and the impulse toward moderation and constructive interchange that will
be needed if viable reform plans are to be devised. Much of the hard work
of designing a workable and centrist system can be begun now, so that
when the current polarization of the political system moderates, the ideas
needed to fashion a viable tax reform will be available.
GO WEST: HOW THE IRS SHOULD FOSTER INNOVATION IN ITS AGENTS

T. KEITH FOGG*

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I. INTRODUCTION

“GO West, young man.”1 This advice, given to a young man seeking advice from a wiser mentor and later popularized to encourage settlement in the American West, perhaps rings true for the Internal Revenue Service (IRS or the “Service”) as it seeks to improve its oversight of noncompliant taxpayers. More literally, the advice has roots in the work of its agent, Joe West, who exposed a path for tracking down taxpayers hiding their income offshore.2 In showing that path, Mr. West set in motion an ongoing battle3 between promoters of offshore investment, work-

* Professor of Law, Director of Federal Tax Clinic, Villanova University School of Law, Villanova, PA, fogg@law.villanova.edu. The author is grateful to Amy Spare, the fabulous faculty research librarian at Villanova University School of Law. He is also grateful to his research assistants Rachel Zuraw, Stephanie Searles, Amun Bashir, and Emily Stilwell.

1. See JOSIAH BUSHNELL GRENELL, MEN AND EVENTS OF FORTY YEARS 87 (1891) (attributing quote to Horace Greeley).

2. Joe West still works for the IRS. The author did not speak with Joe West in preparing this Article because of his continued employment with the IRS. The author did speak with individuals familiar with the cases discussed who do not work for the IRS. The information presented in this paper has been gathered from other parties involved with the matters described and from source documents. The author met Joe West while the author was employed as an attorney with the Office of Chief Counsel, IRS. The author had no involvement with the Tax Court cases described herein and only a minor involvement with the “credit card project” that resulted from the efforts of Joe West.

ing together with their high-wealth individual clients seeking to avoid income detection, and the IRS, whose mission to enforce the law with “fairness to all” includes the responsibility of ensuring that individuals who are “unwilling to comply pay their fair share.”

For the IRS to succeed in its battle with individuals hiding income and assets offshore, it must continue to adopt innovative techniques such as the one designed by Revenue Agent Joe West. This article seeks to describe the insights brought to the IRS by Mr. West and to suggest that the IRS must find a way to encourage its agents to approach their jobs with the same inventiveness he brought to the offshore project.

which was part of the Villanova Law Review Symposium held on September 23, 2011. Two papers prepared by fellow panel members highlight different parts of this continuing struggle with offshore compliance. The first of these papers addresses the settlement offers made by the Service to convince individuals using tax havens to voluntarily report their unpaid taxes. Leandra Lederman, *The Use of Voluntary Disclosure Initiatives in the Battle Against Offshore Tax Evasion*, 57 Vill. L. Rev. 499 (2012). The second of these papers discusses the passage of FATCA by Congress as a means of addressing the problem of offshore accounts through gaining information about those accounts in a manner similar to the transmission of information from banks within the United States. Susan Morse, *Ask for Help, Uncle Sam: The Future of Global Tax Reporting*, 57 Vill. L. Rev. 529 (2012).


5. The actions of Joe West and the others working on the matters described here have been mentioned by others; however, the details of the work have not been chronicled or analyzed. In his book, *Many Unhappy Returns*, describing his tenure as Commissioner of the IRS, Charles Rossotti devotes two pages to Joe West and the offshore project he spawned. CHARLES O. ROSSOTTI, MANY UNHAPPY RETURNS: ONE MAN’S QUEST TO TURN AROUND THE MOST UNPOPULAR ORGANIZATION IN AMERICA 258–60 (2005). Commissioner Rossotti created a subchapter in his book entitled “Finding Money in the Tropical Isles” in order to briefly describe the work of Joe West and to praise it. He stated that “[t]he IRS started to know because Joe West and Dan Reeves, two exceptionally resourceful agents in New Jersey, worked doggedly for years to find a way.” Id. at 259. This Article does not focus on Dan Reeves or several others at the IRS, at Chief Counsel, IRS, or at the Department of Justice Tax Division who were critical to the success of the IRS offshore actions. This Article focuses on Joe West because of his role as the person with the creative spark. Investigative reporter David Cay Johnston also discusses the actions of Joe West in his book *Perfectly Legal*. DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEM TO BENEFIT THE SUPER RICH—AND CHEAT EVERYBODY ELSE (2003). Chapter 15 of his book focuses on John Mathewson, a taxpayer in Texas with significant offshore dealings, and points to the plan developed by Joe West after studying the activities of Mr. Mathewson.

Joe West, a veteran IRS criminal investigator, had a plan. He knew that if he could get the charge records in electronic form, he could look for patterns of spending and then he could go to restaurants, hotels and other businesses where repeat purchases were made to get reservations and registration records that would yield names.

Id. at 211.
To appreciate his innovation, a brief description of the situation Mr. West faced twenty-five years ago is necessary. The tax shelter wars of the 1980s and the changes to the tax code in 1986 cut off many domestic opportunities for reducing taxes to the newly wealthy. In the never-ending search for ways to minimize or eliminate the tax bite on income, offshore tax havens took on new popularity. The growing influence of the internet was making the world a much smaller place. It also allowed for the proliferation of information in a manner not previously possible. After a long period of relatively slow growth, the economy in the United States began taking off in the 1990s. The business opportunities brought about by the technological advances created significant new wealth. With the ease of air travel and the availability of information made possible by the internet, more and more individuals sought to place assets offshore where the assets, and the income they produced, would remain invisible to the IRS.

While individual transactions might be invisible to the IRS, the expansion of the offshore industry to serve wealthy individuals did not escape the attention of the IRS. Websites and other advertisements were everywhere, luring individuals to place their assets in offshore tax havens where the information would remain secret from the IRS. Watching the growth of the offshore havens, the IRS needed to devise a strategy for piercing the veil of secrecy. Devising and implementing such a strategy is not a strong suit of the IRS. Fortunately, it had an enterprising agent who took on the task. While he did not work alone, Revenue Agent Joe West


7. Advertisements enticing individuals to invest offshore were not limited to the internet but proliferated in other places that might attract wealthy investors such as airline magazines. The principal point concerns the ease of transmission of information about offshore investing to the targeted audience and the quantity of such advertisements which could easily lead those with tendencies toward offshore investment to the conclusion that it was not only easy to accomplish, but also normal.


10. See generally John Doe Report, supra note 6.

11. See id.

12. See id.
spearheaded the quest to break down the veil of secrecy provided by offshore havens and reveal the financial transactions lurking behind that veil. This Article seeks to explore the genesis of Agent West’s creativity, the work produced by his efforts, the impact of his creativity in this instance, and how the IRS could foster innovative agents in the future.

II. DORCHESTER INDUSTRIES AND FRANK WHEATON, JR.

In the mid-1980s, Revenue Agent West, an International Examiner, was assigned to examine the return of Wheaton Industries. Wheaton Industries was a glass manufacturing company located in New Jersey.

13. Telephone Interview with Jack Blum, Former Special Counsel to the Senate Foreign Relations Comm. (Nov. 23, 2011). Jack Blum, discussed in detail below, provided the following insight about Joe West:

Joe got out there and got into the mechanics of how the credit card system worked. He figured out how to do it. He was brilliant and determined. The agents working with him were imaginative and the immediate supervisors supportive. The combination of these factors allowed the project to take off.

Id. ¶ 3.

14. During the Tax Court case, the Service served a summons on Wheaton to obtain information to enable it to collect the liabilities it asserted were due. Collection activity ensued due to a jeopardy assessment made after the apparent settlement in the Tax Court case had failed. Wheaton filed a Motion for Protective Order requesting the Tax Court to order the Service to back away from enforcing the summons, arguing that collection action was premature while the Tax Court case continued. The Service filed a Memorandum of Law in Support of Respondent’s Objection to Motion for Protective Order. Memorandum of Law in Support of Respondent’s Objection to Motion for Protective Order at 1229, Dorchester Indus., Inc. v. Comm’r, 108 T.C. 320 (1997) (No. 20515-93), aff’d without opinion, 208 F.3d 205 (3d Cir. 2000). Attached to the Memorandum was an affidavit prepared by Patrick E. Whelan, Assistant District Counsel, Newark, Office of Chief Counsel, IRS. Whelan Aff. The affidavit contains the following statement concerning Joe West’s involvement in the case:

Revenue Agent Joe West has been an integral member of the litigation team. He participated in all of the examinations which resulted in these cases from their inception. As a result of the many years he has been working on these cases, he has become the most knowledgeable employee of the Internal Revenue Service with respect to Frank Wheaton, Jr.’s complex offshore transactions and his offshore assets. He has examined thousands of documents and interviewed dozens of witnesses.

Id. ¶ 9.

15. In an affidavit submitted in the Tax Court case, Wheaton described his business interests and these interests were further described in the answer to Tax Court case docket number 27121-93. Affidavit of Frank Wheaton, Jr. at 135, Dorchester, 108 T.C. 920 (No. 20515-93); Answer of Government at 1373, Dorchester, 108 T.C. 320 (No. 20515-93). The company that brought the family significant wealth was Wheaton Industries, a glass company started by his father, Frank Wheaton, in Millville, New Jersey. Frank Wheaton, Jr. stated that under his leadership, Wheaton Industries grew from a small regional glassmaker with $450,000 annual sales to a major corporation with $450,000,000 annual sales and over 10,000 employees.

The principal business of Wheaton Industries is the manufacture of bottles and other glass products for the pharmaceutical and cosmetic industries. Frank Wheaton, Jr. was a partial owner of Wheaton Industries. See id. The audit of Whea-
The audit began at a time when the IRS was organized by geographic districts, one of which was the district of New Jersey. Joe West was a Revenue Agent in the New Jersey district.

Wheaton Industries itself apparently presented a minor target for the IRS, and the audit of Dorchester also did not turn up significant liabilities; however, the audits of these companies led to the audit of their president, Frank Wheaton. Here a more fertile field for auditing existed. Mr. Wheaton apparently obtained significant income from Wheaton Industries and Dorchester, which he sought to conceal from the IRS both as it left the companies and as he held it. To accomplish the hiding of the assets, he created offshore bank accounts in at least three tax haven jurisdictions.

During the examination, the agents uncovered the offshore activity and pursued information about that activity. The investigation of that activity led the Service, or at least those involved in the Wheaton case, to a much greater understanding of the size and scope of the offshore problem that existed. The audit of Wheaton set Joe West on his quest to discover a means of gaining information about those placing their money

16. See Notice of Deficiency issued to Wheaton Industries, Docket No. 19058-90. Similarly, Dorchester Industries was a minor target. See Notices of Deficiency at 1272-1339, Docket No. 20515-93. A notice of deficiency was issued to Dorchester Industries on June 29, 1993, which led to Tax Court docket number 20515-93. The issues in the notices were primarily disallowance of expenses reclassified as dividends to Wheaton. See id.

17. Two notices of deficiency were issued to Wheaton covering the years 1979 through 1989. See id.

18. Wheaton was the sole shareholder of a number of foreign entities including Tartan Investments, Caribe Bahamas, International Glass Equipment, Vitron Electrometalurgia, an eighty-five percent owner of Wheaton Brasil, and the fifty percent direct owner and fifty percent indirect owner of Commonwealth Charities. He did not disclose his relationship with these companies on his tax returns for the years at issue according to the answer. Answer of the Government, supra note 17, at 1382.

19. Wheaton utilized numerous foreign entities owned and controlled by him to extract constructive dividends from Wheaton Industries without reporting those dividends on his return. See id. at 1460.

20. See id. at 1383. Wheaton controlled a Wheaton-Bormioli bank account at Charterhouse Japhet Bank and Trust International in the Bahamas. See id. The Government made a jeopardy assessment against Wheaton while the Tax Court cases were working their way through the appeals process in order to expedite collection because of concerns that the assets would dissipate or disappear. Details of the foreign assets are set forth in both the memorandum of law filed by the Government in response to Wheaton’s motion for a protective order and in the affidavits of Assistant District Counsel Patrick Whelan and Revenue Officer Michael Rago attached to the memorandum. Mem. of Law, supra note 14.
offshore. Examining the timeline of the audit provides some insight into
the scope of knowledge Joe West must have gained as he worked the case.
He was apparently assigned to the audit by the mid-1980s.21 Yet, the no-
tices of deficiency in the primary Tax Court cases were not issued until
June 29, 1993.22 During that eight-year period, almost enough time for an
undergraduate, master’s, and doctorate degrees, Joe West received a
lengthy education on offshore issues.23 From his subsequent actions, he
appears to have become an expert in this field.24

One important aspect of the case that furthered the education of Joe
West was the enforcement of three summonses which were issued to gain
information about Mr. Wheaton’s offshore activities.25 On June 1, 1989,
the Service issued summonses seeking records of three offshore entities
from Mr. Wheaton. He appeared in response to the summons but
brought no records.26 After an extensive evidentiary hearing that in-
tuded testimony from Mr. Wheaton’s long time administrative assistant at

21. See Testimony of IRS Chief Counsel Special Litigation Assistant William
Garofalo at 404, Dorchester, 108 T.C. 320 (No. 20515-93) (from Tax Court settle-
dment discussion hearing); Interview with William Garofalo, Chief Counsel Special
Litig. Assistant (Nov. 14, 2011). William Garofalo was the lead counsel for the

22. See Answer of the Government, supra note 17, at 1272-1339.

23. The case took an extraordinary amount of time to complete. Because of
goals placed on case completion, Joe West and others working on this case would
have felt significant pressure to close the case from executives within the IRS. On
February 3, 2012, the author spoke with retired Revenue Agent Dennis Raible, who
worked with Joe West on the examination of this case. Mr. Raible indicated that
the examination was allowed to continue only because of the efforts of three indi-
viduals who fought hard within the organization. These individuals, Michael Bem-
bridge (Case Coordinator), John Kaffenberg (International Manager who was also
Joe West’s manager) and Milford Theadford (Case Manager), deserve much credit
for convincing their superiors to allow the case to continue to completion rather
than to terminate early in order to meet artificial deadlines. Telephone Interview
with Dennis Raible, Professor, Dep’t of Accounting at St. Joseph’s Univ. (Feb. 3,
2012). In particular, Kaffenberg and Theadford put their careers on the line by
supporting West and allowing the Wheaton case to remain open. In spite of the
lack of documentary evidence and the consumption of precious IRS resources,
these individuals who were working with West both understood the significance of
the offshore problem and were dedicated to West’s efforts. Their “total support of
West [and] Bembridge, given the down side to their own careers, was unprece-
dented.” E-mail from Dennis Raible, Professor, Dep’t of Accounting at St. Joseph’s

24. This timeline does not take into account the additional three-plus years of
trial preparation between the time of the issuance of the notices of deficiency and
the October 30, 1995 date on which the special trial calendar with Judge Halpern
was set. While the involvement of Joe West during this phase would have been
subordinate to the trial attorney, he continued to have significant involvement in
the case. At trial, the Government planned to call over sixty witnesses, many of
whom were from foreign jurisdictions. Joe West was a key player in working with
the attorneys to pull the case together for trial. See Interview with William
Garofalo, supra note 23; see also Whelan Affidavit, supra note 16, at 1244.


26. See id. at 103–04.
Wheaton Industries, the company pilot, and a company engineer, the court enforced the summons. The court found that Mr. Wheaton was the owner of the three entities from which records were sought and found that he had possession of the records of these entities. According to Dennis Raible, the information gained through the summons process was the key to successfully putting together support for the tax adjustments.  

In working the case, the Service hired an expert witness on offshore activities, Jack Blum. 28 Mr. Blum spoke to me in order to assist me in understanding the significance of this case. 29 Essential to adequately understanding the Wheaton case’s importance to cracking the offshore nut are the events surrounding a case involving offshore issues in the early 1970s. 30 Revenue Agents in Miami, Florida came into possession of records concerning U.S. citizens placing their funds in Castle Bank in the Bahamas. These agents began examining the returns of the individuals on the list. The list contained powerful individuals who were able to wield their influence—something not unusual in offshore account cases. The agents even received pressure from the highest levels of government to end the examinations. The cases were ultimately dropped, and, according to Mr. Blum, the careers of the Miami agents were negatively impacted. As a result, a pall was cast over the landscape of pursuing offshore investors that Mr. Blum felt lasted for two decades until the Wheaton case removed it. Mr. West’s efforts were therefore able to open the eyes of the Service to the compliance needs and the inevitability of IRS action in this segment of the economy. 31

In Mr. Blum’s opinion, the Wheaton case crystallized for the Government the size and scope of the offshore problem. 32 As they got into the case, the agents could see that whatever Mr. Wheaton wanted the trustees of his offshore trusts to do, they did. 33 The agents began to understand how the system operated, causing them to want to know who else was playing the same game as Mr. Wheaton. 34 The Wheaton case revealed the

27. See Telephone Interview with Dennis Raible, supra note 25.
29. Telephone Interview with Jack Blum, supra note 13.
31. Telephone Interview with Jack Blum, supra note 13.
32. Id.
33. Id.
34. Id. Mr. Blum described some undercover work he had done in 1994 when he visited an offshore banker and taped the conversation. The banker described
methods used by the taxpayer and his offshore banker to hide and transfer offshore money. This set the stage for West to uncover how individuals were using credit cards as a mechanism to access and spend their hidden money.

III. USE OF THE WHEATON INFORMATION

With the understanding gained from the Wheaton audit and a determination to prevent such noncompliance activities from proliferating, Joe West set out to turn his newfound knowledge into a blueprint for gaining access to offshore account holders. His effort led to the creation of a document entitled “Offshore Cards—John Doe Referral Report” (the “John Doe Report”) by Joe West, International Examiner, New Jersey District and Fred K. Chin, Internal Revenue Agent, Northern California District. The John Doe Report concludes that “[e]fforts to promote compliance concerning taxpayers engaged in offshore transactions have enjoyed limited success due to the challenges presented by financial secrecy jurisdictions. . . . Due to the characteristics of these transactions, new and creative approaches are needed to take advantage of opportunities to pierce the veil of secrecy surrounding offshore dealings.” The John Doe Report gathered information about offshore activities from myriad sources in order to support the use of a John Doe summons or John Doe summonses to unearth the necessary information on offshore investors.

35. Id.

36. See generally JOHN DOE REPORT, supra note 6. One remarkable aspect of this report not discussed elsewhere concerns its timing within the greater scheme of tax administration. The report came out almost exactly one month before the passage of the Revenue Reform Act of 1998 (RRA 98), the greatest limiting legislation ever passed concerning the IRS. This was a time of great bashing of the IRS, yet these two agents were able to avoid the turmoil around them and produce this report. One aspect of the legislation is the way it limits and controls the selection of examination targets. Had they begun to work on this report much after the passage of RRA 98, the restrictions stemming from the legislation might have stopped the effort. Id.

37. Id. at 3.

38. John Doe summonses require some explanation in order to understand their usefulness for this purpose. In understanding John Doe summonses it is also important to understand that they had never before been used in this way. I.R.C. § 7609 provides that the Service can, with the permission of a district court judge, obtain ex parte permission to summons a party for information pertaining to unknown individuals where the Service can show that the information will likely produce information leading to incidences of tax noncompliance. I.R.C. § 7609(h)(2) (2006). In deciding whether to grant a John Doe summons request, the district court judge must weigh the burden and intrusiveness of the request against the potential gain in tax compliance. To convince the district court judge to allow the Joe Doe summons to issue, the Service must show with some reasonable likelihood that the information sought will lead to the promised result. For a
The John Doe Report explained how Revenue Agent West intended to meet the burden necessary to obtain a John Doe summons: “we have interviewed a number of knowledgeable persons within and outside the government, as well as reviewed numerous books, reports, publications, articles, investigative reports, Internet sites, and advertisement materials.” The balance of the report essentially compiled the data obtained from all of those sources to produce a compelling case for the use of John Doe summonses on the three major credit card issuers in the United States—Visa, MasterCard, and American Express—for the purpose of discovering the identities and the transactional dates of the individuals using those cards to access their offshore accounts. The John Doe Report demonstrated why summonses to these three card issuers to obtain the names of the cardholders affiliated with banks in tax haven countries would produce a gold mine of data concerning tax evasion and pierce the veil of secrecy the cardholders thought existed. At last the government had a plan and a roadmap to shed sunlight on an area of darkness. The specific strategy focused on three countries thought to house the most convenient offshore banks for U.S. citizens: the Bahamas, Antigua, and the Cayman Islands.

The second portion of the John Doe Report’s introductory section explained how the three major credit card companies maintained data on account holders whose cards were issued by offshore banks. After interviewing the credit card companies in conjunction with the preparation of this report, Joe West learned the kind of information that each company keeps with respect to its cardholders. American Express had complete information about its cardholders because it directly issued cards and extended credit. The goals of the John Doe summons on American Express were to obtain:

1. Cardholder information on cards issued to entities organized in the Bahamas, Antigua and the Cayman Islands where a U.S. citizen or U.S. resident has signature authority over the card, and
2. Cardholder information on cards issued to U.S. citizen [sic] or U.S. resident [sic] where the payment of the related card expense comes from accounts located in the Bahamas, Antigua and the Cayman Islands.

The situation with Visa and MasterCard presented a greater challenge because they are associations of member banks and, as a result, do not maintain a direct relationship with the cardholders. Under the Visa and MasterCard business model, the member banks issue the cards and keep the customer account records while Visa and MasterCard process the

Further description of John Doe summonses requirements, see infra notes 83–87 and accompanying text.

39. JOHN DOE REPORT, supra note 6, at 4.
40. Id.
41. Id. at 5–6.
42. Id. at 5.
transactions and keep only transactional records. Therefore, most of the necessary identifying information of these cardholders resided with the issuing banks located in the bank secrecy countries. From the outset, a “subordinate strategy” developed in order to obtain more complete information on Visa and MasterCard cardholders who could not be identified from the transactional data.\textsuperscript{43} That strategy involved a second set of John Doe summonses to U.S. automobile dealerships, car rental businesses, U.S. boat/watercraft dealerships, U.S. travel agents, U.S. airlines, and U.S. hotels and motels for business records identifying the customers who engaged in the transactions revealed in the data obtained from Visa and MasterCard. This merchant data would permit the agents to capture identifying information which was not in the databases of Visa and MasterCard but did exist within the United States because vendors of such purchases would have captured this data.\textsuperscript{44} The understanding of the data available from the credit card companies and the subordinate strategy for supplementing that data in necessary situations demonstrated a deep knowledge of both the U.S.-based records on these transactions and the proof necessary to make a tax evasion case on the credit card holders.

Following this explanation of the data available from the credit card issuers, the John Doe Report then spent the next sixty pages providing detailed support for why the information available from these credit card issuers would identify individuals seeking to evade their U.S. tax obligations. This information essentially appears in the supporting affidavit of all of the John Doe summonses and forms the supporting basis for those summonses. In detailing the bases for concluding that holders of credit cards issued by banks in the Bahamas, Antigua, and the Cayman Islands almost certainly had tax evasion as a motive for doing so, Revenue Agent West found support from myriad sources. This section starts with a quote from Jack Blum: \textsuperscript{45}

Most of the World’s money laundering in offshore centers involves tax evasion. Although there are legitimate ways of using offshore entities to minimize taxes, most of the offshore arrangements are designed to avoid income and estate tax by the home country of the owner of the money. Tax evasion should become a predicate offense for the crime of money laundering. All too frequently the professionals who help serious criminals cover their actions by claiming that all they are doing is helping someone “avoid” taxes.\textsuperscript{46}

\begin{footnotesize}
\begin{itemize}
  \item \footnotesize 43. \textit{Id.} at 6.
  \item \footnotesize 44. \textit{Id.} at 6.
  \item \footnotesize 45. \textit{See} Jack Blum’s Resume, \textit{supra} note 30.
\end{itemize}
\end{footnotesize}
The John Doe Report first took information from the United Nations Office on Drugs and Crime, which released a report on June 10, 1998 entitled “Financial Havens, Banking Secrecy and Money Laundering.” The United Nations report, among other information useful to the purpose of the report by Revenue Agent West, stated:

[Offshore haven banks] also attract those trying to evade taxes through concealing much of their wealth by secreting it in jurisdictions that place a premium on confidentiality and do not regard tax evasion in another country a crime. In the early 1980s . . . the United States Senate conducted a series of hearings which not only highlighted criminal exploitation of offshore financial centers but also the extent of the illegal use of offshore banking “to facilitate tax fraud” by the “man next door.”

Use of the United Nations’s report provided a strong basis for showing a district court judge the problem’s nature and scope, and negated the suggestion that this was just an IRS issue or a witch hunt by a few IRS agents. Starting off with a global overview appropriately set the scene for convincing a judge that the problem deserved attention and the work required of the summoned party to comply with the information-gathering request had merit in the result sought.

The John Doe Report next turned to a series of “old” reports on offshore activity that explained the connection of tax haven banks to tax evasion. First, it discussed the Gordon Report from January 1981. The Gordon Report examined judicial decisions and published literature on offshore tax issues. The not-so-surprising conclusion of the Gordon Report found that “there are a large number of transactions involving illegally earned income and legally earned income which is diverted to or passed through havens for purposes of tax evasion.” This report demonstrated that the problem had persisted for some time, laying the foundation for the groundbreaking suggestion to use the domestic card issuer information as a means of breaking the cycle of evasion. Complementing the Gordon Report was another somewhat self-serving report entitled the Caribbean Basin Report. This report, published by the Treasury Department (the “Department”) in 1984, also reached the expected conclusion that tax haven countries were using strategies to assist in tax evasion by hiding beneficial ownership of assets. The report assessed criminal cases involving offshore connections to the Caribbean, concluding that:

47. See John Doe Report, supra note 6, at 6–10.
49. Richard A. Gordon, Tax Havens and Their Use by United States Taxpayers—An Overview (1981) [hereinafter Gordon Report]. This was a formal study performed by the IRS.
50. Id. at 111.
It is very difficult to measure the illegal use of tax havens because of the nature of the transactions and because of the difficulty of obtaining information from most tax havens. Nevertheless, it seems reasonable to assume that a great deal of activities designed to violate the tax and other laws of the United States takes place in the Caribbean Basin tax havens. While use of these two reports to support a John Doe summons request bootstrapped material created inside the Treasury Department as a means of convincing a court, these reports presented a picture consistent with other reports and supported the conclusion that a problem not only existed but the veil of secrecy had prevented a solution.

Complementing the two older reports from within the Treasury Department, Revenue Agent West found three reports from outside the Department that supported the same conclusion: a 1987 Organization for Economic Co-Operation and Development (OECD) Report; the 1987 Dorgan Report; and a report released in August of 1985 by the Permanent Subcommittee on Investigations of the U.S. Senate Governmental Affairs Committee. The Permanent Subcommittee’s report not only found that offshore havens protect criminals but “are increasingly being used by otherwise law-abiding Americans to avoid paying taxes and to shield assets from creditors.”


52. ORG. FOR ECON. COOPERATION & DEV. COMM. ON FISCAL AFFAIRS, INTERNATIONAL TAX AVOIDANCE AND EVASION: FOUR RELATED STUDIES (1987) [hereinafter OECD REPORT]. Like the United Nations’s report, this report carries significant weight without the self-serving aspect of a report developed by the Treasury Department. OECD consists of the United States and the most industrialized countries of Western Europe. The organization, created in 1961 with roots going back to 1948 and the implementation of the Marshall Plan following World War II, seeks to provide a forum for countries committed to democracy and the market economy. In the past decade, OECD has become very involved in tax haven and financial transparency issues, but this report significantly predates the recent efforts.

53. See DORGAN TASK FORCE, THE DORGAN TASK FORCE ON NARROWING THE $100 BILLION TAX GAP (1987) (led by Congressman Byron Dorgan, Democrat, North Dakota); see also H.R. Con. Res. 138, 100th Cong. (1987). This resolution stated:

[1]In the interest of decreasing the growing gap between taxes owed and taxes collected: (1) the administration and the Congress should substantially increase appropriate resources for the taxpayer assistance and enforcement divisions of the Internal Revenue Service (IRS); and (2) the IRS should implement specified recommendations to improve taxpayer services and to enhance enforcement efforts.


55. Id. at 2.
principal tax haven countries including the Bahamas and the Cayman Islands. The OECD Report explored the problem of international tax evasion through the use of haven countries and specifically identified the Bahamas and the Cayman Islands. The use of these reports further supported the conclusion not only that tax evasion—by using banks in haven countries—was rampant, but also that the three countries targeted by the John Doe summonses were clearly countries whose banks fostered tax evasion. The broad scope of the reports from different sources provided convincing evidence that the problem existed and deserved attention.

Revenue Agent West then focused the John Doe Report on more recent articles appearing in the popular press. Articles from such major news sources as the Washington Post and the Wall Street Journal provided indications that the offshore tax evasion problem persisted and that it impacted all wealthy nations. The second section of the John Doe Report, entitled “Overview on the Use of Offshore Financial Secrecy Jurisdictions,” concluded that a significant threat to the tax system of wealthy nations existed because of the growing use, and ease of use, of offshore banks in secrecy jurisdictions, that this problem had existed for at least two decades, and that the veil of secrecy was preventing enforcement against the perpetrators. The following section then explained the key to lifting this veil of secrecy.

As the John Doe Report shifted its focus to “The Use of Credit and Debit Cards in Offshore Schemes,” Revenue Agent West detailed his experience in studying offshore transactions. This experience provided a critical basis for his affidavits, which would accompany the John Doe summonses. By gathering all of this background information, he made himself a valuable resource—a critical resource for the success of the summons—because the opinion of the judge is based almost entirely on the Government agent’s affidavit. The experiences listed take on greater importance because Revenue Agent West did not encounter the use of credit cards in the Wheaton case. Rather than finding the credit card so-

56. Id. at 45–46.
57. Id. at 52–54.
58. OECD REPORT, supra note 54, at 54 (information contained in Tables 3 and 4).
59. JOHN DOE REPORT, supra note 6, at 15–20.
62. JOHN DOE REPORT, supra note 6, at 6–20.
63. Id. at 20. He lists fourteen specific items of his experience studying offshore transactions, including interviewing offshore bankers, U.S. private bankers, offshore promoters, the credit card companies, attendance at offshore seminars, and the United Nations session on financial havens. Id.
olution during an audit, West came to the revelation that credit cards provided the window on tax havens as a result of his personal study of the offshore industry.

Use of credit cards in an offshore evasion scheme exists because of the fourth component of a successful offshore scheme’s common pattern identified by Revenue Agent West:

- Devise an overall offshore plan and create a suitable offshore entity(s) in an advantageous financial secrecy jurisdiction,
- Create methods to effect the covert transfer of funds and assets to the offshore entity,
- Control the funds and assets transferred offshore, and
- Devise methods to access offshore funds either by repatriation or by accessing abroad.\(^64\)

By the time of the John Doe Report in 1998, credit and debit cards had become a clear mechanism of choice for repatriation of offshore funds.\(^65\) The majority of the advertisements reviewed by Revenue Agent West promoted the use of credit cards as a safe and secure method for accessing money placed offshore and ostensibly away from the peering eyes of the government.\(^66\) He examined the parties who would offer a credit or debit card as part of the financial package. Private bankers did it.\(^67\) Offshore promoters did it.\(^68\) The print media did it.\(^69\) Everywhere Revenue Agent West looked at offshore activity, the use of credit and debit cards to bring the money home prevailed.

Numerous articles appeared in the popular press shortly before the issuance of the John Doe Report. Revenue Agent West documented these and quoted them extensively. One particular case that captured the attention of the press in many articles involved John Mathewson.\(^70\) Mr. Mathewson started his own bank, Guardian Bank, in the Cayman Islands.\(^71\) He

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64. Id. at 21-22.
   Credit and debit cards are the way people who have laundered money draw ready cash without leaving a financial trail. As one advertisement for a bank put it, it is the best way to stay in touch with your offshore account. . . . The banks assure their clients that the card account information is protected by the same rules that protect the other account information.
   Id. at 97.
67. Id. at 23–28.
68. Id. at 27–29.
69. Id. at 31–36.
70. Id. at 34–35.
71. See Ronald Smothers, In Plea Deal, a Banker Outlines Money Laundering in Caymans, N.Y. Times, Aug. 3, 1999, at A1. John Mathewson was a wealthy American construction company owner in the Chicago area. In 1982 he moved to the Caymans, and in 1986 he set up the Guardian Bank and Trust Company with some
bargained information to prosecutors in order to avoid a lengthy sentence.\footnote{See id. Mathewson was charged with money laundering and gave federal prosecutors records from Guardian Bank and Trust Company as part of the plea bargain. Mathewson’s help to the prosecutors resulted in at least $50 million in back taxes and penalties being recovered. While Mathewson faced a potential five-year prison term, Judge Lechner, Jr. of the United States District Court for the District of New Jersey sentenced Mathewson to five years’ probation, 500 hours of community services, and a $30,000 fine.}

Several instances were documented of credit card use through the Guardian Bank in order to repatriate funds while avoiding detection.\footnote{See David Marchant, “Stolen” Cayman Bank Records in Hands of the IRS, OFFSHORE ALERT (Oct. 31, 1997), http://www.offshorealert.com/GetArticle.aspx?id=2382.}

In addition to the print media, Revenue Agent West documented two reports on offshore abuse and use of credit cards in a Frontline documentary entitled “Hot Money” and an episode of 20/20.\footnote{JOHN DOE REPORT, supra note 6, at 36–42.} Excerpts from these two popular news shows supported the same type of reporting appearing elsewhere. As always with film media, however, the power of watching and hearing someone explain how to avoid taxes through offshore havens increases its effect on the audience. The undercover filming of offshore promoters in action combined with the playing of these images on a major news show on national television made the information more compelling.

Finally, the John Doe Report turned to the most direct evidence of all—the brochures and internet advertising produced by the promoters themselves.\footnote{Id. at 42–51.} The John Doe Report documents the language used by the promoters to describe the benefits of offshore accounts, which left nothing to the imagination of the purpose of the offshore accounts they promoted.\footnote{Id. Swiss American Banking Group Offshore Banking and Trust Management Services stated in their brochure: [C]ustomers can use the VISA or Master Card to obtain instant cash advances at most financial institutions worldwide. . . . Charges are billed monthly and customers will typically maintain a separate current or savings account for which they will fax instructions to be debited to pay card charges. With our SwissAmericard programme, customers can enjoy unparalleled flexibility and confidentiality in accessing funds internationally, with discrete payment procedures. Id. at 44.}

Brochure after brochure quoted in the John Doe Report and internet site after site referred to the use of credit cards to allow the flexi-

local business people. After his arrest, he admitted that although he believed Europeans would be the bulk of the depositors, 90% of the depositors were actually American citizens. Mathewson said that the bank eventually acquired deposits totaling $350 million. In early 1995, he was approached by a Caymanian banking regulator who asked for a $250,000 bribe. Mathewson refused and the Bank was later investigated for unspecified irregularities, then taken over by the government and liquidated. Mathewson left the Caymans temporarily and moved to San Antonio. He was arrested in June of 1996 by federal agents as they were closing in on the cable piracy scheme.
bility to obtain money when and where needed. The number of brochures and internet sites referenced made clear that the use of credit cards represented a business norm rather than an aberration.

IV. JOHN DOE SUMMONS—PIERCING THE VEIL OF SECRECY

A. Contents of the Summons

The John Doe Report laid out a plan for discovering the individuals placing their money offshore. On October 18, 2000, more than two years after the John Doe Report, the Service and its lawyer in district court, the Department of Justice Tax Division, initiated action in accordance with the blueprint set out in the report by filing John Doe summonses seeking information from American Express and MasterCard. The John Doe summonses seeking information from these two credit card issuers served as the opening public salvo in the effort to defeat the secrecy shrouding tax haven investments. This initial John Doe summons request sought information with respect to the years 1998 and 1999 regarding credit cards issued by banks from three countries—the Cayman Islands, the Bahamas, and Antigua.

Before going into specifics about the American Express and MasterCard John Doe summonses and the ones that followed it, some background on this form of summons will assist in understanding the device. The summons provisions of the Internal Revenue Code reside in the 7600s. The Code grants the Service broad power to seek information concerning tax liabilities including the power to canvass neighborhoods, summons information directly from taxpayers, summons information from third parties holding information about specific taxpayers the Service has under investigation, and to summons information from third parties about unknown individuals the Service thinks might deserve investigation. This last power travels under the name of John Doe summons.

77. See id.
78. Id. Even more specific than laying out a plan, two of the eighty-three attachments provide specific language for John Doe summonses. Attachment 75 provides the language for a John Doe summons to be issued to MasterCard and Visa while Attachment 76 provides the language for a John Doe summons to be issued to American Express. The optimism of the authors of the report shows these sample summonses sought information from 1996 to present. Comparing the samples with the real summonses demonstrates that a fair amount of work remained at the time the samples were created. Yet, the samples also demonstrate the thoroughness with which the report authors attacked the problem.
79. See In re Tax Liabilities of John Does, No. 00-3919-CIV-JORDAN (S.D. Fla. 2000). The petition for the John Doe summons was filed in the Southern District of Florida, Miami Division.
83. See I.R.C. § 7609(f) (2006). Specifically, subsection (f) provides: (f) Additional requirement in the case of a John Doe summons.—Any summons described in subsection (c)(1) which does not identify the per-
so called because the Service does not know the identity of the individuals or entities it thinks it should consider investigating. The Service uses its John Doe summons power when it accumulates enough information to strongly suggest that a significant area of noncompliance exists among an identifiable group but the individual members of the group are unknown or substantially unknown to the Service.84

Usually, the Service pursues a John Doe summons as a result of snaring some members of a group in its audit net through its general audit selection process and comes to the realization that many other similar taxpayers exist whose returns would likely contain significant adjustments.85 In this instance, the path to the John Doe summonses followed a path not too far from the norm. Certainly, Joe West became interested in offshore avoidance schemes because of his work on the Wheaton case. He followed that work with a general investigation of offshore schemes, which lead him to credit cards as a means of ascertaining the identity of the participants. The John Doe Report discussed above, his affidavit which accompanied the John Doe summonses in the initial American Express/MasterCard request, as well as many of the following summonses, detail his pathway to knowledge.

With respect to whose liability the summons is issued may be served only after a court proceeding in which the Secretary establishes that—

(1) the summons relates to the investigation of a particular person or ascertainable group or class of persons,
(2) there is a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law, and
(3) the information sought to be obtained from the examination of the records or testimony (and the identity of the person or persons with respect to whose liability the summons is issued) is not readily available from other sources.

Id.

84. See generally Michael I. Saltzman, IRS Practice and Procedure (2d ed. 1991). In the memorandum accompanying the petition to serve the John Doe summonses requested from American Express and MasterCard, the Service’s description of the question presented before the Court does an excellent job of setting out the inquiry of the statute:

Whether, as required by Section 7609(f), the Petitioner has demonstrated (1) that the “John Doe” summonses which the Internal Revenue Service desires to serve upon American Express and MasterCard relate to the investigation of an ascertainable group or class of persons; (2) that there is a reasonable basis for believing that such group or class of persons may fail or may have failed to comply with any provisions of any internal revenue laws; and (3) that the information sought to be obtained from the examination of the records or testimony (and the identification of the persons with respect to whose liability the summonses are issued) is not readily available from other sources.


85. See generally United States v. Brigham Young Univ., 679 F.2d 1345 (10th Cir. 1982), vacated as moot, 459 U.S. 1095 (1983); Saltzman, supra note 84.
An examination of the affidavits supporting the John Doe summonses aids in understanding how the work of Joe West plays directly into the credit card project and to the offshore compliance initiative that continues today. The affidavits in these cases now span more than a decade but the DNA still traces back to the Wheaton audit and the subsequent John Doe Report. Because John Doe summonses go to the deciding judge in an ex parte process, supporting affidavits play an important role in convincing the judge of the necessity of the request. Joe West’s affidavit in the initial John Doe summons contains several sections which closely resemble his John Doe Report and which provided to the judge convincing information of the necessity for the Service to receive the requested information.

First, the affidavit detailed the background of Joe West in an effort to convince the judge of West’s knowledge and ability in making a determination about the existence of a scheme to evade taxes and an information source from which to stop the scheme. This information was critical because it was the first John Doe summons of its kind. Convincing the judge on the first summons of its type provided a steeper challenge than the later summonses requested after some success in the project had been demonstrated. In addition to including his basic educational and work background, the affidavit spent the better part of two pages detailing West’s experience in offshore matters including his attendance at a United Nations session on financial havens; his interviews of Mathewson, described as a former Cayman Island banker; his consultations with offshore experts; his interviews with credit card companies; his discussions with IRS employees experienced in offshore examinations; and, inter alia, his participation in the creation of an Offshore Audit Techniques Guide. The affidavit listed eleven different items in support of Joe West’s expertise in offshore matters, strongly evidencing that he had sufficient knowledge of the offshore problem. The IRS could not point to success in a similar request for information.

After describing his credentials and providing a brief background on the goals of the summons, the affidavit moved to a brief introduction followed by an overview of the use of offshore tax havens. This latter section tracked the John Doe Report, provided a history of the growth of the offshore industry for tax avoidance, and summarized the reports detailing that history starting with the Gordon Report in 1981. The affidavit provided a brief description of each of the reports cited in West’s 1998 John Doe Report tying these reports into the concerns giving rise to the requested summons.

Section III of the affidavit, which addressed the “Use of Credit and Debit Cards in Offshore Schemes,” detailed the specifics of the use of credit cards to avoid detection of money placed in offshore accounts. West explained not only how the use of credit cards facilitated the scheme to avoid detection, but also how he came to understand the scheme. In this section, the information gained from John Mathewson served as a key-
stone because of the personal knowledge Mr. Mathewson had concerning credit card usage. Added to that personal knowledge, however, were discussions of the brochures used by the offshore promoters and the information from their web sites. The totality painted an unmistakable picture of the use of credit cards to get around the problem of secretly repatriating funds placed offshore.

Section IV detailed court cases and investigations involving offshore cards. Joe West described the recent cases of several individuals uncovered by the IRS through its audit process. These cases represented the typical types of cases that lead to the approval of a John Doe summons because they demonstrated that the IRS had found a problem that it was addressing on an individual basis that also likely involved a wider, as yet unknown, group.

Section V explained why the IRS had chosen to seek information concerning credit cards issued by banks located in specific countries. Section VI described the summoned parties, explaining how American Express and MasterCard maintained their data and how that data would assist the IRS in identifying specific taxpayers using credit cards as a likely part of a scheme to under-report their federal income taxes. The final section of the report concluded that, based on the information described in the affidavit, a reasonable basis existed for obtaining the requested information in order to ascertain the identities of persons not paying the proper amount of taxes.86

Many parallels exist between the report and the affidavit accompanying the John Doe summons request. Joe West did his homework before he went to Court. It showed in the detailed nature of the affidavit and the persuasiveness of the information provided. The Court took almost no time in approving the request;87 however, the approval of a John Doe summons and the receipt of the information requested in the summons are not one and the same. Approval simply gives the IRS the right to serve the summons on the named parties, which it undoubtedly did shortly after approval.88 Because Joe West had interviewed both American Express and MasterCard for his report, the service of the John Doe summons should

86. JOHN DOE REPORT, supra note 6. In addition to the supporting affidavit of Joe West, the John Doe summons package also contained a supporting affidavit from Jack Blum. Mr. Blum’s affidavit focused on international business corporations, John Mathewson, credit cards, and the fact that setting up offshore corporations and credit cards was a costly endeavor likely undertaken only for the purpose of hiding income and assets.

87. See In re John Does, No. 1:00-cv-03919-AJ (S.D. Fla. 2000). The request was filed on October 18, 2000, and approved on October 30, 2000.

88. See David Cay Johnston, Taking Aim at Tax Havens, I.R.S. Seeks Credit Card Slips, N.Y. TIMES, Oct. 20, 2000, at A1 (reporting that “[t]he agency has asked a federal judge in Miami to issue summonses for two years’ worth of records of MasterCard and American Express card transactions in the United States that were billed to bank accounts in Antigua and Barbuda, the Bahamas and the Cayman Islands”). The filing of the John Doe summons was immediately noticed.
not have come as a total shock. Still, the companies were not waiting to immediately hand over the data requested in the summonses, and a reasonable time to gather the data was needed.

**B. Getting and Using Data From the Credit Card Companies**

The docket sheet in the case indicates that on March 26, 2002 the judge entered an order requiring American Express to comply with the John Doe Summons as modified in the agreement. The docket sheet does not reveal exactly when American Express turned over the information to the IRS. There were several attempts to intervene to prevent compliance with the summons. The case was closed in January 2003, suggesting that by that point the IRS had received whatever records would be submitted. A Department of Justice Press Release on March 25, 2002, announcing the filing of the second John Doe summons for credit cards, stated that MasterCard had already produced over 1.7 million records involving over 230,000 accounts and went on to explain: “We are pleased with the information the IRS has received from MasterCard, and look forward to the information American Express has agreed to provide, and that which we expect VISA to provide in response to the summons we are now seeking to serve . . . .”89 The docket sheet and the press release suggest that the receipt of the summonsed information for American Express arrived in late April of 200290 and that the information from MasterCard had not necessarily been received much in advance of the press release on March 25, 2002. So, almost eighteen months had passed since the issuance of the John Doe summons, and the IRS had little to show.

The timing of the receipt of the information from the first summons is important to the audit of the returns of the identified individuals and in the voluntary initiative offered. The summons concerned the years 1998 and 1999. By March of 2002, the normal statute of limitations for 1998

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90. See id. An order was entered on March 26, 2002 slightly modifying the summonsed information and reflecting an agreement by American Express to provide the information within thirty days of the order. IRS Statement on Offshore Noncompliance, Am. Bar. Ass’n, http://www.americanbar.org/content/dam/aba/migrated/tax/irs/2002/offnon.authcheckdam.pdf (last visited Aug. 11, 2012). Subsequent orders in the case further modified the summons issued to American Express to remove from the requested information the names of several interveners. Id. It appears that the IRS agreed to remove the interveners from the scope of the summons since they had graciously identified themselves and since the IRS did not want to delay the receipt of the information from those who had not self-identified. Id. On August 13, 2002, IRS Commissioner Charles O. Rossotti issued a statement providing that “[t]he Agency is taking aggressive action on this issue. The IRS is already moving forward on hundreds of credit card cases for civil audits or potential criminal investigation. The agency is committed to following up on this issue and pursuing individuals dodging their tax responsibilities.” Statement of IRS Commissioner Charles O. Rossotti on Offshore Noncompliance, Internal Revenue Service, 2002 WL 31914595 (Jan. 1, 2002).
was about to expire and was only a year from expiring with respect to 1999. As described in the John Doe Report, the information contained in the files of MasterCard and Visa did not directly identify specific individuals because it contained insufficient identifying information.91 The summoned data received from MasterCard, and to be received from Visa, was essentially a first step to identifying a taxpayer with an offshore credit card. As discussed in the report, additional summonses to vendors where the cards were used would be necessary to obtain sufficient identifying data for most taxpayers.92

The IRS requested its second John Doe summons on the credit card project on March 25, 2002.93 This summons requested information from

91. JOHN DOE REPORT, supra note 6, at 62. The John Doe Report states: With respect to VISA International and MasterCard International, we were able to identify that card transactional information exists in a manner that can be sorted by the specific bank that issued the card. We further determined that sufficient vendor information exists to specifically identify the vendor who was party to the card transaction. We were told that cardholder information is retained at the bank issuing the card.

. . . . American Express admits to possessing cardholder information. Id. at 62.

92. Id. at 63–65; see also United States v. John Does, No. 1:09-CV-00861-REB (D. Colo. 2009) (stating that summons related to investigation of ascertainable group of persons, there was reasonable basis for believing such group failed to comply with internal revenue law, and information could not be obtained elsewhere). Essentially, MasterCard and Visa had names of cardholders and some data about the cardholders but generally not social security numbers, addresses, and other data that would allow the IRS to move forward with an audit knowing the identity of the taxpayer with the offshore account. The MasterCard and Visa data might show that Robert Campbell (a name used here for illustration purposes) owned a credit card issued by a bank in the Cayman Islands. Because there might be 500 or 5,000 Robert Campbells in the United States, the IRS needed more data before it could effectively begin an audit. If the taxpayer had a unique name, the data from these entities might be sufficient in itself, but that situation was the exception, not the rule. So, the IRS was running out of time on the normal statute of limitations without knowing whom it needed to audit. The IRS would aggressively seek the data from the vendors in 141 John Doe summonses served between August 2002 and December 2003. See IRS Statement on Offshore Noncompliance, supra note 90. The IRS stated:

In this new round of John Doe summonses, the IRS is seeking limited information from companies to help identify people using offshore credit cards.

In our initial steps, we have received significant information from the MasterCard data. However, in some cases we need more information to precisely identify the specific people using these cards.

To obtain or verify the actual names of some of these individuals, the IRS needs to take this additional step of going to some of the merchants where the offshore credit card users made purchases.

Id.

Visa, and covered the years 1999, 2000, and 2001. The number of countries included in this request expanded from three to thirty. Just two days later, the court approved the summons, which was then served on Visa. On August 15, 2002, the IRS served another John Doe summons on MasterCard, expanding the scope to include additional jurisdictions and years, and the order authorizing service was issued on August 20, 2002.\footnote{See In re Tax Liabilities of John Does, No. 02-22404-CIV-UNGARO-BENAGES (S.D. Fla. 2002).}

On August 29, 2002, the IRS petitioned seven U.S. district courts across the country for vendor information relating to the MasterCard data received by the IRS in connection with its first John Doe summons.\footnote{See Barbara Kallenberg Affidavit at 39, In re Tax Liabilities of John Does, No. 05-04167-JW (N.D. Cal. 2005) [hereinafter Kallenberg Affidavit]. The IRS filed a total of twenty-six petitions seeking summonses on 141 merchants. See id. at 39–40 (providing detailed list in chronological order of all credit card summonses). On February 21, 2006, the United States District Court for the Northern District of California, in case No. C 05-04167 JW, issued an order approving service of a “John Doe” summons on PayPal, Inc. See In re Tax Liabilities of John Does, No. 05-04167 JW (N.D. Cal. Feb. 21, 2006).}

By the time the IRS gathered enough data to place cases in the hands of revenue agents, the cases were much older than “normal” cases placed into the audit stream. This meant that agents were receiving cases that would almost certainly have the three-year statute of limitations on assessment expire before the agents could complete their audits. Revenue agents receive much training and instruction on the importance of not allowing a statute of limitations to expire. Receipt of cases that almost by definition required them to complete a blown statute report did not sit well with the agents as a group or their managers. Through the Offshore Voluntary Compliance Initiative (Revenue Procedure 2003-11), issued on January 27, 2003, the IRS offered taxpayers the chance to come out of the cold and volunteer that they had under-reported their taxes by using undeclared offshore accounts. Taxpayers who made “voluntary disclosures” prior to a deadline could avoid criminal prosecution and minimize their exposure to civil penalties. Taxpayers who did not participate in the voluntary initiative were unlikely to sign statute waivers agreeing to extend the statute of limitations on assessment. As a result, revenue agents with these cases generally needed to examine more recent years for which they did not have credit card data in addition to making a fraud case for the early years in order to keep the statute of limitations on assessment open.

The Department of Justice press release issued at the time of the filing of the John Doe summons to Visa indicated that the IRS had received information on 230,000 accounts from its summons to MasterCard involving just three tax haven countries.\footnote{Press Release, U.S. Dep’t of Justice, supra note 89. On November 7, 2002, Sara M. Coe, the tax litigation examination manager for Chief Counsel, IRS (SBSE) stated in a meeting of the D.C. Bar tax section’s Tax audits and Litigation Committee that “[f]rom the information received, the IRS has sent the first 1,000 cases to the field; some of those have been referred to the Service’s Criminal Inves-
American Express and Visa, which it had to integrate with the information received from the 141 vendor summonses that were ultimately served. This influx of data created a situation in which the IRS could not realistically pursue all of the individuals suspected of offshore credit card ownership. The individuals who did not accept the IRS offer of penalty relief through the procedure outlined in Revenue Procedure 2003-11 were not inclined to cooperate with the examination of their returns. These audits required the agents to dig through third party information and were time-consuming. The agents generally did not have significant training or experience in these types of audits or in tracking information by going through offshore accounts. Consequently, the IRS did not have the success it might have hoped for in the credit card project.97

C. Moving Forward

The problem of having too many potential cases and not enough agents or time to pursue them all does not mean that the credit card project was a failure.98 The project was a great success in getting the IRS moving against offshore tax evasion even if it did not gather the information on offshore credit card holders in time to pursue the earlier years.99 The progression of John Doe summonses following the initial cases demonstrates the effectiveness of the project set in motion by Joe West, and that project is still going strong today. The subsequent John Doe cases and their relationship to the project envisioned by Joe West bear some analysis.

97. See Lederman, supra note 3 (discussing generally programs with focus on offshore initiatives). The IRS hopes for a high volume of acceptance of an offer such as the one it made in Revenue Procedure 2003-11. To receive a high volume of acceptance, the IRS must convince the targeted audience that the consequence of failing to accept is worse than accepting. The inability to process all of the cases to audit or to get as many acceptances as it might have hoped for has more importance with respect to the voluntary compliance initiative and for future initiatives than for the success of the overall project. The need to follow up with people not agreeing to come forward serves as an important component of a successful compliance initiative.

98. For further discussion of the project by Commissioner Rossotti and Reporter David Cay Johnston suggesting the project’s importance, see supra note 5 and accompanying text.

99. Telephone Interview with Jack Blum, supra note 13. The brief focus of the discussion here was the timing of the information and the unfortunate effect that had on the ability to audit the individuals who did not voluntarily disclose. Civil audits were only one aspect of the credit card case. Criminal prosecutions were another important component. On that score the IRS had reasonable success. A number of high profile individuals and promoters were identified through the initial phases of the credit card project, resulting in numerous successful prosecutions. Jack Blum especially noted the criminal prosecutions and the impact of those prosecutions in discussing the success of the credit card project.
The initial wave of credit card summonses occurred from October 2000 through December 2003. Essentially, all of the summonses issued during this phase were built using the format adopted for the first summonses: (1) experience of the agent, (2) a brief description of the project, (3) a description of the reports detailing offshore noncompliance, (4) detail on taxpayer use of credit cards, (5) references to prosecuted cases, (6) the data sought via information held by the summoned party, and (7) the anticipated use of the data to stop offshore evasion of taxes. Succeeding summonses cited to earlier ones and to more recent reports and prosecutions, but the format remained generally the same. The second wave of the project sought information from companies processing bank and credit card information. The first case of this second wave sought information from Credomatic, Inc., a third-party processor of bank information from tax haven countries. In 2004, the IRS filed three petitions to serve John Doe Summonses on such processors—one in Georgia, one in Colorado, and one in Florida. The final John Doe summons in this second phase was issued to PayPal, a company used for making payments over the internet that is closely associated with eBay.

The affidavits used in the second phase continued to build on the original affidavit prepared by Joe West even though Joe West was no longer in charge of preparing the affidavits as he had departed from the offshore compliance project by the time these cases were brought. The last of the affidavits, Revenue Agent Barbara Kallenberg’s PayPal case, provides the best example of how the original affidavit designed by Joe West continued to serve as a template through the second phase. Ms. Kallenberg’s affidavit generally mirrored West’s original affidavit, beginning with an introduction detailing Ms. Kallenberg’s experience, the goal of

100. See Kallenberg Affidavit, supra note 95, at 38–40. That wave included the first summons for credit card data from MasterCard and American Express, the first Visa summons, the second MasterCard summons in August 2002, and the 141 vendor summonses requested in twenty-six petitions from August 2002 through December 2003.

101. See id. at 40–42.

102. In re Tax Liabilities of John Does, No. 3-22-22177 CIV-MARTINEZ (S.D. Fla. 2004). This was filed on September 11, 2003, and approved on April 2, 2004.


104. United States v. John Does, No. 05-04167 JW (N.D. Cal. 2006). The petition was filed on October 14, 2005 and the order issued on February 21, 2006.

105. See generally Kallenberg Affidavit, supra note 95. Ms. Kallenberg’s experience is much less detailed, and probably much less in general, than the experience of Joe West detailed in his affidavit. This mattered much less by 2005 because about 150 productive John Doe summonses cases stemming from the credit card program preceded the PayPal summons.
the summons,\(^{106}\) and a brief description of PayPal. Because there was no need to change a winning formula, the format of the affidavit was not significantly altered. Kallenbeg’s affidavit, however, discussed the information provided by Mathewson, the brochures dating back to the 1990s, and the use of credit cards by banks across the array of the thirty countries listed.\(^{107}\) In addition to examining the court cases used in the original summons, this affidavit highlighted newer cases resulting from the credit card project. A history of the approved credit card summonses, a discussion of PayPal, and the value of the information in PayPal’s possession concluded the affidavit.\(^{108}\)

While the IRS may not have been entirely ready to pursue all of the offshore credit card holders at the time of its penalty relief offer in 2003, it continued to work these cases and to expand its sources of information. The new sources resulted in part from leads as the IRS obtained information from investors caught by early activity or simply gained additional information not originally considered. The project continued primarily through the work of Revenue Agent Dan Reeves and by Special Trial Attorney John McDougal in Chief Counsel’s office. With a knowledgeable team in place and an abundance of information gathered from the credit card summonses, the IRS was prepared when opportunity knocked in the form of an informant with insight about deposits by U.S. citizens with Swiss bank UBS. The informant’s knowledge led to a deferred prosecution of UBS and an IRS John Doe summons for information from UBS for U.S. taxpayers who had signature authority to withdraw funds and make investment decisions on UBS accounts in Switzerland. The information request was limited to data on accounts for which no Form W-9 was signed by the account holder and no Form 1099\(^{109}\) issued to the account

\(^{106}\) Id. After the first summons the IRS switched to 1999 as the opening year for its John Doe summonses. This summons requested information for the years 1999 through 2004.

\(^{107}\) Id. The expansion to thirty countries occurred in the second credit card John Doe summons, which was issued to Visa. The paragraphs from the second summons appear almost verbatim in the PayPal summons.

\(^{108}\) See id.

\(^{109}\) The absence of these forms strongly suggests a tax avoidance purpose since it means that the likelihood of information on the account being reported to the Service is extremely low. See Deferred Prosecution Agreement, United States v. UBS AG, No. 09-60033-CR-COHN (S.D. Fla. 2009). The Deferred Prosecution Agreement Information, at paragraph 4, states:

[UBS’s] United States cross-border business provided private banking services to approximately 20,000 United States clients with assets worth approximately $20 billion. Approximately 17,000 of the 20,000 cross-border clients concealed their identities and the existence of their UBS accounts from the IRS. . . . UBS assisted these United States clients conceal the income earned on UBS accounts by failing to report IRS Form 1099 information to the IRS. From 2002 through 2007, the United States cross-border business generated approximately $200 million a year in revenue for UBS.

\(^{109}\) Id.
Revenue Agent Dan Reeves prepared the affidavit submitted with the petition for the John Doe summons. The court approved the summons on July 1, 2008. With this summons and the attendant publicity, the IRS now had the attention of all taxpayers who ever considered hiding their money offshore to avoid U.S. taxes.

What began in the mid-1980s with Joe West’s assignment to the audit of Wheaton Industries developed by 2012 into a situation where it is sufficiently difficult, as opposed to relatively easy, to hide assets overseas. Few promoters advertise on the internet with the same brazen and unbridled contempt for the ability of the IRS to address their activities. Private bankers know their suggestions may not be completely private from the government. Finally, Congress began building on the IRS’s administrative success by passing legislation that discourages banks from aiding


111. See In re Tax Liabilities of John Does, No. 1:09-cv-00861-REB (D. Colo. 2009); In re Tax Liabilities of John Does, No. 3:09-cv-02290-N (N.D. Tex. 2009); In re Tax Liabilities of John Does, No. 11-1686 (N.D. Cal. 2011). The UBS John Doe summons is not the last. The IRS continues to use the John Doe summons to gather information on offshore activities and continues to use the template developed in the first credit card John Doe summons. On April 13, 2009, in Case No. 1:09-cv-00861-REB, the District Court for the District of Colorado approved the issuance of a John Doe summons seeking information of U.S. merchants with merchant sales agreements with First Data Corporation to process credit cards involving software provided by First Atlantic Commerce from 2002 through the date of the petition. Dan Reeves prepared the accompanying affidavit. On December 12, 2009, in Case No. 3:09-cv-02290-N, the District Court for the Northern District of Texas approved the issuance of a John Doe summons to obtain information about the clients of Stanford Group Co. and Stanford Trust Co. Ltd. from 2002-2008 that had an interest in, or signature authority over, accounts at these institutions. Dan Reeves prepared the accompanying affidavit. On April 7, 2011, in Case No. 11-1686, the District Court for the Northern District of California approved the issuance of a John Doe summons to obtain information about customers with direct or indirect interests in, or signature authority over, accounts maintained by HSBC India from 2002–2010. Dan Reeves prepared the accompanying affidavit.

112. This does not mean, however, that the Service has won the war against evading taxes through offshore investment. On January 12, 2012, Stephanie Trilling reported that the Service is moving into new areas of inquiry. Stephanie Trilling, Tax Evasion: Globalization, Tax Evasion Sharpen IRS Focus on International Issues, Agency Officials Say, DAILY TAX REPORT (Bloomberg BNA), Jan. 12, 2012. “Experts estimate that the Americans now have $1 trillion—trillion with a T—in assets offshore and illegally evade $40 billion [to] $70 billion in U.S. taxes each year [through] offshore tax dodges,” said Monika A. Templeman, director of IRS employee plans examinations in Baltimore at a conference.” Id.


and abetting in the hiding of money. \footnote{115}{See generally U.S. Senate Permanent Subcomm. on Investigations, Tax Haven Abuses: The Enablers, the Tools and Secrecy (2006).}

By the time the IRS offered its voluntary compliance initiatives in connection with the information developed in the UBS case, \footnote{116}{See Lederman, supra note 3 (discussing generally voluntary compliance programs with focus on offshore initiatives).} the IRS had demonstrated a commitment for over a decade to pursuing information about offshore accounts. Declining to participate in the voluntary disclosure thus placed taxpayers at significant risk of civil and criminal penalties.

V. Lessons Learned—Applying the Knowledge Gained by Observing Joe West

The credit card project, which evolved into the offshore compliance initiative, resulted from the drive and vision of Joe West. West, in the course of auditing one taxpayer who engaged in extensive use of offshore accounts to hide income and assets, chose to look beyond this one case to see a path for pursuing all taxpayers engaged in similar offshore activity. How can the IRS learn from the success Joe West achieved and apply that learning to attain similar success in other areas of tax law in need of visionary thinking?

The length of the audit in such cases bears some mention. The Service prefers that taxpayer audits not span lengthy periods of time. Prolonged audits create significant burdens on taxpayers, as well as drain the IRS’s limited resources. Yet, in some cases in which the information proves difficult to obtain, audits can take quite some time. Still, eight years pushes the limit. Because of the internal pressures to close this case, Joe West, Willie Garofalo—an attorney assigned to assist during the audit phase—and others close to the case managed to convince their superiors that continuing with the audit in the face of significant reporting requirements due to the age of the case was worthwhile. \footnote{117}{See Interview with William Garofalo, supra note 23. During the time he was working on the Wheaton case, William Garofalo was Special Litigation Assistant with the Newark District Counsel’s Office within Chief Counsel, IRS.}

In managing cases that present steep fact-finding challenges, the IRS must balance issues of resources and timing against the productivity of continuing to pursue these cases. Where the Service can significantly learn from a matter or can significantly alter noncompliant behavior, investing resources in a case makes sense. In many ways, this model forms the basis for the Criminal Investigation Division where the average number of hours on a case and the average time frame for a case greatly exceeds the same averages in the Service’s examination or collection functions. The extra time spent by the Criminal Investigation Division does not ordinarily result in an increased collection on the individual case worked but results, hopefully, in a benefit to the overall tax system. Because of the publicity of such criminal cases, taxpayers are instilled with...
the perception that noncompliant tax behavior may result in significant penalties. The Service must apply the same—or a similar—theory to certain examination and collection cases that do not warrant criminal referral.

In the collection area, the Service realized the need for special enforcement cases at about the same time the John Doe summonses against credit card companies took off. The creation of the Abusive Tax Avoidance Transactions (ATAT) unit allowed revenue officers to pursue difficult collection cases without the time pressure of normal collection case inventory. Special ATAT groups were formed where higher graded revenue officers were trained to use the more sophisticated techniques available under the Internal Revenue Code in order to pursue the more difficult collection cases.118

Allowing certain employees time to pursue cases is a necessary component of encouraging creative solutions. On the other hand, time spent on a case is a precious commodity at the IRS given the vast amount of cases that need attention in relation to the number of employees available to work those cases.119 The IRS should therefore consider other factors which have been identified as encouraging creativity: (1) matching individuals and domains; (2) education and training in cognitive skills; (3) certain clusters of personality traits; (4) innate ability in certain domains;

118. See Memorandum from the Director of Collection Policy for the Director, Advisory and Insolvency Directors, and Collection Area Operations (Dec. 15, 2011) (addressing aging of ATAT and suit development cases). In a memorandum dated December 15, 2011, Scott Reisher, IRS Director, Collection Policy, directed a change in the Internal Revenue Manual to allow the computer coding on ATAT cases and suits to collect flexibility to change so that it did not show these types of cases as overage. This small coding change reflects the importance not only of ATAT cases, but also of the label “overage.” Much of the management of examination and collection cases turns on the age of a case in the inventory of the assigned employee and the supervisor. With age being a primary driver of action, difficult cases that might lead to the type of revelations turned up by Joe West in the Wheaton audit get overlooked in the rush to meet the allowable time frames. The challenge is to strike a delicate balance between picking appropriate cases for turning off the overage switch as Collection Policy is doing in the ATAT cases and providing a revenue agent or revenue officer to complete a case of minor significance. Case completion goals serve an important function in managing a large inventory within a large bureaucracy, but those goals must allow room for exceptional cases that can lead to exceptional results. The ATAT program recognizes this balance and has the potential to significantly serve overall enforcement goals.

119. See T. Keith Fogg, Systemic Problems with Low-Dollar Lien Filing, 133 Tax Notes 88 (2011) (discussing ACS). The lack of employee resources led to the creation of programs such as Correspondence Examinations and Automated Collection Sites in order to process as many cases with as little time commitment as possible. Those units do not encourage creativity or reflection but promote productivity at the cost of individualism and observation. See id. at 4 (noting that “only the taxpayers ‘lucky’ enough to owe a large amount of federal taxes receive . . . individual service”). This does not mean high volume units are bad. They serve a useful purpose, but creativity and new approaches to problems are not among the purposes they serve because the employees in these units have no time to reflect. They receive little or no encouragement to engage in creativity.
and (5) intellectual playfulness and freedom from external constraints. The spark of creativity need not come from a random process. Structure can serve a useful purpose in promoting creativity but it must be a structure that promotes and allows creative ideas to emerge. The IRS cannot simply identify and wall off a select group of individuals to find solutions to major problems. For individuals to identify such solutions, they need grounding in the underlying issues, but once a case leads to a new problem or a new approach to a problem, the IRS needs to foster, as it did with Joe West, space for creativity to emerge.

Just as the military has evolved from armies standing on opposite sides of a field in a huge battle to small strike forces using significant technological advances to stop the enemy, the IRS must also evolve. Having a revenue agent show up with a briefcase to look over accounts in an individual case from one or two years prior to the audit was never going to stop the movement of money offshore. The IRS needed to find strategies that exposed taxpayers, confronted them with real risks, and imposed appropriate sanctions. The tools necessary to meet the current needs may require more fact research skills than simply the audit skills needed in the past. Joe West used the knowledge gained from his experience with an audit as a springboard for fact investigation that led to an effective mechanism for exposing taxpayers moving money offshore and removing the expected veil of secrecy. His creative spark, like so many before him, may have simply come from the diligence applied to the problem in front of him.

The IRS should study exactly what happened to allow Joe West to crack the nut of offshore secrecy. The IRS should also make case studies of this and similar matters a part of its training for executives and upper level managers, charging them to foster such creativity with other problems. In this way, the IRS will better face emerging challenges.


121. See Jacob Goldenberg et al., Creative Sparks, 285 SCI. 1495, 1496-96 (1999); see also Mel Rhodes, An Analysis of Creativity, 42 PHI DELTA KAPPAN 305, 305-10 (1961).


123. See JOHN DOE REPORT, supra note 6. The detail of research demonstrated in his report and the type of research indicates he was not a typical accountant simply reviewing a taxpayer’s books and records. In the mid-1990s he was significantly engaged in researching the internet and finding sources of information that would assist him in exposing offshore activities. He was using interview techniques with individuals like Mathewson, bankers, promoters, credit card companies, and others to gather his data. He was not simply reviewing what a particular taxpayer was presenting, but was actively seeking data from a wide variety of sources. This type of fact-finding zeal formed the basis for his creative ideas on how to approach the problem. The facts he gathered in the 1990s continue to find their way into affidavits supporting John Doe summonses issued fifteen years later. See id.
VI. Conclusion

Joe West set in motion a remarkable action plan which allowed the Service to make significant strides in attacking the tax evasion supported by the offshore banking industry in tax haven countries and the correspondent banks and financial services industries within the United States. His efforts continue to have a significant impact as the Service grapples with the Swiss\textsuperscript{124} following the UBS revelations.\textsuperscript{125} By identifying and promoting the type of creativity shown by Joe West, the Service could improve its ability to break down barriers to compliance in many areas. The difficulty in a large bureaucracy comes in identifying the right individuals and giving those individuals the tools needed to pursue innovative and necessary courses of action. While this Article focuses on Joe West and his remarkable achievements, the real heroes in this Article also include the supervisors who allowed Joe West to spend too long working one case, who motivated him to work hard to find an answer, and who supported him in that quest. Those heroes also include the individuals who picked up what Joe West started and continued it in the decade-long pursuit of information about offshore account holders. In the face of shrinking resources and increasing pressure to manage cases due to challenging time frames, can the managers and executives at the Service find a way to identify and foster more employees like Joe West who may have the creative spark to make a huge difference?

\begin{footnotesize}
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125. See Kevin McCoy, \textit{IRS to Seek Charges Against Some UBS Clients}, USA TODAY (Nov. 17, 2010), http://www.usatoday.com/money/perf/taxes/2010-11-16-irs-ubs_N.htm. A 2009 settlement agreement allowed U.S. authorities to use the tax treaty information exchange provisions to obtain information regarding over 4,000 American clients of UBS who held secret accounts with the Swiss banking giant. As part of the settlement, the IRS withdrew a legal summons filed against UBS, but IRS Commissioner Douglas Shulman announced a crackdown on offshore tax evasion. The Service and the Department of Justice have been pursuing other banks in Switzerland and elsewhere.
\end{footnotesize}
OFFSHORE ACCOUNTS: INSIDER’S SUMMARY OF FATCA AND ITS POTENTIAL FUTURE

J. RICHARD (DICK) HARVEY, JR.*

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* Copyrighted 2011 by J. Richard (Dick) Harvey, Jr., Distinguished Professor of Practice, Villanova University School of Law and Graduate Tax Program. The date of this Article is November 15, 2011. Immediately prior to joining the Villanova faculty in August 2010, Professor Harvey was the Senior Advisor to IRS Commissioner Shulman and was significantly involved in the IRS’s efforts to combat offshore tax evasion, including: negotiations with UBS, development of the 2009 voluntary disclosure initiative, and development of FATCA. Professor Harvey joined the IRS upon retiring from PricewaterhouseCoopers, LLP as Managing Tax Partner of PwC’s U.S. Banking and Capital Markets Tax Practice. Professor Harvey also served in the U.S. Treasury Department Office of Tax Policy during drafting and implementation of the 1986 Tax Reform Act.

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I. INTRODUCTION, PURPOSE OF ARTICLE, AND INTENDED AUDIENCES

SINCE its signing by President Obama on March 18, 2010, the Foreign Account Tax Compliance Act (FATCA) has been criticized by many in the financial community. The purpose of this Article is to: (i) describe my perception of the origins of FATCA, (ii) discuss selected issues, and finally (iii) make recommendations that may ultimately be helpful to ensuring FATCA’s success in both the short and long-run.

This Article is written for several audiences. The entire Article should be of interest to students and academics. For tax professionals and my former colleagues in government, the recommendations in Part IV should be of most interest. In addition, on the off-chance a foreign tax administrator or policy maker reads the Article, Part IV(B)(2) surrounding the benefits of a multilateral FATCA system to countries other than the United States should be of interest.

Before diving into the origins of FATCA, it is important to note that since 2007 the United States has made significant progress in addressing offshore accounts through a combination of tools, including: whistleblowers, John Doe summons, exchanges of information pursuant to tax treaties, two major offshore voluntary compliance initiatives, and the threat of FATCA. Having been involved extensively in many of these efforts, it is my sincere hope this progress continues. Given how quickly money can move around the world, it is very important for the IRS to have adequate transparency into the offshore accounts of U.S. taxpayers.

FATCA was a bold, unilateral action by the United States intended to provide this transparency. However, it will take time to successfully implement FATCA and there will be growing pains. Ultimately, the long-term success of FATCA may depend upon whether the United States can convince other countries to adopt a similar system, or better yet, join with the United States in developing a multilateral FATCA system. Thus, as the IRS and Treasury implement FATCA they need to focus on the long-term. In the short-run, various compromises will need to be made to ease the initial implementation of FATCA. Some of those potential compromises are discussed in this article.

2. See infra Part II.
3. See infra Part III.
4. See infra Part IV.
5. See infra Part IV(B).
6. See infra Part IV(A).
II. Origins of FATCA

A. Background

Although U.S. taxpayers have been hiding income overseas for years, the IRS historically had little success pursuing such income. The primary reason for this failure was that foreign financial institutions (FFIs) did not report any information to the IRS. Occasionally the IRS became aware of an offshore account, but effectively U.S. taxpayers were on the honor system. Given what has transpired since 2007, it would appear many U.S. taxpayers with offshore accounts have not been very honest.

During the period 1999–2003, two events occurred that are worth noting. First, the IRS started to have some success pursuing offshore accounts when it (i) obtained credit card information from *John Doe* summons, and (ii) in 2003 offered its first offshore voluntary compliance initiative (referred to herein as the 2003 OVCI). The 2003 OVCI resulted in approximately 1,300 individuals identifying themselves to the IRS with approximately $75 million collected through July 2003. The knowledge obtained by the IRS from successfully pursuing various *John Doe* summons and structuring the 2003 OVCI would prove valuable in the IRS’s future efforts pursuing offshore accounts in Switzerland starting in 2008.

7. See, e.g., Letter from Henry Morgenthau, Jr., U.S. Sec’y of Treasury, to Franklin D. Roosevelt, President of U.S. (May 29, 1937), available at http://www.presidency.ucsb.edu/ws/index.php?pid=15413#axzz1qRIOpHZ8 (explaining why tax collections are less than anticipated). In this letter, Secretary Morgenthau describes offshore accounts held by U.S. taxpayers as part of the problem. Id.

8. For example, the IRS was occasionally made aware by a whistleblower such as a former business partner or former spouse.

9. See, e.g., STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, REP. ON TAX HAVEN BANKS & U.S. TAX COMPLIANCE 9 (July 17, 2008), available at http://www.hsgac.senate.gov/download/report-psi-staff-report-tax-haven-banks-and-us-tax-compliance-july-17-2008 [hereinafter PSI STAFF REPORT]. The report was prepared for a July 17, 2008 hearing by the U.S. Senate Permanent Subcommittee on Investigations (PSI). See generally id. Per the PSI report, UBS had approximately 20,000 U.S. customers of which only 1,000 (i.e., 5%) were “declared” accounts implying that 95% of UBS’s U.S. accounts may have been evading U.S. tax. See id. at 9. The 20,000 accounts had an aggregate value of approximately $18 billion. See id.


12. See Offshore Compliance Program Shows Strong Results, INTERNAL REVENUE SERVICE (July 30, 2003), http://www.irs.gov/newsroom/article/0,,id=111987,00.html (providing results of 2003 OVCI). Although the IRS tried to portray the 2003 OVCI as a significant success, it was generally viewed as disappointing within the agency because a relatively small number of U.S. taxpayers participated and the amount of money collected was not that significant.

13. A *John Doe* summons is defined as “any summons where the name of the taxpayer under investigation is unknown and therefore not specifically identified.”
The second event occurred on January 1, 2001 which was the effective date for implementation of the United States’ Qualified Intermediary (QI) system. Prior to 2001, FFIs generally did not (i) collect U.S. tax documentation with respect to either U.S. or foreign taxpayers, (ii) with- hold U.S. tax, (iii) file information returns with the IRS, or (iv) submit to IRS oversight. As a result, there were two major problems:

- A U.S. taxpayer could invest in U.S. source assets with a FFI, but the FFI was not required to report anything to the IRS.
- U.S. withholding agents (e.g., U.S. banks) were not obtaining adequate documentation from FFIs to document a reduced U.S. withholding tax rate on payments to foreign customers of such FFIs. This result was not surprising given that the FFI had the customer relationship, and the U.S. withholding agent did not. Plus, the FFI was not anxious to share the identity of its clients with a potential competitor (i.e., a U.S. bank).

When implementing the QI system, U.S. tax authorities were attempting to address these two problems. As a result, the QI system generally required QIs to identify their customers. If they were foreign customers, the QI could keep the identity of their customer secret as long as the correct amount of U.S. withholding tax was imposed on any payments of U.S. source income to such customer. For U.S. customers, the QI was required to report to the IRS any U.S. source income. In order to keep the QIs honest, the QI system required an “audit” of the QI by either the IRS or an independent auditor.

It is important to note that the QI system was a major advancement when compared to the pre-2001 world, especially with respect to determining the correct amount of withholding tax to be applied on payments to foreigners. However, as time passed, it became very apparent that the QI system was not working well at preventing U.S. taxpayers from using offshore accounts to avoid U.S. tax.


15. A U.S. taxpayer could also invest in non-U.S. source assets and avoid reporting, but the failure to report income from U.S. source assets was particularly troubling.

16. This was not a real audit. Rather, it was more analogous to an “agreed upon procedures report.”

17. Although there may have been a handful of QIs that requested the IRS to audit them, substantially all QIs hired an independent auditor (e.g., one of the Big 4 accounting firms) because they did not want the names of their foreign customers made available to the IRS. Many QIs were fearful the customer’s name could be reported by the IRS to a foreign tax authority through information exchange agreements.
B. Problems with the QI System

Although the QI system did include some reporting with respect to U.S. taxpayers, there were several major loopholes that were exploited by U.S. taxpayers and their advisors to avoid reporting income to the IRS. For example:

- **Foreign Source Income Not Reported**—The QI system only required QIs to report to the IRS the U.S. source income of their U.S. customers. Because foreign source income was not reported, many U.S. taxpayers invested in foreign source assets to avoid reporting. When the QI system was first implemented in 2001, many U.S. taxpayers that had previously invested in U.S. source assets through a FFI converted those assets to foreign source assets and continued to avoid reporting to the IRS.

- **No Requirement to Determine the Beneficial Owner**—The QI system did not specifically require that QIs look-through foreign shell entities to determine the underlying beneficial owner. Thus, if a U.S. taxpayer wanted to invest in U.S. source assets, it could establish a foreign shell entity (or entities) and argue under the QI system that the entity was the beneficial owner of the income.18 In such case, the QI took the position that the foreign entity should be viewed as the beneficial owner under the QI regime and no reporting to the IRS was required. When the QI system was implemented, many U.S. taxpayers that had previously invested in U.S. assets and did not want to convert those assets to foreign source assets contributed their U.S. source assets to a foreign shell entity (or entities) and continued to avoid reporting to the IRS.

- **QI Could Represent Only a Portion of the Worldwide Accounts**—Because the primary emphasis of the QI system was to make sure the proper withholding tax was charged on payments to foreigners, the QI system allowed FFIs to designate those accounts that were part of the QI system. This was done to avoid the QI having to perform detailed due diligence procedures on its entire customer base, especially those that never invested in the United States.19 The result was that QIs could exclude certain customers from the QI system, especially “undeclared accounts.”20

- **QIs Were Primarily Banks**—Because the QI system was primarily aimed at custodial relationships, QIs were almost always banks or trust companies. If a U.S. taxpayer wanted to avoid any possibility of U.S. reporting, they could invest in (i) a foreign mutual fund or

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18. Shell entities were also used to further obfuscate the true owner of foreign assets held by U.S. taxpayers.

19. In most FFIs, the percentage of the customer base that invested in U.S. source assets was very small. Although I am not aware of any statistics, it could be less than 1% in many cases.

20. These are accounts where the customer refused to identify themselves.
private equity fund treated as a corporation for U.S. tax purposes, or (ii) any other financial institution that was not a QI.

- **QI Audits**—The QI audit was not really an audit, but rather was a list of procedures that needed to be performed. The procedures did not include any requirement for a QI auditor to look for, or report fraud. More importantly, the focus of the audit was on reviewing customer accounts within the QI system, and not testing to determine whether U.S. taxpayers were avoiding reporting by (i) investing in foreign source assets, (ii) holding U.S. source assets in a foreign shell entity (or entities), or (iii) failing to declare themselves.

As will be described in Part II(E), these loopholes were front and center on the minds of the IRS, Treasury, and congressional staff as they proposed and drafted FATCA in 2009 and 2010. But first, a brief discussion of the LGT and UBS scandals is warranted so the reader can understand the political backdrop under which FATCA was proposed and enacted.

### C. LGT and UBS Scandals

In February 2008, it became public that German tax authorities had purchased customer account information from an employee at LGT, a bank in Lichtenstein with close ties to the royal family in Lichtenstein. The German authorities apparently shared the information with countries around the world and the IRS announced on February 26, 2008 that it was initiating enforcement action against over 100 U.S. taxpayers with offshore accounts at LGT.22 In May 2008, an even bigger scandal erupted when the United States arrested Bradley Birkenfeld, a former UBS private banker who subsequently pleaded guilty one month later to helping U.S. taxpayers evade U.S. tax through the use of offshore accounts. The guilty plea included all sorts of spy-like techniques used by Birkenfeld and his colleagues to avoid U.S. detection. They included encrypted computers, code words, smuggling diamonds in toothpaste tubes, and the list goes on.

It should be noted that Bradley Birkenfeld reportedly came forward under the IRS’s whistleblower program in 2007 and had been disclosing information to the IRS for many months. However, he reportedly failed to disclose information to the IRS and Department of Justice with respect to one of his larger, if not largest, accounts (i.e., Igor Olenicoff). As a result, despite blowing the whistle on UBS, Mr. Birkenfeld was prosecuted and received a forty-month sentence.23

21. See PSI STAFF REPORT, *supra* note 9, at 80–110 (providing significantly more detailed description of tax evasion facilitated by LGT and UBS).


23. See Bradley Birkenfeld: UBS Informant to Begin Prison Sentence Friday, HUFFINGTON POST (Mar. 18, 2010), http://www.huffingtonpost.com/2010/01/04/
On June 30, 2008, the IRS filed a *John Doe* summons with the U.S. District Court for the Southern District of Florida requesting that UBS disclose to the IRS all its U.S. customers that had potentially been avoiding U.S. tax. One day later, the court approved the serving of the *John Doe* summons. UBS refused to comply with the summons arguing that under Swiss bank secrecy law, they were not allowed to disclose customer information.

On July 17 and 25, 2008, the U.S. Senate Permanent Subcommittee on Investigations (PSI) held highly publicized hearings on offshore accounts. At this hearing, IRS Commissioner Shulman gave testimony on the IRS efforts surrounding offshore accounts and also stated the following with respect to the QI system:

[W]e are working on enhancements to the program to increase the level and quality of information reporting coming through the program. Specifically, we are considering changes to the regulations to require QIs to look through certain foreign entities—such as trusts—to determine whether any U.S. taxpayers are beneficial owners. We are also considering a regulation to have QIs report U.S. taxpayers’ worldwide income to the IRS in certain cases—not just U.S. source income.

In addition, the PSI report also made several findings and recommendations surrounding the QI system, including:

- **Abuses by LGT and UBS**—“LGT and UBS have assisted their U.S. clients in structuring their foreign accounts to avoid QI reporting to the IRS, including by allowing U.S. clients who sold their U.S. securities to continue to hold undisclosed accounts and by opening accounts in the name of non-U.S. entities beneficially owned by U.S. clients.”

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25. See generally PSI STAFF REPORT, supra note 9.


27. See PSI STAFF REPORT, supra note 9, at 16 (finding abuses by LGT and UBS and recommending (a) requiring reporting of foreign source income and determination of beneficial owner, and (b) strengthening QI audits).
• **Require Reporting of Foreign Source Income and Determination of Beneficial Owner**—"[T]he Administration should strengthen the Qualified Intermediary Agreement by requiring QI participants to file 1099 Forms for: (1) all U.S. persons who are clients (whether or not the client has U.S. securities or receives U.S. source income); and (2) accounts beneficially owned by U.S. persons, even if the accounts are held in the name of a foreign corporation, trust, foundation, or other entity. The IRS should also close the ‘QI-KYC Gap’ by expressly requiring QI participants to apply to their QI reporting obligations all information obtained through their Know-Your-Customer procedures to identify the beneficial owners of accounts."

• **Strengthen QI Audits**—"The IRS should broaden QI audits to require bank auditors to report evidence of fraudulent or illegal activity."

Given the evidence obtained from Bradley Birkenfeld and the information uncovered during the PSI investigation, the Department of Justice (DOJ) was pursuing UBS on two fronts. First, DOJ and the IRS were pursuing enforcement of the civil *John Doe* summons, and of potentially much more concern to UBS, they were also pursuing criminal charges for tax evasion and securities violations. Ultimately in February 2009, UBS agreed to: (i) a deferred prosecution agreement (DPA) of the criminal charges, (ii) the payment of a $780 million fine, and (iii) the disclosure of an unknown number of accounts.28

The DPA did not settle the civil issues surrounding the *John Doe* summons. As a result, the day after the DPA was announced, the DOJ filed a motion with the U.S. District Court for the Southern District of Florida to enforce the *John Doe* summons to obtain information on up to 52,000 accounts.30 UBS continued to refuse to provide the information requested in the summons because it could violate Swiss bank secrecy law.

Instead of allowing the Court to decide the conflict of laws issue between American and Swiss law, the IRS and UBS ultimately settled the *John Doe* summons.29

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29. Ultimately, it has been reported that information on approximately 250 U.S. customers was turned over to the U.S. government. See, e.g., David Voreacos, **Credit Suisse May Settle U.S. Probe by Admitting Wrongdoing, Paying Fine**, BLOOMBERG (Aug. 15, 2011), http://www.bloomberg.com/news/2011-08-15/credit-suisse-likely-to-settle-u-s-probe-than-risk-charges-lawyers-say.html.

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Doe summons in August 2009.31 The result was that UBS agreed to disclose information on approximately 4,450 U.S. customers.32 The criteria for determining U.S. customers that would be disclosed were carefully chosen to ensure the United States would get information on the largest and potentially most abusive accounts.

D. 2009 Offshore Voluntary Compliance Initiative (2009 OVCI)33

In March 2009, the IRS announced an offshore voluntary compliance initiative (the “2009 OVCI”). This settlement initiative ultimately ended in October 2009 and resulted in over 14,700 U.S. taxpayers admitting they had previously unreported offshore accounts.34 Aside from some processing issues, the 2009 OVCI was universally viewed as being successful. Part of the reason for this success was that U.S. customers of UBS were concerned their account information was going to be included in the 4,450 accounts UBS agreed to disclose to the IRS.

For non-UBS customers and non-Swiss bank customers, there was less concern about their account information immediately being turned over to the United States. Nevertheless, many U.S. taxpayers were concerned given (i) the possibility of future whistleblowers at their banks, and (ii) it was anticipated the IRS would obtain a wealth of information from the 2009 OVCI related to non-UBS banks.35 In addition, U.S. taxpayers were also worried about the long-term implications of certain proposals in President Obama’s fiscal 2010 budget proposal (issued in May 2009).36

E. FATCA Is Conceived

Given the loopholes and issues surrounding the QI system, there was general agreement among senior IRS officials that something had to be done. The question became: what specific changes should be made to the QI system to make it more effective at preventing U.S. taxpayers from hiding income offshore? The obvious answer was to attempt to address the

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32. UBS’s agreement to disclose customer information supplemented the company’s prior disclosure of approximately 250 customers as part of the deferred prosecution agreement (DPA) in February 2009.
33. The IRS also subsequently had a 2011 OVCI.
35. For example, customers of foreign financial institution A were worried that another customer of A would participate in the 2009 OVCI and cause the IRS to start aggressively pursuing foreign financial institution A in a manner similar to UBS.
36. See infra Part II(E).
problems identified in Part II(B) above. Given the July 2008 PSI report\textsuperscript{37} and given the IRS Commissioner’s testimony at the July 17, 2008 hearing\textsuperscript{38}, it was pretty clear that QIs should be required to:

- Report both U.S. and foreign source income for U.S. taxpayers
- Determine if U.S. taxpayers are the beneficial owners of foreign shell entities
- Review all customer accounts within the affiliated group to identify U.S. taxpayers

Thus, the concept of FATCA was born. However, as the IRS started down this path, several issues arose:

- **Would U.S. Taxpayers Switch Their Investments from QIs to Other Financial Institutions Not Part of the QI System (i.e., NQIs)?**—Because the QI system was a “carrot” primarily utilized by custodial and private banks, the QI system practically did not include many other financial institutions. There was significant concern that if the United States made it difficult for U.S. taxpayers to hide money offshore in bank and trust companies, many U.S. taxpayers would start hiding their money in other offshore vehicles (e.g., various funds) to avoid paying U.S. tax. Thus, any proposal needed to either (i) expand the QI regime to include substantially all foreign financial intermediaries, or (ii) adopt some other approach to reduce the opportunities of U.S. tax cheats\textsuperscript{39} to invest with NQIs.

- **Would QIs Abandon the QI system?**—As described in Part II(A), the QI system was designed to encourage FFIs to become QIs so they could avoid disclosing the identity of their customers to potential competitors (e.g., U.S. banks). Given the QI system utilized this carrot approach, there was significant concern that many QIs would abandon the system if they were now required to perform substantial additional burdens, including: (i) report both U.S. and foreign source income for U.S. taxpayers, (ii) determine the true beneficial owner of a shell entity, and (iii) perform customer due diligence on their entire customer base to identify potential U.S. customers.

As a result, it was decided the new and improved QI system needed to have a penalty for failure of a FFI to participate in the QI system. The proposed penalty was to be the imposition of withholding tax on U.S. source payments (both income and gross proceeds) to a NQI.

- **Should the QI System be Changed Administratively or Through Legislation?**—Because the QI system was created through (i) Treasury regulations and (ii) contracts with FFIs, the IRS/Treasury could have changed the QI rules without legislation. However, given the desire

\textsuperscript{37} See PSI Staff Report, supra note 9.
\textsuperscript{38} See 2008 PSI Hearing, supra note 26, at 55–64.
\textsuperscript{39} The term “tax cheat” is used throughout the Article to refer to U.S. taxpayers that use, or want to use, offshore accounts to evade their U.S. tax obligations.
to impose withholding taxes on payments to NQIs, legislation was needed.

The President’s Fiscal 2010 budget released in May 2009 included several provisions to address offshore tax evasion. Given the known problems with the QI system, the proposals to change the QI system were not a surprise. QIs were going to be required to:

- Report both the U.S. and foreign source income for U.S. taxpayers,
- Determine whether U.S. taxpayers are the beneficial owners of foreign shell entities, and
- Potentially review all customer accounts within an affiliated group of companies to identify U.S. taxpayers.

In addition, the Fiscal 2010 Green Book also included various provisions that addressed concerns that (i) QIs would abandon the system, and (ii) U.S. tax cheats might seek out investments with NQIs (e.g., offshore mutual funds). The two major additional provisions were:

- **Withholding Tax**—If a foreign financial intermediary did not become a QI, it would be subject to a withholding tax on both U.S. source income and gross proceeds. This was primarily designed to encourage foreign financial intermediaries to either continue their QI status, or adopt QI status. However, the imposition of a withholding tax on NQIs had the practical effect of extending the impact of the QI regime to a much broader group of foreign financial intermediaries, including offshore funds. In 2008, it was estimated there were approximately 5,600 QIs. The number of financial institutions ultimately impacted by FATCA is likely into the hundreds of thousands.

- **Third Party Reporting of Cross-Border Transfers**—If a U.S. financial intermediary or a QI transferred money or property outside the U.S.


41. Id. at 42. However, it is important to note the Administration’s proposal did not require affiliated entities of a QI to definitely perform due diligence on their entire customer base. Rather, Treasury was given authority to address QI affiliates. This author’s intention was that if an affiliated QI adopted certain procedures, signed a management representation that the procedures were functioning, and agreed to potentially be subject to an audit by a third party, then the affiliated QI should be able to avoid performing detailed customer due diligence on its customer base.

42. Because the cover of the Administration’s revenue proposals is traditionally green in color, it is often referred to as the “Green Book.”

43. GENERAL EXPLANATIONS, supra note 40, at 43.

44. This was not crystal clear from the Fiscal 2010 Green Book and may not have been the intention of some that participated in the drafting. Nevertheless, given its general applicability to NQIs and given the Green Book included authority to exempt a diverse group of NQIs, this author thought it applied to offshore funds. However, others involved in the process may not.

45. See 2008 PSI HEARING, supra note 26, at 60.
reporting regime, there would be a reporting requirement to the IRS.\textsuperscript{46} This provision was intended to make it more difficult for U.S. tax cheats to transfer money or property to NQIs that were outside the reporting system.\textsuperscript{47}

It should be noted, that as originally conceived in the Fiscal 2010 Budget Proposals, FATCA did not:

- Allow “recalcitrant account holders” (i.e., customers that refused to either identify themselves, or allow reporting of their information to the IRS). Rather, it was assumed that QIs would identify all customers, and U.S. customers would be forced to agree to disclosure of their tax information to the IRS or have their account closed.
- Have “passthru payments” (i.e., I.R.C.\textsuperscript{48} § 1471(d)(7)) which can effectively re-source foreign source income to U.S. source income.

Finally, when FATCA was being designed, there was a clear understanding that it would not eliminate all opportunities for a U.S. taxpayer to hide income offshore. For example, a U.S. taxpayer could invest in non-U.S. source assets with an NQI and avoid reporting to the IRS. However, the hope was that substantially all reputable FFIs would become QIs. If this occurred, U.S. tax cheats would be relegated to second or third tier FFIs that could cause the U.S. tax cheat to question whether they really wanted to invest in such institutions.

\section*{F. FATCA Legislation Ultimately Adopted\textsuperscript{49}}

Legislation was ultimately introduced in October 2009,\textsuperscript{50} modified again in December 2009,\textsuperscript{51} and finally adopted in March 2010 as part of the Hire Act.\textsuperscript{52} Although there were several changes during drafting, two of particular interest were:

\begin{itemize}
\item \textsuperscript{46} General Explanations, supra note 40, at 48.
\item \textsuperscript{47} However, U.S. tax cheats could still move money offshore the “old fashioned way” (i.e., in suitcases).
\item \textsuperscript{48} For additional discussion see infra Parts II(f), III(B), IV(A)(2).
\item \textsuperscript{49} The President’s proposals referred to participating FFIs as QIs. However, once FATCA was committed to legislative language, the nomenclature changed from QIs to P-FFIs (i.e., participating FFIs) and NP-FFIs (i.e., non-participating FFIs). The remainder of this Article will generally refer to P-FFIs and NP-FFIs.
\end{itemize}
Recalcitrant Account Holders—As originally outlined in the Fiscal 2010 Green Book, FATCA would have required FFIs to identify the country of residence of all customers—or at least determine whether a customer was a U.S. person or not. The Green Book was silent as to what a qualified foreign financial institution (Q-FFI) should do if a customer refused to provide adequate documentation to demonstrate they were not a U.S. person.

When first drafted by congressional staff, FATCA required that a participating foreign financial institution (P-FFI) would close the account of any customer that would not provide adequate documentation. In addition, if a P-FFI identified a customer as a U.S. person, the FFI would be required to report information to the IRS for such U.S. customer.

It was understood that requiring that (i) a customer’s account be closed and (ii) information on U.S. customers be reported to the IRS, could cause issues with local law. However, given the coordinated worldwide effort to address offshore accounts, it was hoped that recalcitrant account holders would ultimately not be tolerated in the worldwide banking system. In addition, if a FFI wanted to be a P-FFI, it was thought that the FFI could choose to not do business with customers that appeared to be U.S. persons (especially new customers) and refused to sign a waiver allowing the P-FFI to disclose the customer’s information to the IRS.

As FATCA went through the legislative process, many comments were received surrounding local law restrictions on (i) disclosing customer information to the IRS, and (ii) closing of existing accounts. As a result, the final version of FATCA adopted in March 2010 provided that a P-FFI could have so-called “recalcitrant account holders.” It was still hoped that eventually recalcitrant account holders would not be tolerated in the worldwide banking system, but it was understood this could take a number of years to accomplish.

Passthru Payments—As FATCA was being developed, it was understood that in a post-FATCA world a U.S. tax cheat could accomplish

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53. See General Explanations, supra note 40.
55. For example, some customers may not want to identify themselves, local bank secrecy laws may prevent the disclosure of customer information without the customer’s consent, and local laws may prevent the closing of an account.
58. See I.R.C. § 1471(d)(7) (West 2010) (including in definition of “passthru payment” “any withholdable payment or other payment to the extent attributable to a withholdable payment”). Because the first part of § 1471(d)(7)’s definition is relatively non-controversial, for purposes of this Article, the term “passthru pay-
their objective by investing in non-U.S. source assets with a non-participating foreign financial institution (NP-FFI). The hope was that over time, the number of reputable FFIs and countries that a U.S. tax cheat could invest in would gradually be eliminated. In order to accomplish this result, it was understood the United States may need to ultimately convince other countries to adopt FATCA style systems, or alternatively participate in a multilateral P-FFI system.59

Although it was understood U.S. tax cheats could invest in non-U.S. source assets through a NP-FFI, the general intention was to prevent U.S. tax cheats from investing in U.S. source assets through a P-FFI. During the legislative process a group of tax professionals met with congressional staff to express concern that (i) U.S. tax cheats could invest in non-U.S. source assets in NP-FFIs, but more importantly, (ii) tax planners could setup a “blocker entity” to effectively allow U.S. tax cheats to indirectly invest in U.S. source assets.60 The first observation was not a surprise, but the second was to certain staff.

The concern about a “blocker entity” can best be described by an example. Assume Offshore Fund A invests in U.S. source assets and further assume A elects to become a P-FFI. Further assume that a NP-FFI (e.g., another offshore fund X) is an investor in A, and a U.S. tax cheat is an investor in X. Given this scenario, the tax professionals were concerned that payments from A to X would be foreign-to-foreign payments and therefore not subject to withholding under FATCA. Thus, tax planners could avoid FATCA by establishing a P-FFI as a blocker between U.S. investments and NP-FFIs or U.S. tax cheats.

Primarily as a result of this meeting, the passthru payment provision61 was inserted into FATCA. Thus, in addition to withholding on a withholdable payment, a P-FFI needs to withhold on other payments “to the extent attributable to a withholdable payment.” This provision has the potential to effectively (i) re-source a portion of what would otherwise be a foreign source payment to a NP-FFI or recalcitrant account holder, and (ii) impose a 30% withholding tax on the portion of such payment re-sourced to the United States.

Continuing with the example above, assume a U.S. tax cheat invests $1 million in non-U.S. source assets with X (a NP-FFI) and further assume X invests the $1 million in non-U.S. source assets

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59. For further discussion, see infra Part IV(b)(2).


with A (a P-FFI). Finally, assume A makes a $100,000 payment to X. Given these facts, the passthru payment rules provide that A must agree to withhold 30% of any "withholdable payment" or "other payment to the extent attributable to a withholdable payment." Because the $100,000 payment relates to foreign sources, it is not a "withholdable payment". However, it may be a payment "attributable to a withholdable payment" to the extent A invested in U.S. assets and received payments from such assets.

As a result, even though a payment from a P-FFI to a NP-FFI appears to entirely relate to foreign source assets, the passthru payment rules could result in the imposition of withholding tax by effectively re-characterizing a portion of the foreign source payment as a U.S. source payment. The intended effect of this provision appears to have been (i) to discourage U.S. tax cheats from investing in non-U.S. assets with NP-FFIs, and (ii) more directly, penalizing NP-FFIs for doing business with a P-FFI. The hope may have been to encourage NP-FFIs to become FFIs.

In addition, the passthru payment rules also apply to a recalcitrant account holder. Thus, if a recalcitrant account holder invests in non-U.S. source assets with a P-FFI, the passthru payment concept could result in a resourcing of foreign source income to U.S. income and result in withholding.

As will be discussed in Parts III(B) and IV(A)(2), the passthru payment rule has been very controversial because (i) it can be administratively complex, and (ii) it re-sources foreign source income to U.S. source income in situations where there may be no tax abuse.

## III. SELECTED FATCA ISSUES

Although there are many issues surrounding FATCA, this Article will discuss three issues. The first two are specific issues surrounding (i) customer due diligence procedures, and (ii) passthru payments. The customer due diligence issue was recognized during the original conceptualization of FATCA, while the passthru payment issue resulted from decisions made during congressional drafting of FATCA. Although these two issues need to be addressed by IRS/Treasury in both the short and the long-run, the passthru payment issue is particularly complicated.

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62. *Id.*

63. As will be discussed in Part IV(A)(2), because of the additional administrative burdens it imposes on the P-FFI, the passthru payment also effectively penalizes the P-FFI for doing business with an NP-FFI.

64. For a discussion of the various issues surrounding FATCA, see *supra* note 1.

65. See infra Part III(A).

66. See infra Part III(B).
The third issue is a general question: Will FATCA ultimately accomplish its goals?67

A. Customer Due Diligence Procedures for Affiliated P-FFIs

As discussed in Part II of this Article, one of the major problems with the QI system was the ability of a QI to effectively (i) ignore customer accounts at affiliated FFIs, and (ii) even also ignore customer accounts within the QI. One of the major FATCA design features was to require that a QI (now referred to as a P-FFI) have procedures in place to (i) identify all U.S. customers within the P-FFI,68 and (ii) potentially identify U.S. customers in affiliated FFIs.69 When FATCA was being designed, it was understood this would cause certain issues, especially in the short-run.

For example, assume a hypothetical foreign bank has one million customers throughout the world, but only (i) 1% of such customers are U.S. persons, and (ii) 4% of the foreign bank’s customers invest in the United States. In this fact pattern, FATCA theoretically requires the foreign bank to perform detailed customer due diligence procedures on its entire one million customer base in order to properly identify the 5% that could be directly impacted by FATCA. Needless to say, one would expect the foreign bank to be unhappy about this requirement. This problem was known when FATCA was being conceptualized.

As a result, in order to make FATCA operational in the short-run, this IRS official was expecting that affiliated entities of the P-FFI would have an ability to demonstrate there were few if any material U.S. customers that would require reporting to the IRS. I was hoping this requirement could be met by some combination of written procedures and representations by affiliates of the P-FFI that there were no known U.S. customers.70 It should be noted the final FATCA statutory language provided for “deemed compliant” FFIs.71

As will be discussed in Part IV(B) of this Article, this IRS official believed the long-term answer to the customer due diligence issue for affiliated FFIs was additional multilateral agreement among various tax authorities.

B. Passthru Payments72

As discussed in Part II(F), the passthru payment concept originated during legislative consideration of FATCA and was aimed (i) in general at further discouraging the existence of NP-FFIs, and (ii) partially addressing

67. See infra Part III(C).
68. I.R.C. § 1471(b)(1)(A) (West 2010).
69. I.R.C. § 1471(e) (West 2010). However, the Treasury was granted authority to provide exceptions for affiliated FFIs.
70. Or potentially no known U.S. customers above a certain level of assets.
71. I.R.C. § 1471(b)(2) (West 2010).
72. For a further discussion of passthru payments, see supra note 58.
the blocker issue. Although the ultimate goal was clearly worthwhile, it has become clear since the enactment of FATCA that implementation of the passthru payment regime poses many significant challenges, including:

- How does one determine whether a payment to a NP-FFI (or recalcitrant accountholder) is “attributable to a withholdable payment?”
- Potential restrictions under local law to the collection of withholding tax on payments that appear in form to be unrelated to the United States.

As of the drafting date of this Article, the IRS/Treasury has tentatively decided to apply a pro-rata approach in order to determine passthru payments. Thus, if 10% of a P-FFI’s worldwide assets are U.S. assets, then 10% of its non-U.S. source payments to an NP-FFI or recalcitrant account holder could be subject to a 30% U.S. withholding tax.

Needless to say, there are lots of issues and administrative complexity with this approach. Possibly in recognition of these issues and complications, the IRS announced in July 2011 that the passthru payment rules will not be effective until payments after January 1, 2015. The IRS likely believes it has bought itself some more time to address the passthru payment issue.

However, informal discussions with several FFIs and their advisors suggest:
- Many FFIs view the passthru payment rules as the proverbial straw that could break the camel’s back in their decision whether to become a P-FFI.
- Other FFIs (i.e., those that clearly need to be a P-FFI because of their client base) are apparently considering only doing business with other P-FFIs so as to reduce their FATCA system design issues.
- Most FFIs do not want to start building a system to do withholding tax until they know whether the passthru payment rules will be applicable, and if so, how they will be applied.

As will be discussed in Part IV(A)(2) of this Article, this observer suspects the IRS will need to make some decisions soon with respect to the passthru payment rules. The decisions will not be easy and will depend upon several factors.

C. Will FATCA Ultimately Accomplish Its Goals?

Before answering this question, it is helpful to briefly discuss my perspective on the goals of FATCA. The overall goal was to reduce the number of U.S. taxpayers using offshore accounts to hide income from the IRS. Major specific goals included:

73. November 15, 2011.
74. See I.R.S. Notice 2010-34, 2010-17 I.R.B. 612, at § II.
Encourage U.S. Taxpayers to Participate in the 2009 OVCI—Given that FATCA was conceptualized at approximately the same time as the 2009 OVCI was being developed,\(^{76}\) one goal of FATCA was to further encourage participation in the 2009 OVCI.\(^{77}\) Clearly, to the extent U.S. taxpayers were fearful FATCA would substantially increase future reporting of information on offshore accounts to the IRS, U.S. tax cheats should have been more likely to participate in the 2009 OVCI.

Cure Deficiencies in the QI Reporting System for U.S. Taxpayers—This was the main goal of FATCA with the end result that it should be substantially more difficult for a U.S. tax cheat to hide income offshore in a P-FFI.

Provide an Offshore Reporting Model for Other Countries to Emulate—Although not all involved in developing FATCA necessarily shared this goal, it certainly was one of my goals. Furthermore, as discussed in Part IV(B), I believe the ultimate long-term success of FATCA may depend upon whether other countries adopt some version of FATCA, or at least adopt detailed customer due diligence procedures of the type embedded in FATCA.

Given the IRS has had two very successful offshore voluntary disclosure initiatives (i.e., the 2009 OVCI and the 2011 OVCI),\(^{78}\) the first specific goal seems to have been met.\(^{79}\) However, the second and third goals are more important. In order for them to be met, the United States needs to create a viable, long-term reporting system that is accepted by the vast majority of FFIs around the world. Unfortunately, the jury is still out.

The major weakness of FATCA is that the United States is attempting to unilaterally require FFIs to report information to the United States. When FATCA was being conceptualized, it was this author’s hope that the United States would aggressively market the FATCA concept to other ma-

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76. The 2009 OVCI was announced in March 2009 and the President’s Fiscal 2010 Budget Proposals were released in May 2009. The 2009 OVCI was originally scheduled to end in September 2009, but was ultimately extended to October 2009.

77. However, other goals were more important (e.g., curing deficiencies in the QI reporting system).

78. See IRS Shows Continued Progress on International Tax Evasion, Internal Revenue Service (Sept. 15, 2011), http://www.irs.gov/newsroom/article/0,,id=245768,00.html (announcing that, as of September 15, 2011, approximately 30,000 taxpayers had voluntarily disclosed previously unreported offshore accounts resulting in almost $3 billion of additional collections). In addition, one should expect that as disclosures are processed for the 2011 OVCI, the amount of collections should increase substantially.

79. One will never really know how many additional U.S. taxpayers decided to participate in the 2009 and 2011 OVCIs because of FATCA. Nevertheless, FATCA was one of the factors that many U.S. taxpayers likely considered when determining whether to participate.
The issues caused by this unilateral action include:

- Resistance by FFIs to (i) perform extensive customer due diligence procedures on all of their customer bases to identify a relatively small number of U.S. taxpayers, and (ii) create a specific reporting and withholding system applicable to only the United States.
- Various sovereign country issues, including (i) bank secrecy laws, and (ii) laws prohibiting the closing of accounts.

Some might argue the United States should work through the Organization for Economic Co-operation and Development (OECD) to obtain a global consensus. Given such an effort could take many years (if not decades) to accomplish, the alternative is for the United States to approach other countries individually to pursue multilateral action.

### IV. Recommendations

This Part is divided into short-run and long-term recommendations surrounding the issues discussed in Part III of this article. Hopefully these recommendations will encourage discussion and comment. The author’s ultimate goal is to attempt to improve the chances of FATCA being a long-term success by greatly improving transparency surrounding offshore accounts held by U.S. taxpayers.

#### A. Recommendations Important to the Short-run Success of FATCA

1. **Customer Due Diligence Procedures for Affiliated FFIs**

   As discussed in Part II(B), the QI system had a major loophole in that a QI and its affiliates could select which customer accounts to include in the system. When developing FATCA, there was a clear need to require P-FFIs to address all accounts held by a P-FFI and its affiliates. However, as discussed in Part III(A), it was generally understood that requiring detailed customer due diligence of affiliated FFIs could be difficult until there is more multilateral agreement surrounding the appropriate customer due diligence procedures.

   As a result, the IRS/Treasury should balance (i) the urge to write airtight rules surrounding customer accounts in affiliated FFIs versus (ii) the need to develop an operational rule prior to more multilateral agreement on the appropriate customer due diligence procedures. The approach should be balanced taking into consideration the following factors:

   - The nature of the affiliate FFI’s customer base,

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80. Informal discussions suggest most of the IRS’s attention has been on implementing FATCA in the United States without much attention being paid towards educating other countries about joining with the United States to leverage the FATCA system. Hopefully, my information is incorrect.

81. There are many other FATCA issues, but this Article does not attempt to address them.
• Management representations surrounding the nature of accounts in the affiliated FFI and the procedures/controls in existence to avoid doing business with material U.S. customers, and
• The possibility that an external auditor would review a P-FFI’s representations surrounding affiliated FFIs.

Existing IRS guidance has attempted to consider some of these factors, but the general operating presumption seems to be that affiliated FFIs will go through the same customer due diligence procedures as P-FFIs unless the affiliated FFIs can meet the very restrictive criteria for a “deemed compliant FFI.” Among the criteria is that the affiliated FFI does not have any business outside of its country of organization.

I agree the long-term goal of FATCA should be very detailed customer due diligence procedures for all customer accounts held by an affiliated FFI. However, as described in Part IV(B), the method for obtaining this long-term goal is to obtain better international agreement surrounding customer due diligence procedures. In the meantime, the IRS/Treasury should be more willing to rely on management’s representations surrounding procedures/controls at affiliated FFIs. In addition or as an alternative, IRS/Treasury should consider relaxing the deemed compliant FFI criteria to allow certain affiliated FFIs that operate cross-border to qualify.

2. Passthru Payments

As summarized in Part III(B), the requirement to withhold on “other payments to the extent attributable to a withholdable payment” (i.e., referred to as passthru payments for this Article) has created major issues. Given these complications and given passthru payments were not part of the IRS’s original conceptualization of FATCA, I am tempted to suggest the IRS/Treasury figure out a way to avoid adopting or enforcing the position.

Unfortunately, the analysis is not so straightforward. In case you do not want to wade through Parts IV(A)(2)(a) and IV(A)(2)(b), I basically conclude the IRS/Treasury should err on the side of not implementing the passthru payment regime unless IRS/Treasury is highly confident it is administrable and will not have any material negative consequences. My suspicion is the IRS may struggle to meet these two criteria. One option that has been proposed is to adopt a fixed percentage for the portion of the passthru payment attributable to a withholdable payment.

82. See I.R.S. Notice 2011-34, 2011-19 I.R.B. 765, at § III(B) (discussing “deemed compliant FFIs”); see also id. at § VI (discussing affiliated FFIs).
83. Reliance is warranted as long as the nature of the business supports such representation.
84. See supra note 58.
85. This could involve either obtaining a legislative change, or more likely a creative reading of the existing Internal Revenue Code provisions.
Assuming the IRS decides to retain the passthru payment concept, the IRS/Treasury should seriously consider a fixed percentage approach. It would be substantially more administrable and would likely result in more FFIs deciding to become P-FFIs. In the long-run, the solution is to obtain multilateral agreement from other major countries to require withholding on all payments from a P-FFI to a NP-FFI.  

a. Analytical Framework

First, the IRS needs to evaluate whether there is a potentially workable solution to the passthru payment issue. If not, its decision should be obvious. If there is a potentially workable solution, but it is has the potential to create major administrative issues for FFIs, the IRS needs to balance the costs and benefits of implementing the solution with respect to FFIs.

• **Benefit**—The potential benefit is that the mere existence of the passthru payment rules could drive NP-FFIs to become P-FFIs. This would obviously be a good result. This could occur if FFIs on the fence decide they need to do business with P-FFIs, but do not want to suffer the passthru withholding. It could also occur if a material number of respected P-FFIs decide they will only do business with other P-FFIs and thus, NP-FFIs could become pariahs in the financial system.

  My sense is that the first scenario will not be that common because FFIs will likely have NP-FFIs with which they can do business. As to the second scenario, I have heard some large respected FFIs are thinking of only doing business with other P-FFIs. If this is the case, the passthru payment rules could actually drive certain FFIs to decide they want to be part of the club.

• **Cost**—The passthru payment rules have the potential to drive FFIs away from the FATCA system. This could occur if either (i) NP-FFIs decide they do not want to do business with P-FFIs because of the additional withholding, or more likely (ii) FFIs decide they do not want to suffer the administrative burden of determining passthru payments and all the other requirements of FATCA. Said differently, the passthru payment rules could be the proverbial straw that breaks the camel’s back as a FFI is deciding whether to become a P-FFI. This observer believes there is a real risk the camel’s back

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86. NP-FFIs would be effectively excluded from the worldwide financial system unless they either (i) subject themselves to a 30% withholding tax, or (ii) decide to become a P-FFI. In order for this to occur, several major countries would need to agree in order to have the leverage to implement such a radical system.

87. Do not enforce the provision.

88. Personally, I am skeptical there will be many P-FFIs that ultimately refuse to do business with NP-FFIs. Tax and systems employees may be of such view, but once the business folks get involved, I suspect there will be less interest in cutting off revenue sources.
could be broken if the IRS/Treasury retains the pro-rata approach to passthru payments proposed in IRS Notice 2011-34.

In addition to evaluating the impact of the passthru payment rule on FFIs, the IRS/Treasury should attempt to evaluate the impact on U.S. tax cheats potentially investing in (i) P-FFIs, and (ii) NP-FFIs. In theory, the passthru payment rules should result in some additional withholding tax from these two categories of individuals. However, practically one wonders what the real world consequences might be.

• **U.S. Tax Cheats Investing in P-FFIs**—If a U.S. tax cheat is going to invest in a P-FFI, they will presumably (i) become recalcitrant and (ii) only invest in non-U.S. source assets so as to avoid 30% withholding on U.S. source income and gross proceeds. If this occurs, the passthru payment rules could re-characterize a portion of the foreign source payments to U.S. sources and result in additional U.S. withholding tax. However, the question is how will a U.S. tax cheat react to this possibility?

  If the withholding tax is imposed on a relatively small portion of the payments, it is possible the U.S. tax cheat may decide to bear the withholding tax. However, given the withholding tax can potentially be imposed on gross proceeds, my suspicion is that U.S. tax cheats may decide to take their business to a NP-FFI. In addition, to the extent the IRS will likely be monitoring recalcitrant account holders, one suspects P-FFIs will not be anxious to have too many recalcitrants in their customer bases, especially if they have any U.S. indicia. Finally, if I were a U.S. tax cheat, I would worry about a P-FFI ultimately being more likely to turn-over my name to the IRS, than a NP-FFI.89

For all the above reasons, I don’t believe the passthru payment rule will have much impact on U.S. tax cheats attempting to directly invest with P-FFIs. Rather, I believe U.S. tax cheats will want to avoid P-FFIs and only invest in NP-FFIs.

• **U.S. Tax Cheats Investing in NP-FFIs**—If a U.S. tax cheat is planning to invest in non-U.S. assets with a NP-FFI, the passthru payment rules would impose no direct withholding tax. However, if the NP-FFI wants to hedge its counter-party risk to the U.S. tax cheat, it needs to decide whether to do so by investing with another NP-FFI or investing with a P-FFI. If it chooses the P-FFI, it could suffer a withholding tax on a passthru payment. Thus, one would presume that

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89. For example, the United States may be able to make a treaty request to obtain the names of a P-FFI’s customers that are recalcitrant and have U.S. indicia. Historically, treaty requests have required the requesting countries to have an individual’s name and account information. However, the U.S. has recently been able to obtain information from Switzerland by just describing fact patterns in which it was interested (e.g., the UBS and Credit Suisse cases). If this approach spreads to other countries, U.S. tax cheats will likely want to avoid any financial institution with any sort of reporting responsibility to the United States.
a NP-FFI would want to hedge any risk with another NP-FFI, rather than a P-FFI.

If the U.S. tax cheat wants to invest in U.S. assets with a NP-FFI and the NP-FFI invests in U.S. assets, presumably when the dust settles the passthru payment rules will impose some withholding tax. This should occur in the blocker fact pattern discussed above and other similar fact patterns.

b. Passthru Payments Summary

In summary, there seem to be two major benefits of the proposed pro-rata passthru payment rule. First, because it is so administratively burdensome, it could cause certain P-FFIs to refuse to do business with NP-FFIs and recalcitrant customers. Second, it attempts to address the so-called blocker issue. The primary cost of the rule is that it is administratively complex and may result in many FFIs refusing to participate in FATCA because of the administrative difficulties.

Because IRS/Treasury has accumulated substantial information from their discussions with FFIs and others, they are in the best position to weigh the relative costs and benefits. However, I recommend IRS/Treasury err on the side of not implementing the passthru payment regime unless it is highly confident it is administrable and will not have any material negative consequences on the long-term success of FATCA. My suspicion is the IRS may struggle to meet these two criteria as the rule is currently proposed. Although it would be nice if the passthru regime could be made workable, it is likely not crucial to the long-term success of FATCA. Rather, because of its complexity, it has the potential to do more harm than good in the short-run.

One option that has been proposed is to adopt a fixed percentage for the portion of the passthru payment attributable to a withholdable payment. Assuming the IRS decides to retain the passthru payment concept, the IRS/Treasury should seriously consider a fixed percentage approach. It would be substantially more administrable and likely result in more FFIs deciding to become P-FFIs. Finally, if the IRS/Treasury can develop an alternative to addressing the blocker issue, it would be extremely helpful, even if it were only a short-run solution. One possibility might be to adopt an anti-abuse rule that specifically targets blocker entities. For example, if a P-FFI is determined to have been formed or availed of for the purpose of circumventing FATCA, the P-FFI would retroactively lose its P-FFI status and potentially be subject to other penalties.

90. For a discussion of what is needed to make FATCA a long-term success, see supra notes 93–101.

91. Depending upon how FFIs react, it is possible the passthru payment regime could cause FATCA to “crash and burn.” Given what is at stake, the IRS/Treasury should not risk this possibility.

92. In addition, if another P-FFI had knowledge of such activity, they could also be subject to various penalties or sanctions.
In the long-run, the solution is to obtain multilateral agreement from other major countries to require withholding on all payments from a P-FFI to a NP-FFI. In essence, NP-FFIs would be excluded from the worldwide financial system unless they either (i) subject themselves to a 30% withholding tax, or (ii) decide to become a P-FFI. For this to occur, several major countries would need to agree in order to have the leverage to implement such a radical system.

B. Recommendations Important to the Long-term Success of FATCA

1. Unilateral vs. Multilateral Action

In order to ultimately address offshore tax evasion by U.S. taxpayers, FATCA needs to be successful in the long-run. The effort to impose transparency on offshore accounts held by U.S. taxpayers (and other countries’ taxpayers) is a marathon, not a sprint!

The key question is: What end result will indicate FATCA has been successful in the long-run? I believe the two key indicators will be:

- **The United States is Assured that Adequate Customer Due Diligence is Done by P-FFIs and Their Affiliates**—As discussed in Parts III(A) and IV(A)(1), there currently are issues with FATCA unilaterally attempting to force FFIs and their affiliates to perform detailed due diligence on their entire customer base.

- **The Investment Options Available to Offshore U.S. Tax Cheats are Very Limited**—Given a dedicated U.S. tax cheat can avoid FATCA by investing in non-U.S. assets with a NP-FFI, a key goal of the IRS/Treasury going forward should be to limit the investment opportunities for U.S. tax cheats.

There are two key variables surrounding investment options: (i) the number and quality of financial institutions, and (ii) the range of non-U.S. assets available to invest in. If ultimately U.S. tax cheats are relegated to investing in very small, disreputable financial institutions, or the assets available to invest in are severely limited, offshore tax evasion should be greatly reduced. If both occur, offshore tax evasion should be effectively eliminated.

There are two basic approaches the United States could use to accomplish both of these indicators:

- **Unilateral Action**—First, the United States could continue down the course of unilateral adoption of FATCA with the hope that the U.S. investment market is sufficiently large that substantially all FFIs will need to become P-FFIs. Although this is theoretically possible, it is

93. Tax cheats are relegated to investing in very small, disreputable financial institutions, and the assets available to invest in are severely limited.

94. Some diehard U.S. tax cheats may take to burying their money in the backyard, or pursuing other options (e.g. investing in diamonds), but as a practical matter the vast majority of U.S. tax cheats currently using offshore accounts will waive the white flag and agree to pay their U.S. taxes.
practically very unlikely. For example, even if P-FFIs and their affiliates perform adequate due diligence, all a U.S. tax cheat needs to do is find one reasonably reputable NP-FFI and invest in non-U.S. assets with such NP-FFI. Given there are likely to be reasonably reputable FFIs that decide to be NP-FFIs, this is a real concern.

- **Multilateral Action**—Alternatively, the United States could pursue multilateral action to help accomplish both indicators. Multilateral action could take many forms. For example, the United States could work through the OECD to obtain a global consensus. However, such an effort could take many years (if not decades) to accomplish. One alternative is for the United States to approach other major countries individually about jointly addressing offshore accounts. Again, there are various options.

  The most limited option would be to pursue discussions with other major countries and attempt to reach agreement about the appropriate customer due diligence procedures to be performed. If several major countries agreed on customer due diligence procedures, it could go a long way towards successfully addressing the customer due diligence issue in FATCA for affiliated FFIs. Specifically, it could significantly strengthen the IRS’s hand when attempting to force a FFI to perform detailed due diligence procedures on its entire customer base (i.e., FFIs and affiliated FFIs).

  An additional major benefit from multilateral action would be to reduce the investment options for a U.S. tax cheat (i.e., reduce the number of (i) NP-FFIs and (ii) countries whose assets a U.S. tax cheat could invest). This could be accomplished by a multilateral FATCA system.

95. Nevertheless, the IRS/Treasury needs to continue implementing FATCA so as to (i) effectively force U.S. tax cheats to invest in NP-FFIs, and (ii) create a model for other countries to hopefully follow. If the U.S. were to abandon FATCA, it would be a serious long-term setback to addressing offshore tax evasion both in the U.S. and the world.


97. The IRS/Treasury may be able to piggy-back to a certain extent on the desire of developed countries to address anti-terrorist financing activities. Thus, there are both tax and non-tax reasons for attempting to strengthen customer due diligence procedures around the world.

98. See infra Part III(A).

99. It could also be accomplished through a bilateral exchange of information among countries. However, this author believes it is better for the IRS to receive information directly from the financial institution, rather than relying on another country to forward the information. Aside from administrative issues with interposing an intermediary, it would seem to be much easier to force FFIs to participate in a multilateral FATCA system than it will be to get countries with bank secrecy to participate in information exchange arrangements.
2. What Might a Multilateral FATCA System Look Like?

The easiest way to illustrate a multilateral system would be to explain what would happen if another country joined with the United States in implementing FATCA. Assume Country A decided to join the United States in its FATCA system. In such case, the following would result:

- If a FFI wanted to invest in either the United States or Country A, it would need to execute a FFI agreement with both the United States and Country A.
- The FFI would agree to identify customers from both the United States and Country A and report information on such customers to the appropriate country (i.e., the United States or Country A). The United States would obtain three principle benefits:
  - First, because a FFI would need to perform detailed due diligence on its customer base to identify both U.S. and Country A customers, it would mitigate some of the criticism currently applicable to FATCA (i.e., it is a unilateral approach that requires FFIs to perform an unreasonable amount of due diligence to identify the proverbial needle in the haystack—a U.S. customer).
  - Second, for a FFI contemplating not participating in FATCA, it would effectively have to make a decision to not do business with both the United States and Country A. This is obviously a tougher decision than just boycotting the United States.
  - And third, a U.S. tax cheat should effectively be prevented from investing in both U.S. and Country A source assets.

Country A would also receive substantial benefits. Specifically, it could leverage the desire of FFIs to do business in the United States. Said differently, if Country A tried to implement FATCA on its own, it is highly likely that a substantial number of FFIs would boycott Country A’s standalone FATCA system. However, if Country A joins up with the United States, it will be substantially more difficult for a FFI to boycott both the United States and Country A.

Although it would be ideal if all countries in the world agreed to join the United States’ FATCA system, in reality, the United States likely only needs a few other major countries to participate in a multilateral FATCA regime to mitigate many of the issues being raised with the United States’ unilateral adoption. Plus, as each additional country joins in a multilateral FATCA system, the number of investment opportunities available to a U.S. tax cheat would decline. Although there will always be some tax cheats that are willing to go to great lengths to avoid paying tax, one suspects as the number of countries participating in a FATCA type system increases, viable investment options will become few and far between.

3. Would Countries Need to Agree to All Aspects of FATCA?

In short, the answer is “no.” The major aspects of FATCA include: (i) the requirement to perform due diligence on a FFI’s entire customer base
(including affiliated FFIs) to identify the true owner of an account, (ii) the imposition of a 30% withholding tax if a customer is either recalcitrant or a NP-FFI, and (iii) the reporting of information to the resident country for resident customers.

Certainly, it would be helpful if all countries participating in a multilateral FATCA arrangement could agree on all three major aspects of FATCA. However, in the real world the chances of different countries agreeing on all aspects of FATCA are not high. Fortunately, agreement on all three aspects is not necessary for the United States to accomplish its goals. Rather, all that is needed is for the United States and other countries to agree on (i) a standard set of customer due diligence requirements to be performed by P-FFIs, and (ii) some stick to get FFIs to participate.

The imposition of a 30% withholding tax on payments to NP-FFIs could be the stick, but each country would be free to choose its own penalty to be applied to a NP-FFI. However, the penalty would need to have some teeth to it.

When it comes to reporting, there also could be flexibility as to (i) the content of the information, and (ii) the flow of the information. In addition, although it would introduce complications, it may be possible to have some countries adopt a withholding regime, and others adopt a reporting regime. Both the withholding and reporting regimes would need to be subject to an audit.

V. OVERALL CONCLUSION

The United States and foreign countries have made significant headway in the past several years addressing the use of offshore accounts to evade tax. The United States has benefited from whistleblowers and two very successful offshore voluntary compliance initiatives. FATCA was enacted to help give the IRS the long-term tools necessary to better combat offshore tax evasion by U.S. taxpayers.

However, because FATCA is a unilateral action by the United States, there are several major implementation issues surrounding FATCA, including how to (i) require detailed customer due diligence procedures for a FFI and its affiliates, (ii) implement the potentially very complicated passthru payment rules, and (iii) minimize the offshore investment opportunities for U.S. tax cheats (i.e., NP-FFIs).

100. For example, instead of the FFI reporting information to the residence country (e.g., the U.S.), information could flow first from the FFI to the country where the FFI is located (i.e., source country), and then from the source country to the residence country. As described in note 89, supra; this is not my preferred flow of information, but it could be made to work if the source country is cooperative.

101. See Daniel Pruzin, Financial Institutions: As U.S. Prepares Hammer, U.K., Germany Ready to Leave Swiss Banking Secrecy Intact, Analysis & Perspective, Foreign Income (BNA) 198 DER J-1 (October 13, 2011) (describing recent withholding agreements between Switzerland, UK, and Germany). Given these agreements, this is an issue that needs to be further evaluated.
Because it is important that FATCA be successful in the long-run, Treasury is urged to use significant judgment when first implementing FATCA with respect to the following:

- **Customer Due Diligence for Affiliated FFIs**—In general, the current proposed guidance surrounding affiliated FFIs and deemed compliant FFIs may be too restrictive. The IRS/Treasury should consider allowing certain affiliates of a P-FFI to use policies and procedures to demonstrate adequate due diligence on their customer base. Alternatively, the deemed compliant FFIs provision could be expanded to allow FFIs that operate cross-border to potentially qualify.

- **Passthrough Payment Rules**—The current proposed passthrough payment rules are very complex, and likely unadministrable. The IRS/Treasury should be seriously considering either (i) not enforcing the rules, or (ii) adopting an alternative (e.g., a fixed percentage for determining the portion of a payment that is “attributable to a withholdable payment,” an anti-abuse rule aimed at blocker entities, or both). Given many FFIs will not make a decision whether to become a P-FFI until they fully understand the passthrough payment rules, the Treasury needs to make decisions quickly.

In the long-run, IRS and Treasury could greatly increase the probability of FATCA’s success by actively discussing FATCA with other major countries. The goal of such discussions should at a minimum be to agree on common customer due diligence procedures. Preferably, other countries would join the United States in administering a multilateral FATCA type system. Foreign countries would benefit greatly from using the United States’ leverage to effectively force FFIs to join the system. The United States would benefit from reducing the number of investment options available to tax cheats, and making recalcitrant account holders significantly less likely.

Finally, financial institutions worldwide should seriously consider attempting to help forge an international consensus. Currently, some financial institutions appear as though they are planning to resist efforts for increased transparency. Although financial institutions will clearly incur substantial costs from FATCA, those costs may pale in comparison to the costs that could be incurred over the next five to twenty years as other countries implement their own specific systems. It would be substantially cheaper for financial institutions if there is one global standard, rather than ultimately building separate FATCA type systems for each country.

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102. See I.R.S. Notice 2011-34, 2011 I.R.B. 765, at § III(B) (discussing “deemed compliant FFIs”); see also id. at § VI (discussing affiliated FFIs).

103. See id. at § II.

104. If not already taking place, these discussions should be taking place in the very near future because it will take many years to reach agreement with other major countries.
THE USE OF VOLUNTARY DISCLOSURE INITIATIVES IN THE
BATTLE AGAINST OFFSHORE TAX EVASION

LEANDRA LEDERMAN*

I. INTRODUCTION

THE individual income tax gap—the gap between taxes due and taxes
timely and voluntarily paid—was recently estimated at $450 billion for
tax year 2006.1 That estimate does not break out international activity,2
but international tax noncompliance may be on the order of $100 billion
or more annually.3 The federal government is aware that some individuals
make use of bank accounts in overseas jurisdictions with bank secrecy laws
to evade federal taxes.4 Other U.S. taxpayers with offshore bank accounts
may inadvertently fail to comply with U.S. tax laws, which include a re-
requirement to report ownership of foreign accounts that have a balance of
over $10,000 during the year.5 Failure to report such an account gives rise

* William W. Oliver Professor of Tax Law, Indiana University Maurer School
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pub/newsroom/tax_gap_map_2006.pdf.
2. See id.; see also The Tax Gap and International Taxpayers, I.R.S. (Feb. 2008),
(“[T]here is currently no specific data to indicate what portion of the tax gap is
attributable to international taxpayers . . . . Individual international taxpayers will
be included in [the National Research Program] for the first time in 2008 with the
examination of tax year 2006 returns.”); Treasury Inspector Gen. for Tax Ad-
min., 2009-IE-R001, A Combination of Legislative Actions and Increased IRS
Capability and Capacity Are Required to Reduce the Multi-Billion Dollar
reports/2009reports/2009IER001fr.html (“Non-IRS estimates of the international
tax gap range from $40 billion to $123 billion. While there might be overlap be-
tween the IRS tax gap estimate and the international tax gap, it is doubtful that
the $345 billion estimate includes the entire international tax gap.”).
3. See Permanent Subcomm. on Investigations, Comm. on Homeland Sec.
and Gov’t Affairs, 110th Cong., Tax Haven Banks and U.S. Tax Compliance 1
4. See id. at 1–2.
agency transactions.”); 31 C.F.R. § 1010.350 (2011) (“Reports of foreign financial
irs.gov/businesses/small/article/0, id=148849,00.html (last updated Mar. 5,
2012); Ellen Wallace, U.S. Versus Switzerland Over Bank Details: New Battle Round
Opens (Update), GENEVALUNCH.COM (Sept. 5, 2011), http://genevalunch.com/
blog/2011/09/05/us-versus-switzerland-over-bank-details-new-battle-round-opens-
update (“The Fbar [sic] was originally designed as an anti-terrorism measure, but
to information-return penalties, as well as to penalties on any unpaid taxes.

The tax penalties include accuracy, delinquency and fraud penalties that can range from 20% to 75% of the underpaid tax. In addition, there are penalties for failure to file or falsely filing information returns such as . . . a Report of Foreign Bank Account ("FBAR"), and Forms 3520, 3520A, 5471, 5471, 926 and 8865. Some of these information return penalties can be quite large. For example, the penalty for willfully failing to file or falsely filing a FBAR can be 50% of the amount in the unreported account per year.6

Taxpayers who engage in intentional tax evasion typically do so by disguising their ownership of the offshore assets and failing to report on their tax returns ownership of the account or transactions in the account. The United States Senate Permanent Subcommittee on Investigations described several examples, including the following:

Mr. [Robert] Holliday [a client of a promoter who authored a how-to manual] transferred about $450,000 in untaxed income to an Isle of Man shell corporation he controlled in payment for non-existent feasibility studies. To make use of the funds placed offshore, Mr. Holliday paid his bills using a credit card issued by an offshore bank, directed the offshore companies to pay designated expenses, and instructed [his] Nevada [shell] companies to borrow money from his offshore entities. These efforts allowed Mr. Holliday to conceal his income from the IRS, while enjoying control and use of the money.7

The federal government has engaged in a number of well-publicized enforcement efforts in an attempt to collect back taxes owed on funds in these accounts and encourage future compliance with the federal income

it has in the past two to three years surfaced as a tool to find assets that might have slipped through the net."). Some tax attorneys have commented that many of their clients had never heard of an FBAR before the government started cracking down on FBAR noncompliance. David D. Stewart, IRS Voluntary Disclosure Program Gets High Marks from Practitioners, So Far, Tax Notes Today, Sept. 3, 2009, at 169-3. Some foreign residents were unaware even that they were U.S. citizens and thus subject to U.S. tax laws. See IRS Clarifies Scope of Offshore Voluntary Disclosure Initiative Deadline Extension, Tax Notes Today, Aug. 31, 2011, at 169–18 (providing examples of this situation and guidance with respect to the 2011 Offshore Voluntary Disclosure Initiative).


tax laws. Among those efforts are special “voluntary disclosure” initiatives run by the Internal Revenue Service (IRS), one of which ended in September 2011, and another of which began in January 2012.

Under a voluntary disclosure program, eligible taxpayers report their delinquent taxes in return for reduced penalties, a reduced likelihood of criminal prosecution upon detection of the evasion, or both. It is thus a form of “tax amnesty.” The 2012 offshore voluntary disclosure initiative is the third such program within the past few years.

It is difficult to measure the success of a voluntary disclosure initiative because, in the year of its implementation, a voluntary disclosure program, like any tax amnesty, is a boon to the federal fisc. But government actions also create incentives. The tax amnesty literature recognizes the risk that amnesties, especially repeated ones, will encourage taxpayers to believe that they can evade taxes currently, then come in later and pay a dis-
counted rate—unless the amnesty is coupled with increased enforcement.

This Article examines the advisability of continued use of voluntary disclosure initiatives as a tool in the fight against international tax non-compliance. Part II of the Article briefly discusses the history of IRS voluntary disclosure programs, focusing particularly on the offshore initiatives of 2003, 2009, 2011, and 2012. In Part III, the Article evaluates the government’s approach to voluntary disclosure of offshore evasion in light of the literature on optimal tax amnesties, finding that the offshore tax amnesties meet some but not all of the elements of an optimal amnesty. The Article concludes that the crackdown on offshore evasion has encouraged quite a number of taxpayers to make voluntary disclosures, but that the IRS’s repeated use of offshore voluntary disclosure initiatives may have diminishing returns unless the government continues to engage in well-publicized criminal prosecutions of tax evaders.

II. A BRIEF HISTORY OF VOLUNTARY DISCLOSURE

A. Voluntary Disclosure Generally

The IRS has a long history of encouraging voluntary disclosures of tax evasion. In 1919, the IRS had a policy not to criminally prosecute taxpayers making a voluntary disclosure. Although the policy was quickly amended to remove the commitment to forgo criminal prosecution, the IRS reinstated that policy from 1945 to 1952. The IRS abandoned the policy again in 1952 partly because it allowed taxpayers to claim immunity from prosecution regardless of the context of their voluntary disclosure.

Once the non-prosecution policy was withdrawn in January 1952, the IRS’s official position was that voluntary disclosure was merely a factor to be considered in whether to recommend a taxpayer for criminal prosecution. In 1962, the advent of automatic processing of tax returns raised

14. See Herman B. Leonard & Richard J. Zeckhauser, Amnesty, Enforcement, and Tax Policy, 1 TAX POL’Y & ECON. 55, 55 (1987) (“Current amnesties may have encouraged some citizens to believe that there will be future amnesties as well, reducing their incentives to keep current on their payments.”).

15. See id. at 65 (“A tax amnesty is almost inevitably coupled with increased penalties and enforcement efforts. . . . If strong sanctions are prerequisites for maintenance of guilt and conscience . . . then a tax amnesty could actually be part of a guilt-strengthening effort.”).


17. See id. at 403–04 (reviewing history of voluntary disclosure policy).

18. See Gerald P. Moran, Tax Amnesty: An Old Debate as Viewed from Current Public Choices, 1 FLA. TAX REV. 307, 317 (1992) (“There was also some concern about possible corruption by government officials arising from the discretion inherent in the original policy.”).

concerns on the part of some nonfilers that they would be detected.\textsuperscript{20} At that time, Commissioner Mortimer Caplin issued a news release stating, “[T]he question may arise whether a taxpayer’s voluntary disclosure of his willful violations will afford immunity against criminal prosecution. I want to reaffirm our existing policy in this regard. Even true voluntary disclosure of a willful violation will not of itself guarantee prosecution immunity.”\textsuperscript{21} Nonetheless, one commentator reports that “[d]espite the admonition that a voluntary disclosure did not immunize a taxpayer from criminal liability, an internal [IRS] memorandum disclosed that, at least from 1969 until 1974, the position of the Chief Counsel’s Office was that a timely, good faith disclosure was ‘dispositive’ of the prosecution issue.”\textsuperscript{22} In 1974, the IRS adopted a policy of considering the factors that triggered the taxpayer’s disclosure.\textsuperscript{23}

Currently, the Internal Revenue Manual (IRM) provides general voluntary disclosure provisions under the section titled Criminal Investigations—Other Investigations.\textsuperscript{24} The IRM provides that “a voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended.”\textsuperscript{25} It further states that:

A voluntary disclosure occurs when the communication is truthful, timely, complete, and when:

a. A taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his/her correct tax liability, and

b. The taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.\textsuperscript{26}

It goes on to define what constitutes a timely disclosure.\textsuperscript{27} In general, in order to be “timely,” a voluntary disclosure must occur before the taxpayer’s noncompliance is on the IRS’s radar.\textsuperscript{28}


\textsuperscript{21} Id. at 104.

\textsuperscript{22} McLeay, \textit{supra} note 16, at 406.

\textsuperscript{23} See id. at 406-07.

\textsuperscript{24} See IRM 9.5.11.9 (2011), \textit{available at} http://www.irs.gov/irm/.

\textsuperscript{25} Id. \textsection 1. The IRM further provides, “A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended. This practice does not apply to taxpayers with \textit{illegal source income}.” Id. \textsection 2 (emphasis added).

\textsuperscript{26} Id. \textsection 3 (emphasis added).

\textsuperscript{27} See id. \textsection 4.

\textsuperscript{28} More precisely, the IRM provides:

A disclosure is timely if it is received before:
In addition to this general voluntary disclosure regime, the IRS also periodically offers targeted voluntary compliance initiatives. For example, it offered one in 1992 for nonfilers. 29 With respect to offshore tax evasion, the IRS has offered a series of programs in the last decade. Each of these was connected with publicity about a crackdown on offshore evasion.

### B. Voluntary Disclosure of Offshore Tax Evasion

The first of the offshore voluntary disclosure initiatives was in 2003. That initiative was related to an offshore credit card project the IRS pursued starting in 2000. 30 That project involved serving “John Doe” summonses on major credit card companies, such as MasterCard and American Express, seeking records on foreign bank accounts. 31 For example:

On October 30, 2000, a U.S. District Court in Miami, Florida, authorized the IRS to issue John Doe summonses to MasterCard International and American Express. These summonses relate to accounts in Antigua, Barbuda, the Bahamas, and the Cayman Islands issued to U.S. customers for tax years 1998 and 1999. These John Doe summonses were designed to allow the IRS to secure information from a reasonably identifiable group—U.S.-based customers with credit card accounts in certain foreign countries—who may be using offshore bank accounts to evade U.S. taxes. 32

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A. The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation.

B. The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer’s noncompliance.

C. The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer.

D. The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).

Id.

29. See Moran, supra note 18, at 318 (“On September 30, 1992, the Internal Revenue Service issued a notice announcing the adoption of a special program to provide comprehensive support for the ten million nonfilers.”).


In 2002, the IRS served additional summonses on MasterCard International and Visa International. 33

The summonses produced a substantial amount of data, 34 but the data was not very complete. “The cardholder records obtained from the credit card companies did not include cardholder identifiers such as name or Social Security Number. In addition to the cardholder records from the John Doe summonses . . . the IRS issued merchant summonses for charge card transactions, which helped identify specific taxpayers.” 35 After collecting the information from the John Doe summonses, the IRS revised downward its estimate of how many credit card holders were involved. 36

Professor Keith Fogg explains that taking enforcement action based on the information obtained from the John Doe Summonses proved institutionally difficult for the IRS. For one thing, the “influx of data created a situation in which the IRS could not realistically pursue all of the individuals suspected of offshore credit card ownership.” 37 For another,

By the time the IRS gathered enough data to place cases in the hands of revenue agents, the cases were much older than “normal” cases placed into the audit stream. This meant that agents were receiving cases that would almost certainly have the three-year statute of limitations on assessment expire before the agents could complete their audits. Revenue agents receive much training and instruction on the importance of not allowing a statute of limitations to expire. Receipt of cases that almost by definition required them to complete a blown statute report did not sit well with the agents as a group or their managers. 38

Around the time of the service of the John Doe summonses, 39 “[i]n February 2003, the IRS announced its ‘Offshore Voluntary Compliance

33. Id.
35. 2003-30-160, supra note 30 (footnote omitted).
38. Id. at 462. He added, “[R]evenue agents with these cases generally needed . . . to mak[e] a fraud case . . . in order to keep the statute of limitations on assessment open.” Id. The government bears the burden of proving fraud. See I.R.C. § 7454(a) (2006).
39. See Fogg, supra note 37, at 464 (“The initial wave of credit card summonses occurred from October 2000 through December 2003.”).
Initiative,’ [(OVCI)] a program designed to allow taxpayers to step forward and ‘clear up their tax liabilities.’”40 It provided that the IRS would, “in appropriate circumstances, impose the delinquency penalty under section 6651, the accuracy-related penalty under section 6662, or both penalties against taxpayers that participate in the Offshore Voluntary Compliance Initiative.”41 The program waived the fraud penalty, the fraudulent failure-to-file penalty, and certain information return penalties otherwise applicable to participating taxpayers.42 In addition, participating taxpayers would not be criminally prosecuted.43

The IRS directly linked the offshore credit card project and the voluntary disclosure initiative:

OVCI is just one part of an on-going, multi-pronged effort by the IRS to counter offshore tax evasion.

A related, but separate component of the effort is the Offshore Credit Card Program (OCCP). This program stems from the John Doe summons investigation. Since October 2000, the IRS has issued a series of summonses to a variety of financial and commercial businesses to obtain information on residents who held credit, debit or other payment cards issued by offshore banks.

Investigators have been using records from the John Doe summons to trace the identities of people whose use of these payment cards may be related to hiding taxable income.

. . . .

In the weeks and months ahead, the IRS will continue working on the OVCI and OCCP programs. As part of this process, the IRS will continue its work to identify and pursue civil and/or criminal penalties against those engaged in improper offshore transactions.44

The 2003 voluntary disclosure initiative had an April 15 deadline,45 but, in June 2003, the IRS sent over 600 “last chance” letters to taxpayers it had identified as having offshore credit cards, offering them an opportu-

42. See id. § 2(1) (“[T]he Service . . . will not impose the civil fraud penalty under section 6663, the fraudulent failure to file penalty under section 6651(f), and information return civil penalties for failure to comply with sections 6035, 6038, 6038A, 6038B, 6038C, 6039F, 6046, 6046A, and 6048”); see also IR-2003-5, supra note 36.
44. IR-2003-95, supra note 43.
The 2003 initiative had some modest success, but less than the IRS initially thought. In July 2003, the IRS reported:

[C]urrent results show the initiative’s effectiveness:

- Taxpayers have already paid more than $75 million in taxes to the program.
- The $75 million figure will continue to grow because most taxpayers accepted into the program have until Oct. 15 to amend their tax returns and pay back taxes.
- OVCI applicants identified more than 400 offshore promoters. Of these, 214 promoters were previously unknown to the IRS, which helps the agency’s efforts to counter offshore tax evasion.
- While the program has led to $75 million in taxes collected, the cost of the OVCI program is approximately $2 million to date.

Subsequently, however, an investigation by the Treasury Inspector General for Tax Administration (TIGTA) undermined those results:

The IRS initially believed that upwards of $100 million in identified unpaid taxes were available for assessment. As of June 30, 2003, the IRS assessed only $3.3 million with only $744,546 having been collected. According to TIGTA, the largest assessment was for $375,000. . . . TIGTA also reported that the cost of the OVCI project has been estimated at $56 million.

The credit card initiative had limited success largely because the IRS was not prepared to audit all of the individuals it identified who did not participate in the voluntary disclosure initiative. However, the IRS did

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47. IR-2003-95, supra note 43.
49. See Joint Comm. on Taxation, JCT Describes Compliance Issues Affecting Offshore Accounts, TAX NOTES TODAY, Apr. 1, 2009, at 60–15 ("Then IRS Commissioner Mark Everson discussed the limited success of the OVCI initiative at a . . . hearing on August 1, 2006. Within his testimony, he stated ‘In reality, we did not have a good idea of the potential universe of individuals covered by this initiative. As a result, the incentive for taxpayers to come forward and take advantage of this initiative was diminished due to the fact that we did not have the ability to identify immediately and begin examinations for all non-participating individuals.’“ (quoting Written Testimony of Commissioner of Internal Revenue Mark Everson Before Senate Committee on Homeland Security and Governmental Affairs’ Permanent Subcommittee on Investigations Hearing on Offshore Abuses: The Enablers, The Tools and Offshore Secrecy, 109th Cong., August 1, 2006)).
identify over 400 promoters of abusive offshore financial arrangements. It also referred a few dozen cases to the Criminal Investigation Division for prosecution prior to the voluntary disclosure deadline.

A number of years went by before the IRS’s next voluntary disclosure initiative, which took place in 2009. That initiative was also in conjunction with a crackdown on offshore evasion. The crackdown focused on Swiss bank accounts, particularly those held at Union Bank of Switzerland (UBS):

Strained relations between Switzerland, a country with a long tradition of bank secrecy, and the United States began during the summer of 2008 when a disgruntled former UBS employee, code name Tarantula revealed that “he was part of a UBS team that made frequent trips across the Atlantic [to the United States] to aggressively market investment strategies to rich Americans” to evade the IRS.

“Tarantula” was Bradley Birkenfeld, a UBS “private banker.” Birkenfeld’s job had been to prospect for American clients. The Justice Department indicted him in 2008, and he pled guilty to helping an American billionaire evade federal income taxes.

Birkenfeld’s arrest prompted the Justice Department to investigate UBS. In June 2008, the Justice Department:

[F]iled a petition in the U.S. District Court for the Southern District of Florida requesting leave to file an IRS administrative summons with UBS asking the bank to disclose the names of all of its U.S. clients who have opened accounts in Switzerland, but for which the bank has not filed forms with the IRS disclosing the Swiss accounts. The court approved service of the summons on

50. See id.
51. See INTERNAL REVENUE SERV., IRS Release on Offshore Credit Cards, TAX NOTES TODAY, Mar. 13, 2003, at 50–8.
53. See id. Birkenfeld was Tax Analysts’ 2009 Person of the Year. See Year in Review: The 2009 Person of the Year, TAX NOTES TODAY, Jan. 4, 2010, at 1–3.
55. See Stewart, supra note 5. Birkenfeld was arrested in May 2008 when he returned to the U.S. from Switzerland to attend his 25th high school reunion. See Year in Review: The 2009 Person of the Year, supra note 53 (also noting that “Birkenfeld did not obtain immunity from prosecution in exchange for his disclosures” about UBS’s actions).
57. Seff, supra note 52, at 162.
UBS on July 1, 2008. . . . This John Doe summons represents the first time that the United States has attempted to pierce Swiss bank secrecy by compelling a Swiss bank to name its U.S. clients.\textsuperscript{58}

In 2009, the U.S. government charged UBS with conspiring to defraud the United States by assisting accountholders in evading the IRS.\textsuperscript{59} In February 2009, UBS signed a deferred prosecution agreement. “[U]nder the terms of the agreement, UBS will provide the U.S. government with the names of 200 to 300 U.S. clients of UBS’s cross-border business, exit the business of providing banking services to U.S. clients with undeclared accounts, and pay a total of $780 million in fines and penalties.”\textsuperscript{60}

At that time, UBS had not yet responded to the John Doe summons, so the U.S. government filed a petition in district court to enforce the summons.\textsuperscript{61} UBS objected, citing Swiss bank secrecy law among its reasons.\textsuperscript{62} The Swiss government stepped in, filing an amicus brief arguing that the United States could only obtain accountholder information via a request under the 1996 U.S.-Swiss tax treaty.\textsuperscript{63} In August 2009, the United States and Switzerland reached an agreement to treat the request as occurring under the treaty, as well as to sign a protocol amending the treaty and to have the U.S. government withdraw the John Doe summons.\textsuperscript{64} Under the agreement, the U.S. government received the names of 4,450 U.S. UBS account holders.\textsuperscript{65}

\begin{itemize}
\item \textsuperscript{59} DOJ Announces Deferred Prosecution Agreement with UBS, TAX NOTES TODAY, Feb. 19, 2009, at 31–32.
\item \textsuperscript{60} Laura Szarmach, Note, Piercing the Veil of Bank Secrecy? Assessing the United States’ Settlement in the UBS Case, 43 CORNELL INT’L L.J. 409, 411 (2010).
\item \textsuperscript{61} See id.
\item \textsuperscript{62} See id. Swiss bank secrecy focuses on protecting the financial information of accountholders. See Urs Martin Lauchli, Swiss Bank Secrecy with Comparative Aspects to the American Approach, 42 ST. LOUIS U. L.J. 865, 865 (1998) (“The Swiss approach to bank secrecy, simply stated, protects the right of bank customers to have their financial information remain confidential and enforces the banker’s duty to safeguard that right. If bankers fail in this duty, they are subject to criminal sanctions.”).
\item \textsuperscript{63} See Szarmach, supra note 60, at 411.
\item \textsuperscript{65} Wallace, supra note 5. Tax attorney Charles Rettig explained:
\begin{quote}
The criteria included the disclosure of accounts at UBS between 2001 and 2008 with a balance of more than 1 million Swiss francs, together with various types of custody accounts (including bank-only ac-
\end{quote}
\end{itemize}
Right around this time, in March 2009, the IRS announced the 2009 voluntary disclosure initiative for offshore tax evasion. Under the initiative, participating taxpayers were required to pay taxes and interest due on amounts in the account for the previous six years; either an accuracy-related penalty or a delinquency penalty on each of those six years; and a penalty of 20% on the highest account or asset value in that six-year period. The program also required participants to disclose information about their foreign accounts, including the names of the financial institutions they used and the names of their contacts at those institutions.

The 2009 initiative was timed to profit from the publicity about Birkenfeld and UBS: “Following the announcement in May 2008 that the Justice Department had indicted former UBS banker Bradley Birkenfeld, the IRS voluntary disclosure program saw a dramatic rise in taxpayers coming forward to turn over information on previously undisclosed Swiss bank accounts.” The 2009 initiative brought in about 15,000 disclosures—many times more than the approximately 1,000 that the IRS reportedly expected. In early 2012, the IRS reported that it had “collected $3.4 billion so far from people who participated in the 2009 offshore program, reflecting closures of about 95 percent of the cases from the 2009 program.”


67. See id.; see also Internal Revenue Serv., *IRS Issues Memorandum Outlining Penalty Structure for Voluntary Disclosure*, Tax Notes Today, Mar. 27, 2009, at 57–34 [hereinafter IRS Issues Memorandum]; Internal Revenue Serv., *IRS Releases FAQ on Voluntary Disclosure Program for Offshore Accounts*, Tax Notes Today, May 7, 2009, at 86–14 [hereinafter IRS Releases 2009 FAQ] (“The twenty percent penalty applies to all assets (or at least the taxpayer’s share) held by foreign entities (e.g., trusts and corporations) for which the taxpayer was required to file information returns, as well as all foreign assets (e.g., financial accounts, tangible assets such as real estate or art, and intangible assets such as patents or stock or other interests in a U.S. business) held or controlled by the taxpayer.”).

68. See Rettig, supra note 65.

69. Stewart, supra note 5.

70. Shulman Addresses IRS’s Strategic Priorities for the Future, Tax Notes Today, May 19, 2011, at 97–11 (releasing prepared remarks of I.R.S. Commissioner Douglas Shulman) [hereinafter Strategic Priorities].

71. IR-2012-5, supra note 10.
After 2009, the government continued to focus on pursuing offshore tax evasion. The IRS mined the data it received from the 2009 initiative.72 The government continued to prosecute UBS clients.73 In early 2012, it also indicted three private bankers from the Swiss bank Wegelin & Co.74 and a number of Credit Suisse bankers in the United States.75 The government also requested from other Swiss banks, including Credit Suisse, the names of U.S. account holders.76

In another widely publicized move, HSBC [a London-based banking and financial services organization] ended its foreign banking services for its wealthiest U.S.-resident customers. United States residents will now be served only by the bank’s wealth management division through its U.S. branch. The news came shortly after the DOJ announced an indictment implicating HSBC India.77

The U.S. government has also received information about offshore evasion from whistleblowers.78 Bradley Birkenfeld, who applied for

72. See Rettig, supra note 65.
74. See David D. Stewart, 3 Swiss Bankers Indicted for Hiding $1.2 Billion, TAX NOTES TODAY, Jan. 5, 2012, at 3–2 (“In its case before the U.S. District Court for the Southern District of New York, the Justice Department alleged that Michael Berlinka, Urs Frei, and Roger Keller helped conceal more than $1.2 billion in assets for U.S. clients. The government claims that the defendants used a website to solicit U.S. clients and sought to attract UBS customers whose accounts were scheduled to be closed after that bank announced that it was closing its U.S.-held offshore accounts as it faced investigations in the United States.”).
75. See Marie Sapirie, Practitioners Assess Offshore Initiative as Deadline Approaches, TAX NOTES TODAY, Aug. 15, 2011, at 157-1.
76. See id. After this request, Credit Suisse started informing “its U.S. private banking clients that their information is subject to disclosure under a treaty request made by the U.S. authorities.” See David D. Stewart, Credit Suisse Preparing to Report Client Data to U.S., TAX NOTES TODAY, Nov. 9, 2011, at 217-8. However, the Swiss Federal Administrative Court in Bern recently upheld an accountholder’s appeal, relying on the distinction under Swiss law between tax fraud, for which information exchange exists under the 1996 U.S.-Swiss treaty, and tax evasion, for which it does not. See David Jolly, Swiss Court Ruling Hampers a Tax Deal, N.Y. TIMES, Apr. 11, 2012, at B5.
77. Sapirie, supra note 75.
whistleblower status,\textsuperscript{79} was successfully prosecuted.\textsuperscript{80} However, practitioners have said that Birkenfeld’s prosecution had only “a ‘slight chilling effect’ on other would-be informants.”\textsuperscript{81}

In 2010, as another line of attack on offshore tax evasion, the federal government enacted the Foreign Account Tax Compliance Act (FATCA), as part of the Hiring Incentives to Restore Employment (HIRE) Act.\textsuperscript{82} In part, FATCA requires taxpayers to disclose foreign financial assets aggregating in excess of a financial threshold.\textsuperscript{83} The disclosure must be made in a statement attached to the taxpayer’s return; the IRS released Form 8938 for this purpose.\textsuperscript{84} This requirement may overlap with the FBAR, but it has a higher reporting threshold and includes non-cash assets.\textsuperscript{85}

FATCA also imposes obligations on foreign banks, requiring them to withhold 30% on United States-sourced payments to foreign financial institutions unless the bank enters into an information-disclosure agreement with the Secretary of the Treasury.\textsuperscript{86}

Because the choice to withhold rather than report is an institution-wide one, foreign banks with clients from different countries have an incentive to comply with FATCA, especially if some of

\textsuperscript{79} See David D. Stewart, Attorney in UBS Scandal Sees Reward Claim as Test of U.S. Whistle-blower Policy, TAX NOTES TODAY, Dec. 7, 2009, at 232-4 (“Dean Zerbe, national managing director for Alliantgroup and special counsel to the National Whistleblowers Center, discussed Birkenfeld’s claim in a December 3 interview. Zerbe explained that Birkenfeld filed a whistle-blower claim early on in the process of his cooperation with the IRS. He said that his role is to ‘perfect’ Birkenfeld’s claim.”)

\textsuperscript{80} National Whistleblowers Center Takes Issue with DOJ Prosecution of UBS Whistleblower, TAX NOTES TODAY, Apr. 8, 2010, at 67–30 (“The DOJ not only did not credit Mr. Birkenfeld with disclosure of the scandal, it actively prosecuted him. In other words, the bad guy was let go and the good guy is in jail.” (quoting statement by NWC Executive Director Stephen M. Kohn)).

\textsuperscript{81} Marie Sapirie, New Era of International Enforcement Follows UBS, TAX NOTES TODAY, Aug. 10, 2011, at 154-2 (quoting Scott D. Michel of Caplin & Drysdale).


\textsuperscript{83} See I.R.C. § 6038D (West 2010) (providing for threshold of $50,000, or higher amount determined by the Treasury Department); Temp. Treas. Reg. § 1.6038D-2T(a) (2011) (providing thresholds ranging from $50,000 to $600,000, depending on marital status and whether taxpayer lives in United States or abroad). The reporting requirement “is effective for tax years starting after March 18, 2010, which for most people will be their 2011 tax returns filed during the 2012 filing season.” IRS Releases Information DetailingRegs, Filing Requirements for Reporting Foreign Financial Assets, TAX NOTES TODAY, Dec. 16, 2011, at 242-25.


\textsuperscript{86} See Niels Jense, Note, How to Kill the Scapegoat: Addressing Offshore Tax Evasion with a Special View to Switzerland, 63 VAND. L. REV. 1823, 1849–50 (2010).
their non-U.S. clients would be taxed at less than thirty percent on their investment income or are evading their home country’s taxes completely. By choosing not to disclose under FATCA, a foreign financial institution in essence subjects all of its customers to a thirty percent tax on U.S. income. Since such a uniform tax may scare away clients, foreign banks have a strong incentive to comply. Although U.S. clients will lose their privacy protection, the institution’s other clients will remain unaffected by the institution’s compliance—they can continue to enjoy favorable tax treatment by the United States, while possibly avoiding their home countries’ taxes.\footnote{Id. at 1850.}

The effective date of this part of FATCA was recently extended, so that withholding obligations will begin in 2014.\footnote{See I.R.S. Notice 2011-53, 2011-32 I.R.B. 124 (“[Planned] regulations will provide that certain obligations of participating FFIs [Foreign Financial Institutions] will commence in 2013. Further, those regulations will provide that the section 1471(a) and section 1472(a) withholding obligations of withholding agents with respect to amounts described in section 1473(1)(A)(i) (U.S. source FDAP payments) will begin on January 1, 2014.”).}

Professor Morse explains that the withholding requirement may not really be enforceable.\footnote{Susan C. Morse, Ask for Help, Uncle Sam: The Future of Global Tax Reporting, 57 Vill. L. Rev. 529, 537 (2012) (explaining that “imposing a withholding tax could . . . require the commitment of international relations resources” and “produce unwanted capital market disruptions” and that “the United States lacks the jurisdiction to confirm directly that FFIs are in fact complying with their obligations under their agreements”). She suggests ways in which the United States government might maximize its enforcement of FATCA. See id. at 542–49.}

Nonetheless, and although it has not yet taken effect, this portion of FATCA has already had an impact:

The reporting and withholding requirements of the Foreign Account Tax Compliance Act have stung some U.S. taxpayers who live abroad: They have found themselves being unceremoniously dumped by their local banks in anticipation of what Scott D. Michel, a partner at Caplin & Drysdale, referred to as the coming “era of automatic disclosure.”\footnote{Sapirie, supra note 75.  Professor Morse explains: [N]on-U.S. FFIs might embrace compliance with FATCA as a positive reputational signal to clients and governments. This signal might grow in strength as more banks comply with the FATCA and as compliant banks increasingly commit to FATCA compliance through their very acts of due diligence and reporting. There are certain choices that U.S. policymakers can make to maximize the chance that FATCA will succeed as a reputational strategy. . . . But the success of this approach is far from certain. Morse, supra note 89, at 537–38.}

Despite the highly publicized crackdown on offshore evasion in 2009, some eligible taxpayers did not take advantage of the 2009 voluntary dis-
closure initiative. Some made voluntary disclosures under the general policy.\textsuperscript{91} Other taxpayers came in “quietly”—simply amending old returns and paying back taxes and interest,\textsuperscript{92} an approach the government discouraged.\textsuperscript{93}

Given the continuing volume of taxpayers coming in to disclose non-compliance regarding offshore accounts after the close of the 2009 initiative,\textsuperscript{94} the government perceived a need for another voluntary disclosure program.\textsuperscript{95} Accordingly, on February 8, 2011, the IRS announced the

\begin{itemize}
  \item \textsuperscript{91} See IRS Releases FAQ on Second Offshore Voluntary Disclosure Program, TAX NOTES TODAY, Feb. 9, 2011, at 27-19 [hereinafter IRS Releases 2011 FAQ] (“Is a taxpayer who previously sought relief under the IRS’s traditional Voluntary Disclosure Practice or who made a quiet disclosure before the 2011 OVDI was announced eligible for the terms of the 2011 OVDE?”).
  \item \textsuperscript{92} See IRS Releases 2009 FAQ, supra note 67 (“The IRS is aware that some taxpayers have attempted so-called ‘quiet’ disclosures by filing amended returns and paying any related tax and interest for previously unreported offshore income without otherwise notifying the IRS.”).
  \item \textsuperscript{93} See Jeremiah Coder, U.S. Gaining on Offshore Accounts, IRS Officials Say, TAX NOTES TODAY, Nov. 17, 2009, at 219-7 (“Arlette Lee, a special agent in the IRS Criminal Investigation division . . . . [W]arned that trying to make a quiet disclosure to avoid directly putting the government on notice of unreported offshore accounts could result in charges of tax evasion and filing a false tax return. ‘We want people to come through the program; if you don’t and take another route, this is what you potentially could be facing if we find out about you,’ she said.”); Bank Director Charged with Hiding Foreign Assets, Used Offshore Account to Conceal Income from IRS, DEP’T OF JUSTICE (May 19, 2011), http://www.justice.gov/opa/pr/2011/May/11-tax-642.html (“On its website, the IRS strongly encourages taxpayers to come forward under the Offshore Voluntary Disclosure Program and warns them that taxpayers who instead make silent disclosures risk being criminally prosecuted for all applicable years.”). At least one taxpayer who made a quiet disclosure was prosecuted. See id. (“According to the criminal information and plea agreement, on Oct. 6, 2009, following widespread media coverage of UBS’s disclosure to the IRS of account records for undeclared accounts held by U.S. taxpayers and the IRS’s Voluntary Disclosure Program, [Michael] Schiavo made a ‘silent disclosure’ by preparing and filing FBARs and amended Forms 1040 for tax years 2003 to 2008, in which he reported the existence of his previously undeclared account at HSBC Bank Bermuda.”). However, according to the indictment, Mr. Schiavo did not amend his 2006 return to report a taxable payment he had received until after an IRS special agent contacted him. See Bank Director Charged with Failure to Report Interest in Foreign Bank Account TAX NOTES TODAY, May 23, 2011, at 99-21 (discussing United States v. Schiavo, No. 11-10984 (D. Mass. 2011)).
  \item \textsuperscript{94} See Strategic Priorities, supra note 70 (“[S]ince [the 2009 initiative] closed, we’ve received an additional 4,000 voluntary disclosures from individuals with secret bank accounts from around the world.”); Paul Sullivan, Voluntarily Disclose Your Offshore Accounts, or Else, N.Y. TIMES, Aug. 27, 2011, at B5 (“[A]fter [the 2009 program] officially ended, thousands more came forward, flooding the I.R.S. enforcement system.”).
  \item \textsuperscript{95} See Sullivan, supra note 94 (“[I]t made sense from an I.R.S. perspective to offer a second round of disclosure . . . .” given the continuing volume of disclosures after the 2009 program closed); see also IRS Clarifies Scope of Offshore Voluntary Disclosure Initiative Deadline Extension, supra note 5 (“The IRS’s prior Offshore Voluntary Disclosure Program . . . . which closed on October 15, 2009, demonstrated the value of a uniform penalty structure for taxpayers who came forward voluntarily and reported their previously undisclosed foreign accounts and assets. . . .”)
\end{itemize}
2011 Offshore Voluntary Disclosure Program (OVDI). “The roughly 3,000 taxpayers who came forward after the [2009 program] ended will be eligible for the terms of the new OVDI.”

Under the 2011 OVDI, individuals voluntarily disclosing offshore bank accounts owed a 25 percent penalty on the highest aggregate account or asset balance from the years 2003-2010. For those who have offshore accounts totaling less than $75,000, the penalty was reduced to 12.5%. Taxpayers could also qualify for a 5% penalty if (1) they did not open the account, (2) had minimal contact with the account, (3) did not withdraw more than $1000 in any year covered by the OVDI, and (4) could establish that taxes were paid on the amounts they deposited. Foreign residents who did not know they were U.S. citizens could also receive the 5% penalty. Participants in the OVDI program also had to pay back taxes and interest for up to eight years as well as paying applicable accuracy-related penalties, delinquency penalties, or both. The program waived other penalties, including criminal prosecution. The program was scheduled to expire on August 31, 2011, but was extended to September 9, 2011, due to Hurricane Irene.

The 2011 program thus had a longer look-back period than the 2009 initiative did—eight years rather than six—so, taxpayers who did not participate in 2009 but did in 2011 did not get a “pass” with respect to the 2003 and 2004 tax years. This also means that the period included is determined that a similar initiative should be available to the large number of taxpayers with offshore accounts and assets who applied to IRS Criminal Investigation’s traditional voluntary disclosure practice since the October 15 deadline.

96. Sapirie, supra note 78.
97. See IR-2011-14, supra note 9; IRS Releases 2011 FAQ, supra note 67. The latter document explains:

The offshore penalty is intended to apply to all of the taxpayer’s offshore holdings that are related in any way to tax non-compliance. . . . The penalty applies to all assets directly owned by the taxpayer, including financial accounts holding cash, securities or other custodial assets; tangible assets such as real estate or art; and intangible assets such as patents or stock or other interests in a U.S. or foreign business. If such assets are indirectly held or controlled by the taxpayer through an entity, the penalty may be applied to the taxpayer’s interest in the entity or, if the Service determines that the entity is an alter ego or nominee of the taxpayer, to the taxpayer’s interest in the underlying assets. Tax noncompliance includes failure to report income from the assets, as well as failure to pay U.S. tax that was due with respect to the funds used to acquire the asset.

Id.
98. See id.
99. See Sapirie, supra note 78.
100. See id.
101. See IR-2011-14, supra note 9.
102. See id.
103. See OVDI Deadline Extended Due to Hurricane Irene, supra note 9 (discussing extension).
greater than the non-fraud statute of limitations periods. In addition, the general penalty rate in the 2011 program was five percentage points higher than that of the 2009 initiative. The 2011 initiative introduced a 12.5% penalty and provided for more generous application of the 5% penalty, but it extended the scope of both reduced penalties to participants in the 2009 initiative, thereby avoiding disadvantaging taxpayers who made a voluntary disclosure in 2009 rather than waiting until 2011.

In connection with the 2011 program, the IRS provided specific guidance on “opting out” of the penalty structure. “Opting out” involves participating in the initiative but making “an irrevocable election . . . to have his or her case handled under the standard audit process.” In other words, under an opt-out, a taxpayer has the penalties determined on an individual basis. While the one-size-fits-all penalties under the 2009 and 2011 programs are lower than what some taxpayers would face, they are higher than the penalties imposed for a non-willful violation of the FBAR requirements. One practitioner explained:

The [voluntary disclosure] penalty applied whether or not the taxpayer knew about the requirement to report the foreign account. . . . The programs assume that just because the taxpayer had unreported overseas assets, the taxpayer knew of his legal obligation to report the overseas accounts and to file an FBAR, a form many tax practitioners had not even heard of before 2008.

By opting out, a taxpayer takes the chance of a full audit and penalties in excess of what is being offered in the voluntary disclosure program. Although the words “full audit” strike fear in all taxpayers and tax professionals, those are chances worth taking when willfulness clearly does not exist.

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104. See I.R.C. § 6501(a) (West 2010) (providing general three-year period); I.R.C. § 6501(e) (West 2010) (providing six-year period for substantial omission of items). With respect to the eight-year lookback period in the 2012 initiative, one practitioner stated:

I think many taxpayers who did not act willfully, have strong reasonable cause arguments, and intend to opt out will reject the eight-year lookback period—which covers closed years for many taxpayers—and the required [statute of limitations] extensions, which the IRS cannot force upon a taxpayer outside the settlement initiative.


105. See IRS Updates FAQ on Second Offshore Voluntary Disclosure Initiative, TAX NOTES TODAY, Aug. 25, 2011, at 165-14; see also Sapirie, supra note 75.


Some practitioners praised the 2011 program as addressing concerns raised by the previous initiative.108 In 2011, the IRS reported that almost 12,000 taxpayers filed disclosures under the program.109 In early 2012, the IRS reported that it had received 33,000 disclosures under the 2009 and 2011 initiatives.110

Perhaps because of the high volume of disclosures in 2009 and 2011, and the fact that “[s]ince the 2011 program closed . . . hundreds of taxpayers have come forward to make voluntary disclosures,”111 the IRS announced an additional offshore voluntary disclosure initiative in 2012. The new initiative is very similar to the 2011 program, except that the highest penalty rate was increased from 25% to 27.5%, and the program was made indefinite.112 Thus, whenever taxpayers choose to come in under the 2012 program, the penalty will apply to “the eight full tax years prior to the disclosure.”113 Therefore, it appears that waiting could remove early tax years from the calculus. The IRS did warn taxpayers, however, that “the terms of the program could change at any time going forward. For example, the IRS may increase penalties in the program for all or some taxpayers or defined classes of taxpayers—or decide to end the program entirely at any point.”114

III. Are Voluntary Disclosure Initiatives Worthwhile for the Government?

As discussed above, the IRS’s voluntary disclosure initiatives are a form of tax amnesty.115 Under all three offshore voluntary disclosure initiatives, the government waived certain penalties, including criminal ones, in return for a disclosure of an undetected tax offense and payment of back taxes for a period of time and some civil penalties. There is thus compromise on both sides: The government collects more than it might otherwise have but less than theoretically it is entitled to, just as it does when it settles a civil tax liability through other means.

108. See Sapirie, supra note 78 (“Practitioners gave the announcement a warm reception. . . . The new penalty structure of 25 percent plus amended returns going back to 2003 ‘hits a good balance,’ said Scott D. Michel, a partner at Caplin & Drysdale.”).
110. See IR-2012-5, supra note 10.
111. Id.
112. See id.
113. Id.
114. Id.
115. For a further discussion of how the voluntary disclosure initiatives are a version of a tax amnesty, see supra notes 11–14, and accompanying text.
A. The Characteristics of an Optimal Tax Amnesty

As with most compromises, tax amnesties have both benefits and drawbacks.116 In an article about offshore tax evasion, Professor Craig Boise identified the benefits of tax amnesties as the collection of tax revenue, encouragement of future tax compliance by taxpayers who participate in the amnesty, and easing a transition to a more stringent enforcement regime.117 The first two goals are analogous to the goals of the Offer in Compromise program, under which the IRS may settle known tax liabilities for less than the full amount owed.118 The third goal reflects the fact that increased enforcement calls for a change in norms, and amnesties are a form of transition relief. In the offshore context, the U.S. government put a lot more people on notice about their tax obligations119 and accomplished major breakthroughs with respect to foreign bank secrecy, but attitudes do not change overnight.

Professor Boise explained in his article that tax amnesties have costs, as well. Those costs include undermining the perceived fairness of the tax system, diminishing the perceived seriousness of the crime of tax evasion, and creating expectations of repeated amnesties that thereby undermine ongoing compliance.120 In light of the pros and cons of tax amnesties, Professor Boise developed a very useful list of characteristics for an optimal tax amnesty. Such an amnesty should: (1) be accompanied by reform that will discourage evasion in the future; (2) be accompanied by greater enforcement; (3) be offered only once; (4) minimize perceptions of unfairness by not being offered to known tax evaders and waiving few penalties, ideally only criminal prosecution; and (5) not be relied on principally to raise revenue.121

In fleshing out these factors, Professor Boise points out that amnesties accompanied by statutory or administrative reforms bring in more revenue than those not accompanied by such reforms.122 They also are more likely to result in improved compliance.123 In part, that is because re-

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116. See Boise, supra note 12, at 696–705.
117. See id. at 696–701.
118. The author thanks Keith Fogg for the Offer in Compromise analogy.
119. See IR-2012-5, supra note 10 (“The IRS recognizes that its success in offshore enforcement and in the disclosure programs has raised awareness related to tax filing obligations. This includes awareness by dual citizens and others who may be delinquent in filing, but owe no U.S. tax. The IRS is currently developing procedures by which these taxpayers may come into compliance with U.S. tax law.”).
120. See Boise, supra note 12, at 701–05.
121. See id. at 705–11.
122. See id. at 705 (citing Ines Macho-Stadler et al., Tax Amnesties in a Dynamic Model of Tax Evasion, 1 J. of PUB. ECON. THEORY 439, 441 (1999); William M. Parle & Mike W. Hirlinger, Evaluating the Use of Tax Amnesty by State Governments, 46 PUB. ADMIN. REV. 246, 246 (1986)).
123. See Boise, supra note 12, at 705–06.
forms may alter the incentives that led to the noncompliance in the first place.124

In this regard, an amnesty offered in conjunction with a transition to increased enforcement of the laws subject to the amnesty may be particularly effective at raising revenue.125 Publicity about the increased enforcement is also important to increasing compliance.126 That increases the perceived likelihood that cheaters will be caught, and increases the incentive to come clean during the amnesty. This also highlights the importance of timing; increased enforcement, such as criminal prosecutions, and publicity about that enforcement, should precede an amnesty, so that taxpayers are aware of a stick as well as a carrot.127

Conversely, repeated amnesties are well known to collect less revenue128 and to threaten future compliance, as taxpayers perceive unfairness and anticipate further amnesties.129 The result may well be diminished compliance as taxpayers avoid being a “chump” complying while others do not,130 and anticipate an opportunity to comply later at a reduced cost.131

124. See id. at 705 (“After all, if the incentives within the tax system that prompted the tax delinquency remain in place following the amnesty, there is minimal likelihood that tax evaders will change their behavior over the long-term.”).

125. See Leandra Lederman, The Interplay Between Norms and Enforcement in Tax Compliance, 64 Ohio St. L.J. 1453, 1465 (2003) (“[E]conomic models of tax compliance counsel that increased audit rates and/or sanctions will increase compliance. . . .”); cf. Boise, supra note 12, at 706 (noting that “the failure of Argentina’s 1987 amnesty to generate significant revenue was largely attributed to the fact that it was not offered in conjunction with an increase in enforcement activity or any reforms of that country’s fiscal system”).

126. See Boise, supra note 12, at 706–07 (explaining that “[h]eightened tax enforcement efforts should be highly publicized in order to raise awareness among taxpayers and obtain the maximum signaling benefit,” and citing amnesties in California and New York as examples).

127. See Scott D. Michel & Mark E. Matthews, OVDI Is Over—What’s Next for Voluntary Disclosures?, 133 Tax Notes 369, 371 (2011) (“If the IRS wants people to come forward voluntarily, it needs to couple its VDP with well-publicized tax enforcement. . . . With the iron fist hammering away . . . thousands of people will come forward.”); cf. Boise, supra note 12, at 707 (“[I]n the months leading up to California’s 1984-85 amnesty, the State projected a tough and high-profile image on tax enforcement by publicizing criminal tax prosecutions and arrests, publicly seizing boats and luxury cars, and auctioning unusual seized property. . . . The State collected the fifth highest revenue total among states offering tax amnesties.” (footnote omitted)).

128. Boise, supra note 12, at 707 (“[E]vidence from both international amnesties and amnesties offered by the states indicates that repeated amnesties generate successively smaller amounts of revenue.”).

129. See id. at 708.

130. See Lederman, supra note 125, at 1487.

131. See Boise, supra note 12, at 708 (referencing a study that found that “the average level of compliance generally falls after an amnesty is given, and that this decline is most likely a result of taxpayer expectations of future amnesties, or the ‘anticipation effect’” (citing James Alm et al., Amazing Grace: Tax Amnesties and Compliance, 43 Nat’t. Tax J. 23, 24 (1990))).
Similarly, a focus on the fairness of the amnesty to the taxpaying public generally should help to minimize alienation and noncompliance by others.\textsuperscript{132} In addition, although Professor Boise does not focus on this, the design of the amnesty should be such that it is internally fair. That may mean treating differently situated taxpayers differently. One article explains:

One large group of taxpayers in OVDI #1 comprised persons whose foreign accounts were established by their parents or other family members, with the assets passing by gift or inheritance. Those taxpayers often had knowingly failed to disclose their accounts to their return preparers, and thus they did not report the accounts on FBARs or report the income on their returns. Many of them had family stories involving the Holocaust or political or economic oppression outside the United States. The persons who had opened the accounts originally were often foreign-born and had since died. The funds were rarely earned in the United States, and our clients often relied entirely on non-U.S. financial advisers.\textsuperscript{133}

These taxpayers may not warrant the same penalty as taxpayers who opened offshore bank accounts in an effort to evade taxes.\textsuperscript{134} Finally, Professor Boise argues that “an optimal tax amnesty should not be employed principally as a means to raise revenue.”\textsuperscript{135} In other words, although the net revenue raised by an amnesty is highly relevant, ex post, in evaluating the amnesty’s effectiveness, revenue-raising should not be the primary purpose of an amnesty ex ante. Instead, bringing taxpayers into compliance should be.

Although an amnesty typically brings in a large amount of tax dollars in a short time, it may raise less money than expected, particularly if it follows other relatively recent tax amnesties.\textsuperscript{136} In addition, some of what the government collects during an amnesty may have already been identi-

\textsuperscript{132} See id. at 709.

\textsuperscript{133} Michel & Matthews, supra note 127, at 373.

\textsuperscript{134} See id. (“To us (not to mention to our clients), that group was categorically different than the core tax evader who skimmed funds from a business and deposited them in an overseas account.”). The IRS provides a 5\% penalty for some taxpayers in this situation. See id. (“While IRS guidance would have reduced the penalty to 5 percent for some inherited or similar accounts, officials interpreted that guidance so narrowly that we joked about the mythical unicorn. We suspect that out of the thousands of participants in OVDI #1, very few received that 5 percent safe harbor penalty, even though a large component of the program involved inherited or gifted accounts.”).

\textsuperscript{135} Boise, supra note 12, at 711.

\textsuperscript{136} See id. at 710 (providing examples by noting that “[a]mnesties in North Dakota, Idaho, Texas, Kansas and Missouri each collected under $1 million.” (citing Alm, supra note 131, at 54)).
fied by the tax authorities. Amnesties also typically include a waiver of penalties in order to make the amnesty attractive, and that may represent forgone revenue. Moreover, it is difficult to determine the longer-term effects of an amnesty, which may include deleterious effects on future compliance.

B. Evaluating the Voluntary Disclosure Initiatives

Professor Boise’s framework provides a helpful context in which to evaluate the IRS’s offshore voluntary disclosure initiatives. Each of these initiatives—and the four amnesties as a group—meet most, but not all, of the factors developed by Professor Boise.

First, the voluntary disclosure initiatives were undertaken in conjunction with legislative and administrative reforms designed to target non-compliance generally, and offshore evasion in particular. Some of these efforts focus on increasing transparency of taxpayer information. Congress enhanced the federal whistleblower statute in 2006, and, in connection with its crackdown on offshore tax evasion, enacted FATCA. The IRS also strengthened its international audit process, such as through the credit card project it began in 2000. After September 11, 2001, the IRS also entered into tax information exchange agreements (agreements

137. See id. (explaining that "while nearly 30% of the revenue collected by New York as a result of its 1985-86 amnesty program was from tax liabilities for which the state had no information, the remaining 70% likely would have been collected anyway" (citing Bonnie G. Ross, Federal Tax Amnesty: Reflecting on the States’ Experiences, 40 TAX LAW. 145, 176 (1986))).

138. See id. at 711 ("[W]hatever short-term revenue gains are realized from a tax amnesty also will be reduced to the extent that the amnesty carries with it a waiver of penalties, which is the central attraction of most tax amnesty programs.").

139. See id. (noting that “[a] comprehensive 1995 study that evaluated Indian amnesties offered between 1965 and 1995 found that for all but a single amnesty, the adverse indirect effects overwhelmed the direct amnesty receipts” (citing Arindam Das-Gupta & Dilip Mookherjee, Tax Amnesties in India: An Empirical Evaluation (Ctr. for Institutional Reform & the Informal Sector, Working Paper No. 4, 1995))).


142. For a further discussion of the credit card project, see supra notes 30–35 and accompanying text.
with a foreign government to exchange tax and other financial information) with countries with which it had not previously had such an agreement.\(^\text{143}\) Second, all of the voluntary disclosure initiatives were accompanied by greater enforcement of the relevant tax laws. In fact, they have generally been in conjunction with special enforcement initiatives, as in the case of the crackdown on Swiss bank accounts. Moreover, those enforcement initiatives have been well publicized—a factor that is helpful in disseminating information about the increased enforcement.\(^\text{144}\)

However, the timing of enforcement in relation to the voluntary disclosure programs was not always ideal. Criminal tax prosecutions, in particular, tend to spur increased compliance.\(^\text{145}\)

\(^{143}\) See William M. Sharp, Sr. & Hale E. Sheppard, Privilege, Work-Product Doctrine, and Other Discovery Defenses in U.S. IRS’s International Tax Enforcement, 52 Tax Notes Int’l 377, 394 (2003) ("[I]mmediately following the September 11 tragedies, the IRS has executed a number of TIEAs in its effort to curtail what it considers abusive international tax transactions and also to counter global terrorism. The United States has recently executed TIEAs with the Cayman Islands, the Bahamas, the British Virgin Islands, Antigua and Barbuda, the Netherlands Antilles, Guernsey, the Isle of Man, and Jersey, and several others are under negotiation.").

\(^{144}\) See Steven A. Dean, More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime, 84 Tul. L. Rev. 125, 136 (2009) ("Like [double-tax] treaties, TIEAs employ a structure that assigns reciprocal rights and obligations between pairs of states. . . . Although TIEAs are formally reciprocal, because they typically exist between states that are profoundly different, their nominal symmetry tends to be illusory. In practice, one state is likely to need extraterritorial tax information covered by the TIEA while the other does not").

\(^{145}\) See Boise, supra note 12, at 706–07 (referring to publicity campaigns by New York and California, and the relative success of their amnesties); see also Marie Sapirie, News Analysis: More Written Guidance Needed as OVDI Deadline Nears, Tax Notes Today, Aug. 30, 2011, at 168-1 ("Interest in the OVDI has spiked in recent weeks after a slow initial response from taxpayers with offshore accounts to the announcement of the new program. Practitioners speculate that recent developments such as the announcement of the investigation of Credit Suisse Group in July and the renewed interest of the foreign press in the OVDI are contributing factors to the last-minute rush.").
conviction of offshore tax evaders—particularly if they are both numerous and publicized—should therefore be an effective way to encourage similarly situated taxpayers to pursue voluntary disclosure. Most of the criminal prosecutions came after the 2003 voluntary disclosure initiative.\textsuperscript{146} Even the 2009 and 2011 initiatives, though much more successful, preceded many indictments, prosecutions, and publicity suggesting that the U.S. government was going after more than UBS bank account holders.\textsuperscript{147} In that regard, the IRS’s announcement in early 2012 of an additional, and indefinite, initiative is not surprising.

Of course, these repeated voluntary disclosure regimes violate Professor Boise’s criterion that an optimal amnesty should only be offered once. The 2012 program is the third in a series since 2009 of amnesties focusing on offshore bank accounts and other assets.\textsuperscript{148} Moreover, it is actually the fourth offshore voluntary disclosure program since 2003.\textsuperscript{149} It is possible that the 2003 initiative reached a slightly different group of taxpayers from the later initiatives, however. Although the 2003 program was designed to reach “taxpayers who used ‘offshore’ payment cards or other offshore financial arrangements to hide their income,”\textsuperscript{150} it was closely connected with the payment card enforcement effort that preceded it.\textsuperscript{151} By contrast, the 2009 and 2011 programs, though of general applicability to offshore noncompliance,\textsuperscript{152} were closely linked with the crackdown on offshore bank accounts.\textsuperscript{153} The 2012 program was announced soon after the close of the 2011 program and is designed in a similar fashion.\textsuperscript{154} Nonetheless, since
all four initiatives focused on offshore tax evasion, there is substantial overlap among them.

Professor Boise pointed out that repeated tax amnesties bear the risk of raising considerably less revenue and undermining future compliance.155 However, Boise’s article does not focus on the specific design of successive amnesties. To its credit, the IRS has raised the general penalty level with each voluntary disclosure initiative, which should help discourage non-compliers inclined to wait for a better “deal.” However, in its most recent initiative, the IRS raised the penalty only slightly—from 25% to 27.5%—and provided the same eight-year window as the 2011 program. With no deadline to apply, taxpayers with high account or asset values in early years in the eight-year window could wait to apply until those years are out of the window, to receive a lower penalty. Of course, the IRS stated that it could change the terms of the 2012 program or end it at any time,156 but the problem is that repeated amnesties undermine the credibility of this threat.

There is also a risk that compliant taxpayers might feel like chumps in the face of a series of highly publicized voluntary disclosure programs. However, criminal prosecutions of taxpayers who come in voluntarily, coupled with the relatively high (and increasing) level of penalties included in the recent initiatives, should help reduce that risk. In addition, the voluntary disclosure initiatives generally were not open to known evaders, but rather only to taxpayers whose evasion was not already known to the IRS.157 The “last chance” letters the IRS sent to taxpayers in 2003 after the expiration of the program are an exception because those taxpayers were known to the IRS to be potentially eligible to participate in the offshore initiative. Allowing taxpayers already in the IRS’s sights to opt in late to an amnesty program may increase the revenue from that program but it does not send a strong enforcement message. Fortunately, the IRS has not repeated this approach with subsequent amnesties.

With respect to Professor Boise’s fourth factor, the voluntary disclosure initiatives do seem intended to raise revenue. However, that is not their only goal. One article explains the two goals of the 2011 initiative as

155. See Boise, supra note 12, at 707–08.
156. See IR-2012-5, supra note 10.
157. See Rev. Proc. 2003-11, 2003-1 C.B. 311, § 4.01(1) (2003), available at http://www.irs.gov/pub/irs-drop/rp-03-11.pdf (noting that taxpayer’s request to participate in 2003 program must have been received before any of four different events occurred, including beginning of IRS audit or criminal investigation of taxpayer); 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers, I.R.S., http://www.irs.gov/businesses/international/article/0,,id=235699,00. html (last updated Aug 29, 2011) (“If the IRS has initiated a civil examination, regardless of whether it relates to undisclosed foreign accounts or undisclosed foreign entities, the taxpayer will not be eligible to come in under the 2011 OVDI.”); see also Parillo & Coder, supra note 66 (“The reduced penalty scheme will be available only to taxpayers whose disclosure meets the ‘voluntary’ requirements set out in Internal Revenue Manual 9.5.11.9.”).
“to (1) incentivize noncompliant, eligible taxpayers to become compliant by setting forth a circumscribed and favorable penalty framework, as evidenced by the much reduced FBAR penalty compared to that of current law and (2) to recoup lost tax revenues.”

Thus, the revenue-raising goal may not be the government’s principal motivation, consistent with Professor Boise’s recommendation. In addition, the fact that the IRS increased the penalty level with each initiative seems reflective of a desire not to maximize short-term revenue at the expense of long-term compliance and is thus consistent with a program design that balances factors other than short-term collections.

Ultimately, the success of these amnesties will depend in part on their net collections and on whether they succeed in reducing the amount of offshore evasion in the future, which, in turn, likely depends in large part on the effectiveness and publicity surrounding criminal prosecutions. Unlike the Offer in Compromise program, under which taxpayers agree to be compliant for the next five years, or risk having the IRS try to collect the full amount that was settled, the voluntary disclosure regimes do not require any representations about future compliance. However, the voluntary disclosure programs are designed to allow taxpayers to come into compliance with respect to offshore assets and thereby be able to repatriate the funds in those accounts. To the extent taxpayers do that, they will not be relying on foreign bank secrecy laws to shield those amounts from the IRS in the future.

The longer-term effects the voluntary disclosure initiatives will have on compliance are much harder to measure than their short-term effects. The 2003 initiative may not have raised revenue, net of costs, even in the


159. See I.R.S. Form 656 (Offer in Compromise) (Mar. 2011) at 3, available at http://www.irs.gov/pub/irs-pdf/f656.pdf (requiring taxpayer to agree to statement, “I will file tax returns and pay required taxes for the five year period beginning with the date of acceptance of this offer, or until my offer is paid in full, whichever is longer. If this is an offer being submitted for joint tax debt, and one of us does not comply with future obligations, only the non-compliant taxpayer will be in default of this agreement.”). 160. See id. (“If I fail to meet any of the terms of this offer, the IRS may levy or sue me to collect any amount ranging from the unpaid balance of the offer to the original amount of the tax debt without further notice of any kind. The IRS will continue to add interest, as Section 6601 of the Internal Revenue Code requires, on the amount the IRS determines is due after default. The IRS will add interest from the date I default until I completely satisfy the amount owed.”).

short term, though it seems to have signaled to offshore evaders that the IRS had them in its sights, and laid the groundwork for future offshore enforcement and voluntary disclosure initiatives. The 2009 voluntary disclosure program reportedly raised the much higher amount of $2.2 billion, according to the IRS.

It is too soon to tell how much revenue the 2011 disclosure program will raise, though early indications are positive, and the IRS reported in early 2012 that it had collected “$1 billion from up front payments required under the 2011 program.”

Perhaps most important, in conjunction with its overall crackdown on offshore tax evasion, including criminal prosecutions, the 2009 and 2011 voluntary compliance initiatives have provided some cause for optimism:

It’s clear that the 2009 offshore voluntary disclosure program (OVDP) and the 2011 OVDI were huge successes. Tens of thousands of Americans participated in the programs. The IRS collected billions of dollars in unpaid taxes, interest, and penalties. Undeclared assets have been reported to the IRS and will be taxed for years to come. The landscape in tax enforcement has forever changed, and the Justice Department and IRS have broken the back of bank secrecy and obtained a treasure-trove of information that will provide fodder for criminal and civil investigations for the next 10 years.

Of course, as with any amnesty, it is hard to determine what effect it will have on taxpayer behavior in the longer term. Some newly compliant taxpayers may stay compliant, reporting earnings on offshore funds, as the IRS hopes. Other people may invest more resources in evasion, increasing enforcement costs for the IRS.

One practitioner, Robert McKenzie, found that while the vast majority of potential clients calling him have taken affirmative steps to create their offshore arrangements, the actual numbers of clients retaining him are more evenly split, with 40 percent seeking to disclose inherited accounts. From this, McKenzie concludes that those who have “af-

162. For further discussion of the 2003 initiative, see supra notes 41–42 and accompanying text.
163. See Trivedi, supra note 109.
164. IR-2012-5, supra note 10.
165. Neiman, supra note 107.
166. See Internal Revenue Serv., Taxpayers Face August 31 Deadline to Come Clean Under Offshore Voluntary Disclosure Initiative, TAX NOTES TODAY, Aug. 9, 2011, at 153-6 ("‘The time has come to get back into compliance with the U.S. tax system, because the risks of hiding money offshore keeps going up,’ said IRS Commissioner Doug Shulman. ‘Our goal is to get people back into the system.’"); Strategic Priorities, supra note 70 ("Collecting additional revenue for past misdeeds—as important as that may be—is not the main consideration here. It’s equally important that we’re bringing U.S. taxpayers back into the system . . . back into compliance . . . so they properly report and pay their taxes for years to come.").
firmatively taken steps are not as prone to decide to come into the voluntary disclosure program." 167
Another practitioner, Martin Press, termed this group the "risk-takers." 168 "This group is engaged in skimming or otherwise not reporting income received in industries such as international trade. Press said he believed that people in this group are the least likely to come forward under voluntary disclosure." 169 These practitioners’ experiences suggest that the IRS may be primarily collecting the low-hanging fruit:

"Given the difficulties the IRS has had in obtaining quality information on the accounts in question, including the UBS cases, it suggests to us that even fewer high-income taxpayers will come forward under the harsher [2011] initiative," [Gregory S.] Lynam [of the Ferraro Law Firm] said. "While it is great that the IRS is stepping up use of all of its enforcement tools, there is a danger that the IRS may focus on the little fish that voluntarily swim into the net." 170

Amnesties alone probably will never bring in the risk-takers. To target them, increased global financial transparency and criminal investigations and prosecutions seem to be key. As the government makes strides in those regards, its announcement of the 2012 voluntary disclosure initiative so soon after the end of the last one suggests that it thinks the risk calculus is changing. But it remains to be seen how successful the new program will be, and for what period of time.

IV. Conclusion

In recent years, the government has marshaled its forces in its battle against offshore tax evasion. Its well-publicized crackdown on the use of secret bank accounts appears to have encouraged a number of taxpayers to participate in the voluntary disclosure initiatives it has offered. The IRS structured the 2011 and 2012 offshore initiatives both to respond to concerns expressed by practitioners and to assure that taxpayers who waited to come in did not face a lower penalty structure than those who made a disclosure under an earlier initiative.

Repeated use of voluntary disclosure initiatives will likely result in diminishing returns, however. The IRS has wisely increased the general penalty each time, rather than offering the same or more attractive terms, which would encourage non-compliers to wait for a better deal, as well as undermining taxpayers’ perceptions of the fairness of the federal income tax system generally and the offshore compliance effort in particular. The

167. Stewart, supra note 5.
168. Id.
169. Id.
170. Sapirie, supra note 78.
IRS may have concluded that it has reached the limit on penalties for the moment, in that it has no specific deadline under the 2012 program. The lack of a deadline, however, may allow taxpayers to strategically time their disclosure to leave early years outside the eight-year window, where those are years with higher account or asset values.

Moreover, many of the taxpayers who have not already taken advantage of an offshore disclosure initiative may be “risk-takers” engaged in willful evasion who are gambling on continuing to go undetected. In light of this dynamic, the government’s best bet is to continue to press forward with obtaining names of U.S. account holders in jurisdictions with strong bank secrecy laws and to prosecute tax evaders criminally when appropriate.
ASK FOR HELP, UNCLE SAM:
THE FUTURE OF GLOBAL TAX REPORTING

SUSAN C. MORSE*

I. INTRODUCTION

The problem of tax evasion on principal placed in, and income earned from, offshore financial accounts is neither complicated nor subtle as a matter of law. Many jurisdictions’ income tax laws require residents to pay income tax on income earned from such accounts even though the accounts happen to be housed outside the taxing jurisdiction. But tax administrators lack the information necessary to enforce the law with respect to offshore accounts. These accounts largely remain hidden from tax administrators unless taxpayers self-report them. One estimate puts the resulting worldwide annual revenue loss at $255 billion, based on an assumption of $11.5 trillion total asset value in such accounts. Residence governments have strong incentives to address this information problem, but banking jurisdictions, often historically committed to strong bank secrecy laws, do not.

Third-party reporting by the banks and other large intermediaries that administer financial accounts solves the related information problem for domestic accounts held by U.S. taxpayers. Banks send reports of investment returns, such as interest and dividend income and gross proceeds from the sale of securities, to the U.S. government and to U.S. taxpayers. The compliance rate on such reported income exceeds ninety-five percent.

* Associate Professor, UC Hastings College of the Law. Many thanks to Itai Grinberg and Dick Harvey for helpful conversations and to the participants and commentators at the Villanova Law Review Norman J. Shachoy Symposium held in September 2011.

1. See Reuven S. Avi-Yonah, International Tax as International Law: An Analysis of the International Tax Regime 23 (2007) (“The residence rule [for imposing income tax on individuals’ investment income] is so widely followed and is incorporated into so many treaties that it can be considered part of customary international law . . . .”).

2. See Ronen Palan, Richard Murphy & Christian Chavagneux, Tax Havens: How Globalization Really Works 61–64 (2010) (calculating $255 billion from estimated total assets of $11.5 trillion, average annual return of 7.5%, or roughly $860 billion, and average tax rate of 30%).


4. See, e.g., I.R.C. § 6042 (2006) (requiring dividend reporting); id. § 6045 (requiring gross proceeds reporting); id. § 6049 (requiring interest reporting).

5. See Joel Slemrod & Jon Bakija, Taxing Ourselves 179 (4th ed. 2008) (reporting ninety-six percent compliance rate for dividend and interest income in United States, where reporting but not withholding requirements apply).
An ongoing United States attempt to address the offshore account problem exports the concept of third-party reporting by large intermediaries to the international context. The Foreign Account Tax Compliance Act, or FATCA, requires “foreign financial institutions,” or FFIs, to obtain and report information about U.S. account holders and submit to certain audit requirements. Otherwise, the law provides for a thirty percent withholding tax on U.S.-source portfolio income streams and gross proceeds from the sale of certain securities that produce U.S.-source portfolio income, regardless of whether those payments are made to U.S. or non-U.S. accounts at the FFI. FATCA follows a bank-to-residence government, or B2G, approach to global information reporting.

The European Savings Directive, or EUSD, also addresses the problem of offshore accounts held by domestic resident taxpayers. The EUSD uses a bank-to-bank jurisdiction-to-residence jurisdiction, or B2G2G, approach to global information reporting. Under the EUSD, a bank or other “paying agent” within the jurisdiction of a participating state must transfer information about interest payments made by the paying agent to the government of the participating state, which then reports the interest payment information to the government of residence of the beneficial owner of the interest payment. A few countries, such as Luxembourg, offer withholding at a rate of thirty-five percent rather than reporting. Withholding instead of reporting maintains bank secrecy.

The B2G approach of FATCA, which would cut non-U.S. governments out of the information reporting chain, has the advantages of greater simplicity and more latitude to develop broad and innovative reporting strategies. But FATCA almost certainly cannot solve the problem of U.S. taxpayers’ offshore accounts without the cooperation of non-U.S. governments. The United States will be reluctant to actually impose the statutory withholding tax for capital markets and international relations reasons. In addition, jurisdictional constraints and local legal constraints, including bank secrecy laws, prevent the United States from building an adequate method of ensuring the compliance of non-U.S. FFIs. Except to the extent that FFIs, their auditors, or both adopt FATCA compliance as a positive reputational signal, gaining the cooperation of non-U.S. governments is an essential piece of a FATCA implementation strategy.

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7. See I.R.C. § 1471.
10. See Susan C. Morse, Tax Compliance and Norm Formation Under High-Penalty Regimes, 44 Conn. L. Rev. 675 (2012).
A successful future for global information reporting based on the FATCA model thus almost certainly requires the United States to enlist non-U.S. governments. A 2012 framework devised by the United States and five European countries that anticipates B2G2G reporting provides one approach, which is formalized in U.S. model agreements featuring reciprocal and non-reciprocal reporting. The United States and the UK finalized the first bilateral agreement, including reciprocal B2G2G reporting, in September 2012. Other incremental steps toward multilateral cooperation also deserve consideration.

Part II of this Article describes the United States and European approaches to the problem of offshore accounts and cross-border information reporting. Part III explores three recommendations that would further the important goal of gaining non-U.S. government cooperation in the administration of the FATCA. In particular, Part III considers the tactics of simplicity, reciprocity, and side payments.

II. UNITED STATES AND EUROPEAN SOLUTIONS

A. The U.S. Approach: Bank-to-Residence Government

FATCA is a new solution to the old problem of U.S. domestic taxpayers evading tax on their income from offshore accounts. The recent


15. For example, the 1970 legislative history of the Bank Secrecy Act shows a concern for tax evasion through offshore accounts. See H.R. Rep. No. 91-975
path to FATCA’s enactment began around 2008, when the offshore account issue came into the public spotlight. The issue gained attention after the U.S. “qualified intermediary” (“QI”) program for non-U.S. banks revealed an enforcement problem for holders of offshore accounts.

From 2000 on, many non-U.S. banks and other financial intermediaries have operated under QI agreements with the U.S. government. The QI program primarily aims to ensure that the correct amount of tax is collected when U.S.-source investment returns are paid to non-U.S. investors. A non-U.S. bank that agrees to act as a QI may forward to U.S. intermediaries summary information about the treaty-based and other withholding positions of its client base, keep secret the identity of its non-U.S. account holders, and achieve the desired result of reduced withholding on U.S.-source investment returns paid to its accounts held by non-U.S. investors.

The QI program was not set up to provide information on U.S. investors to the U.S. government, despite the nominal requirement that QIs disclose U.S. account holders. The model QI agreement did not provide significant withholding penalties for payments to undocumented accounts, most notably refraining from imposing withholding on gross sale proceeds. It did not apply to accounts held by U.S. taxpayers if those accounts did not produce U.S. source income. It permitted diligence based on so-called “know your customer” rules developed to address (1970), reprinted in 1970 U.S.C.C.A.N. 4394, 4398 (“[I]t is grossly unfair to leave the secret foreign bank account open as a convenient avenue of tax evasion.”). The academic literature has considered this problem for some time. See, e.g., Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573, 1669 (2000) (noting problems posed by bank secrecy law and recommending an OECD-adopted uniform refundable withholding tax of “at least 40%”).

16. See Harvey, supra note 6, at 475–78 (describing 2008 Liechtenstein and UBS scandals and contemporaneous Senate Permanent Subcommittee on Investigations hearing and report).


18. Over 5,000 foreign banks, such as UBS, Credit Suisse, and Deutsche Bank, have signed QI agreements with the United States. See Letter from N.Y. State Bar Ass’n to Sen. Max Baucus et al. (Sept. 10, 2009), available at 2009 TNT 175-67.

19. These include interest and dividends paid on debt or equity issued by U.S. corporations or the U.S. government. See I.R.C. § 1441(b) (2006).


23. See Harvey, supra note 6, at 476 (identifying ability to designate accounts outside system as weakness of QI regime).
money laundering and related criminal law concerns. And, finally, the QI rules defined “beneficial owner” to include a corporation, a rule which permitted U.S. account holders to hide their U.S. identity.

Because the “beneficial owner” of an account was defined to include a corporation under the QI rules, a U.S. taxpayer could form a non-U.S. shell corporation, name the corporation as the account owner, and treat the account as owned by a bona fide non-U.S. person. The Swiss bank UBS, as well as, presumably, other non-U.S. banks, apparently openly advised its clients to avail themselves of this exit route. The U.S. government learned about these practices in part thanks to ex-UBS banker Bradley Birkenfeld, who offered information about his former employer’s practices including the formation of client shell corporations and the cross-border smuggling of cash and precious gems.

The United States criminally prosecuted UBS and reached a deferred prosecution agreement. It then pursued civil litigation against UBS which resulted in an agreement to disclose the identities of about four thousand U.S. UBS clients to the United States. The path to this disclo-

24. See Susan C. Morse & Stephen E. Shay, Qualified Intermediary Status, Act II: Notice 99-8 and the Role of a Qualified Intermediary, 28 TAX MGM’T INT’L J. 259, 262 (1999) (describing typical practice of country’s bank association guiding KYC rules to IRS approval for use in QI agreement). These rules might not look automatically through entities, for example, but restrict investigation to situations where criminal activity seems likely.


26. See UBS EXECD. BD. WEALTH MGMT. & BUS. BANKING, QI SOLUTIONS FOR SIMPLE AND GRANTOR TRUSTS “SWISS SOLUTION”—ALTERNATIVE TO BE APPLIED/THRESHOLDS 1 (2004) (recommending that “UBS . . . establish an underlying company in the Bahamas” where U.S. client account housed in “Swiss solution” trust exceeded certain threshold) (on file with author); UBS, QUALIFIED INTERMEDIARY SYSTEM: U.S. WITHHOLDING TAX ON DIVIDENDS AND INTEREST INCOME FROM U.S. SECURITIES 2 (2004) (noting that non-U.S. legal entities could claim reduced withholding rates under QI system and that certification with respect to any applicable limitation on benefits treaty article was required for reduced rates of dividend withholding, but not for portfolio interest exemption) (on file with author).

27. See Mark Hosenball & Evan Thomas, Cracking the Vault, NEWSWEEK, Mar. 23, 2009, at 32 (reporting Birkenfeld’s cross-border transport of diamonds in toothpaste tube).


29. See Lynnley Browning, I.R.S. to Drop Suit Against UBS Over Tax Havens, N.Y. TIMES, Aug. 27, 2010, at B6 (reporting that 2000 names had been disclosed and that United States expected disclosure of balance).
sure, which presented no small tension with Swiss bank secrecy law, involved the announcement of an agreement following a visit to Switzerland by Secretary of State Hillary Clinton, acquiescence by the Swiss Parliament, and the approval of Switzerland’s highest court. Meanwhile, the United States engaged in a high-profile and fairly successful campaign to persuade taxpayers to self-report their offshore accounts, which included the use of Reports of Foreign Bank and Financial Accounts, or FBARs.

The Obama administration then generated the idea of FATCA, which was initially proposed in May 2009 and passed, in modified form, in March 2010. The statutory and regulatory components of FATCA meticulously avoid various deficiencies of the QI program. FATCA’s provisions allow for significant withholding penalties on a broad range of payment streams, require that all accounts must be disclosed regardless of whether they produce U.S.-source income, impose relatively stringent dili-


32. See Lynnley Browning & David Jolly, Swiss Approve Deal for UBS to Reveal U.S. Clients Suspected of Tax Evasion, N.Y. TIMES, June 18, 2010, at B3 (reporting that Swiss legislature approved deal in lieu of pursuing national referendum).

33. Originally, the Swiss Federal Administrative Court held that the failure to file a W-9 with UBS for transmission to the U.S. tax authorities did not constitute “tax fraud and the like” and therefore did not meet a requirement under the 1996 treaty for an exception to bank secrecy protection. See Daniel Pruzin, Switzerland for Now to Hand Over Data on Only 250 Secret Accounts with UBS, BNA TAX MANAGEMENT WEEKLY REPORT 144–45 (Feb. 1, 2010). In July 2011, the lower court’s decision was reversed, preventing UBS account holders from claiming damages for breach of bank secrecy from UBS. See Emma Thomasson, Swiss Court Says Was Right to Give U.S. Bank Data, REUTERS (July 15, 2011), http://www.reuters.com/article/2011/07/15/ubs-idUSLDE76E12W20110715 (noting court’s view that U.S. indictment that could have resulted absent Swiss regulator’s order for handover of information “would have led to the bankruptcy of the bank which in turn would have caused serious and virtually uncontrollable economic repercussions for Switzerland . . . .”’ (quoting Federal Supreme Court of Switzerland)).

34. See Morse, supra note 10, at 710–18 (arguing that creative publicity and expectation-setting for appropriate penalties helped make offshore voluntary disclosure initiatives successful).


36. See Harvey, supra note 6, at 479–81 (relating initial concept of FATCA as expansion of QI system).


These provisions are remarkable innovations, and push existing law and practice in several ways.

First, FATCA broadens the scope of covered payments subject to its 30% withholding tax to include virtually all returns from financial investment accounts, and notably includes the sledgehammer of withholding on gross proceeds from the sale of securities. This is not consistent with the idea that the application of an income tax to sale proceeds should be limited to gain on sale, or the difference between the gross proceeds realized from the sale and the basis of the securities sold. One commentator has characterized FATCA as a penalty statute rather than an enforcement statute because it is not designed to reach taxable income.

Second, FATCA’s requirement for disclosure of accounts regardless of whether they generate U.S. source income or are held at an affiliate of a participating FFI broadens the existing idea that source withholding may be used to enforce taxes due to a source government by reason of its source jurisdiction. The source withholding idea is a cornerstone of the existing international tax system and lies at the heart of the QI regime. Under FATCA, the idea morphs, and the threat of source withholding on one set of accounts (those that hold securities that generate U.S.-source investment income) is used to prompt and enforce disclosure of another set of accounts (those owned by U.S. taxpayers). The first and second group of accounts may overlap only partially, or even not at all.

Third, FATCA refuses to allow FFIs to rely on documentation provided to them that asserts clients’ residence or tax status, but instead spec...
specifically requires extra diligence if certain indicia of de facto U.S. ownership exist in the materials provided in connection with the account.\textsuperscript{45} This departs from, or at least changes the interpretation of, the usual principle that withholding agents\textsuperscript{46} and tax preparers\textsuperscript{47} may rely on representations provided to them by the taxpayer absent an obvious reason to believe that such representations are incorrect.

Fourth, FATCA refuses to presume that a corporation is a taxpayer and beneficial owner. It requires reporting, for example, of accounts held by a foreign entity if more than ten percent of the equity in that entity is held by a U.S. person.\textsuperscript{48} This is consistent with the approach of the FBAR reporting rules, which require reporting for accounts over which a U.S. person has signatory authority, but it departs from the longstanding principle of U.S. federal income tax law that respects corporations as taxpayers.\textsuperscript{49}

FATCA’s status as a unilateral piece of legislation facilitated its innovations. U.S. policymakers immersed in the UBS case and responding to the revealed deficiencies of the QI regime crafted an audacious statute that goes right to the doors of FFIs to demand needed information.\textsuperscript{50} The United States’ decision to move the legislation without seeking consensus

\textsuperscript{45} For example, under proposed regulations, a U.S. address or telephone number or U.S. place of birth constitutes “reason to know” that non-U.S. documentation is inaccurate. See Prop. Treas. Reg. § 1.1471-3(e)(4), 77 Fed. Reg. 9022, 9027 (Feb. 15, 2012) (providing reason to know guidelines for U.S. withholding agents); id. § 1.1471-4(c)(4) (providing due diligence requirements for FFIs and adding other U.S. indicia). Diligence requirements are more stringent for larger accounts, see, e.g., id. and for later-opened accounts. See, e.g., id. § 1.1471-3(c)(8) (requiring additional diligence for accounts over $1 million); id. § 1.1471-4(c)(4)(ii) and (iii) (providing relief for certain pre-existing accounts at FFIs). The intergovernmental framework adopted by France, Germany, Italy, Spain, the United States, and the UK anticipates negotiation over due diligence requirements. See FATCA 2012 FRAMEWORK JOINT STATEMENT, supra note 12, at 3 (anticipating the “development of reporting and due diligence standards”).

\textsuperscript{46} See, e.g., Int’l Lotto Fund v. Va. State Lottery Dep’t, 800 F. Supp. 337, 342 (E.D. Va. 1992) (“The role of a withholding agent is ministerial in nature. The agent is not granted the discretion by the I.R.S. to conduct an audit-like inquiry upon submission of a properly completed Form 1001.” (citation omitted)), rev’d, 20 F.3d 589 (4th Cir. 1994).

\textsuperscript{47} See I.R.C. § 6694(a)(3) (2000) (providing that no tax preparer penalty is due if “there is reasonable cause for the understatement and the [preparer] acted in good faith”); Treas. Reg. § 1.6694-2(c)(4) (2008) (describing “good faith” standard to include consideration of actual knowledge of preparer and whether preparer’s normal procedures promote accuracy and include “methods for obtaining necessary information from the taxpayer”).

\textsuperscript{48} See I.R.C. § 1471(d)(1)(A) (defining “United States account” as “account which is held by one or more specified United States persons or United States owned foreign entities”); id. § 1471(d)(3) (defining “United States owned foreign entity” as entity with “substantial United States owners”); id. § 1473(2) (defining “substantial United States owner” as more than ten percent owner).

\textsuperscript{49} See supra note 25 and accompanying text (reviewing authorities regarding independent corporate taxpayer status).

\textsuperscript{50} See Harvey, supra note 6, at 479–82 (describing genesis of FATCA).
from banking jurisdictions sped up the process of enacting FATCA. And if FATCA’s streamlined information reporting channel does not involve non-U.S. governments, such governments should not be able to hold the system hostage, whether through intentional lack of cooperation or understandable logistical challenges.

But the United States almost certainly cannot enforce FATCA all by itself. First, imposing a withholding tax could produce unwanted capital market disruptions and require the commitment of international relations resources.\(^{51}\) Second, local legal barriers including bank secrecy law limit banks’ ability to disclose information about their account holders.\(^ {52}\) Third, the United States lacks the jurisdiction to confirm directly that FFIs are in fact complying with their obligations under their agreements.

The statute contemplates FFIs’ agreement to regular audits, and the model FFI agreement will likely require FFIs to use a certified firm, such as one of the Big 4 firms or one of their affiliates, to conduct the audit.\(^{53}\) These audit requirements push the responsibility for ensuring that FATCA’s requirements are met onto the local divisions or affiliates of audit firms, over which the United States also generally does not exercise jurisdiction, making direct enforcement impractical. The potential of the audit firm gatekeeper enforcement strategy for FATCA is limited by the extent to which audit firms perceive that compliance will attract reputational benefits (or noncompliance will produce reputational detriments) and by such firms’ capacity to execute their responsibility within the limits of local confidentiality requirements.

It is possible that FATCA may succeed under an expressive law and reputational signaling strategy. As I have written elsewhere, non-U.S. FFIs might embrace compliance with FATCA as a positive reputational signal to clients and governments.\(^ {54}\) This signal might grow in strength as more banks comply with FATCA and as compliant banks increasingly commit to FATCA compliance through their very acts of due diligence and reporting. There are certain choices that U.S. policymakers can make to maximize the chance that FATCA will succeed as a reputational strategy. For example, policymakers can consider strategies that reference reputation, have high salience, target management, and embrace incrementalism to foster

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\(^{51}\) See Morse, supra note 10, at 725–26 (outlining capital markets and international relations obstacles to imposition of FATCA’s withholding tax). U.S. government representatives have said that they want “transparency,” not withholding, to result from FATCA. See, e.g., Tom Braithwaite, U.S. Delays Reporting Rules for Foreign Banks, FIN. TIMES (July 15, 2011), http://www.ft.com/cms/s/0/fe2f7bae-ae49-11e0-844e-00144feabdc0.html#axzz1nQH7aEb7 (quoting IRS Commissioner Doug Shulman).

\(^{52}\) See Scratched by the FATCA, ECONOMIST, Nov. 26, 2011, at 86 (noting conflict between FATCA and other nations’ “data-protection laws”).

\(^{53}\) The QI agreement also takes this approach. See Rev. Proc. 2000-12, 2000 C.B. 387 § 10.

\(^{54}\) See Morse, supra note 10, at 729 (proposing reputation-signaling FATCA administration strategy targeting FFIs).
the development of a virtuous norm-development cycle.55 But the success of this approach is far from certain. Except to the extent that a reputational strategy works, the United States will require the cooperation of other governments to enforce FATCA.


The European approach to the problem of offshore accounts has taken a more multilateral tone compared to FATCA. Its centerpiece, the EUSD, applies to more than forty countries when combined with closely related and parallel agreements. These countries include twenty-seven EU member states, plus ten territories associated with EU member states and five other European states, including Liechtenstein and Switzerland.56 The core of the EUSD is its requirement that the competent authority, or national tax administration, of a jurisdiction must forward information about the interest income flows paid by banks located in that jurisdiction to the residence jurisdictions of the owners of the interest income.57

The “years of fierce debate” that preceded the adoption of the EUSD in June 2003 featured objections from EU members Austria, Belgium, and Luxembourg that they would not agree to the reporting requirement unless their banking industry competitor Switzerland—not an EU member—did the same.58 The EU negotiators resolved the debate by permitting countries to opt to impose a withholding tax on interest income, now set at thirty-five percent, in lieu of reporting.59 Relatively few countries permit withholding rather than reporting.60 When a country withholds, it keeps twenty-five percent of the withholding proceeds and pays over seventy-five percent to the beneficial owner’s residence jurisdiction.61

The weaknesses of the EUSD parallel some of the weaknesses of the roughly contemporaneous QI system, although the EUSD squarely aimed to address underreporting by domestic resident taxpayers while the QI system focused on taxpayers not resident in the United States. First, the


56. See EU Taxation of Savings: Rules Applicable, supra note 9 (describing scope of ESD).


59. See id. (describing compromise).

60. These include EU member states Austria and Luxembourg and five banking jurisdictions with parallel withholding agreements: Andorra, Liechtenstein, San Marino, Monaco, and Switzerland. Belgium now reports rather than withholding. See EU Taxation of Savings: Rules Applicable, supra note 9 (listing countries that withhold).

EUSD requires withholding only on “interest payments,” rather than reaching all types of income from financial investments. In addition, the EUSD permits reliance on the same kinds of documentation presented for purposes of know-your-customer anti-money-laundering laws. Finally, the EUSD, like the QI system, permits payers to recognize “legal persons” such as corporations as beneficial account holders. Thus the shell corporation workaround also avoids EUSD reporting and withholding obligations.

While Bradley Birkenfeld’s disclosures about UBS revealed the QI system’s deficiencies and prompted litigation against UBS in the United States, contemporaneous European events similarly disclosed the inadequacy of the EUSD. The EUSD simply did not ensure the taxation of European residents by their home countries, even when those residents held their interest-producing assets in banks subject to the disclosure or withholding requirements of the EUSD. In the most prominent example, Germany in 2008 launched a major investigation regarding up to four billion euros in funds held by German citizens in Liechtenstein banks. The investigation targeted a large number of prominent German taxpayers, many of whom held assets through shell entities.

European residence jurisdictions responded to the shortcomings of the EUSD in several ways. First, they stepped up audit activity, in one instance purchasing confidential bank data to assist the effort. Second, several residence jurisdictions struck bilateral deals with bank secrecy jurisdictions inspired by the withholding option offered by the EUSD.

62. See id. at art. 6 (defining interest payment). It is possible that nearly all offshore accounts pay some kind of bank deposit interest, so that the ESD could operate as a comprehensive requirement to disclose offshore accounts if the withholding option did not apply. But the narrowness of the definition raises a close substitutes problem. In other words, banks might substitute another form of investment income or fee relief for bank deposit interest if only bank deposit income is subject to reporting. Cf. Morse, supra note 10, at 691–92 (describing close substitutes problem in general terms).


64. See id. at art. 4(2) (providing that paying agents need not look through “legal persons”).

65. See, e.g., Vanessa Houlder, When There Are Fewer Places to Hide Funny Money, FIN. TIMES (Aug. 3, 2006), http://www.ft.com/intl/cms/s/1/99eb9e7c-2247-11db-bc00-0000779e2340.html#axzz25iu2Y6NG (reporting relatively small withholding tax collections under ESD and “[l]oopholes[ ] such as the exemption of trusts and companies”).


67. See id. (noting increased audit activity and recounting purchase of confidential bank data); see also Not-So-Safe Havens, ECONOMIST (Feb. 19, 2009), http://www.economist.com/node/13148143 (noting “intense pressure from Germany, France, Britain and a few others” on tax havens).

68. Germany and the UK have both struck agreements with Switzerland that provide for withholding and preserve secrecy. See Grinberg, supra note 3 (manu-
Under these agreements, banking jurisdictions would “in effect pay a fat fee” to residence jurisdictions, said to be equal to the withholding tax due on noncompliant accounts, “to avoid revealing clients’ names.”69 When clients’ names are kept secret, the residence government cannot further investigate their tax compliance, for example with respect to taxes due on account principal or on non-interest investment income.70

In 2008, the EU developed a proposal, still pending, to tighten the EUSD’s provisions.71 The EU’s proposal falls short of the U.S. FATCA provisions in several respects. It expands the scope of the EUSD to returns on certain financial instruments that economically substitute for interest payments, but it does not attempt to reach other investment returns, including gross proceeds.72 It does not impose expanded, tax-evasion-tailored diligence requirements based on indicia of connections with taxing jurisdictions. It provides that the owners of corporations may be treated as the beneficial owners of accounts nominally held by corporations, but these rules are limited by existing anti-money-laundering rules and diligence procedures.73 Finally, November 2012 marks the fourth anniversary of the proposal’s publication, and it has not become law.

In February 2011, a EU Directive regarding cooperation on direct taxation matters included the requirement that one member state automatically transfer to another member state information available to the tax

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70. See, e.g., Grinberg, supra note 3 (manuscript at 54); Simonian, supra note 68 (reporting that participants at G20 meetings “hint[ed] [that] Switzerland should do more”).


72. See id. at 19 (recommending amendments to Article 6).

73. See id. at 14–15 (proposing amendment to Article 2). The explanation states that the intent of the proposal is to apply anti-money laundering look-through principles to the beneficial owner definition and the proposal lists types of entities that paying agents must look through. See id. at 3–4, 28–40 (discussing proposed amendments).
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authorities of the first state.74 The Directive includes member state reporting requirements, for example applicable to information-sharing statistics, and anticipates a 2017 proposal “regarding the categories of income and capital and/or the conditions [of reporting], including the condition that information concerning residents in other Member States has to be available.”75 Like FATCA, this 2011 EU Directive is moving in the direction of automatic global information reporting,76 but it has made less progress than FATCA in setting forth the mechanics of how to achieve that goal and erecting an enforcement structure around it.

A system that permits withholding instead of reporting is generally less satisfactory to a taxing authority. There are at least two reasons for this. First, reporting, like withholding, should produce very high rates of compliance.77 Second, a tax authority may use reported information about the individual taxpayer to determine whether that taxpayer has fully complied with the law. Suppose, for example, there was a strong statistical correlation between taxpayers who had large offshore bank accounts and taxpayers who failed to pay tax on amounts they deposited in such accounts. Or, suppose that many offshore account holders reported some, but not all, of their offshore income. A system that provides the residence government with the identity of the offshore account holders allows that information to improve audit selection and increase the chance of successful audit.78

Though the EU approach lacks the boldness of FATCA, it has greater potential for good enforcement. This is so simply because the EU approach involves the banking jurisdiction governments, which have the power to enforce its provisions, so far as these provisions go. From the perspective of a tax administrator, the disadvantages of Switzerland’s decision to strike withholding tax deals on behalf of its banks include greater support for the goal of bank secrecy and the logistically difficult involvement of another party in the tedious project of crafting a working system. But a significant advantage is that the Swiss tax authority joins the project

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75. See id. at art 8.

76. See Grinberg, supra note 3 (manuscript at 34–35) (noting that this directive could lead to proposal including reporting of capital gains, dividends and royalties that would be generally consistent with FATCA).

77. Reporting is generally sufficient to assure very high compliance. See Slemrod & Bakija, supra note 5, at 179 (reporting very high rates of compliance when income is reported but not withheld upon).

78. Itai Grinberg has raised the question of whether developing countries, as well as developed countries, would prefer an automatic information reporting system to an anonymous withholding system. An automatic information reporting system permits a residence jurisdiction more control over its public finance system. See Grinberg, supra note 3 (manuscript at 65–70). An anonymous withholding system produces tax revenue without reliance on domestic audit and collection functions. Different residence jurisdictions may weigh these opposing benefits differently.
of achieving the tax collection goal. Also, the Swiss agreement to participate might provide a stronger starting point for reconciling a reporting law with Swiss confidentiality requirements.

FATCA features innovative provisions that adopt broad definitions of reportable payments, beneficial ownership, and diligence requirements. It may well represent best practices for many elements of a global information reporting system. But the lack of any involvement by non-U.S. governments in FATCA’s B2G reporting infrastructure makes FATCA enforcement unrealistic. U.S. tax administrators can improve the chances of FATCA’s success by seeking the cooperation and involvement of non-U.S. governments. Part III outlines three possible tactics: simplicity, reciprocity, and side payments.

III. RECOMMENDATIONS FOR U.S. POLICYMAKERS

A. Possible Forms of Non-U.S. Government Cooperation

The cooperation of non-U.S. governments with the endeavor of FATCA could come in several different forms. Cooperation could follow the mainstream EUSD B2G2G reporting model and transfer the obligation to report beneficial owner income streams from FFIs to the tax authorities of the jurisdictions where such FFIs operate. The Model Agreements developed by the U.S. in accordance with a multilateral framework follow this approach. Cooperation could also involve non-U.S. governments less formally in developing an approach to reconciling FATCA with other countries’ bank secrecy laws. For example, it could feature an agreement by a non-U.S. government to include a FATCA compliance checklist for examinations or reports required under domestic law, such as for securities, banking law, or third-party auditor licensing purposes. A non-U.S. government might permit U.S. government representatives access to FFIs for direct audit purposes. Or cooperation could

79. For a further discussion of FATCA, see supra notes 36–49 and accompanying text (describing FATCA’s provisions).

80. See FATCA 2012 FRAMEWORK JOINT STATEMENT, supra note 12 (noting parties United States, France, Germany, Italy and UK).

81. One appropriate goal would be state-of-the-art data encryption and other system design features in order to prevent the leakage of customer information outside government computer systems, rather than an agreement to withhold and maintain bank secrecy based on the Swiss Rubik model.

82. Options that would involve non-U.S. governments’ involvement in the enforcement of U.S. law assume that historic revenue rule constraints could be overcome. See William S. Dodge, Breaking the Public Law Taboo, 43 HARV. INT’L L.J. 161, 170–77, 202–06 (2002) (giving history of “revenue rule” refusal to enforce other countries’ tax laws and absence of mutual collection assistance provisions from tax treaties). The ESD, treaty-based information exchange, and other developments, including U.S. case law developments, suggest that the revenue rule would not preclude this type of intergovernmental cooperation. See, e.g., Pasquantino v. United States, 544 U.S. 349, 356, 364 (2005) (holding in five to four decision that scheme to evade Canadian excise taxes qualified as fraud under U.S. law and hence could support wire fraud conviction).
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consist of the non-U.S. governments’ adoption of diligence provisions,83 reporting provisions,84 or both that are similar to or borrowed from FATCA—thus aligning non-U.S. governments’ interests with U.S. interests without any explicit involvement of non-U.S. governments in U.S. enforcement of the FATCA rules.

In anticipating the development of a cooperative, intergovernmental system of automatic tax information reporting, policymakers must make regular choices between, on the one hand, accepting incremental agreements and anticipating further development of cooperation based on these incremental changes, and, on the other hand, striving to get things right the first time. Recent history in this area suggests the value of incremental change. The existence of QI laid the groundwork for FATCA within the U.S. political environment. The OECD’s tepid Tax Information Exchange Agreement program provides a building block upon which automatic information exchange may partly rest.85 The EU’s 2011 Directive shows evidence of halting progress from on-demand, to spontaneous, to automatic information sharing.

As Itai Grinberg has written, one model for incremental change is a “bifurcated” system. This approach would establish a compliance model for cooperative nations and a noncompliance model for uncooperative nations. A noncompliant nation’s banks would be subject to harsher rules, such as more onerous diligence and a real threat of punitive withholding.86

A bifurcated approach presents the risk that significant numbers of countries and non-U.S. banks will refuse to move into the compliance group on the terms offered. The nations negotiating intergovernmental FATCA agreements are generally developed nations with strong interests in collecting information about their residents’ offshore income.87 Other nations have different interests. For example, their interest in maintaining bank secrecy laws could be greater relative to their interest in collecting information on their residents’ offshore income.

In a one-jurisdiction context, the idea of forcing a choice between two menu options draws support from the fact that taxpayers must deal with

83. See Harvey, supra note 6, at 495 (“If several major countries agreed on customer due diligence procedures, . . . it could significantly strengthen the IRS’s hand when attempting to force a FFI to perform detailed due diligence procedures on its entire customer base . . . .”).
84. See id. (outlining multilateral FATCA system where each FFI would report to more than one residence country).
85. See Morse, supra note 10, at 702–07 (framing OECD harmful tax competition project as incremental expressive law effort).
86. See Grinberg, supra note 3 (manuscript at 86).
87. See, e.g., FATCA 2012 FRAMEWORK JOINT STATEMENT, supra note 12 (naming United States, France, Germany, Italy, and UK as parties).
the tax administration of the jurisdiction on some terms. In a multijurisdictional context, it may not work to force a choice between two menu options presented by a subset of the relevant jurisdictions because taxpayers might opt out of the menu altogether. U.S. taxpayers in the offshore account could opt out by seeking out banks that did not invest in U.S. securities. In addition, U.S. taxpayers might reasonably decide to try to call Uncle Sam’s bluff, gambling that the United States is really not prepared to impose punitive withholding on U.S. source income streams going to, say, Hong Kong or Singapore.

The balance of this Part III presents the cooperation strategies of simplicity, reciprocity, and side payments. In part, the discussion frames the course of ongoing negotiations over intergovernmental FATCA agreements based on the multilateral FATCA framework and the models presented by the United States. In addition, it provides a toolbox that could establish different cooperative objectives to further the goal of persuading as many nations as possible to join the project of automatic information reporting.

The strategies described here could accommodate an incremental pattern of reform in which initial compromises help to build commitment to the program of global reporting, which could later support modifications that expand reporting requirements, tighten diligence obligations or otherwise strengthen the program. The strategies could also accommodate a pattern of global information reporting development that varied from jurisdiction to jurisdiction.

B. Simplicity

The promise of FATCA lies in the possibility that it will become a model for an automatic global income tax information reporting system that effectively delivers bona fide beneficial owner information. The quality of FATCA reporting is important. Increasing the range of payments and accounts subject to reporting, expanding due diligence requirements, tailoring due diligence to the requirements of tax law rather than piggybacking on money laundering law’s risk assessment approach, looking through shell corporations, and other FATCA innovations increase the chance of producing high-quality beneficial owner reporting.

Yet greater simplicity would also benefit FATCA’s implementation. Effective non-U.S. government involvement in the implementation of FATCA—whether directly as part of the reporting stream, indirectly as enforcers of FFI compliance or FFI auditor compliance, or in parallel as users of the same rules for their own domestic tax enforcement pur-


89. See Morse, supra note 10, at 731–35 (advocating incrementalism due to its norm-building potential but noting countervailing factors including possible close substitutes, uncertainty, and public choice).
poses—will be easier if FATCA’s requirements are simpler.\footnote{Cf. David Jolly, For Americans Abroad, Taxes Just Got More Complicated, N.Y. Times (Apr. 15, 2012), http://www.nytimes.com/2012/04/16/business/global/for-americans-abroad-taxes-just-got-more-complicated.html?pagewanted=1&_r=2, (quoting practitioners as describing unfortunately complicated “shadow FBAR” form required to be filed by taxpayers including American expatriates as “monstrosity” that would “take a full Saturday to [complete]”).} Also essential is the delivery of the required information in an electronic form compatible with different countries’ and companies’ database and software systems.\footnote{See, e.g., OECD 2009 TRACE REPORT, supra note 11, at 32 (“[E]lectronic submission of documents is not a sufficient answer to the question of how to create an efficient system for making and granting claims for treaty benefits.”).}

One way to simplify the administration of FATCA is to provide exemptions to types of financial products and institutions that do not present a high risk of harboring tax-evading U.S. account holders. Some commentators describe this as “the primary area for negotiation” in the model intergovernmental FATCA agreements.\footnote{Sapirie & Parillo, supra note 14, at Annex II.} Annex II of the agreement between the U.S. and the UK exempts products like certain retirement funds, and institutions including the Bank of England and some financial institutions with a local client base and no non-UK fixed place of business, from FATCA requirements.\footnote{See U.S.-UK FATCA Agreement, supra note 14, at Annex II.}

As another example, FATCA implementation could take at least three approaches when describing required FATCA reporting. The first, minimal approach would restrict FATCA reporting to seven fields: (1) taxpayer name; (2) taxpayer address; (3) taxpayer identification number; (4) bank name; (5) bank identification number; (6) taxpayer account number; and (7) account value, for example the maximum during the reporting year. This is consistent with the statute, which conditions more detailed reporting requirements on the discretion of the Secretary of the Treasury.\footnote{See I.R.C. § 1471(c)(1)(D)(2010) (giving Secretary of Treasury discretion to decide whether to require reporting of receipts and withdrawals).}

This first approach achieves the delivery of the most important piece of information: that a domestic taxpayer holds an offshore account of a certain size. The taxpayer’s awareness of the government’s knowledge of the offshore account serves a useful function even absent specific income flow information. Relevant empirical and experimental research demonstrates that perceived opportunity to evade drives decisions to not report income from certain sources. A taxpayer need not believe that the government knows the precise amount of income flows in order to believe that there is a significant chance of getting caught because the government knows that the account exists.\footnote{For example, studies have demonstrated that tax compliance is higher for income received in the form of a check than for cash income. See Maryann Richardson & Adrian J. Sawyer, A Taxonomy of the Tax Compliance Literature: Further Findings, Problems and Prospects, 16 Austl. Tax Forum 137, 171 (2001) (citing studies);}
Second, the U.S. government could require reporting of income streams as defined under local law. This is the approach taken in the proposed regulations, which also give FFIs some ability to report in local currency rather than U.S. dollars.\textsuperscript{96} It may be that reporting of income streams as determined under local law does not add additional complexity to the reporting project, but that application of U.S. law, the currency conversion, or both would be particularly burdensome. If so, this compromise struck in the regulations is appropriate within the context of the goal of reaching cooperative solutions.

Finally, FATCA guidance could require reporting of income streams as defined under U.S. law, in U.S. currency. This would make automatic matching to tax return information easier.\textsuperscript{97} But the compliance advantage, as the regulations appear to acknowledge, is likely not worth the trouble of implementing the approach within the non-U.S. banks on whom the success of FATCA rests.

The 2012 FATCA framework also anticipates negotiation over reporting and diligence requirements. Perhaps there is a chance that this process could produce a simple, salient electronic reporting methodology. That should be an important and stated goal.

C. Reciprocity

One challenge facing a U.S. attempt to persuade non-U.S. countries to cooperate with its FATCA project of offshore information reporting is that the United States does not readily share account holder information with other countries. Different obstacles to information sharing appear in the cases of payments of U.S. source income to non-U.S. beneficial owners depending on whether the beneficial owners hold accounts at non-U.S. institutions or U.S. institutions. Despite these challenges, the multilateral 2012 FATCA framework\textsuperscript{98} and the finalized U.S.-UK agreement both feature reciprocity.\textsuperscript{99}

In the case of accounts maintained at non-U.S. institutions, it may be that no institution under U.S. jurisdiction has the necessary customer in-


\textsuperscript{97} Precise income flows can facilitate the automatic matching of specific items of income to specific lines on a taxpayer’s tax form. But different definitions of, for example, interest and dividends in different countries would make matching more difficult. \textit{Cf.} Martin A. Sullivan, \textit{Economic Analysis: Treasury Expects Billions from Credit Card Reporting Proposal}, 115 TAX NOTES 890, 891 (2007) (noting that automatic item matching requires separate listing on third party tax reports).

\textsuperscript{98} See FATCA 2012 FRAMEWORK JOINT STATEMENT, supra note 12.

\textsuperscript{99} See U.S.-UK FATCA Agreement, supra note 14, at Article 2.2.b (describing U.S. undertaking to report interest income and U.S.-source dividend and certain other income paid to UK reportable accounts).
formation. In particular, the QI program shields non-U.S. accountholder information from disclosure to any U.S. party, including both U.S. intermediaries and the U.S. government. Consequently, at least with respect to payments routed through QIs, the United States is left without the information needed to assist a non-U.S. government with the non-U.S. government’s project of combating tax evasion engaged in by its residents with respect to investment returns paid from U.S. sources into non-U.S. accounts.

In the case of accounts maintained at U.S. institutions, the example of Canada illustrates the possibility of automatic information sharing with another government. The United States-Canada tax treaty includes Article 26A, an addition to the usual U.S. model treaty form, which provides that “[t]he Contracting States undertake to lend assistance to each other in the collection of taxes.” A Treasury Regulation implements this treaty article by providing for automatic reporting of bank deposit interest “with respect to a deposit maintained [by a Canadian treaty resident] at an office within the United States.” Mexico has specifically requested similar reporting, and a U.S. regulation finalized in 2012 would require this sort of bank deposit reporting to all other countries’ residents.

Opponents of reciprocal measures like the nonresident bank deposit reporting regulation warn of reduced inbound deposits from nonresidents, decreased lending capabilities, and regional economic contraction. But the Treasury has stood its ground. For example, in a series of

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100. See Rev. Proc. 2000-12, 2000 C.B. 387, at § 6.01 (“QI is not required to disclose . . . any information regarding the identity of an account holder that is a foreign person . . . .”).


103. See Kevin Preslan, Note, Turnabout is Fair Play: The U.S. Response to Mexico’s Request for Bank Account Information, 1 GLOBAL B US. L. REV. 203, 224–26 (2011) (considering different ways to comply with Mexico’s request for automatic information exchange).


105. See, e.g., Lee A. Sheppard, Bank Interest Reporting, Finally, Maybe (Aug. 31, 2011), available at 2011 WTD 173-2 (LEXIS) (detailing objections to proposed regulation based on capital flight and other arguments and government’s “stern and
similar letters written to legislators concerned about reductions in inbound bank deposits, officials explained that reciprocity is key to the success of the government’s campaign against offshore tax evasion and that, after all, “the additional reporting requirements should affect only nonresidents who are not properly reporting interest income themselves in compliance with their home country’s laws.”

Capital flight concerns arise if account holders have the opportunity to shift funds to banks in other countries with not only bank secrecy, but also strong property right protections and stable governments, so that nonresidents are willing to bank there. Investment in U.S. banks may be sticky enough that capital flight is simply not a significant concern. But if policymakers were worried, they might consider coordination mechanisms to address this concern. For example, they might tie the effective date for U.S. bank deposit reporting to the effective date for FATCA adoption by a certain percentage of FFIs or a certain percentage of non-U.S. jurisdictions. Or they might make such reporting a part of ordinary course treaty negotiations. The negotiation of intergovernmental FATCA agreements provides another avenue to reciprocal information reporting.

D. Side Payments

Side payments are an important potential tool that might be used to induce non-U.S. governments to cooperate in the enforcement of FATCA. The EUSD withholding option, which features 75/25 revenue sharing between the residence jurisdiction and the paying agent’s jurisdiction, provides one example of a side payment that is closely related to the architecture of the tax itself.

Different forms of side payments have different advantages and disadvantages. A side payment that fully compensates withholding or reporting
agents for their costs may over-incentivize investment in withholding or reporting systems. A nonrefundable side payment that is unrelated to the project of withholding fails to properly motivate the parties responsible for building the system. Especially if there is no withholding tax, a side payment that shares revenue resulting from the cooperation of a particular government will face various accounting challenges including the identification of a baseline and the separation of increased revenue amounts resulting from the efforts of different governments.

Steven Dean has proposed one solution that strikes a promising balance between the advantages and disadvantages of different forms of side payments. Under Dean’s proposal, a residence jurisdiction (like the United States) would loan a banking jurisdiction (like Switzerland) the funds necessary to construct a withholding and reporting system. Then, the paying jurisdiction would keep a certain percentage of amounts withheld, presumably repaying the loan out of these amounts.

Dean’s loan model might be amended to accommodate different features of a system. For example, in a system that required reporting rather than withholding, the residence jurisdiction might forgive the loan based on a percentage of the amounts reported. More liability for possible failure of the withholding or reporting system could be assigned to the non-U.S. banks or governments by loaning less than the full cost of building the system. Loans from a consortium of residence jurisdictions could fund the initial construction of a system. Payment of maintenance and update costs could depend on audit access.

IV. Conclusion

The emerging U.S. FATCA system provides an innovative model for the future of offshore information reporting. But its bank-to-residence government, or B2G, model lacks a good enforcement mechanism, because the United States lacks jurisdiction over the non-U.S. banks and other foreign financial institutions targeted by the FATCA rules. In contrast, European nations’ approach to the problem of offshore information reporting takes a bank-to-bank governing jurisdiction-to-residence govern-
The FATCA implementation project should seek non-U.S. government cooperation. Despite the possibility that FFIs or local auditors might adopt FATCA for reputational signaling reasons, the United States should open the possibility of successful enforcement by presenting FATCA as a model for automatic global information reporting and building other nations’ commitment to the project. The greater involvement of non-U.S. governments could take several forms, including direct assumption of reporting responsibility, assistance in the project of reconciling FATCA’s requirements with client confidentiality rules, inclusion of FATCA compliance in criteria for government inspection of non-U.S. banks or auditors, or adoption of parallel due diligence and/or reporting requirements. The 2012 FATCA framework agreed to by the United States, France, Germany, Italy, and the UK, together with the negotiation over intergovernmental agreements based on U.S.-drafted models, provides an example of the kind of cooperative action possible under FATCA.

U.S. administrators of FATCA can use tactics based on simplicity, reciprocity, and side payments to encourage non-U.S. governments to support the FATCA project. Existing model agreements make use of the reciprocity tactic and, to some extent, the simplicity tactic. FATCA administrators might also use the simplicity, reciprocity, and side payment tactics in incremental and varied fashion in seeking the cooperation of different jurisdictions in the effort to build a global automatic tax reporting system.
THE USE OF FEDERAL LAW TO CURB EXCESSIVE EXECUTIVE
COMPENSATION: LESSONS IN PAST FAILURES
AND LESSONS FOR THE FUTURE

KATHRYN J. KENNEDY*

I. INTRODUCTION

WHEN one thinks of the use of legislative power to curb the size and
the type of compensation paid to executives, one normally thinks
such power is reserved to the states. That is, one tends to think that regu-
lating corporate governance falls within traditional state police powers.
However, while state courts have been willing to review the processes boards
of directors use in setting the size and type of executive compensation,
they have been less willing to review the actual results of such decisions.1
Hence, it is no shock that Congress continues to dabble in the area of
corporate governance in order to have an impact on the size and type of
executive compensation, especially with the recent meltdown of the finan-
cial institutions.

This Article begins with a discussion of Congress’s use of the Internal
Revenue Code (“I.R.C.” or the “Code”)2 over the past century to impinge
upon and change corporate behavior, particularly in the area of executive
compensation. Such a tactic is not startling due to the potential power of
taxation over executives and corporations, and the recent congressional
requirement that legislative initiatives be deficit-neutral in the totality.3

* Kathryn J. Kennedy is a professor of law at The John Marshall Law School
and Associate Dean for Advanced Studies and Research. This article is a
continuation of the dialogue raised in a previous article by Professor Kennedy,
Excessive Executive Compensation: Prior Federal Attempts to Curb Perceived Abuses, 10
Hous. Bus. & Tax. L.J. 196 (2010). The material in this Article was presented at
the Villanova Law Review Norman J. Shachoy Symposium, U.S. Taxation of Offshore
Activity, and Regulating Executive Compensation, held on Sept. 23, 2011.

1. See In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 705 (Del. Ch.
2005), aff’d, 906 A.2d 27 (Del. 2006). Here, the court focused on process instead
of results. The case involved a shareholder derivative suit alleging that the board
of directors committed waste and breached its fiduciary duties by approving an
employment agreement of a proposed president of the company without full dis-
losure of its terms and conditions, including a non-fault termination clause that
could result in a hefty severance package. Id. As the court was reluctant to judge
the board’s decision made ten years earlier in light of current “notions of best
practices,” it found in favor of the defendants. Id. at 697. Upon appeal to the
Delaware Supreme Court, the court affirmed as the shareholders had failed to
rebut the business judgment presumption, which focused on the quality of the
board’s process rather than the quality of its decision. See In re Walt Disney Co.
Derivative Litig., 906 A.2d 27, 56 (Del. 2006).

2. The Internal Revenue Code, 26 U.S.C., may be referred to as the “Code” in
the text and will appear abbreviated as I.R.C.

(codified in scattered sections of titles 2 and 15 of the U.S.C.). Here, Congress

(551)
However, Congress’s use of the Code has failed in this regard, resulting in further complexity of the Code and unintended consequences. As a result, we have seen a shift in the last decade on the part of Congress to use federal securities law to enact corporate governance rules, which focus the public spotlight on executive compensation. Congress hopes to cause public outrage over the size and type of executive compensation, resulting in a shift in the corporate culture. It is not unforeseen that Congress has used the federal tax code and the federal securities law to regulate in this area—the Code gets to the pocketbook of the executive and the corporation whereas the securities law uses disclosure and transparency to focus on the corporation’s actions. Whether the use of securities law will be successful or not is too early to tell.

II. HOW ARE EXECUTIVES PAID?

Before beginning a discussion about executive compensation, it is important to distinguish between the pay package that the typical employee receives and that which the typical executive receives. The typical employee is paid with salary, perhaps a year-end bonus, maybe overtime pay (if hourly), and benefits (e.g., health, retirement, severance, life insurance, and disability insurance). The predominant portion of the total pay package for the typical employee is their salary. The typical executive’s pay package is poles apart: mandated that direct spending and tax legislation be deficit-neutral in the totality. See JIM SAXTON, J. ECON. COMM., EXTENDING THE BUDGET ENFORCEMENT ACT: REVISIONS OF PAYGO RULES NECESSARY FOR BETTER TAX POLICY 3 (2002).

4. See I.R.C. § 7803(c)(2)(B) (2006) (requiring National Advocate to provide annual reports to Congress as to any legislative Code amendments). In 2001, the Joint Committee on Taxation surmised that there are in excess of 1,395,000 words in the Code. Id. Another study approximated the number to be 2.1 million by 2005, triple the number in 1975. See CHRISTOPHER M. PIETRUSZKEWICZ, THE COMPLEXITY OF THE TAX CODE, 28 NEWS Q., Spring 2009, at 12, 12. Using the Gini coefficient, which acts as a distributional measure, ranging from zero (each individual has equal share of income) to one (one person owns all income), Lynch states that the U.S. Gini score has risen to 0.47 in 2010 from 0.39 in 1968. Id. The thirty-nation Organization for Economic Cooperation and Development remarks that the rich-poor divide has increased by twenty percent since the mid-1980s, higher than any other developed nation. Id. In the article, the author quotes Raghuram Rajan, the IMF’s former chief economist, who criticizes countries with high levels of inequality as they contribute to “ineffective economic policies.” Id. This could account for the inaction in Washington D.C. Id.

The executive is paid a base salary, which amounts to about 10% of the overall pay package according to the 2010 Wall Street Journal (WSJ) and Hay Group CEO Compensation study;7

There may be signing bonuses and undoubtedly short-term bonuses (which could be based on meeting individual or group incentive goals), which can amount to around 20% of the overall pay package according to the study;8

There are long-term incentive pay awards in the form of stock options, restricted stock units, phantom stock awards, or stock appreciation rights (“SARs”), which can amount to about 60% of the overall pay package, according to the study.9 These benefits are tied to performance either by the executive, the employer, or both;

There are qualified and nonqualified benefits, which can provide the same retirement, medical, insurance, severance, and disability benefits extended to the general employee community, as well as enhanced benefits that cannot be paid through those plans due to maximum limitations and nondiscrimination requirements imposed by the Code; and

Finally there can be perquisites unavailable to the typical employee community but extended to executives (e.g., use of corporate aircrafts, club memberships, personal loans at favorable interest rates, relocation expenses, enhanced health benefits and executive physica, and tax gross-ups (i.e., additional taxes owed by the executive because of the specific compensation that is paid by the corporation)).10

7. The Wall Street Journal/Hay Group Survey of CEO Compensation, WALL ST. J. (May 8, 2011), http://graphicsweb.wsj.com/php/CEOPAY11.html. This study examines 350 U.S. public companies that filed proxies between May 1, 2010 and April 30, 2011. Id. The median CEO base salary was $1,127,363 as compared to the median CEO total direct salary of $9,271,865. Id.

8. See id. The median total CEO annual cash award was $3,354,950, which included a base salary of $1,127,363, as compared to a median CEO total direct salary of $9,271,865. Id.

9. See id. Median long term CEO incentives were $6,234,834 as compared to the median CEO total compensation of $10,273,500. Id. The option of equity-based awards goes further than the basic compensation strategy. These options have different implications such as: accounting and financial reporting issues, tax-related issues (for the employer and the employee), SEC disclosure requirements, as well as the possible impact on the company’s stock. Analyst Michael Brush reported that three of the most overpaid CEOs during 2010 were: Philippe Dauman of Viacom, who earned $84.5 million; Larry Ellison of Oracle, who earned $70 million; and John Hammergren of McKesson, who earned $54.4 million. Michael Brush, CEOs Got a Big Raise; How About You?, MSN MONEY (May 30, 2011), http://money.ca.msn.com/investing/michael-brush/ceos-got-a-big-raise-how-about-you.

10. See Executive Perquisites: A Changing Landscape, HAY GROUP, http://haygroupnews.com/ve/7460b881b63Zbh6/VT=0/page=4 (last visited Mar. 16, 2012) (taking selection of 200 companies with revenues over $5 billion). “All but nine of the companies disclosed that they provided at least one perk to their executives.” Id. Six of the companies provided no perquisites, whereas three companies noted no perquisites below the aggregate value mandated to be revealed. Id. The WSJ
Since the base pay is an insignificant part of the executive’s overall pay package and is usually unrelated to the executive’s or company’s performance, Congress has largely targeted the short-term and long-term incentive components paid to executives, as well as the use of retirement benefits and severance benefits.

There has been a lot of commentary as to why executive compensation has increased exponentially over the past decades in comparison to the typical employee’s compensation. There are a number of answers to that question, including: changes in the federal income tax legislation (as will be discussed later in the Article);\textsuperscript{11} increased use of stock options as long term incentives due to their initial favorable accounting treatment and the employer’s view that such awards were a low-cost method of compensation;\textsuperscript{12} decreases in the maximum limitations on benefits and contributions under qualified retirement plans, resulting in more benefits in nonqualified retirement plans to make the executive “whole” with respect to such benefits;\textsuperscript{13} and external corporate hiring—as opposed to internal—which generally results in higher pay packages to “make whole” the executive as to benefits left behind with the prior employer.\textsuperscript{14}

III. USE OF THE FEDERAL INCOME TAX CODE

This next section will review, in chronological order of enactment, congressional use of the Code to curb the level of executive compensation and influence the type of executive compensation—all with unintended consequences. The section will begin with I.R.C. § 162(a) enacted in 1918 and proceed to § 280G and § 4999 enacted in 1984 and 1986, respectively, § 162(m) enacted in 1993, § 409A enacted in 2004, and end with § 457A enacted in 2008.

A. I.R.C. § 162(a)

I.R.C. § 162(a) permits business entities to take a deduction for both “ordinary and necessary” business expenses, and for reasonable salaries

\begin{itemize}
  \item study done in 2009 calculated that the most common perquisites given to the executives were: corporate jets (66%), financial planning (58%), company autos (52%), tax gross-ups (46%), and executive physical exams (40%). \textit{Id.} Due to pressure from institutional investors and shareholders, companies now analyze executive perquisites to make sure there is a link between these perquisites and corporate performance. \textit{Id.}
  \item 12. See \textit{id.} at 39.
  \item 14. See Jensen et al., \textit{supra} note 11, at 34.
\end{itemize}
paid for personal services rendered. This same standard is used for justifying the deduction of deferred compensation payments for executives, even though that deduction may be deferred in time.

Assuming that services have been rendered, the issue of “reasonableness” is then raised in order for the entity to claim the deduction. This issue will later become critically important to privately held or closely held entities as the Code will continue to impose a “reasonableness” standard on all base pay, which is not subject to the $1 million cap imposed under I.R.C. § 162(m), as will be discussed later in the Article. The Internal Revenue Service (the “Service”) uses an objective test. The IRS Revenue Manual lists twelve different factors in ascertaining reasonableness. The courts have fashioned as many as twenty-one factors, resulting in a case-by-case analysis. That fact-intensive analysis has made it harder for the Service to audit and track.


18. See id. Such amount would ordinarily be paid for like services by like enterprises under like circumstances.

19. Internal Revenue Serv., Internal Revenue Manual § 4.35.2.5.2.2 (2006), available at http://www.irs.gov/irm/part4/irm_04-035-002.html#d0e212 (stating relevant factors for ascertaining reasonableness as: nature of employee’s duties, background, expertise, and knowledge of business; size of employer; employee’s contribution to employer’s profitability; time spent with employer; local and general economic conditions; employee’s character and extent of responsibility; when compensation is determined; relationship between shareholder’s compensation to stockholdings; whether compensation is in full or in part for assets purchased; and comparison of amount paid by similarly situated employers to similar employees for comparable services).

20. See Mayson Mfg. Co. v. Comm’r, 178 F.2d 115, 119 (6th Cir. 1949) (listing eight factors). These factors are:

[T]he nature, extent and scope of the employee’s work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; ... the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.


21. See Perlmutter v. Comm’r, 373 F.2d 45, 47 (10th Cir. 1967).
The courts, especially the Seventh Circuit Court of Appeals, have also raised the issue of whether courts should decide what constitutes reasonable compensation. The end result, however, is that denying the deduction simply hurts the employer—instead of the executive—and thus has little impact on reducing the size of executive compensation. This obviously depends on the extent to which the employer and executive agree to share the lost deduction. But, I.R.C. § 162(a)’s overall application to curb the size of executive compensation has been largely ineffectual.

B. I.R.C. §§ 280G and 4999

Due to the outbreak of mergers and acquisitions in the early 1980s, Congress perceived that executives were being unduly protected by enhanced severance packages that were payable in the event of a hostile takeover. A corporation’s board of directors guaranteed these enhanced severance packages as a tactic to incentivize executives to ward off a hostile takeover in order to keep their position. Of course, such arrangements could also be designed to incentivize the executives to agree to the acquisition, assuming that was in the best interest of the corporation, regardless of the executive’s self-interest. Such arrangements were referred to as “golden parachutes,” as they were apart from the typical severance arrangements paid to executives, and instead paid enhanced severance arrangements as a result of a change in control of the employer. Thus, through the enactment of I.R.C. § 280G, Congress deemed that severance payments in excess of three times base pay were “golden parachute payments” for purposes of the Code, and therefore would be nondeductible to the employer—through I.R.C. § 280G—and result in a 20% excise tax payable by the executive through I.R.C. § 4999.

To no surprise to the benefits community, these changes caused a variety of unintended consequences:

22. See Menard, Inc. v. Comm’r, 560 F.3d 620, 622–23 (7th Cir. 2009). The court held that although courts had tried to make uniform the multifactor reasonable salary standard, it remained opaque and awkward in application. Id. The court found the standard lacking in providing a neutral basis for a judicial analysis. Id. See generally Jones v. Harris Assoc., 537 F.3d 728 (7th Cir. 2008) (deciding whether courts are best arbitrators as to what is reasonable compensation).


Three times base became the new parachute payment minimum for most executives, thereby increasing the overall executive package;\(^26\)
Employers began to offer “tax gross-ups” as new benefits for executives—i.e., reimburse the executive for the additional excise taxes due on the parachute payment—to lessen the blow for the executives;\(^27\) and
Companies in danger of a takeover became more helpless and felt compelled to offer larger compensation packages to compete, making some companies more open to altering the date of the executive stock options (back-dating the option prior to the stock value increase or post-dating the option in anticipation of a loss).\(^28\)
Since the original passage, the use of parachute payments by boards of directors has flipped—they now incentivize executives to welcome takeovers, rather than resist them.\(^29\) But such use can be protective of executives who act in the best interest of the corporation and its shareholders regarding a takeover. The amount of such packages also continues to be noticed by the public, especially in light of the economic turmoil, as four highly profiled Chief Executive Officers (CEOs) could each receive parachute payments of $50 million or more, and four other CEOs could each receive such packages of $30 million or more, as of November 2011.\(^30\)

C. **I.R.C. § 162(m)**

In 1993, Congress again corralled the size of executive compensation that could be paid with the enactment of subsection (m) to I.R.C. § 162.\(^31\)

In an effort to tighten the tie between compensation and performance for publicly held corporations,\(^32\) Congress imposed a $1 million cap on the

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27. Companies use this practice of tax gross-ups to give executives the same compensation as if the executives were not assessed taxes/excise taxes on that income. See Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 139–40 (2001) (noting full gross-up would include executive’s reimbursement for excise tax on golden parachute payments and taxes on gross-up).
30. See id.
32. See H.R. Rep. No. 103-111, at 646 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 877. “[T]he amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced” by the cap to limit compensation. *Id.*
employer’s deduction for executive compensation that was not performance-based.33

Again the benefits community saw unintended consequences resulting from such legislation:

• Executives’ base salary of $1 million became the new standard as its deductibility would not be questioned;34
• There began a real growth in stock option awards as they were considered to be performance-based;35 and
• Using stock option awards changed the executive’s perspective from that of a long-term perspective based on the employer’s financial growth to that of a short-term perspective based on the changes in employer stock.36

The Joint Committee of Taxation examined Enron’s executive compensation practices in the wake of that scandal.37 Enron had a pay-for-performance attitude toward executive compensation,38 relying heavily on the use of stock options. While most of the executives’ compensation was performance-based, Enron did compensate a noteworthy amount of base pay that was nondeductible because it exceeded the $1 million cap—in fact, 11% of compensation for executives was nondeductible.39 The Joint Committee concluded that Congress’s $1 million deduction cap did not accomplish its goal and in fact recommended its elimination.40 The Joint Committee also affirmed that Congress should use non-tax laws to affect executive compensation decisions.

Despite the Joint Committee’s response to I.R.C. § 162(m), the Service continues to hone in on its utility. While the initial regulations stated that a compensation package would not fail to be performance-based simply because it allowed payouts upon death, disability, termination of employment, or retirement, regardless of whether the performance goals had been met,41 the Service has proven more aggressive in a recent 2008 revenue ruling by holding that payments upon death, disability, or termination

35. See Sheppard, supra note 31, at 99 (“Some banks are remunerating their employees with shares . . . .”).
36. See id. at 100 (“‘Some of the decisions that contributed to this crisis occurred when people were able to earn immediate gains without their compensation reflecting the long-term risks they were taking for their companies and their shareholders.’”).
38. Id. at 13.
39. Id. at 42.
40. Id. at 42–43.
of employment prior to attainment of the performance goals would not be deemed performance-based.\textsuperscript{42}

Under the existing regulations, in the context of stock options or SARs, the performance-based rule requires that the plan granting such options or SARs set forth the maximum number of shares that may be granted within a specified period to “any employee.”\textsuperscript{43} Proposed changes made in 2011 to those regulations would require the plan to disclose the maximum number of shares that may be granted per employee within a specified period.\textsuperscript{44} Thus, disclosure of the aggregate amount of shares that could be granted under the plan would no longer be sufficient.

\textbf{D. I.R.C. § 409A}

Also regarding the Enron scandal, there were reports that Enron executives were able to dip into their deferred compensation arrangements\textsuperscript{45} and accelerate the payment of such amounts—through the use of “haircut” provisions, which resulted in a forfeiture of a portion of the amounts—at the very time the stock value was plummeting, and the retirement benefits of the typical Enron employee, invested in company stock, were losing value. Thus, as part of the American Jobs Creation Act of 2004, Congress enacted I.R.C. § 409A, which severely limits the ability of an executive to defer compensation under a nonqualified arrangement.\textsuperscript{46} The focus now was not on the \textit{amount} of the compensation, but the \textit{type} of compensation—deferred compensation. Instead of punishing the employer with the loss of a deduction, failure to comply with the rules results in immediate taxation of the deferred amounts and a 20\% excise tax to the executive.\textsuperscript{47}


\textsuperscript{43} Treas. Reg. § 1.162-27(e)(2)(vi)(A) (1006). This is referred to as “Individual Limitation.”

\textsuperscript{44} Id. § 1.162-27(e)(4)(iv). See generally Andrew L. Oringer & Steven W. Rabitz, \textit{Deducing from Flexibility under § 162(m)—New Proposed Treasury Regulations Released}, 39 \textit{TAX MGMT. COMPENSATION PLAN. J.} 179 (2011).


The regulations took years to develop and resulted in onerous and detailed rules for compliance. A correction program was announced in late 2008 to correct a limited number of operational failures.

While it is too early to predict the unintended consequences, the onerous and complicated rules, coupled with the severe tax consequences to the executives, may result in the curtailment or elimination of deferred compensation. While that may have been Congress’s ultimate goal, deferred compensation does align the executive’s self-interest with the long-term financial health of the employer, as he/she is dependent on that employer to make the payment sometime in the distant future. Similar to the changes made to I.R.C. § 162(m), executives’ focus on short-term changes in the employer’s stock—which results in using stock options—may not be in the long-term best interest of the financial health of the employer.

E. I.R.C. § 457A

Hidden within the Troubled Asset Relief Program (TARP) legislation was yet another example of congressional intent to further limit deferred compensation by executives through the passage of I.R.C. § 457A. Again the focus was on the type of executive compensation—deferred compensation. Originally, it was targeted to limit the deferred compensation of hedge fund managers—sheltered in offshore tax jurisdictions—by subjecting such deferrals to taxation upon vesting. Nevertheless, the final terms of the provision were more expansive in order to act as a revenue enhancer to negate tax extenders within the bill.

Normally under the Code, the employer’s deduction for deferred compensation is postponed until the employee reports the compensation as income, referred to as the “matching” principle. For a typical U.S. employer, the tax rules do not incentivize the employer to defer the payment of employee compensation, as the deduction is also deferred. However, there may be no similar rule in the context of a foreign employer. Thus, such employers may be happy to allow deferrals by executives since


51. I.R.C. § 457A(a) (West Supp. 2009). Although the TARP legislation offers several ways of delaying the payment of taxes, the legislation has offset this by creating other revenue measures. Id. It was estimated that the arrival of I.R.C. § 457A would generate between $24 and $26 billion in revenue over the scoring period. Id.

52. See I.R.C. § 404(a)(5) (2006); see also Albertson’s, Inc. v. Comm’r, 42 F.3d 537, 541 (9th Cir. 1994).
there is no tax consequence to the employer. I.R.C. § 457A subjects compensation deferred under a nonqualified plan of a nonqualified entity to immediate taxation when such compensation is no longer subject to a substantial risk of forfeiture.\textsuperscript{53} If such amounts are not ascertainable as of the date of vesting, such amounts become includible in income when they are ascertainable, with a potential 20% excise tax plus interest imposed.\textsuperscript{54}

I.R.C. § 457A shows Congress’s continued dislike of deferred compensation arrangements and its continued use of the Code as a method to affect corporate governance. It is certainly too soon to predict whether this section will also produce unintended consequences.

IV. Use of Federal Securities Law

A. Introduction

In the aftermath of the WorldCom and Enron outrage, Congress turned to federal securities law in 2002 as another tool to regulate corporate governance, using the Securities Act of 1933\textsuperscript{55} and the Securities Exchange Act of 1934.\textsuperscript{56} As the federal securities laws were designed as full-disclosure laws for publicly traded entities, Congress decided to use those disclosure rules to spotlight and direct the actions of boards of directors of publicly held corporations. In 2002, Congress enacted the Sarbanes-Oxley legislation (“SOX”),\textsuperscript{57} requiring publicly held corporations to create independent audit committees and to mandate certain responsibilities for such committees.\textsuperscript{58}

Through this legislation, the audit committee was to have meaningful control over the audit process,\textsuperscript{59} and the ability to hire financial advisors and special counsel as needed.\textsuperscript{60} The CEO and the Chief Financial Officer (“CFO”) must now certify that all reportable financial disclosures are accurate and dependable.\textsuperscript{61}

\textsuperscript{53} I.R.C. §§ 409A(d), 457A.
\textsuperscript{54} See id. § 457A(c)(1).
\textsuperscript{58} Id. § 301 (codifying at 15 U.S.C. § 78j-1) (mandating SEC to announce new rules to clarify role and structure of corporate audit committees).
\textsuperscript{59} Id. § 301(m)(2) (“The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer . . . for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.”).
\textsuperscript{60} Id. § 301(m)(5).
\textsuperscript{61} Id. § 302. The purpose of this rule is to make certain that the flow of information is reliable and complete through the company’s controls. Id.
SOX’s accomplishment can be credited with the ability “to get auditors to start being auditors again.” But what benefits practitioners saw in SOX was a model that Congress would ultimately use in drafting future legislation.

B. SEC Regulation

Then in 2006, the Securities and Exchange Commission (SEC) used its powers under the Securities Act of 1933 to propose new disclosure rules, which honed in on the various components of executive compensation packages. These included:

- A narrative in the Compensation Discussion and Analysis (the “CD&A”), which focused on the CEO, CFO, and top three executive officers, and would describe new executive and director compensation disclosures, including tables that listed the various compensation components and their totals;
- Additional disclosure rules for describing stock option programs, plans, and practices, with the table disclosing grant dates, grant fair market value, whether the exercise price of the option differed from the closing price on grant date, and the particulars of the timing of the grants;
- Additional disclosure as to independence of directors and expanded disclosure around related person transactions.


63. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, 274) (describing significant adjustments made to rules in December 2006 which helped equity compensation disclosures conform with financial statements reported pursuant to Financial Account Standards Bulletin (FASB)); see also Executive Compensation, 17 C.F.R. § 229.402 (2008). These disclosure rules are expected to influence plan design since the limitations of the plan will be published for public consumption; therefore, these disclosure rules are often referred to as “the tail wagging the dog.”

64. Press Release, U.S. Sec. & Exch. Comm’n, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), available at http://www.sec.gov/news/press/2006/2006-123.htm. The CD&A requires the company’s CEO and CFO to file and certify the disclosure form. Id. The disclosure form was initially intended to give details about the compensation packages for the organization’s Chief Executive Officer, Chief Financial Officer, and the three other most highly compensated executive officers. Id.

65. Id. Equity interests were tabulated showing awards that could be received in the future and “the amount of securities underlying exercisable and unexercisable options, the exercise prices and the expiration dates for each outstanding option . . . .” Id.

66. Id. The amendment increased the dollar threshold for transaction disclosures, required disclosure of related company policies and procedures, and specified exceptions for certain categories of transactions. Id.
Required disclosure of the number of shares pledged by management;\textsuperscript{67}
Required Form 8-K description of employment agreements and their amendments;\textsuperscript{68}
All disclosures to be in “plain English”;\textsuperscript{69}
More extensive disclosure requirements for registered investment and business development companies;\textsuperscript{70} and
An additional compliance portion, which describes the triggering events and time frame of these new disclosure rules.\textsuperscript{71}

The notion was to spotlight disclosure of the specifics of the top executives’ employment arrangements and pay packages to elicit responses from the general public and institutional investors who had significant ownership interest in the employers. As the SEC was dissatisfied with the results of such enhanced disclosures, it later modified its proposals.\textsuperscript{72}

C. SEC Proposed Corporate Governance Initiatives

By July 2009, the SEC altered its proxy disclosure requirements, now examining whether the company’s compensation arrangements in general—going outside the packages of the CEO, CFO, and the top executive officers—put the company at risk, and if so, how the company would handle such risk.\textsuperscript{73} It specifically proposed that the board’s Compensation Committee evaluate all compensation arrangements, not only for the size and the type of compensation, but also as to the risk they could pose to the employer’s financial health.\textsuperscript{74} This was obviously a reaction to the finan-

\textsuperscript{67.} Id. Also, “the inclusion of directors’ qualifying shares in the total amount of securities owned” needs to be disclosed. Id.

\textsuperscript{68.} Id.

\textsuperscript{69.} Id.

\textsuperscript{70.} Id.

\textsuperscript{71.} Id.

\textsuperscript{72.} See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35,076 (July 17, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270, and 274). SEC Chairman Mary Schapiro stated:

The Commission will be considering whether greater disclosure is needed about how a company—and the company’s board in particular—manages risks, both generally and in the context of setting compensation. I do not anticipate that we will seek to mandate any particular form of oversight; not only is this really beyond the Commission’s traditional disclosure role, but it would suggest that there is a one-size-fits-all approach to risk management.

Instead, I have asked our staff to develop a proposal for Commission consideration that looks to providing investors, and the market, with better insight into how each company and each board addresses these vital tasks.


\textsuperscript{73.} Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,077–78.

\textsuperscript{74.} Id.
cial meltdown during 2008 during which certain compensation arrangements allowed executives to take excessive risks, subjecting the corporation and its shareholders to greater vulnerability.

In addition, the SEC made specific recommendations with respect to corporate governance issues. Four new areas of corporate governance that were being proposed included:

- Disclosure as to whether the board’s Compensation Committee was operating under any conflict of interest—that is, to the extent outside consultants were being utilized by the Committee, what fees were being paid to such consultants from the employer in total, management’s contribution in appointing these consultants, and whether the board or Compensation Committee consented to the use of these consultants for other services;
- Disclosure regarding the unique qualification, knowledge, and practice-set of individuals recommended to be board members;
- Disclosure as to the corporation’s leadership structure (asking the question as to whether the CEO could also be the chairman of the board); and
- Disclosure regarding the board’s responsibility in engaging in risk analysis, not only with respect to compensation levels, but also in general.

D. TARP

The meltdown in the financial sector during 2008 set the stage for the Administration and Congress to set forth a new regime of regulation for those companies that would receive public aid through the Capital Purchase Program (“CPP”) formed under TARP, which was created under the Emergency Economic Stabilization Act of 2008 (EESA). Initially,

75. Id. Additionally, the new proposed SEC requirements would require companies to report the full grant date fair value of stock and options in the year of the grant. Id. at 35,079.
76. Id. at 35,086.
77. Id. at 35,108.
78. Id. at 35,108.
79. Id. at 35,108. See Matthew G. Isakson, Meridian Compensation Partners, LLC, 2011 Corporate Governance & Incentive Design Survey 5 (2011), available at http://www.meridiancp.com/images/uploads/Meridian_2011_Governance_and_Design_Survey_Results.pdf (surveying 250 large publicly traded companies and finding about one-third of such companies separated role between CEO and chairman of board). When such roles were separated, in the majority of cases, the non-CEO Chairman was also an independent director. Id.
nine banks used the resources available through the legislation. The TARP requirements were viewed as a preview of what the government was prepared to impose on the vast number of publicly held corporations. For TARP participants, the government subjected executive compensation to four new restrictions:

- The I.R.C. § 162(m) deduction of $1 million was lowered to $500,000 for any Senior Executive Officer (“SEO”)—defined as the top five highly paid executives whose compensation is subject to SEC proxy disclosure rules—for any year that the company continued to receive TARP money, not only for base pay but also for performance-based compensation;
- Several of the § 162(m) exclusions were eliminated or paired down;

The Secretary of the Treasury gained authority from EESA to re-establish the financial markets and “to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary.” Emergency Economic Stabilization Act of 2008 § 101(a)(1). TARP recipients now had corporate governance and executive compensation limits under Section 111 of the EESA. Id. at § 111(b)(2)(A). EESA was modified and replaced on February 17, 2009 by the enactment of § 7001 of the American Recovery and Reinvestment Act of 2009 (ARRA), which prescribed new executive compensation limits and required the Treasury to publish regulations to implement section 111 of EESA. Id.; American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 sec. 7001, § 111(a)(2) (amending 12 U.S.C. § 5221(a)(2)).

82. Citigroup, JPMorgan, Wells Fargo, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bank of America, Bank of New York Mellon, and State Street Bank were the banks participating in TARP.

83. See Stephanie L. Soondar & Allen Major, Litigation and Recoupment of Executive Compensation, 6 HASTINGS BUS. L.J. 397, 399 (2010). The Department of Treasury stated that the implementation of TARP was within “the ultimate goal of systemic regulatory reform” and was part of an investigation into “how corporate governance regulation can be improved to better promote long-term economic growth and to prevent future financial crises.” Id.; see also Jonathan G. Katz, Who Benefited from the Bailout?, 95 MINN. L. REV. 1568, 1569 (2011). The money disbursed by TARP was “merely one component of a much larger governmental intervention . . . .” Id.; Lisa M. Fairfax, The Legal Origins Theory in Crisis, 2009 BYU L. REV. 1571, 1595 (2009) (stating that Treasury Regulations associated with receiving TARP funds were in step with President Obama’s plan to “promote systemic regulatory reform”).

84. See Emergency Economic Stabilization Act of 2008 § 302(a) (amending I.R.C. § 162(m)) (defining special Rule for Application to Employers Participating in TARP). Congress may be wary of using performance–based compensation as the measure for performance since it can be easily met, which is evident by not including a performance based compensation exception in EESA. See id.

85. Id.; see I.R.C. § 162(m)(5)(D)(i)-(iii) (West 2011). Once an executive is identified and meets the qualifications for a “covered executive” for any applicable year, that individual is considered to be a “covered executive” in all subsequent tax years. Id. This is true regardless if the executive meets the requirements of “covered executive” in future years. Id.
The amount of any golden parachute payment—meaning any compensation payment that was or is contingent on a change (I) in the ownership or effective control of the corporation, or (II) in the ownership of a substantial portion of the assets of the corporation, and (ii) the aggregate present value of payments exceeds three times the recipient’s “base amount.”—would be limited to three times the base pay, and the scope of the compensation for such payments was expanded to include any payment for departure (1) due to involuntary termination or (2) as a result of the employer’s bankruptcy, liquidation, or receivership; and

- The ability to rebut the presumption that arrangements made within the last year were parachute payments was eliminated.

The TARP legislation ushered in the following new corporate governance requirements:

- For the SEOs, the Compensation Committee would be mandated to examine the SEO incentive compensation packages to make sure that such packages would not promote unwarranted risk-taking on their part, and if so, to alter such packages;

- SEO compensation arrangements must now afford the company the ability to “clawback” bonuses/awards that later were found to be ill-gotten as the company’s “statements of earnings, gains, or other criteria” were “materially inaccurate;” and

- Subsequent golden parachute arrangements for the SEOs that would be triggered upon an involuntary termination, bankruptcy, insolvency, or receivership could not be entered into.

86. The definition of a parachute payment is any compensation payment that was or is contingent on a change (I) in the ownership or effective control of the corporation, or (II) in the ownership of a substantial portion of the assets of the corporation, and (ii) the aggregate present value of payments exceeds three times the recipient’s “base amount.” I.R.C. § 280G(b)(2)(A) (West 2006).


88. In determining the base amount, one takes the executive’s annualized includible compensation averaged over the five calendar years determined prior to the change of control year. I.R.C. § 280G(b)(3) (West 2008).

89. Emergency Economic Stabilization Act of 2008 §111(b)(2)-(3) (barring any SEO from receiving golden parachute when Treasury retains equity or debt position in employer).

90. I.R.C. §§ 280G(b)(2)(C), (e)(1)(D).


92. Id. § 111(b)(2)(A). There is no definition of “risk” or “excessive risk” in the legislation. Typically risk is considered as an anticipated harm that could result in attempting a given objective, a balancing of risks versus rewards. Although EESA does not disallow using risk as a criterion in determining compensation, it disallows excessive risk-taking. See Gideon Mark, Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA, 39 Conn. L. Rev. 1097, 1131 (2007) (explaining “risk-and-rewards” method in general business context as “estimation of expected losses and returns”).


94. Id. § 111(c). Additionally, covered employers are barred from giving any golden parachute payments to the five highest paid executives who are under existing arrangements. Id.
As Congress viewed itself as a major shareholder of these banks, it decided to not only limit the employer’s deduction, but to set the size and type of existing, as well as new, executive compensation arrangements.

E. **TARP II**

One of the original TARP participants, Merrill Lynch, decided to advance certain bonus payments to executives beginning in January of 2009, prior to its sale to Bank of America.\(^95\) The Administration and the Treasury Department issued press releases in early February setting forth even more rigorous limitations on the executive compensation programs of TARP recipients.\(^96\)

This set the stage for Congress to pass the American Recovery and Reinvestment Act of 2009\(^97\) (ARRA) on February 17, rewriting the prior TARP restrictions on executive compensation and imposing new requirements. While these new rules were applicable only to companies receiving TARP funds (both financial and nonfinancial corporations), they caught the attention of most publicly traded corporations in the event such limitations would one day become universal. The changes included:

- Clawback provisions were to be imposed not only on the SEOs, but also on the next twenty most highly compensated employees;\(^98\)
- A new prohibition existed against “paying or accruing any bonus, retention award, or incentive compensation” for certain SEOs while the company was the recipient of TARP monies;\(^99\)
- A new requirement that the company institute policies regarding excessive or luxury perquisites;\(^100\)


\[*A* crystallizing episode in the Great Financial Meltdown. To most Americans, it’s absurd for a company that lost nearly $28 billion in 2008, nearly collapsed, and survived thanks only to a taxpayer-subsidized rescue, to lavish million-dollar bonuses on dozens of executives . . . .

This can only end badly for Merrill and BofA, with repercussions that could ricochet throughout Wall Street and dramatically change established practices.

*Id.*


\(^99\). *Id.* sec. 7001, § 111(b)(3)(D)(i).

\(^100\). *Id.* sec. 7001, § 111(d)(1)–(4). These luxury expenses include: “(1) entertainment or events; (2) office and facility renovations; (3) aviation or other transportation services; or (4) other activities or events” to the extent that those expenditures “are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of the business . . . .” *Id.*
A new requirement that the Compensation Committee perform a semiannual review of the executive compensation arrangements to evaluate risk, along with certifications and disclosure narratives;\textsuperscript{101}

A new requirement for shareholder say-on-pay vote on the compensation of executives in the annual proxy statement\textsuperscript{102}—while non-binding, a negative vote was hoped to carry weight and result in changed corporate behavior;\textsuperscript{103} and

The creation of a “Special Master” (i.e., the new pay czar), who would review the compensation packages of seven of the TARP recipients receiving “exceptional assistance” and make recommendations accordingly.\textsuperscript{104}

V. DODD-FRANK PASSAGE IN 2010

The series of TARP legislations certainly provided the template for the Administration and Congress to extend many of the TARP restrictions to all publicly held companies through the passage of the Dodd-Frank Wall Street Reform & Consumer Protection Act in 2010.\textsuperscript{105} By amending the Securities Exchange Act of 1933 and adding a new Section 14, publicly held companies would now be subject to the following new requirements:

- The shareholder say-on-pay initiative would now be universal for publicly held companies beginning with the 2011 proxy season.\textsuperscript{106} While the vote would be non-binding, shareholders would be given the right to vote on executive pay packages for the named executive officers, as well as the right to vote on the frequency of such vote.\textsuperscript{107} The say-on-pay vote was also extended to the offering of any golden parachute packages requested in the event of an acquisition, merger, consolidation, or sale of assets of the reporting company that would occur within six months;\textsuperscript{108}

\textsuperscript{101} Id. sec. 7001, § 111(c)(2).

\textsuperscript{102} Id. sec. 7001, § 111(e).


\textsuperscript{104} Id. at 28,416.


\textsuperscript{106} Id. sec. 951, § 14A(a)(1); see Jeff Green, America’s Teflon Corporate Boards, BLOOMBERG BUSINESSWEEK (July 14, 2011), http://www.businessweek.com/magazine/americas-teflon-corporate-boards-07142011.html (noting that in past three years, more than 200 directors received negative say-on-pay votes, but continued in leadership roles).

\textsuperscript{107} Dodd-Frank Wall Street Reform and Consumer Protection Act, sec. 951, § 14A(a)(2). Shareholders can elect to hold a vote on executives’ compensation every one, two, or three years. Id.

\textsuperscript{108} Id. sec. 951, § 14A(b)(2).
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- Enhanced independence standards would be imposed on the Compensation Committee of the board\textsuperscript{109} and its use of independence factors in selecting and using outside compensation consultants and other advisors;\textsuperscript{110}
- All publicly traded companies would be required to have clawback policies in order to recover from former or existing executive officers in the event the financial statements had to be restated for material noncompliance with securities law;\textsuperscript{111} and
- New disclosures on the proxy summarizing the pay packages of any named executive officer of the company and the size of the package, including comparing the CEO’s pay to the pay of the average employee (the so-called “internal pay equity”) and the CEO’s pay to total pay of all employees (excluding the CEO’s pay).\textsuperscript{112}

VI. CONCLUSION

The use of the Code in curbing the size and type of executive compensation has not only been unsuccessful, but has also created unintended consequences that contributed to the growth of executive pay. It has also led to more complexity in the Code, adding to the cost of complying and auditing such provisions. As Congress directs its corporate governance mandates under federal securities law, its reach is obviously limited to publicly traded corporations. Undoubtedly, it hopes that such mandates will become “best practices” for all businesses. This is undoubtedly a huge leap of faith for small businesses that struggle with low profit margins with a small group of insiders that are employed and control the business.

It is too early to tell whether the use of federal securities law will be successful in legislating corporate governance “best practices” for publicly traded corporations. The 2010 Wall Street Journal/Hay Group CEO Compensation Study saw little change in the median CEO base salary amount, but did see a shift in the long-term incentive portfolio away from stock options to a mixture of stock options, restricted stock, and performance awards.\textsuperscript{113} As to executives’ perquisites, the only fade away has been tax gross-ups. The results of the 2011 proxy season showed that the vast majority of employers received favorable say-on-pay votes regarding executive compensation,\textsuperscript{114} indicating either a strong endorsement of executives’ pay packages or apathy on the part of shareholders.

\textsuperscript{109} Id. sec. 952, § 10C(a)(2).
\textsuperscript{110} Id. sec. 952, § 10C(b)(2).
\textsuperscript{111} Id. sec. 954, § 10D(b)(1).
\textsuperscript{112} Id. sec. 953(a)–(b) (amending 15 U.S.C. § 78n).
\textsuperscript{113} The Wall Street Journal/Hay Group Survey of CEO Compensation, supra note 7.
As Congress encroaches on the States’ traditional police powers to regulate corporate governance issues, it will continue to find resistance from business entities and executives, as well as the federal courts, as they query federal mandates in such areas that normally would be perceived to be within the States’ traditional police powers. A similar fight between the lines of federal mandates and States’ traditional police powers—which include insurance regulation—is being waged in the recent health care reform legislation, as health insurance has been typically regarded as within the purview of the States’ traditional police powers. How far federal legislative powers can extend to regulate individuals’ and corporations’ abilities to receive compensation and benefits will be the subject of continued debate for decades to come.
PERIODICALLY, the federal government has altered the tax rules relating to executive compensation. Sometimes these changes have been driven by pure tax policy concerns. At other times, the changes in tax policy were motivated by a desire to correct market failure in the executive pay-setting mechanism. That is, tax intervention was driven largely by intrafirm concerns—usually that managers were extracting rents to the detriment of shareholders and, possibly, other corporate constituencies.

In all events, these attempts to use tax policy to influence executive compensation have been routinely decried. More particularly, the interventions driven by corporate governance concerns, most prominently Section 162(m)’s limitation on the deductibility of compensation costs and the Sections 280G/4999 deduction limitation for, and excise tax on, parachute payments, have been widely panned. The complaints about these innovations are varied but tend to coalesce around an accusation that the intervention is either ineffective, distortive, or both.

This Article is devoted to explaining the ineffectiveness of tax policy as a response to compensation market failure. In short, market forces seem to overwhelm whatever prodding the tax code tries to effect. Part II describes Sections 162(m) and 280G/4999 and briefly shows how they have been largely ineffective in changing compensation practices. Why have these kinds of tax interventions—the ones that try to correct the pay-setting process between executives and boards—failed? Undoubtedly, there is a plausible public choice explanation centered on political motivations and competence. Part III describes this explanation. Parts IV and V, however, suggest that public choice explanations for the failure of governance-driven tax interventions are actually too generous and might lead us to be

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* Associate Professor of Law, Pace University School of Law. I thank Bridget Crawford, Gregg Polsky, and David Walker for helpful comments and Ian Sloss for his research assistance.


too sanguine about the possibility of “better” executive compensation tax rules in the future. Part IV lays out the basic case that tax interventions, as observed to this point, have trivial effects on board decision making regarding executive pay. Simply put, the tax penalties pale in comparison with boards’ perceptions of the performance-related gains to be realized by either hiring the best (even if most expensive) executive or properly incentivizing any executive with a particular mix of compensation elements. This intuition has been borne out by empirical studies showing the extremely modest effects of tax interventions on pay practices.

Part V develops the triviality thesis by recognizing that tax has little effect on pay practices because the penalties are modest. Were penalties more significant, they might not be overwhelmed by the considerations described in Part IV. But Part V offers reasons to believe that tax penalties in this context will almost never be implemented so as to be so heavy-handed. Most importantly, many policymakers and almost all scholars believe that there is substantial heterogeneity among firms regarding optimal compensation practices, leading to a reluctance to adopt tax penalties with real bite that feel closer to mandatory rules.

II. Sections 162(m) and 280G/4999 in Action

Section 162(m) of the Code was enacted in 1993. It operates by limiting the business-expense deduction available to public firms for amounts paid to “top five” executives. Specifically, a firm may not deduct amounts paid to such officers in excess of $1 million annually. The deduction limitation may be avoided by qualifying the compensation that exceeds $1 million, usually by paying under a plan that (i) provides for payments based on objective performance goals, (ii) is approved by an independent compensation committee of the board, and (iii) is approved by a majority of the shareholders after disclosure of the material terms of the compensation arrangement.

Thus, Section 162(m) evinces a preference for contingent forms of pay such as performance bonuses, at- or out-of-the-money stock options, and stock awards that vest upon achievement of performance targets. That preference is based on a significant theoretical literature produced by legal academics and financial economists describing the importance of performance-based compensation. This standard account observes that performance-based pay works to align incentives and mitigate agency costs.

3. Top five executives include the CEO and the four next most highly compensated officers. See Treas. Reg. § 1.162-27(c)(2) (2012). The definition of “officer” is determined in accordance with the rules for executive compensation disclosure under Regulation S-K. Id. In effect, then, the covered employees for purposes of § 162(m) are the same as those for whom compensation disclosure is mandated unless the firm’s chief financial officer is not among its five highest paid officers. In that case, disclosure would capture that officer but not the fifth most highly paid officer, while § 162(m) would cover in the opposite fashion.

otherwise borne by public firms when they are run by non-owner executives.\(^5\) Section 162(m)’s additional requirements of independent director and shareholder approval respond to the additional concern that nominally performance-based pay might not truly be “performance-based” because of the clubby nature of the board/executive relationship.\(^6\) Working together, these requirements for receiving a full deduction were intended to produce optimal intrafirm governance outcomes, heightening executive incentives to maximize profits and reducing their ability to extract rents.\(^7\)

As most of those who have studied the issue concede,\(^8\) Section 162(m) has been largely unsuccessful in achieving its governance goals. This failure may be driven by forces beyond the legislative design,\(^9\) but nevertheless the design itself is problematic. Its preference for completely performance-contingent pay may often lead to suboptimal contracts. First, it encourages workarounds through the use of deferred compensation arrangements such that the actual taxable/deductible event occurs once the executive in question is no longer a covered officer.\(^10\) Second, the design of Section 162(m) advantages options vis-a-vis restricted stock. At-the-money or out-of-the-money options introduce convexity into compensation arrangements thereby increasing risk-taking incentives,\(^11\) but it is less clear that this heightened convexity will provide optimal incentives in a significant set of cases.\(^12\) Finally, the definition of the performance-based qualification allows firms to deduct expenses even in cases where the compensation is hardly performance-based.\(^13\)


\(^6\) For the formal account of this view, see Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 49–51 (2004).


\(^8\) For a pessimistic view of section 162(m)’s success, see *supra* note 2.

\(^9\) For a discussion of other influences, see *infra* notes 23–39 and accompanying text.


\(^12\) See id. at 33; see also Lucian Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1940–41 (2010).

\(^13\) See, e.g., Mullane, *supra* note 2, at 523–25 ("As an initial matter, satisfying the performance-based requirements is not challenging. Treasury regulations provide that a performance goal does not need to be ‘based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses.’ Furthermore, once the thresh-
To add insult to injury, it may be that Section 162(m) had the unintended consequence of pushing pay higher at firms where executives had not previously earned $1 million. The legislative announcement that salaries in excess of $1 million were excessive in Congress’s view seems to have implied that any salary below $1 million was reasonable. On this account, Section 162(m) was able to set a norm that quickly ratcheted up executive salaries, particularly given the Lake Wobegon world of pay-setting and pay-setting’s transparency due to heightened disclosure rules.

The problems with Section 162(m)’s deduction-limitation regime are more significant in magnitude but not especially different in kind from that other attempt to influence corporate governance through the tax code—the restrictions on golden parachute payments to executives at acquired firms. Similar to Section 162(m), Section 280G operates to limit a firm’s deduction for compensation paid. Under Section 280G, the compensation in question involves payments made to highly compensated individuals that are contingent upon a change in control in the firm. If the contingent payment is greater than three times the individual’s five-year average take home pay prior to the change in control, then it qualifies as a “parachute payment” and the excess of that amount over the average take home pay is a non-deductible expense for the firm. Section 4999 hits the other side of the payor-payee equation and imposes an excise tax on the executive receiving the excess parachute payment.

Like Section 162(m), Sections 280G and 4999 have hardly met resounding success. In the realm of unintended consequences, Section 280G seems to have driven an increase in the adoption of change-in-control agreements and normalized a “2.999X” standard for change-in-control payments. By leading to both the proliferation and normalization of these payments around a “~3X” multiple, Sections 280G and 4999 arguably requirements have been met, there is no limit to the amount of performance-based compensation that can be deducted.” (footnote omitted)).


16. I.R.C. § 280G(2)(c)(2) (2006) (defining “highly-compensated individual” as one who is (or would be if the individual were an employee) a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation”).

17. See id. § 4999 (imposing “tax equal to 20 percent of the amount of [an excess parachute payment]”).

18. See Murphy, supra note 2, at 14 n.20 (quoting studies by Richard Alpern and Gail McGowan).

19. See Miske, supra note 2, at 1679–84 (“By codifying a salary multiple, § 280G created a floor on parachute benefits that directors and executives could point to as a congressionally sanctioned standard of reasonableness.”).
probably increased compensation costs at firms. Just as in the case of 162(m) (heightened convexity), the propriety of the governance ends purported to be achieved by Sections 280G/4999 are a matter of some dispute, with many suggesting that high golden parachute payments increase shareholder value by making executives more open to takeovers. Finally (and most importantly for the purposes of this Article), easy workarounds were developed to blunt the effect of the tax rule, in particular, tax gross-ups.

III. THE STANDARD CRITIQUE OF TAXING EXECUTIVE COMPENSATION FOR CORPORATE GOVERNANCE ENDS

Why does it seem so hard for Congress to properly tax executive compensation so as to improve intrafirm governance outcomes? Perhaps most obviously, there is a simple political economy story that calls into question the likely effectiveness of executive compensation intervention. Omari Simmons, for one, has previously noted the peculiar political characteristics of executive compensation debates. In essence, information about the efficacy of various corporate reforms is in short supply and executive compensation is one of the most salient issues to the voting public. As a result, legislators may deviate from efficient policy outcomes more than they would otherwise in order to satisfy their constituents’ desire for action, even if only the symbolic sort.

The special nature of executive compensation thus subjects federal tax intervention to an even more serious critique than is generally leveled at congressional action in the corporate governance arena. For instance, Roberta Romano famously called the Sarbanes-Oxley Act’s mandates “quack corporate governance.” As she described it, the law’s quack-ish

20. Kevin Murphy also contends that Section 280G encouraged firms to shorten vesting periods in equity plans to avoid a greater charge in case calculations under Sections 280G/4999 needed to be made to account for the gain to executives by the accelerated vesting caused by the change in control. See Murphy, supra note 2, at 15.


22. See id. at 517–19.

23. See, e.g., Murphy, supra note 2, at 2 (“A larger part of the problem is that the regulation is often mis-intended. The regulations are inherently political and driven by political agendas . . . .”).


25. See id. at 329 (“Knee-jerk responses to populist outrage may not qualify as earnestly pursuing the public interest, especially when symbolic measures are used to mitigate outrage from less informed constituencies. Given the credence characteristics of corporate reform, federal lawmakers have greater capability and incentives to camouflage their rent seeking.”); see also id. at 332 (“The credence characteristics of executive compensation reform provide self-interested lawmakers with greater flexibility to choose a diagnosis of the executive compensation problem that is the most politically profitable. As a result, lawmaker diagnosis and recommended treatment regimens are at times inconsistent and muddled.”).

governance provisions were largely the product of policy entrepreneurs who found themselves in a position to drive the legislative process because legislators were ignorant and uninterested in corporate governance provisions and the fact of the crisis post-Enron provided a push to accomplish something.\textsuperscript{27} Romano rejects the notion that those governance mandates represented merely symbolic politics,\textsuperscript{28} but notes that the law’s enhanced criminal penalties for corporate actors may have been just that.\textsuperscript{29} This dismal account of the production of business law reform corresponds with other post-crisis moments where regulation of questionable effect was enacted to slake the public thirst for accountability.\textsuperscript{30}

More recently, Stephen Bainbridge has leveled a similar charge of quackery at the Dodd-Frank legislation passed in response to the financial crisis of 2008.\textsuperscript{31} Again, a crisis pressured legislators to do something, leading them to ready-made solutions provided by policy entrepreneurs.\textsuperscript{32} Again, some of the actions may have been merely symbolic.\textsuperscript{33} And, again, it is far from clear that the corporate governance rules adopted under Dodd-Frank are justified by any evidence or plausible theory of firm behavior.\textsuperscript{34} Bainbridge sums up the characteristics of corporate governance quackery:

1. It is a bubble law, enacted in response to a major negative economic event.
2. It is enacted in a crisis environment.
3. It was a response to a populist backlash against corporations and/or markets.
4. It is adopted at the federal rather than state level.
5. It transfers power from the states to the federal government.
6. Interest groups that are strong at the federal level but weak at the Delaware level support it.
7. Typically, it is not a novel proposal, but rather a long-standing agenda item of some powerful interest group.
8. The empirical evidence cited in support of the proposal is, at best, mixed and often shows the proposal to be unwise.\textsuperscript{35}

Not all of these characteristics would seem to be required before leveling the charge of ineffective and possibly destructive political pandering at a

\textsuperscript{27} See id. at 1568–85.
\textsuperscript{28} See id. at 1585–87.
\textsuperscript{29} See id.
\textsuperscript{32} Id. at 1786–87.
\textsuperscript{33} Id. at 1783, 1796.
\textsuperscript{34} Id. at 1818–19.
\textsuperscript{35} Id. at 1796.
regulatory measure. In fact, the cause of the crisis (1), anti-federalism markers (4-6), and the measure’s history (7) are arguably unimportant for doing so.

On Bainbridge’s terms, then, we should be concerned with post-crisis legislation that manifests a popular backlash against business without any evidence in favor of doing so. Along these lines, the danger of “quackery” is probably stronger in matters of executive compensation than in governance matters generally. It is perhaps useful to note that a large chunk of Dodd-Frank’s governance provisions were executive compensation provisions. Executive compensation is hugely salient to the press and voters. As one homely example, consider the recent conflagration over a report demonstrating that some public companies paid more to their CEOs than they did in federal income taxes. The urge to do something in response to populist outrage is likely to be among the strongest a legislator faces and, accordingly, we should not expect much good to come from compensation-related legislation.

I have no quibble with the characterization of tax measures directed at reining in executive compensation as something akin to “quackery.” It may very well be an apt one and the tale of political economy alone might help explain much of the trouble with tax intervention in executive compensation that aims to achieve ends unrelated to corporate governance. But, in the remaining sections of this Part, I wish to emphasize that the case against tax incursions into executive compensation is much more damning than implied by the traditional complaints from political economy.

IV. THE TRIVIALITY OF EXECUTIVE COMPENSATION TAX RULES

Most importantly, taxing executive compensation for governance purposes will have trivial governance effects under almost every plausible regime. Boards, whether facing a competitive market for executive talent, beholden to powerful executives, or both, will not usually negotiate differently in response to a new tax regime. Because tax considerations are generally overwhelmed by all of the other pressures found in the compensation-setting process, we should expect firms to agree to bear any

37. See Andrew C.W. Lund, Compensation as Signaling, 64 FLA. L. REV. 591, 613–618; see also Simmons, supra note 24, at 322–23.
39. See Polsky supra note 1, at 643–51.
40. For a discussion questioning the limits of political plausibility, see supra notes 23–39.
costs imposed by the tax rules unless some non-tax reason arises to cause them not to do so.\footnote{41}

At the most basic level, when tax law becomes a species of corporate law it becomes subject to the “triviality” attribution leveled by Bernie Black over twenty years ago.\footnote{42} Black’s claim was that state corporate law would have literally no effect on governance outcomes in most cases. That law would either be (i) market mimicking in that it simply duplicated what the market would have otherwise required, (ii) avoidable via easy workarounds, (iii) changeable over time via political or litigation pressure, or (iv) unimportant.\footnote{43} The claim for tax law’s triviality made here is less robust, though it implies some version of the “workaround” and “unimportance” strands of Black’s framework.

Admittedly, tax rules that increase the compensation burden will have some effect on the firm as the new tax will be a cost that must be paid.\footnote{44} That cost may qualify the tax rule as “important” or “unimportant” relative to firm value, but this is beside the point. The charge of triviality in this instance simply means that the tax incursions in executive compensation will have no effect on the way in which firms pay managers.\footnote{45} Put another way, tax is trivial with respect to the sphere of activity Congress intends to impact when it uses sticks to prod firms.

Why are compensation patterns so insensitive to tax rules? Consider the baseline assumption animating most tax interventions that massive market failure exists in the compensation bargaining process at public companies. Boards that might negotiate aggressively with managers to arrive at an optimal pay package face incentive and relational problems in doing so. Most famously, Bebchuk, Fried, and Walker suggested that managerial power over directors—of both hard and soft varieties—characterized much of executive compensation contracting.\footnote{46} There is more to their powerful argument, but, essentially, it conceives of executives being able to extract rents during pay negotiations with relatively obsequious boards constrained only by “outrage costs” in the form of shareholder revolt, bad press, a governmental response, or some combination thereof.\footnote{47}

\footnote{41. Alternatively, tax penalties could become so extraordinary that there might be a constraint on firms’ abilities to absorb them without the capital markets exacting some sort of price. For a discussion rebutting this proposition and suggesting that there is good reason to think that tax penalties will not reach such levels, see infra notes 89–93 and accompanying text.}
\footnote{42. See Bernard S. Black, \textit{Is Corporate Law Trivial?: A Political and Economic Analysis}, 84 NW. U. L. REV. 542, 544–46 (1990).}
\footnote{43. Id. at 551–52.}
\footnote{44. See id. at 563 (discussing costs imposed by 280G and 4999).}
\footnote{45. If the burden is high relative to firm value, the tax may shift valuations as to make private firms more attractive to capital markets than the public firms subject to the tax rules.}
\footnote{47. See, e.g., Bebchuk, Fried & Walker, supra note 46 at 786.
The managerial power thesis has been criticized both for its inability to explain why certain arrangements exist and, more often, for its implicit or explicit implications for reform.\textsuperscript{48} Regardless of the merits of that debate, one can certainly conclude that some level of distortive managerial power exists such that there is some slack at some firms. Boards may not be completely beholden to CEOs and they may often operate in good faith to arrive at the optimal pay package, all things considered. Still, they face informational problems\textsuperscript{49} and cognitive biases that may lead, for example, to an overvaluation of the impact of managerial talent.\textsuperscript{50} Thus, whether managerial power of the kind Bebchuk, Fried, and Walker suggest is strong or weak, we should expect to see some level of excess compensation packages for public company managers.\textsuperscript{51} Given a background level of managerial power, tax rules, it is thought, might help in moving executive compensation contracts back towards optimality.\textsuperscript{52} Hence, Section 162(m) attempts to push firms towards more performance-sensitive arrangements on the assumption that powerful managers are able to systematically distort outcomes toward less performance sensitive arrangements.\textsuperscript{53}

But precisely because of this baseline assumption regarding the manager’s bargaining position, the tax penalty has a very serious strike against it in changing firm behavior. First, assume the strong managerial power view suggested by Bebchuk, Fried, and Walker. Recall under this theory

\textsuperscript{48} See Lund & Polsky, supra note 5, at 684 n.14.


\textsuperscript{50} See Rakesh Khurana, \textit{Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs} 190–91 (2004).

\textsuperscript{51} See Core, Guay & Thomas, supra note 49, at 1142 (noting that executive compensation contracts are almost sure to be second-best efficient).

\textsuperscript{52} See, e.g., Mullane, supra note 2, at 522 (“The Senate Finance Committee believed ‘excessive compensation [would] be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations [was] limited.’” Section 162(m) thus appears to have two aims: (1) to curtail levels of executive pay, and (2) to encourage a stronger connection between pay and performance.” (footnote omitted)); see also David I. Walker, \textit{A Tax Response to the Executive Pay Problem} 7-8 (Boston Univ. Sch. of Law, Working Paper No. 11-50, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1944115 (offering a tax solution to corporate governance failure attributable to managerial power).

\textsuperscript{53} There are reasons, however, to think that managers might actually prefer performance sensitive pay designs. First, managers may be overconfident and discount the possibility of firm failure under their watch. See Tung-Hsiao Yang & Don M. Chance, The Effect of Executive Confidence, Ability and Private Beliefs on the Valuation of Executive Stock Options 7–8 (March 10, 2011) (unpublished manuscript), available at http://ssrn.com/abstract=1783034. Second, managers may recognize that contingent pay is generally less salient in the eyes of shareholders and the business press and therefore subject to a more relaxed outrage constraint. See Lund & Polsky, supra note 5, at 721–23.
executives hold too much sway over pay-setting boards and, as a result, observed pay practices tend to be both too rich and too insensitive to performance.\textsuperscript{54} It is hard to see how the incentives provided by Section 162(m) could do much work in this world.\textsuperscript{55} A truly powerful executive might simply prevent the restructuring of his or her pay into qualifying, performance-based types. In that case, the firm would lose the deduction, thereby harming shareholders. Even if Section 162(m) disclosure provided a focal point that activated outrage, Section 162(m)’s requirement that any pay over $1 million be performance-based would simply shift the mode of rent extraction away from salary increases to performance-based compensation increases, deferred compensation increases, or the camouflaging of performance-insensitive pay (assuming imperfect tax regulations permit it). Most importantly, managers with power over their boards, forced to take on risky pay, should simply demand more of it to compensate themselves for the increased risk.\textsuperscript{56} Even when the risky pay has a significantly higher expected value than the less risky kind, the risky pay is less salient to shareholders and the business press (and obviously tax regulators) precisely because of the risk and the sense that an executive must have earned pay that is performance-based.\textsuperscript{57}

Section 162(m) does require that performance-based pay be approved by an independent board and shareholders which might mitigate such rent extraction. But the kind of board independence required by Section 162(m) is not materially more restrictive than compensation committee independence requirements in place at the time of its adoption relevant to avoiding short-swing profit liability under securities laws.\textsuperscript{58} If managerial power over boards was a problem then or now, Section 162(m)’s safeguard of independent board approval seems to do very little.\textsuperscript{59} Moreover, even unhappy shareholders are at a disadvantage when faced with approving a performance-based pay plan in that a veto would potentially cause the firm to forego any deduction.\textsuperscript{60}

If one adopts a less strong view of managerial power, tax intervention might again be thought appropriate to remedy residual rent accumulation

\textsuperscript{54} See Bebchuk, Fried & Walker, \textit{supra} note 46, at 784.

\textsuperscript{55} Bebchuk and Fried say as much themselves. \textit{See Bebchuk & Fried, supra} note 6, at 72–73.

\textsuperscript{56} See, e.g., Jensen & Murphy, \textit{supra} note 5 at 147 (“Creating better incentives for CEOs almost necessarily means increasing the financial risk CEOs face.”).

\textsuperscript{57} See Lund & Polsky, \textit{supra} note 5, at 718–23.

\textsuperscript{58} Rule 16b-3 excludes from short-swing profit liability officers’ exercise of an option and subsequent sale of the acquired security provided the options were awarded by “non-employee” directors. Section 162(m)’s independence requirements do not contain certain exclusions for related-party transactions that the short-swing profit rules do, though there is no indication that the Treasury intended to draw this distinction when the regulations for Section 162(m) were promulgated.

\textsuperscript{59} And if managerial power is not much of a problem, then the distortive capacity of a rule like Section 162(m) would overwhelm its benefits.

\textsuperscript{60} \textit{See Bebchuk & Fried, supra} note 6, at 49–51.
due to some other sort of market failure afflicting the pay-setting process, e.g., informational problems or systematic overvaluation of executives’ labor. Even then, however, the market forces pushing towards excess pay should overwhelm all but the most penal tax rules. Consider the likely possibility that excessive pay is at least partially caused by distortions in the CEO labor market such that prospective managers have overly inflated negotiating power.\footnote{See Khurana, supra note 50, at 26.} In order for tax to correct the problem, one has to have an account of how a relatively small tax penalty (and one that is generally restricted to a lost deduction for the company such that it is externalized to shareholders) is able to overcome that pressure. Tax cannot make that power go away and, given its economic effect, should barely be expected to blunt it.

As a result, the governance changes encouraged by the tax rules are largely ignored or distorted. Moreover, whether the resulting tax penalties are nominally incurred by the firm (Sections 162(m) and 280G) or the manager (Section 4999), the firm will usually bear the cost of those penalties because of the negotiating dynamic. To the extent that this model breaks down at all, it does so not because of the tax rules, but rather because of an exogenous market constraint.\footnote{For an example of how market constraints may shift the burden sharing of tax penalties, see infra note 87 and accompanying text.} Unless tax is somehow focusing market attention on some objectionable pay practice and therefore activating an otherwise dormant constraint, it does almost nothing other than increase firm expenses.

Finally, if strong or weak managerial power does not exist or does not lead to market failure in compensation setting, the case for governance-driven tax intervention becomes obviously weaker.\footnote{There may, of course, be broader tax goals that such intervention might promote, though measures targeted at executive compensation seem likely to be an inefficient means of achieving those goals.} A number of financial economists have offered reasons for thinking that the executive compensation market is relatively efficient. For example, Kevin Murphy and Ján Zábojník posit that the nature of the CEO position has changed in recent years such that managerial ability, which is transferrable across firms, now trumps firm-specific knowledge in importance.\footnote{See Kevin J. Murphy & Ján Zábojník, Managerial Capital and the Market for CEOs 4 (Queen’s Univ. Dep’t of Econ., Working Paper No. 1110, Apr. 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984376.} As a result, we should expect to see an increase in the price of talented managers’ labor.\footnote{See id. at 24–30. Of course, the fact that firms are increasingly likely to hire outside CEOs may be linked to a less rational explanation. See Khurana, supra note 50, at 47 (noting market failures in the CEO labor market). If true, the higher wages commanded by CEOs would not represent an efficient outcome and tax intervention might be appropriate.} If true, there would be no bargaining problem capable of amelioration through regulation, as heightened levels of executive compensation
simply reflect the increased competition for managerial talent. Any tax penalties would impose needless costs on firms. But, to be clear, we should expect those costs to be unrelated to incentive reduction or retention problems as firms should simply choose to take the tax penalty and hold firm on the optimal compensation contract to avoid more damaging managerial departures or other behavioral defections. The distortion instead would occur in the capital markets as firm’s expected cash flows would have to be discounted by the tax.

Experience with tax interventions bear out these predictions of triviality. Consider first, Section 162(m) and the push for increasingly performance-sensitive pay. To be sure, executive pay is riskier and more contingent on firm performance than it once was. Brian Hall and Jeffrey Liebman found that the median elasticity of CEO pay relative to firm performance doubled between 1980 and 1994, driven by both an overall increase in payouts and a shift away from fixed pay to contingent pay. The trend has continued over the last decade plus, but it is interesting to note that the Hall and Liebman study covered a period almost entirely before Section 162(m)’s enactment meaning that at least the early part of the drive towards more performance-sensitive pay had little to do with tax consequences.

In another study, Hall and Liebman analyzed tax rate changes during the 1980s and 90s and found little effect of those changes on pay components. Rather, the increased emphasis on stock options during that period was apparently driven by market forces beyond tax rules. With respect to Section 162(m) in particular, Hall and Liebman find evidence of a “minor substitution of performance-related pay for salary” after the enactment of the rule. Yet even this small substitution effect is impossible.

66. For another defense of the efficiency of the compensation-setting market, see Core, Guay & Thomas, supra note 49, at 1165–69 (noting that U.S. firms had higher returns than lower-paying international peers during period in which U.S. pay increased). Core et al. offer a more robust attack on Bebchuk and Fried’s managerial power thesis on the grounds that contracting costs make arm’s-length bargaining impossible and permit a process that involves some level of managerial power to be optimal at a given firm. Id. at 1160–65. Note, however, that this would not preclude regulatory intervention aimed at balancing out the distortions created by those contracting costs. See id. at 1182.

67. There should be a level of tax that would be high enough to completely offset the gains achieved by the optimal compensation contract such that firms would begin to deviate. But see infra notes 89–93 for reasons to expect that level to remain unmet.

68. See Walker, supra note 52, at 9.


71. See id. at 3 (“Instead, changes in corporate governance, especially in the role of large institutional investors, appear to have provided the main impetus for the increase in stock-based pay.”).

72. Id. at 36.
ble to tease out from the increased market pressure to pay in performance-based pay during this period.73 The smallness of the observed substitution seems to indicate that tax played a very small role, if any.

Similarly, Nancy Rose and Catherine Wolfram found little evidence that Section 162(m) had an impact on salary growth rates.74 Like Hall and Liebman, they looked to differences between “affected”—meaning firms with predicted compensation near Section 162(m)’s $1 million cap—and “unaffected” firms’ changes in salary growth around Section 162(m) enactment. In the majority of their tests, they found no significant evidence of differences between such firms.75 In fact, they concluded by noting the fragility of the Section 162(m) effects and suggesting that Section 162(m) has apparently had little impact on compensation practices.76

How do these post hoc findings manifest themselves in firms’ pay decisions? First, a large number of firms simply forego deductions because of Section 162(m) rather than limit an executive’s salary to $1 million. Steven Balsam and Jennifer Yin studied a number of “firm years” between 1994 and 1998 and found that in almost 38% of them the firm forfeited deductions by failing to comply with Section 162(m).77 That percentage consisted of one or more firm years at almost exactly half of the sample firms.78 About a third of the forfeitures were caused by salaries in excess of $1 million and a minority of the forfeiting firms qualified their short-term bonus plans as performance-based.79 Firms consistently opted for compensation flexibility over tax savings.80

More recently, many firms have shifted away from stock options toward restricted stock. Restricted stock is essentially a heavily discounted

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73. See id. at 24.
75. See id. They did find higher variation among “affected” firms that did not adopt plans to qualify pay as performance-based. Id. It is hard to interpret this datum, however, because plan qualification has no tax effect on the salary payments that are the fluctuating dependent variable.
76. See id. (“This conclusion is consistent with the views expressed by many compensation consultants and corporate directors we have consulted. . . . Our results suggest that corporate pay may be more insulated from this type of blunt political pressure than its from the more direct pressure brought to bear at the individual firm level by stakeholder groups or through the regulatory process.” (citations omitted)). But see Balsam & Ryan, supra note 14, at 600 (arguing that stickiness of pay practices for incumbent CEOS at time of Section 162(m)’s adoption account for lack of evidence for its effect).
78. See id.
79. See id. at 315.
80. See also Austin Reitenga, Steve Buchheit, Qin Jennifer Yin & Terry Baker, CEO Bonus Pay, Tax Policy, and Earnings Management, 24 J. AMER. TAXATION ASS’N, 2002, at 1, 2–3.
option.\textsuperscript{81} Because of that discount, restricted stock cannot count as qualified compensation for Section 162(m) purposes unless its vesting is conditioned on separate performance goals.\textsuperscript{82} Yet in 2006, restricted stock grants became the largest component of pay packages for senior executives at large public companies, pushing stock options to second place.\textsuperscript{83} This change was driven by any number of reasons, but occurred in spite of the plainly negative tax considerations.\textsuperscript{84}

There is less direct evidence of the effect of Sections 280G and 4999 on change in control severance packages, but perhaps that is because it was immediately apparent that they would have a very small one. Firms were willing to work around the tax rules, forfeiting deductions and grossing executives up for the cost of the excise tax. This happened despite the fact that the resulting tax impact was significantly higher than it would have been had the executive borne the brunt of it.\textsuperscript{85} Of late, gross-ups have become more limited.\textsuperscript{86} But nothing changed in the tax regime to bring about this shift. Rather, institutional investors and other activists have begun to push back against Section 4999 gross-ups after twenty years of their proliferation. The reduction in gross-ups has correlated directly with the adoption of anti-gross-up guidelines by the most significant proxy advisor in 2009.\textsuperscript{87} What we see, then, is the clash between market forces—a competitive market for managerial talent on the one hand and the effect of increasing shareholder activism on the other—not anything remotely driven by tax rules.\textsuperscript{88}

\textsuperscript{81} Specifically, it is an option to purchase company stock with an exercise price of $0.


\textsuperscript{83} See id. at 633.

\textsuperscript{84} See id. at 634–39.

\textsuperscript{85} See, e.g., Mullane, \textit{supra} note 2, at 517–18.


\textsuperscript{88} Moreover, a relatively simple workaround for anti-gross-up rules would be to simply top up the initial severance payment so that, even after the 10\% excise tax, the net payment to the executive is the same. It is unclear whether this strategy has been utilized in a post-gross-up environment.
V. THE MODESTY OF TAX RESPONSES

Much of the triviality analysis in the preceding section can be attributed to the magnitude of the penalty imposed by the tax intervention. For example, imagine if Section 162(m) not only limited the ability of a firm to claim a deduction but also imposed a significant surtax on a firm that paid over $1 million to a top five executive in non-performance-based pay. In that case, we might very well expect firms to alter their behavior in response to tax incentives. The tipping point in this context may be higher or lower than someone might predict, but the basic point should be uncontroversial: there is a point at which tax costs could outweigh the costs of deviating from market-based pay outcomes. As a result, much of the argument for triviality implies that the costs imposed by tax intervention are relatively small, at least in comparison with those deviation costs.

Why are the tax burdens so low? One way to conceive of tax rules with more significant penalties is as coercive regulation. An extreme tax is effectively a mandatory rule. But despite all of the hand wringing about excessive executive pay, few critics have endorsed some sort of coercive regulation limiting executive pay. For instance, David Walker, one of the main proponents of the managerial power thesis described above, has expressed concerns about distortions occasioned by coercive compensation regulation, e.g., pay caps.89 The concern about distortive effects brought on by mandatory rules presupposes an important point: firm heterogeneity with regard to optimal pay packages.90 Essentially, the worry is that coercive regulation is too blunt an instrument and will impose a one-size-fits-all rule on a world where there is substantial difference between firms in compensation needs. As Walker puts it, “[p]rices result in greater freedom of behavior and less distortion [than do sanctions].”91

For example, it would be a net negative socially, if some firms, in response to new information regarding the benefits of risk-taking, were unable to move away from stock options and toward restricted stock in compensation packages. A mandatory version of Section 162(m) that required all executive pay to be performance-based would therefore be problematic at least to the extent there is significant heterogeneity over such matters across firms.92 It is possible that the case for the heterogeneity of optimal pay packages has been overstated or at least under-supported, but it certainly holds a significant amount of influence even

89. See Walker, supra note 52, at 53–56.
90. See, e.g., id. at 51 (“Even if executive pay levels are too high systematically, we do not know the exact degree of excess pay and there is likely to be substantial heterogeneity in the amount of excess pay from firm to firm.”). Alternatively, the concern about mandatory rules could be driven simply by a fear of regulatory mistake.
91. Id. at 50.
92. If restricted stock dominated stock options as a pay choice across firms, then coercive regulation would only be problematic to the extent it misinterpreted the data and reached the wrong policy prescription.
among critics of executive pay practices. Accordingly, there are few serious proposals to mandate certain payment levels to executives.

For exactly the same reasons, though, we should not expect any tax intervention to be particularly aggressive. If those who are concerned about executive pay levels are unwilling to consider coercive regulation, how likely are they to consider tax penalties that truly tilt the scales when pay decisions are being made? Yet, for the reasons discussed in the previous section, absent extreme tax penalties, any tax intervention is bound to be of little effect beyond imposing costs on firms. Many may want to change compensation practices, but most are too scared of doing so and causing harm.

Aside from interfirm heterogeneity, there is also likely to be substantial intrafirm heterogeneity with regard to optimal pay packages over time. Take, for example, some firms’ revealed preference for restricted stock over stock options reflecting a reevaluation of the best set of risk-taking incentives.93 Even if every public firm in 1994 would have benefited from a coerced move to stock options via a more penal Section 162(m) regime, within a matter of years that state of affairs could have shifted. At that point, the coercive Section 162(m) regime would have produced suboptimal results making it too costly for firms to adapt. It is possible that the coercive tax law could then have been changed, but it seems more than plausible to expect any changes to lag behind the market shift. Thus, even if firms are not as different from each other in terms of compensation needs as is generally suspected, draconian tax interventions may still be problematic. This recognition too leads us along the path of relatively weak tax interventions.

VI. Conclusion

Given the tension between ineffectiveness and coercion, the best claim to be made for governance-driven tax interventions is that they may be able to focus the more powerful market forces on particular practices. Thus, Section 4999 could be seen as causing the need for gross-ups, which eventually prove a convenient lightning rod for outrage costs. In the same way, Section 162(m) (non-)compliance patterns could have generated political and market pressure on firms to change their practices. But note that, in either case tax is more or less beside the point. It simply serves as a tool by which some compensation norm is expressed and tested by a disclosure rule.

It would have been just as easy for, say, RiskMetrics to announce guidelines for severance multiples in 2009 in the absence of guidance from Section 280G or Section 4999. Tax rules have no monopoly on providing a focal point for market outrage —disclosure rules seem much more important in that regard. In fact, to the extent tax rules miss the

93. For a discussion of firms’ preference for restricted stock over stock options, see supra note 82 and accompanying text.
market’s preferences in establishing that focal point, as they appear to have done with Section 162(m), they may impose unnecessary tax-related costs in the process. If tax is reliant on market forces galvanizing around the norms it establishes, why not just rely on those market forces to establish such norms? This seems particularly sensible in a world where large institutional investors and shareholder advisors are more than capable of concocting detailed compensation guidelines.

Alternatively, an ambitious researcher could seek to demonstrate that firms are not that heterogeneous with respect to their compensation needs. If that were the case, coercive regulation or tax interventions with teeth might be back on the table, at least insofar as the risk of regulatory mistake were minimized. But until that day comes, it might be best to simply refrain from using tax tools to try and achieve corporate governance outcomes.
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PERFECT STORMS: CONGRESSIONAL REGULATION OF EXECUTIVE COMPENSATION

JOY SABINO MULLANE*

I. INTRODUCTION

EXECUTIVE compensation has been front-page news for much of the past decade, beginning with the fall of Enron Corporation and ending most recently with the meltdown of the financial sector of the U.S. economy.1 During this time frame, Congress enacted several significant pieces of legislation containing provisions designed to regulate executive pay in some manner.2 Together, these events generated a significant body of scholarly literature addressing the merits of pay regulation in general or assessing particular aspects of enacted legislation.3

The twenty-first century, however, is not the first time in U.S. history that controversy over executive pay and resulting legislation has been the subject of intense academic study.4 In each prior instance, though, most of the literature examining the regulation of executive compensation focused on a narrow point in time and limited legislative scope.5 Neverthe-

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1. For a discussion of this decade’s financial downturns and related scandals, see infra notes 131–76.
2. See id.
3. Indeed, the literature is too voluminous to provide an exhaustive string cite here. Instead, for a discussion of several of the most recent legislative enactments addressing executive compensation, see infra notes 141, 150, and 176.
4. For a discussion of the deeply rooted history of executive compensation, see infra notes 9–176.
5. This makes sense for a variety of reasons, including allowing for a fuller examination of a particular piece of legislation. It is also the result of the fact that executive compensation is subject to regulation in a variety of forms, covering more than one academic discipline. Scholars, understandably, tend to concentrate on the area in which they are experts. Thus, corporate governance scholars, for example, typically focus on corporate governance legislation affecting executive pay to the exclusion of tax legislation. Tax scholars likewise tend to stay on their side of the academic dividing line. Executive compensation scholarship, particularly from the corporate governance angle, is wont to compare and contrast the focus of a particular writing with events or legislation from the Great Depression era. See, e.g., Linda J. Barris, The Overcompensation Problem: A Collective Approach to Controlling Executive Pay, 68 IND. L.J. 59, 62 (1992) (referring to early 1990s public opinion towards executive compensation packages as “echo of the 1930s”); Andrew R. Brownstein & Morris J. Panner, Who Should Set CEO Pay? The Press?
less, a longer and wider view of congressional regulation of executive compensation is warranted. This Article considers the executive compensation debates of the past century and resultant regulations that have arisen. From this historical perspective, it draws some important insights regarding the factors that elicit legislative regulation of executive compensation, and provides a prescription for future regulation in this area.

This Article proceeds as follows. Part II provides the historical context of executive pay regulation in broad outline. It begins with the rise of the modern corporate executive in the early 1900s, and the public’s awakened awareness of executive compensation in the aftermath of the Great Depression. This part ends with present-day events.

Congress? Shareholders?, Harv. Bus. Rev., May-June 1992, at 28 (discussing events of early 1990s and 1930s); Larry E. Ribstein, Bubble Laws, 40 Hous. L. Rev. 77, 90–94 (2003) (discussing Sarbanes-Oxley Act and Great Depression era from U.S. history); Harwell Wells, “No Man Can Be Worth $1,000,000 A Year”: The Fight Over Executive Compensation in 1930s America, 44 U. Rich. L. Rev. 689, 696 (2010) (discussing Great Depression era in great detail). There is generally, however, little to no consideration of other eras, and legislation therefrom, within a given article. Again, this makes sense considering the most significant pieces of corporate governance legislation were enacted in the Great Depression era and then not again until the twenty-first century. In the intervening years, however, Congress enacted important pieces of tax legislation regulating executive compensation.

This Article merges the history of legislation regulating executive pay through the vehicles of corporate governance legislation and tax legislation, and draws insights therefrom. Note, however, that this Article generally does not discuss other modes of regulation, such as administrative law developments or changes in accounting practices. Further, when it comes to considering prescriptions for problems in executive pay legislation, this author remains rooted in tax law.

6. This Article is the first to consider in depth the factors that trigger legislation regulating executive compensation from the inception of such regulation in the 1930s. Prior to this Article, scholarship generally mentions possible factors in brief passing commentary, with most of the focus on the nexus of regulation and the state of the economy. See, e.g., Brownstein & Panner, supra note 5 at 28 (briefly mentioning factors perceived as relevant to debate over executive pay in 1990s, such as new corporate proxy environment, economic recession, Americans’ perception of declining competitiveness, and election year); Louis M. Thompson, Jr., The SEC Targets Executive Pay, Directors & Boards, June 22, 1991, at 48, 48 (editorializing that it “did not take a whiz kid” to realize that Congress would get involved with such an “emotionally charged issue” as excessive compensation in time of recession). But see Kevin J. Murphy, Politics, Economics, and Executive Compensation, 63 U. Cin. L. Rev. 713, 714-15 (1995) (examining in depth “the political and economic forces that created the controversy over executive compensation” in early 1990s and proposing that those forces are “fundamental and rapid changes in the United States and world economies that began in the mid-1970s and will continue throughout the next several decades”). Importantly, this Article shows that an economic downturn alone is insufficient to generate legislation in this area.

It is worth noting that Professor Larry Ribstein has considered the causes of securities regulation. See Ribstein, supra note 5. Focusing primarily on two points in U.S. history (the stock market crash of 1929 and the bursting of the internet bubble in the early 2000s), Professor Ribstein concludes that securities regulation follows a “boom-bubble-bust” cycle. See id. at 78 (discussing, too, other scholars reaching similar conclusions regarding securities regulation).
Part III then analyzes this history and finds that legislation regulating executive pay is enacted when three factors coalesce: economic turmoil (i.e., a recession), rising unemployment, and an executive pay controversy. The foregoing factors are instructive; they support the instinctive notion that the state of the economy, reflected to some extent by the unemployment rate, is important when it comes to inciting serious criticisms about executive pay. However, it is important to note that, alone, both a declining economy and rising unemployment rate are insufficient to trigger regulatory legislation. Legislation results when those factors are combined with an executive pay controversy that acts as a focusing event.

Given the increasing frequency with which these factors have been converging in modern times, it is reasonable to conclude that they are likely to occur again. Through the lens of tax-based regulation of executive pay, Part IV thus considers the predicament of a Congress compelled at certain points in time to “do something” about executive pay, but that resulted in legislation that is widely viewed as seriously flawed. It suggests that the most viable of imperfect solutions is to enact this legislation with a sunset provision. Part V concludes the Article.

II. A Concise Socio-Political History of Executive Compensation

A. The Rise of the Modern Executive in the Early 1900s

Executives, as we now conceive of them, are a twentieth century invention. Less than one hundred years ago, large commercial enterprises led by professional managers were a relatively new phenomenon. The earliest business leaders were owner-managers whose fortunes were bound to those of the company through stock ownership. As such, there was a natural incentive—naked self-interest—to managing the company with

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7. See, e.g., infra notes 177–206. Also illuminating is noting what factor does not seem to matter much: how much executives are paid. History shows that the public displays significantly less concern and interest in executive pay, even as it increases dramatically, so long as the economy is doing well, jobs abound, and there are no pay controversies to catalyze public sentiment. See infra notes 199–202.

8. A focusing event is “a crisis or disaster that comes along to call attention to [a] problem” and push “people in and around government” to address it. JOHN W. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICIES 94–95 (2d ed. 1995). This definition is a bit strong for the events described in this Article, but it is nevertheless a helpful way of conceiving of the function of the executive pay controversies throughout the last century.

9. See George T. Washington, The Corporation Executive’s Living Wage, 54 HARV. L. REV. 733, 739-34 (1941); Wells, supra note 5, 695 (observing that early twentieth century America witnessed shift from proprietary management system in which corporate control was vested in “individuals who owned an appreciable percentage of the firm and whose economic rewards derived mostly from ownership” toward executive management as large corporations became more common).

10. See Wells, supra note 5, at 696.
the utmost diligence, and manager salaries were rarely extraordinary, with little or no opportunity for additional performance-based pay.\textsuperscript{11}

This corporate structure began changing as business operations grew in size and complexity.\textsuperscript{12} Professional managers, a new class of executive that had little or no personal ties to the corporation, gradually replaced owner-managers.\textsuperscript{13} The emergence of professional executives generated new challenges for the business owners. Among them, the separation of ownership and management created a need to align the executives’ interests and the interests of the owners.\textsuperscript{14} The response to this need was the introduction of performance-based compensation as a component of an executive’s pay package.\textsuperscript{15}

Incentive programs were thought to encourage professional executives to perform with the same diligence as the owner-managers by tying

\begin{footnotes}
\footnote{11. See F.W. Taussig \& W.S. Barker, \textit{American Corporations and Their Executives: A Statistical Inquiry}, 40 Q.J. ECON. 1, 19 (1925) (noting that one study found that in 1904-1914 executives of largest manufacturing companies received on average salaries approaching \$10,000, approximately \$228,515.15 in today’s dollars); Washington, supra note 9, at 734 (“The corporate manager, as such, simply had no place in the upper income levels.”).


13. See, e.g., Taussig \& Barker, supra note 11, at 2 (recognizing that at time of their writing, in 1925, “[i]ncorporated industry under salaried managers [was] the order of the day.”); Washington, supra note 9, at 734 (offering profile of new generation of executives).


15. See Marlo A. Bakris, Note, \textit{Executive Compensation Disclosure: The SEC’s Newest Weapon in its Arsenal Against Executive Compensation Abuses}, 71 U. DET. MERCY L. REV. 105, 111–12 (1993); Bakris, supra note 5, at 68 (recognizing need to compensate salaried executives differently than owner-managers); Washington, supra note 9, at 734 (explaining how executive identity helped to shape compensation packages). Performance-based pay was unnecessary when the manager was also the owner and as such necessarily reaped the rewards of good performance or suffered the loss of bad performance.}
the executive’s fortunes to that of the company’s. In theory, this means the executive risks receiving little or no pay if the company does not perform as expected. To offset this risk, a premium is added to the amount of compensation paid to the executive if the company performs well, increasing overall compensation above the level that would have been paid absent the presence of performance-based risk.

The separation of ownership and management was also the impetus for increasing levels of an executive’s base salary. Corporate boards thought offering a generous salary was necessary to attract and retain a top executive who would be able to successfully manage the company. These increases, combined with incentive pay, laid the foundation for modern debates about both the level and types of pay executives receive.

16. See Barris, supra note 5, at 61 (explaining that salaried executives had “little incentive” to perform at level “greater than that required to retain their positions”); see also Bakris, supra note 15, at 105 (describing as “universally understood” notion that pay encourages better results); Randall S. Thomas & Kenneth J. Martin, The Determinants of Shareholder Voting on Stock Option Plans, 35 WAKE FOREST L. REV. 31, 38 (2000) (stating executive compensation packages comprised of salary and bonuses alone are arguably inferior to those that include incentive compensation). But see Andrew C.W. Lund & Gregg D. Polsky, The Diminishing Returns of Incentive Pay in Executive Compensation Contracts, 87 NOTRE DAME L. REV. 677, 679–82 (arguing that, in light of evolving corporate governance mechanisms, push for greater and greater incentive pay is no longer warranted). It is noteworthy, however, that performance-based pay has existed in some form for thousands of years. Julius Caesar created an incentive program for his armies, granting bonuses to soldiers after successful conquests. See Bakris, supra note 15, at 105.


18. See Graef S. Crystal, In Search of Excess: The Overcompensation of American Executives 47 (1991) (noting boards’ reluctance to reduce executive compensation even during declines in profitability to ensure retention of top talent); see also Bakris, supra note 15, at 111 (offering corporate rationales for large executive compensation packages such as necessity of large salaries for corporation seeking to ensure continued success by attracting and retaining top executive talent); Washington, supra note 9, at 734 (noting that manager-for-hire was not necessarily independently wealthy, and in absence of stock ownership, sought large salaries to both provide for his future and maintain lifestyle of executive in large company).

19. With the shift in executive identity, “[b]y 1928 the executives of some of America’s largest companies were receiving compensation running as high as $1,000,000 or $1,500,000 annually” (approximately $13,229,825 or $19,844,737 in today’s dollars). Washington, supra note 9, at 734; see also Taussig & Barker, supra note 11, at 19 (explaining that salaries “greatly increased” during World War I and remained high after war’s end). Additionally, executives were awarded an array of profit-based bonuses. See Wells, supra note 5, at 700 (“Executive bonus plans flourished in the 1920s.”); Washington, supra note 9, at 737–56.
B. The Revelation of Executive Pay: The Great Depression Era

The Great Depression era, by most accounts, began in 1929 and lasted through the late 1930s or early 1940s.\textsuperscript{20} The beginning is often marked by the stock market crash of October 29, 1929, referred to as Black Tuesday.\textsuperscript{21} Thereafter, the world plunged into a deep economic depression.\textsuperscript{22}

Scores of Americans lost their jobs. In the years leading up to the Great Depression, the unemployment rate in the United States was around 3.3\%.\textsuperscript{23} In 1930, the rate jumped to 8.9\%, and it almost doubled by 1931 to 15.9\%.\textsuperscript{24} Unemployment was at its highest during this era in 1933, when the rate hit 24.9\% before slowly declining to 17.2\% by 1939.\textsuperscript{25} Although the lives of executives had long been a popular subject of the media, albeit mostly favorable, executive pay arrangements first re-


\textsuperscript{22} See Ben S. Bernanke & Kevin Carey, Nominal Wage Stickiness and Aggregate Supply in the Great Depression, 111 Q.J. Econ. 853, 855 (1996) (contending “world economy collapsed in the 1930s” and examining cause of crisis in twenty-two countries worldwide); Crafts & Fearson, supra note 20, at 294 (asserting international reliance on gold standard was primary reason Great Depression effects were transmitted worldwide); Robert C. Effros, Sir Joseph Gold and His Times, 8 L. & Bus. Rev. Americas 9, 14 (2002) (observing that during 1930s, “the world experienced its greatest collapse of commodity prices and shrinkage of world trade”).

\textsuperscript{23} See infra Appendix (chart of unemployment rate spanning years 1923 to 2010). It should be noted that the unemployment rate is a lagging indicator. See, e.g., Pia M. Orrenius & Madeline Zavodny, The Effect of Minimum Wages on Immigrants’ Employment and Earnings, 61 Indus. & Lab. Rel. Rev. 544, 555 (2008) (noting that “the unemployment rate, unlike employment, lags economic activity”). In other words, it measures an effect after an occurrence. Thus, the unemployment rate will continue to rise for a period even after the economy has started to recover, and conversely will remain low for a period after the economy has started to falter.

\textsuperscript{24} See id. (reporting unemployment rate in 1930 and 1931).

\textsuperscript{25} See id. (noting unemployment rate was highest in 1933).
ceived public attention during the Great Depression. Before then, corporations closely guarded information concerning their financial condition and business practices, including executive pay levels. As a result, stockholders and the general public had been unaware of the size of executive compensation packages. In the early 1930s, however, executive compensation levels emerged into the public sphere as a result of litigation and congressional investigations. The size of the pay packages


27. See Barris, supra note 5, at 61 (identifying secrecy as primary shield from public resentment over executive compensation); Taussig & Barker, supra note 11, at 7 (stating that “[n]o economic data are so hard to procure as the jealously guarded figures of earnings, accruals, business profits, and salaries”); Detlev Vagts, Challenges to Executive Compensation: For the Markets or the Courts?, 8 J. Corp. L. 231, 245 (1983) (discussing corporate tradition of secrecy); Washington, supra note 9, at 756; see also Savarese, supra note 26, at 15–17 (asserting public was unaware or apathetic to executive salary prior to Great Depression).

Until laws were enacted as part of New Deal legislation, publicly traded companies were not required to disclose information about compensation. See Wells supra note 5, at 707–08 (noting public companies were not required to and did not routinely disclose executive compensation levels prior to 1930s).

28. See Berendt v. Bethlehem Steel Corp., 154 A. 321, 321 (N.J. Ch. 1931) (enjoining Bethlehem Steel from awarding further payments as part of bonus scheme characterized as “exorbitant” by shareholders); see also Rogers v. Hill, 53 F.2d 395, 396 (S.D.N.Y. 1931) (requesting judicial intervention to compel disclosure of bonus payments to American Tobacco Company executives between 1921 and 1930); Rogers v. Am. Tobacco Co., 257 N.Y.S. 321, 325 (Sup. Ct. 1931) (affirming “stockholders’ privilege of demanding a full disclosure by the directors”); Barris, supra note 5, at 62 (noting that shareholder litigation helped to unearth previously unpublished information regarding executive compensation); Vagts, supra note 27, at 245 (recognizing that several otherwise undisclosed salary figures were publicized through litigation they inspired).

these events revealed were simply stunning to the American public, and galvanized legislators to begin regulating executive pay.\footnote{See Wells, supra note 5, at 690.}

The earliest challenges to executive compensation at large corporations came in the form of shareholder lawsuits in 1931. Through disclosures made during litigation related to a proposed merger, shareholders of Bethlehem Steel, one of the nation’s largest companies, first learned of the size of the compensation paid to the company’s executives.\footnote{See Washington, supra note 9, at 738.} The enormity of the pay was due in large part to incentive compensation—bónuses—not the executives’ fixed salaries.\footnote{See id. at 757.} After this pay information was disclosed, four stockholders sued for a return of the extravagant bonuses and sought an injunction against further payments.\footnote{Berendt, 154 A. at 321 (enjoining Bethlehem Steel from awarding further payments as part of bonus scheme characterized as “exorbitant” by shareholders); see also Washington, supra note 9, at 737–41 (providing narrative history of Bethlehem Steel litigation).} The Bethlehem Steel suit ultimately settled. However, a shareholder of the American Tobacco Company, another large corporation, sued in 1931 to inspect company books to obtain information about executives’ compensation.\footnote{Rogers v. Hill, 53 F.2d 395, 396 (S.D.N.Y. 1931) (requesting judicial intervention requiring disclosure of bonus payments to American Tobacco Company executives between 1921 and 1930); Rogers v. Am. Tobacco Co., 257 N.Y.S. 321, 325 (Sup. Ct. 1931) (affirming “stockholders’ privilege of demanding a full disclosure by the directors”); see also Washington, supra note 9, at 741–48 (detailing American Tobacco Company bonus practices and litigation).} The shareholder won, and, upon learning the significant sums paid to executives, brought further suits attacking the company’s compensation plans.\footnote{See generally Rogers v. Hill, 289 U.S. 582 (1933) (detailing shareholder action to recover more than $1 million in bonuses paid to executives of American Tobacco Company). In Rogers, the Supreme Court famously recognized the doctrine of corporate waste, stating that bonus payments that bore no relationship to services rendered by executives were in fact gifts that could not be granted without majority shareholder approval. See id. at 591–92; Steven C. Caywood, Note, Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation, 109 Mich. L. Rev. 111, 117 (2010). Since the time of Rogers, the corporate waste doctrine has not provided strong grounds for challenging executive compensation payments. See Rogers, 289 U.S. at 591–92; Caywood, supra, at 117; Nathan Knutt, Note, Executive Compensation Regulation: Corporate America, Heal Thyself, 47 Ariz. L. Rev. 493, 494 (2005) (recognizing courts’ general unwillingness to consider compensation disputes).} In the end, these prominent suits as well as suits against other large companies revealed previously unpublished information regarding...
executive compensation.36 This information was reported in the press and ignited public indignation over high executive pay.37

Various congressional investigations were also unearthing information about executive pay. In 1932, a senate committee examining the causes of the stock market crash scrutinized the salaries and tax returns of the banking executives appearing in hearings before the committee.38 The process revealed the disturbing information that prominent banking and investment executives in some instances managed to pay no federal income taxes and in others received compensation considered exorbitant at that time.39

Then, in 1933, the Federal Trade Commission began preparing a report on the “Compensation of Officers and Directors of Certain Corporations” pursuant to a Senate resolution calling for such information.40 The report was completed and its findings made public in 1934, triggering fur-

36. See Barris supra note 5, at 62 (stating litigation by shareholders during 1930s “unearthed some of the previously hidden information” regarding executive compensation); Vagts, supra note 27, at 246 (observing litigation “unearthed” high levels of executive pay occurring during 1920s); Wells, supra note 5, at 710 (suggesting executive salaries at Bethlehem Steel would have “stayed a secret” but for litigation).

37. See Carl T. Bogus, Excessive Executive Compensation and the Failure of Corporate Democracy, 41 BUFF. L. REV. 1, 48–49 (1993) (labeling disclosed executive salaries “obscene” when compared to earnings of teachers, construction workers, and sweatshop employees in time period); Randall S. Thomas & Harwell Wells, Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers’ Fiduciary Duties, 95 MINN. L. REV. 846, 858 (2011) (highlighting Fortune magazine poll following salary disclosures reflecting public disapproval of executive salary); Wells, supra note 5, at 713 (observing salary revelations “particularly stung in a period when many were out of work . . . and wages were reduced for those with jobs”).

38. For a discussion of those hearings, see supra note 29 (citing hearings); see also Wells, supra note 5, at 714 (describing information revealed by the Pecora investigation). The Senate Committee on Banking and Currency launched an inquiry into the causes of the nation’s economic decline in 1932, which generated a wealth of information after Ferdinand Pecora assumed leadership of the investigation as chief counsel in 1933. The so-called “Pecora investigation” produced 12,000 pages of documents detailing Wall Street excess, fraud, and tax evasion in the years leading up to the stock market crash of 1929. See Ron Chernow, Where Is Our Ferdinand Pecora?, N.Y. TIMES, Jan. 25, 2009, at A2 (describing Pecora investigation by Senate Committee on Banking and Currency); Amanda Ruggeri, Pecora Hearings a Model for Financial Crisis Investigation, U.S. NEWS & WORLD REPORT, Sept. 29, 2009, at 2, http://www.usnews.com/news/history/articles/2009/09/29/pecora-hearings-a-model-for-financial-crisis-investigation (crediting Pecora’s “methodical [ ] prosecutorial style” with uncovering salary information that lead to resignation of National City Bank’s chairman and president, and set stage for reform legislation).

39. See Wells, supra note 5, at 714 (“Pecora disclosed, for example, that the partners of J.P. Morgan paid no taxes in 1931 or 1932,” and that Charles Mitchell, President of New York’s National City Bank and its affiliated securities firm, National City Company, had received over one million dollars in compensation in 1927, 1928, and 1929).

40. For a discussion of the Senate Resolution, see supra note 29 (citing Senate resolution).
ther public resentment of corporations and executives. As one researcher has noted:

[T]he report was groundbreaking in the public attention it focused on long held company secrets. For the first time in U.S. history, the average citizen experienced a clear picture of the internal operations of some of the largest corporations in the world that, in many ways, had strong indirect influences on the lives of most people in the country.

One of the most shocking revelations to come forth during this era was how little the stock market crash of 1929 and the early years of the ensuing depression affected the compensation level of many executives. Most bonus payments, of course, disappeared as profits did, but salaries remained largely intact. Indeed, some managers received salary increases to compensate for lost incentive pay. The irony of corporate

41. It should be noted that:
The report . . . was not easy to compile. Though the Federal Trade Commission was authorized by the United States Senate, and the Supreme Court via the commerce clause, to investigate corporations and individuals engaged in interstate commerce, executives at the companies targeted were less than willing to cooperate. After years of operating without government oversight, powerful executives were not ready to concede so quickly to what they perceived to be a new presidential administration flexing its muscles. Consequently, the report was not entirely complete.

Although 877 schedules were returned, "shortly after the returns began to come in it became obvious that many companies had not included indirect compensation, that is, amounts paid by subsidiary or affiliated companies." Several companies made incomplete returns; some alleged that they did not engage in interstate commerce and were thus exempt from the inquiry; and others refused or neglected to report entirely.

Savarese, supra note 26, at 20–21.

42. See id. at 21 (noting also that "the findings of the Commerce Commission provided data that allowed scholars to finally study executive compensation through an academic lens").

43. See Vagts, supra note 27, at 245–46 (explaining that stock market crash had "mild[ ] effects" on executive salaries, which remained "stable"); see also Washington, supra note 9, at 734 (explaining that bonus payments "either ceased or were sharply reduced").

44. See MARK LEFF, THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933–1939 75 (1984) (explaining that some companies grudgingly reduced salaries of their executives, but others actually increased salaries); Washington, supra note 9, at 743 (noting that executives were compensated with increased salaries in 1930 and 1931).

It is still not unusual for companies to buffer executives' compensation from the vagaries of the economy or stock market. See, e.g., Barris, supra note 5, at 66 ("Many compensation packages are constructed so that the executive profits in good times and is protected in bad. If stock prices decline, the executive may lose his bonus, but he may have the ability to renegotiate the option portion of his existing plan to lower the strike price, the price at which the option can be exercised. Thus, the executive is rewarded regardless of his or the corporation's performance and is simultaneously insulated from the ravages suffered by fellow shareholders if stock value declines." (footnote omitted)); Louis Lavelle, Executive Pay, BUSINESSWEEK, Apr. 16, 2001, http://www.businessweek.com/magazine/con-
executives receiving pay increases to compensate for stock market bonus losses—while at the same time numerous average Americans were struggling to find work and, if able to do so, a living wage—was apparent to the general public.45

Resentment toward executives grew considerably.46 Politicians were eager to capitalize on this public resentment and earn political points by “castigating the ‘greedy pigs’” committing “robbery” of businesses in their control.47 Thus, they undertook a number of legislative efforts aimed at curtailing executive compensation levels. As briefly discussed below, these efforts fell into two broad categories: mandated disclosures and salary limits at companies doing business with the government.48 Use of the tax system to regulate executive compensation was also considered, but ulti-

tent/01_16/b3728013.htm (noting that “in 2000, w]hile shareholders got ham-

45. For a discussion of the increasing public awareness of executive compensation, see supra notes 43 and 44; see also Wells, supra note 5, at 709–16 (explaining that information revealed during early 1930s regarding executive compensation, salaries and bonus plans, “particularly stung in a period when many were out of work (unemployment grew to twenty-five percent early [sic] 1933) and wages were reduced for those with jobs”).

46. See Leff, supra note 44, at 74–90 (noting subsequently enacted legislation that was prompted by such public resentment specifically targeted highly paid corporate executives while excluding other highly paid individuals such as doctors, lawyers, and small businessmen).

47. Id. at 76 (explaining further that Roosevelt administration feared “un-
happy public reaction” if action was not taken); see also Brownstein & Panner, supra note 3, at 28 (describing Roosevelt’s New Deal reforms designed to confront what President Roosevelt condemned as “entrenched greed” of corporate managers).

48. For a discussion of the legislative efforts designed to limit executive compensation, see infra notes 51–59 and accompanying text. See generally Charles M. Elson, Executive Overcompensation—A Board-Based Solution, 34 B.C. L. REV. 937, 937 (1993); I. George T. Washington & V. Henry Rothschild, 2d, Compensating The Corporate Executive 9 n.32, 10–11 (rev. ed. 1951); Leff, supra note 44, at 74–90 (discussing legislative efforts to reduce executive compensation levels).
mately dismissed.\textsuperscript{49} Instead, tax rates were raised on America’s wealthiest citizens.\textsuperscript{50}

Many policymakers viewed corporate transparency as a natural restraint on high levels of executive compensation.\textsuperscript{51} The theory was that if

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\item Some legislative proposals would have imposed additional taxes or special higher rates of tax on individuals receiving salaries above certain levels. See \textsc{Leff}, supra note 44, at 86–87 (discussing various proposals); Joseph J. Thorndike, \textit{Too Much: The Historical Link Between Bailouts and Pay Caps}, \textsc{Tax Analysts}, Oct. 6, 2008, http://www.taxhistory.org/thp/reading.nsf/ArtWeb/0AE30B4E5C8A2B0852574DA0051591F?OpenDocument (same). Conversely, other proposals would have capped corporate tax deductibility for compensation paid to executives. See id. None of these proposals were enacted. However, one reason the proposal to cap corporate tax deductibility for executive compensation lacked support was that legislators realized that, under the tax laws at that time, any income tax corporations and shareholders might pay as a result of the proposal was surpassed by the income tax executives would pay on receiving a high level of compensation. See Washington, supra note 9, at 767 n.105 (recounting congressional determination of benefit of capping deductibility); see also \textsc{Leff}, supra note 44, at 88–89 (explaining Congress’s reasoning in rejecting cap).
\item See generally Elson, supra note 48, at 937; \textsc{Washington & Rothschild}, supra note 48, at 9 n.32, 10–11. For the years immediately preceding and following the stock market crash of 1929, i.e., from 1925 to 1931, the federal income tax rates and brackets changed little, with the highest marginal rate reaching 25%. See \textsc{Tax Found.}, \textsc{Federal Individual Income Tax Rates History} (2011), available at http://www.taxfoundation.org/files/fed_individual_rate history_nominal&adjusted-20110909.pdf. [hereinafter \textsc{Tax Rates}]. This rate applied to taxable income over $100,000 (approximately $1,292,743 to $1,480,355 in 2011 dollars). See id. In 1932, and again in 1936, both the federal income tax rates and brackets were significantly changed, with the top marginal rate being raised to 63% and 79%, respectively.
\item It is important to note that, from the inception of the modern income tax in 1913 to the beginning of United States involvement in World War II in 1940, at most only about 5% of working Americans paid any income tax at all. See Understanding Taxes, \textsc{Internal Revenue Service}, http://www.irs.gov/app/understandingTaxes/teacher/whys_thm02_les05.jsp (last visited May 28, 2012) [hereinafter Understanding Taxes]. This was due, in large part, to the high exemption level set by the income tax laws, under which no income tax was due. Once an individual’s taxable income rose above the exemption level, the tax rate structure was progressive. The individual federal income tax system did not become more broadly applicable until the Revenue Act of 1942. See id. Thereafter, approximately fifty to seventy-five percent of American workers paid federal income tax. See id. (detailing history of U.S. tax system).
\item See John W. Head, \textit{The Global Financial Crisis of 2008-2009 in Context—Reflections on International Legal and Institutional Failings, “Fixes,” and Fundamentals}, 23 \textsc{Pac. McGeorge Global Bus. & Dev. L.J.} 43, 95 (2010) (stating 1933 began "reliance on transparency to guard against financial chaos on the theory that supplying players in the marketplace . . . would guard against chaos and crisis"); see also \textsc{Leff}, supra note 44, at 76–77 (quoting politicians at that time expounding on importance of salary publicity); Jerry W. Markham, \textit{Regulating Excessive Executive Compensation—Why Bother?}, 2 \textsc{Bus. & Tech. L.} 277, 284 (2007) (stating disclosure legislation reflected ideal that "sunlight is said to be the best of disinfectants, electric light the most efficient policeman" (quoting \textsc{Louis D. Brandeis, Other People’s Money and How the Bankers Use It} 92 (1933)));
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pay packages were readily available for public inspection, then corporations would somehow be shamed into paying their executives less.\footnote{See \textit{Leff}, supra note 44, at 76–80 (discussing salary publicity as governmental attempt to attack corporate salaries); Peter V. Letsou, \textit{The Changing Face of Corporate Governance Regulation in the United States: The Evolving Roles of the Federal and State Governments}, 46 \textit{Williamette L. Rev.} 149, 176 (2009) (suggesting plain language of Securities Exchange Act reflects aim of “shaming” corporations); \textit{see also} Markham, \textit{supra} note 51, at 278 (suggesting disclosure regulations designed “to shame executives into accepting lower compensation” but arguing these efforts actually fueled excess salaries).} Or, put differently, corporations would be deterred from paying overly large compensation packages. The most significant disclosure legislation—indeed, the most enduring legislation from the Great Depression era regulating executive compensation—was the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934.\footnote{See \textit{Securities Act of 1933, 48 Stat. 74} (codified as amended at 15 U.S.C. § 77a-77m (2006)); \textit{Securities Exchange Act of 1934, 48 Stat. 881} (codified as amended at 15 U.S.C. § 78a-78nn (2006)). A disclosure provision was also enacted as part of the Revenue Act of 1934. The Act ordered the Treasury Department to provide Congress with a list identifying the names and corporate salaries of employees receiving more than $15,000 annually (approximately $253,243 in today’s dollars). \textit{See \textit{Leff}, supra note 44, at 77; \textit{see also} Brownstein & Panner, \textit{supra} note 5, at 28. The $15,000 floor was raised to $75,000 annually in 1938 (approximately $1,203,351 in today’s dollars) before this form of salary publicity was repealed in 1949. \textit{See \textit{Leff}, supra note 44, at 80. Congress generally forwarded this information, extracted from corporate income tax returns, to the press, which in turn made the information public—though the press often only provided incomplete accounts to the public. \textit{See Washington, supra note 9, at 765 n.102. Although more straightforward than disclosures made to the SEC, this provision was duplicative of the disclosure requirements of the newly-created SEC and was eventually repealed in 1949. \textit{See \textit{Leff}, supra note 44, at 79.}}. Through the latter Act, Congress created the Securities and Exchange Commission (SEC). As part of the SEC’s mission “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation,” the SEC administers the securities laws, which require disclosure of executive compensation packages.\footnote{The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, U.S. SEC. \& EXCH. COMM’N (Oct. 24, 2011), http://www.sec.gov/about/whatwedo.shtml. Those subject to disclosure and the content of required disclosures have varied over the years but the legal obligation to disclose continues to this day. The most significant amendments to the original executive pay disclosure rules occurred in 1978, 1992, 2006, and 2011. For a discussion of these amendments, \textit{see infra} notes 73, 124, and 131–76. The efficacy of the disclosure requirements has been the subject of continual debate. The potential of disclosure to affect managerial behavior is widely recognized. \textit{See Knutt, supra note 35, at 501–02 (discussing potential effects of disclosure); \textit{see also} Amir N. Licht, \textit{International Diversity in Securities Regulation: Roadblocks on the Way to Convergence}, 20 \textit{Cardozo L. Rev.} 227, 245 (1998) (discussing President Roosevelt’s opinion of benefits of corporate transparency). Nevertheless, some view the ability of SEC disclosure requirements to deter excessive compensation with skepticism. \textit{See Knutt, supra note 35, at 500 (“[F]ederal disclosure . . . regulations have been unable to reduce executive compensation packages.”); \textit{see also} Joshua A. Kreinberg, Note, \textit{Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive}, 45 \textit{Duke L.J.} 138, 157–58.}
Although policymakers were inclined to believe that public disclosure of salaries would result in lower overall levels of executive compensation, Congress did not stop there. In 1933, Congress also enacted legislation mandating salary caps as a condition of doing business with the federal government. The Reconstruction Finance Corporation (RFC) was authorized to deny federal financial assistance to companies providing executives with salaries the RFC deemed unreasonable, and, with regard to insurance companies, there was an express salary limit of no more than $17,500—$304,797.50 in 2011 dollars. Similarly, federal mail

(1995) (stating that recent amendments to SEC proxy requirements have had little effect on compensation): Markham supra, note 51, at 278 (suggesting disclosure regulations designed "to shame executives into accepting lower compensation" but arguing these efforts actually fueled excess salaries). There is also concern about the extent to which such disclosure fosters a "free rider" syndrome, wherein shareholders feel secure in their own inactivity, assuming that other shareholders are monitoring the situation. See Knutt, supra note 35, at 502–03 (discussing potential for "rational apathy" among investors who may not have time or cognitive ability to process all disclosed information).

Moreover, in the opinion of some commentators, executives have been resourceful in their attempts both to provide the information in an unclear manner and to conceal as much as possible while still obeying the rules. See Isa T. Kay, Value at the Top: Solutions to the Executive Compensation Crisis 176 (1992) (noting that proxy disclosure "has seldom been a model of clarity," and discussing corporate counsel’s ability to conceal compensation from proxy disclosure). Today's concerns often focus not upon a lack of disclosure but on information overload resulting in confusion for investors. See Troy A. Paredes, Blinded by the Light: Information Overload and its Consequences for Securities Regulation, 81 Wash. U. L.Q. 417, 444–62 (2003) (examining potential for information overload in proxy disclosures and arguing that securities regulation has often ignored usefulness of newly available information). The SEC has indicated its awareness of the potential for harm if investors are unable to understand the disclosures. See id. Responding to some of these concerns, in 2006, the SEC promulgated new rules that require simplified "plain English" narratives that explain compensation information otherwise provided in a tabular manner. See Leigh Johnson, et al., Preparing Proxy Statements Under the SEC’s New Rules Regarding Executive and Director Compensation Disclosures, 7 U.C. Davis Bus. L.J. 373, 376–78 (2007) (discussing enhanced disclosure requirements of 2006 amendments).

55. See Leff, supra note 44, at 80–87 (discussing congressional attempts to create salary ceilings for executives).

56. See id. at 81 (discussing enactment of RFC loan denial legislation). After contentious floor debate, Congress passed this more lenient form proffered by the House Banking and Currency Committee. See id. at 82–83 (same). Initially, the measure would have denied federal loans to any corporation paying their executives more than $17,500 in salary. See id. (same). Shortly after enactment, the RFC successfully required salary cuts as a condition for a loan to Southern Pacific Railroad. See id. at 82 (recognizing effectiveness of RFC legislation). Thereafter, the RFC was more conservative in exercising its regulatory discretion. See id. at 81 (same); Throrndike, supra note 49 ("[I]n later years, Jones used his regulatory discretion with great discretion; by most accounts, RFC regulation had only a modest effect on corporate salaries during the Depression.").

tracts were withheld from companies compensating managers in excess of $17,500 (again, $304,797.50 in 2011 dollars). However, these limits are viewed as having been more symbolic than real, and affected few executives.

In sum, information about executive compensation at America’s largest corporations became known amidst an economic depression and record-holding levels of unemployment. Significant negative public sentiment ensued, prompting legislators to take action. Thus began America’s foray into regulating executive pay.

C. The Calm Before the Storm: The 1940s-1970s

After the Great Depression era, the United States experienced a period of relative economic stability from the 1940s to the early 1970s. Many attribute this stability to a steady stream of wars and related wage and price stabilization laws. There were, as always over any period of time spanning more than a few years, some economic peaks and troughs (i.e., business cycles represented by periods of expansion followed by contraction). The official recessions occurring during this time span, as de-
terminated by the National Bureau of Economic Research (NBER), were nevertheless relatively minor in comparison both to the Great Depression as well as the recessions that would follow in the mid-1970s, early 1980s, early 1990s, and 2000s.63

The most significant economic downturn during this period occurred during 1973 to 1975.64 Following that recession, the economy went through a period of expansion lasting from the end of 1975 to 1979.65 Although this was one of the longest expansions in U.S. history up to that point in time, the public was still very dissatisfied with the economy because of high inflation, an increased unemployment rate, and slow wage growth.66

Reflective of the relative economic stability of this era was the unemployment rate. Coming out of the Great Depression era, the unemployment rate was 14.6% in 1940.67 That rate dropped significantly in 1941 to 9.9%, and by 1943 had declined dramatically to 1.9%.68 Thereafter, the unemployment rate mostly oscillated between 3.0% and 5.9% until 1975.

See Howard J. Sherman, The Business Cycle: Growth and Crisis Under Capitalism 11 (1991) (“One could measure peak to peak, but that is not as convenient for illustrating most theories of the business cycle, so this book uses trough-to-trough cycles exclusively.”). Thus, the first phase of a business cycle, occurring after the initial trough, is an upturn that is called the recovery. See id. (explaining meaning of recovery or revival). This is followed by a further expansion that is called the prosperity, which subsequently turns into a crisis after the peak. See id. (explaining concepts of prosperity and crisis). Finally, the crisis turns into a contraction that is called a recession or depression. See id. (explaining meaning of recession—a mild depression—and depression, and noting that author prefers uniform use of term “depression” for all contractions). Note, however, that while the time from trough to trough determines the duration of a business cycle, the amplitude and scope are what determine whether it is considered a recession. See Moore, supra, at 4 (explaining characteristics of business cycles). For more on amplitude and scope, as well as the determination of business cycles, see generally Moore, supra, and Sherman, supra.

63. See Sorkin, supra note 60, at 63–64, 102 (explaining why recessions during this time period were not severe). The most significant economic downturn during the 1940s to 1970s occurred in 1973–1975. See Hall, supra note 20, at 176 (stating timeframe and severity of recession). Following that recession, the economy went through a period of expansion lasting from the fourth quarter of 1975 to 1979. See id. at 177 (discussing expansionary period); see also Sorkin, supra note 60, at 68 (discussing beginning of recovery in fourth quarter of 1975). Although this was one of the longest expansions in U.S. history up to that point in time, the public was still very dissatisfied with the economy because of high inflation, an increased unemployment rate, and slow wage growth. See Hall, supra note 20, at 177 (explaining public dissatisfaction despite fifty-eight month long expansion).

64. See Hall, supra note 20, at 176 (stating timeframe and severity of recession).

65. See id. at 177 (discussing expansionary period); see also Sorkin, supra note 60, at 68 (discussing beginning of recovery in fourth quarter of 1975).

66. See Hall, supra note 20, at 177 (explaining public dissatisfaction despite fifty-eight month long expansion).

67. See infra Appendix.

68. See id.
when it rose sharply for one year to 8.5%. For the rest of the late 1970s, it settled between 5.8 and 7.7%. During this time period, intense public scrutiny of executive compensation levels was also quiescent. There were no high profile executive pay controversies capturing media or public attention. Compared to subsequent time periods, media reporting on executive pay matters was minimal. So, too, was congressional attention.

69. See id.
70. See id.

Some corporate governance scholars attribute this in part to the effect of the steeply progressive tax rate structure, in addition to other factors, on executive compensation levels. See, e.g., Elson, supra note 48, at 938–39 ("With the judiciary a reluctant venue for compensation reform, Congress attempted to resolve the issue by dramatically raising the income taxation rates imposed on those receiving the greatest compensation."); see also, e.g., Barris, supra note 5, at 62 ("Although the government refused to directly control private sector compensation, it did devise a way in through the back door—redistributing wealth through taxation. . . . While the average executive earned considerably more than the average worker, his proportionally higher tax rate significantly reduced the disparity. Furthermore, the futility of awarding huge salaries only to see them swallowed up by taxes helped to keep salaries lower.").

While "[o]nly a handful of studies have examined the influence of tax policy on managerial pay empirically, [ ] none have found a significant effect of taxation on the level or structure of pay." Frydman & Molloy, supra note 44, at 1. In 2009, two scholars in the field of economics, Carola Frydman and Raven S. Molloy, undertook a more comprehensive study and reached similar conclusions. See id. Their study found that there was "no evidence that changes in tax rates appreciably affect the level or structure of executive compensation." Id. at 20. Frydman and Molloy do note, however, that their "results do not imply that tax policy has not affected any aspect of executive pay," noting, for example, that "high tax rates in the 1950s and 1960s might have spurred the adoption of pensions, perks and qualified stock options, even though the use of these benefits did not decrease as their tax advantage diminished over time." Id. at 26. Conversely, there are those who attribute lower income tax rates to the overall growth in income inequality over the last forty years. See, e.g., Martin J. McMahon, Jr., The Matthew Effect and Federal Taxation, 45 B.C. L. Rev. 993, 993 (2004) (discussing effect of income tax rates on growth in income inequality).

72. For example, based on February 22, 2011 search results performed on Lexisnexis.com for the N.Y. Times, Washington Post, Chicago Tribune and Los Angeles Times for “executive compensation,” only 63 articles regarding executive compensation were published in major U.S. newspapers between 1940 and 1949—a marked decrease from the 238 articles published in the 1930s. There were seventy-nine articles published regarding executive compensation in the 1950s, a slight increase from the 1940s. In the 1960s, there were sixty-five news articles published regarding executive compensation, a slight decrease from the 1950s. Lastly, the 1970s saw the most significant increase in articles published regarding executive compensation: 204.

73. During the 1950s, Congress did enact tax rules regarding stock options, a common component of executive pay packages. These actions, however, were de-
The dormancy in focus on executive compensation issues coincided with fairly static executive compensation levels in comparison to the pay of an average worker. This executive pay to worker pay ratio is sometimes looked to as an indication of the “alleged unfairness of the corporate wage structure.” The earliest time period for which pay ratios can be or have been calculated is the mid-1930s, although most pay ratio data typically begins in the 1960s. By one estimate, in 1936-1939, the pay ratio was eighty-two. Thus, executives made, on average, eighty-two times the amount of pay an average worker received. In the 1940s, the ratio contracted, reflecting “a sharp decline in the real value of pay during World War II,” followed by a “sluggish rate” of growth for the next thirty years. Thus, throughout the 1940s, 1950s, and 1960s, the executive to average worker pay ratio largely hovered in the range of forty to fifty. In the 1970s, “executive earnings began to rise faster than those of the average worker,” leading to a pay ratio of sixty-nine heading into the 1980s. Another source, the Economic Policy Institute (EPI), provides different ratio amounts, but reveals the same trend: from 1965 to the mid-1970s the ratio hovered in the twenties, but rose to thirty-five for 1978. In any event, although the actual numbers may differ, varied sources agree that the pay ratio was relatively steady until the 1970s, and was certainly steady in comparison to the rapidly upward movements that began in the late 1970s continuing to the present day.


In the late 1970s, executive perquisites (or perks) were receiving increased negative attention and Congress considered taking action to curb perceived abuses. The SEC, however, moved first and significantly amended the pay disclosure rules to require tabular disclosures with a column for perks. See Kathleen T. McGahran, SEC Disclosure Regulation and Management Perquisites, ACCT. REV., Jan. 1988, at 23, 23. The SEC also clarified which perks needed to be disclosed as compensation in company proxy statements. See id.

74. As recognized above, some corporate governance scholars would attribute the stability of executive pay levels in part to the high marginal income tax rate that prevailed until rates were significantly lowered during the 1980s, but thus far the economic studies that have been conducted to analyze the effects of tax rates on executive pay levels are not in accord with that conclusion.

75. See Levine, supra note 44, at 1.

76. See Frydman & Saks, supra note 44, at 2 (explaining that “very little is known about the compensation arrangements of corporate officers prior to [1980]”).

77. See id.

78. See id.

79. See id. at 9.

80. See Mishel, Bernstein & Shierholz, supra note 44.

81. A reasonable question is whether pay regulation is merely a result of escalating pay levels in comparison to the pay of average workers. As discussed above, while executive pay levels are certainly not irrelevant, they do not alone explain
D. A Hiccup: The 1980s

The overall stability of the 1940s-1970s came to an end in the 1980s. The economy peaked in 1980 and was followed by a widely expected recession. The recession and a weak recovery persisted until 1984. Thereafter, but for the brief stock market crash in October of 1987, the economy remained stable until 1990.

Not surprisingly, the unemployment rate followed the same path. Heading into the 1980s, the unemployment rate was 5.8% for 1979. The rate peaked in 1982 and 1983 at 9.7% and 9.6%, respectively. Thereafter, the unemployment rate dropped back down to 7.5% in 1984, steadily declining to 5.3% by 1989.

In addition to a more turbulent economic climate, the decade of the 1980s was significant for its heightened level of merger and acquisition activity. In particular, the high profile takeover of Bendix Corporation in 1982 garnered widespread media attention—as well as scrutiny from the SEC and ultimately Congress—and highlighted a new form of executive pay.

the occurrence of regulation of executive pay. Pay trends in the socio-political context of the 1980s and 1990s, in particular, show that the public displays significantly less concern and interest in executive pay, even as it increases dramatically, so long as the economy is doing well, jobs abound, and there are no significant pay controversies to catalyze public sentiment.

82. See Business Cycles, supra note 62; Hall, supra note 20, at 180 (discussing beginning of 1980 recession).
83. See Business Cycles, supra note 62; Sorkin, supra note 60, at 70.
84. See Business Cycles, supra note 62; Hall, supra note 20, at 184–85 (discussing economy in 1984 and stock market crash in 1987).
85. See infra Appendix.
86. See id.
87. See id.
89. See Coffey, supra note 88, at 294–95 (summarizing Bendix-Marietta battle and noting after effects of that confrontation).
The tale of the Bendix merger began with the company’s chairman announcing a $1.5 billion takeover bid for Martin Marietta Corporation. While Bendix was obtaining control of Martin Marietta, however, Martin Marietta was acquiring control of Bendix with the assistance of a third company, United Technologies Corporation. Bendix responded by merging with yet another company, Allied Corporation, “[t]o avoid a disastrous situation in which [Bendix and Martin Marietta] in effect owned [each] other . . . .”

The Bendix merger was costly. Both Martin Marietta and Allied Corporation significantly increased their debt burdens to fund their acquisitive activities. This left the companies in a very different, arguably worse, financial position. “When the action subsided, the takeover, and those who orchestrated it, [were] harshly criticized.” One aspect of that criticism focused heavily on golden parachutes, a component of the compensation paid to the executives of both Bendix and Martin Marietta that protected them, in a sense, throughout the takeover process from their actions and the outcome. In the aftermath of the Bendix merger controversy, golden parachutes became the subject of intense examination.

90. See id.
91. See id.
92. Id. at 294 (quoting William Agee, Corporate Mergers’ Value, N.Y. TIMES, Oct. 19, 1982, at A31).
93. See id.
94. See id.
95. Id. at 294.
96. Id. at 294–95. A golden parachute refers to a severance agreement payable to a company’s executives in the event of a change in the control of the company. See I.R.C. § 280G(b)(2)(A)(i) (2006); see also William R. Spalding, Golden Parachutes: Executive Employment Contracts, 40 WASH. & LEE L. REV. 1117, 1117–22 (1983) (explaining golden parachute agreements). Generally, these agreements are quite lucrative, promising aggregate payments worth more than several times the executive’s annual income, in addition to other benefits, should the executive voluntarily or involuntarily leave the company as a result of a change in corporate control. See id. (same); Susan Stabile, Is There a Role for Tax Law in Policing Executive Compensation?, 72 ST. JOHN’S L. REV. 81, 88–89 (1998) (same). For more on the panoply of benefits, variety of terms, and tax consequences of golden parachute agreements, see generally BILL C. WILSON & DIANE M. MCGOWAN, GOLDEN PARACHUTES 396 (2008).
and debate. Professionals and academics alike called for the government to intervene.

Congress first considered proposals to directly prohibit the adoption of parachute contracts under certain circumstances, such as when they are created after the commencement of a tender offer. Ultimately, though, in 1984 Congress decided to use the tax system to try to affect corporate and executive behavior regarding parachute agreements. Congress enacted sections 280G and 4999, two tax penalty provisions that are designed to work synergistically to discourage parachute payments above a defined level. Section 280G does its part by prohibiting companies from taking

97. See Edward A. Zelinsky, Greenmail, Golden Parachutes and the Internal Revenue Code: A Tax Policy Critique of Sections 280G, 4999 and 5881, 35 VILL. L. REV. 131, 134, 148-49 (1990) (noting that golden parachutes were among most hotly contested issues surrounding takeover wave of 1980s); Henry F. Johnson, Those "Golden Parachute" Agreements: The Taxman Cuts the Ripcord, 10 DEL. J. CORP. L. 45, 48, 56 (1985) (commenting that “[t]he opinions are lining up on either side of the issue as to whether [golden parachutes] are beneficial or detrimental to the concern’s future existence,” and “commentators have been unable to agree on the validity and usefulness of golden parachute[s]”); Spalding, supra note 96, at 1121–22 (noting debate over propriety in spite of parachute popularity).

98. See DEFRA BLUE BOOK, supra note 88 (explaining that golden parachute legislation was enacted in response to recent wave of mergers and acquisitions that had raised alarm among Congress and professionals).


100. See I.R.C. §§ 280G, 4999 (2006); see also, e.g., Jamie Dietrich Hankinson, Comment, Golden Parachute Tax Provisions Fall Flat: Tax Gross-Ups Soften Their Impact to Executives and Square D Overinflates Their Coverage, 34 STETSON. L. REV. 767, 778 (2005) (noting that Congress intended golden parachute provisions to work together to reduce largesse of golden parachutes); Stabile, supra note 96, at 91 (commenting that golden parachute provisions were expected “to make excessive parachute payments financially prohibitive” for companies and their executives). It should be noted that sections 280G and 4999 only apply with regard to a limited group of individuals. This group is comprised of employees and independent contractors who are also a shareholder, an officer, or a highly-compensated individual. See § 280G(c). A highly-compensated individual is defined as one “who is (or would be if the individual were an employee) a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation.” Id. § 280G(c)(2). The targeted group is further limited in that the golden parachute provisions do not apply to payments made by a small business company (as defined in § 1361(b) but without regard to paragraph (1)(C)) or by a company whose stock is not readily tradable
a deduction for any excess parachute payment it makes to an executive.101 Section 4999, in turn, imposes a twenty percent tax on any person who receives an excess parachute payment.102 Thus, together they increase the after-tax cost for both the company paying and the executive receiving such payments.103

The acquisitive activity of the early 1980s both proliferated and brought to light a new aspect of executive compensation: the golden parachute. At the same time that golden parachutes were being demanded and received by many executives as part of their compensation packages, executive compensation levels in general started to climb. During the 1980s, executive pay suddenly grew at a pace nearly four times that of the average worker.104 As a result, the disparity between executive and worker

and three-quarters of the shareholders have approved the payments. See § 280G(b)(5).

101. See § 280G. An excess parachute payment is present when a golden parachute agreement provides for payments equal to or greater than three times a base amount, which is determined with reference to the executive’s average annual taxable compensation. § 280G(a)-(b), (d). For more information on the tax consequences of excess parachute payments, see generally Joy Sabino Mullane, Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code, 15 LEWIS & CLARK L. REV. 485, 515–19 (2009).

In the absence of § 280G and prior to the enactment of § 162(m) in 1993, golden parachute payments were fully deductible by the paying company so long as such payments were reasonable compensation paid to executives for services rendered within the meaning of § 162(a)(1). See id. at 514 n.113 (discussing interpretation and application of § 162(a)(1)).

102. See § 4999. The company must withhold the 20% penalty tax from its payment to the executive. See § 4999(c)(1). A deduction for the amount of the penalty tax is also specifically disallowed. See § 275(a)(6).

103. For numeric examples of these cost effects, see Mullane, supra note 101, at 515–19. It should be noted that the golden parachute tax penalty provisions have been the subject of much criticism for being ineffective and counterproductive. See, e.g., Meredith R. Conway, Money for Nothing and the Stocks for Free: Taxing Executive Compensation, 17 CORNELL J.L. & PUB. POL’Y 385, 410, 417 (2008) (noting limited effectiveness of section 280G); Stabile, supra note 96, at 95 ("[N]either with respect to ordinary compensation nor with respect to compensation contingent on a change in control has the Code proven a very meaningful curb on executive compensation."); Bruce A. Wolk, The Golden Parachute Provisions: Time for Repeal?, 21 VA. TAX REV. 125, 181 (2001) (arguing for repeal of golden parachute provisions because they “not only allow[ ] golden chutes to flourish, but achieve[ ] this counter-productive result in a complex and costly fashion”); Zelinsky, supra note 97, at 187–92 (concluding, in part, that golden chute provisions—§§ 280G and 4999—“satisfy none of the tests for identifying an appropriate tax provision”); Ryan Miske, Note, Can’t Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code, 88 MINN. L. REV. 1673, 1675 (2004) (concluding “the federal government will not be successful in capping executive compensation by providing disincentives through the tax code”); Hankinson, supra note 100, at 783–89 n.108–46 (highlighting examples of ways sections 280G and 4999 can be circumvented).

104. See MARK A. SARGENT & DENNIS R. HONABACH, PROXY RULES HANDBOOK § 4:1 (2006) (noting that during 1980s, executive salaries increased by average of 212%, while worker salaries increased by average of just 53%); Barris, supra note 5, at 62 (explaining that in 1990 executives were earning eighty-five times salary of
salaries doubled during the 1980s. According to EPI’s calculations, in 1978 the pay ratio was thirty-five, and by 1989 it had risen to seventy-one. Nevertheless, this growth was modest compared to the latter half of the 1990s.

E. The First Great Debate Since The Great Depression: The 1990s

The 1990s began with a brief recession. By late 1991, however, the economy was turning around and continually expanded for the remainder of the decade. The unemployment rate, which was at 5.6% in 1990, hit its peak in 1992 when it reached 7.5%. Thereafter, the unemployment rate steadily declined, and was 4.2% in 1999.

The recession of the early 1990s pushed executive salaries to the forefront of national news coverage. Media coverage of the troubling times highlighted the sharp contrast between the situation of highly-paid executives and that of ordinary Americans. During 1991, executive compensation levels received unprecedented media coverage on all the major television news shows and in business magazines.

Even so, controversy over executive pay did not explode until the media covered a trip President Bush made to Japan in 1992 to seek trade concessions. A group of prominent American executives was traveling average factory worker, up from forty-two times salary of average wage-earner at beginning of decade; Vagts, supra note 27, at 246. See Mishel, Bernstein & Shierholz, supra note 44. See also Frydman & Molloy, supra note 44.

106. See Business Cycles, supra note 62; see also Crystal, supra note 18, at 23 (explaining that “the financial boom of the 1980s went bust in a painful recession in 1990 and 1991”).

107. See Business Cycles, supra note 62.

108. See infra Appendix.

109. See infra Appendix.

110. See Brownstein & Panner, supra note 5, at 28 (noting that recession had turned executive compensation into “a front-page story”); Murphy, supra note 6, at 713 (recounting media fixation on executive compensation and explaining that issue reached “national prominence” during 1991).

111. See Derek Bok, The Cost of Talent: How Executives and Professionals Are Paid and How it Affects America 95 (1993) (recounting media descriptions of executive salaries as “mind-numbing,” “eye-popping,” and noting that “[b]y 1990, almost everyone seemed to agree that executive pay had reached unseemly heights”); Brownstein & Panner, supra note 5, at 28 (noting that public “can’t help but notice the sharp contrast” between highly-paid executives and troubling economic realities of recession).

112. See supra notes 109–10 (noting unprecedented level of media coverage on executive compensation); see also Murphy, supra note 6, at 713 (stating that in 1991 the three major network newscasts featured stories on executive compensation, as did CNN, 60 Minutes, and Nightline).

113. Murphy, supra note 6, at 713 (recalling that controversy “exploded” in aftermath of President Bush’s trip to Japan); Douglas C. Michael, The Corporate Officer’s Independent Duty as a Tonic for the Anemic Law of Executive Compensation, 17 J. Corp. L. 785, 788 (1992) (noting that within weeks following President Bush’s trip to Japan, several newspapers noted executive compensation had become big issue.
with the President, and the media aptly observed that, despite a flagging economy, American executives were earning salaries in gross disproportion to those of their highly productive Japanese counterparts. With many Americans out of work, this coverage intensified the public’s resentment of executives and their pay. By mid-1992, Americans were convinced that executive compensation lay at the heart of the country’s economic woes. Indeed, one study found that Americans believed that executive compensation practices were the “prime culprit in the loss of U.S. jobs during the past decade.”

In light of the foregoing, executive compensation was at the forefront of 1992 presidential campaign issues. Indeed, so deep was public resentment of large executive compensation packages that candidates from both parties publicly decried executive excesses. For example, then-Governor Bill Clinton called for a stronger relationship between pay and performance:

It’s wrong for executives to do what so many did in the 1980s . . . . The biggest companies raised their [CEOs’] pay by four times the percentage their workers’ pay went up, and three times the percentage their profits went up . . . . For America to be more competitive, there must be a stronger link between our executives’ pay and performance. with Fortune writing, “[t]he issue of [executive] pay has finally landed on the national agenda and won’t be leaving soon” (quoting Geoffrey Colvin, How to Pay the CEO Right, FORTUNE, Apr. 6, 1992, at 61)).


See Jill Dutt, Study Shows Anger Over Executives’ Pay, NEWSDAY, Jul. 1, 1992, at B42 (commenting on American belief that executive pay was key economic issue). See supra note 111 (noting economist was interviewed and described the country’s anger towards highly paid executives as “misplaced” and “disturbing.” Id). See Jeffrey H. Birnbaum, Campaign ‘92: From Quayle to Clinton, Politicians Are Pouncing on the Hot Issue of Top Executives’ Hefty Salaries, WALL ST. J., Jan. 15, 1992, at A14 (noting that one Republican strategist referred to issue as “political . . . dynamite”); see also Thomas McCarroll, Executive Pay, TIME, May 4, 1992 (referring to executive compensation as “populist issue that no politician can resist”).

See Birnbaum, supra note 118 (stating that Vice President Quayle and Governor Bill Clinton agreed that executive salaries were “too high,” and reporting on number of republicans and democrats espousing similar views).

Kevin G. Salwen, Clinton Backs Executive Pay Set by Holders, WALL ST. J., Oct. 9, 1992, at C1 (quoting Clinton).
Congress likewise was responsive to the public’s resentment of executive compensation. Throughout 1991 to 1993, Congress conducted hearings, and several congressmen submitted legislative proposals designed to rein in or shape compensation. The leading proposals sought to impose some form of limit on corporate deductibility of compensation paid to executives. For example, one plan aimed to bring executive and worker salaries into better proportion by capping deductibility of executive compensation at no more than twenty-five times the salary of the lowest-paid company employee. Others sought to tie executive pay more closely to corporate performance by denying a deduction for pay unrelated to performance in excess of varying amounts.

In the end, in 1993, Congress enacted section 162(m), a tax penalty provision designed to encourage companies to limit executive pay unrelated to performance. Thus, it disallows, subject to exceptions, a deduction in excess of $1 million for annual compensation paid by a publicly held corporation to its CEO and the three other highest paid officers at the company. The most significant exception to the deduction limita-

121. A search of lexiscongressional.com performed on June 28, 2011 for “executive compensation” finds that there were seven hearings regarding executive compensation during this time frame, as compared with none in the six immediately preceding years.


124. See I.R.C. §§ 162(m)(1), (2) (2006); see also § 162(m)(3). Section 162(m)(3) defines a “covered employee” and should be interpreted consistently with I.R.S. Notice 2007-49 and Internal Revenue Bulletin 2007-25. For purposes of § 162(m), a publicly held corporation is “any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934.” § 162(m)(2).

Section 162(m) modifies the general rule of section 162(a)(1), which normally allows a company to deduct any reasonable compensation paid to its employees for services rendered. See § 162(a)(1); see also Mullane, supra note 101, at 506–09 (discussing interpretation and application of section 162(a)(1)). In 1992, prior to enactment of section 162(m), the SEC also responded to public sentiment by again amending the pay disclosure rules. See Executive Compensation Disclosure, 57 Fed. Reg. 48,126 (Oct. 21, 1992) (to be codified at 17 C.F.R. pts. 228, 229, 240, and 249) (amending executive compensation disclosure requirements). This time the SEC required disclosures to include a table summarizing executive pay components over a three-year period, and adding more tabular disclosures regarding stock options. See id.; see also Michael E. Ragsdale, Comment, Executive Compensation: Will the New SEC Disclosure Rules Control “Excessive” Pay at the Top?, 61 UMKC L. Rev. 537, 544 (1993). These changes, among others, were intended to make pay disclosures more comprehensible for shareholders. See id.
tion is for compensation that is tied to performance—there is no limit to the amount of performance-based compensation that can be deducted.125

Following the enactment of section 162(m), the gap between executive pay and the pay of the average worker grew considerably, at a pace outmatched by any prior period since executive pay levels were revealed during the Great Depression.126 Executive pay did decline marginally in

125. See § 162(m)(4)(C). One author has referred to this exception as “a loophole large enough to fly a private jet through.” Frank Partnoy, Infectious Greed: How Deceit and Risk Corrupted the Financial Markets 156 (2003). This is because the performance-based exception is very easy to satisfy, rendering the $1 million deduction limit “virtually meaningless.” Stabile, supra note 96, at 88. For more on the parameters of the performance-based compensation exception, see Treas. Reg. § 1.162-27(e) (1996). Other exceptions to the $1 million deductibility limit are listed in § 162(m)(4).

Section 162(m), like earlier executive compensation tax penalty provisions, has been the subject of significant criticism for being ineffective and leading to negative unintended consequences. See, e.g., Meredith R. Conway, supra note 103, at 410, 417 (noting ineffectiveness of section 162(m)); Mullane, supra note 101, at 522–26 (explaining ineffectiveness and recounting unintended consequences); Polsky, supra note 17, at 884 (concluding that section 162(m) is likely ineffective provision); Stabile, supra note 96, at 94–100 (concluding that section 162(m) is ineffective at controlling executive compensation and discussing unintended consequences); Miske, supra note 103, at 1680 (concluding Congress cannot effectively limit executive compensation by using Code to provide disincentives).

126. See Mishel, Bernstein & Shierholz, supra note 44; see also CEO Compensation in the Post-Enron Era: Hearing Before the S. Comm. on Commerce, Sci. & Transp., 108th Cong. 10 (2003) [hereinafter CEO Compensation Hearing] (statement of Brian Hall, Associate Professor, Harvard Business School), available at http://www.gpo.gov/fdsys/pkg/CHRG-108shrg97981/html/CHRG-108shrg97981.htm (“[T]he pay trend . . . makes it look as if [162(m) was] passed with the intention of accelerating, not curbing, CEO pay increases.”). This has been attributed in part to section 162(m)’s emphasis on performance-based pay. See, e.g., Executive Compensation: Backdating to the Future: Hearing Before the S. Comm. on Finance, 109th Cong. (2006) (statement of Nell Minow, Editor, The Corporate Library), available at http://finance.senate.gov/imo/media/doc/090606testnm.pdf (“When the tax code was changed to prevent executive compensation of over $1 million to be deducted unless it was tied to performance . . . . [E]veryone got boat-loads of options. The very definition of a ‘mega-grant’ had to be changed, so it now can be as much as eight times the CEO’s base pay and bonus.”); Staff of the J. Comm. on Taxation, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 2 (Comm. Print. 2006), available at http://www.jct.gov/publications.html?func=startdown&id=1482 (“Studies have indicated that the deduction limitation may have led to some substitution away from salary compensation toward performance-based compensation, but that growth in overall executive compensation has not been reduced.”); Partnoy, supra note 125, at 157 (“FASB officials knew that the $1 million cap on non-performance-based pay would lead companies to switch to stock options.”); Polsky, supra note 17; James R. Repetti, The Misuse of Tax Incentives to Align Management-Shareholder Interests, 19 CARDEZO L. REV. 697, 708–09 (1997). But see Lora Cicconi, Blaming the Tax Code for the Backdating Scandal, 114 TAX NOTES 1129, 1140 (2007). Such pay is often determined with reference to changes in the company’s stock price, with the most quintessential form of performance-based pay being the stock option. See, e.g., Murphy, supra note 6, at 738; Polsky, supra note 17, at 889–90; Partnoy, supra note 125, at 156. Note that only stock options with an exercise price at or above the market price on the date of grant qualify. See Treas. Reg. § 1.162-27(c)(2)(vi)(A) (1996). Stock prices in gen-
1993 and 1994 coincident with the recession, but thereafter pay levels rose sharply for the rest of the decade. As mentioned above, according to EPI’s calculations, the CEO pay ratio was seventy-one in 1989. It rose to 248 by 1999. Once again, calculations performed by others reveal the same trend of steeply escalating pay during the 1990s.

F. A Decade of Controversy: The 2000s

The 2000s began with a relatively low (by historic standards) unemployment rate of 4%; 1969 was the last time it was any lower. Another recession, however, began in 2001. Although the 2001 recession officially only lasted roughly eight months, it came a small rise in the unemployment rate, which hit 6% in 2003 before it began to descend. After the 2001 recession ended, the economy modestly expanded until the financial sector of the economy began melting down in 2008. In 2010, the unemployment rate hit a comparatively high 9.6%, up from 4.6% just a few years before in 2006 and 2007.

Significantly, this decade was marked by two separate and distinct periods of high profile scandals that coincided with the 2001 and 2008 economic disturbances. In the early 2000s, the media exposed serious accounting scandals at a number of major corporations, including Enron Corporation, Tyco International, and WorldCom. The executive began rising around the same time that stock options became a more significant component of an executive’s compensation package. See Ellig, supra note 73; Mark A. Sargent, Lawyers in the Perfect Storm, 43 Washburn L.J. 1, 9 (2003). Thus, the stock market boom inured to the benefit of executives receiving hefty stock option awards.

127. See Mishel, Bernstein & Shierholz, supra note 44.
128. See id.
129. See id.
130. See Frydman & Saks, supra note 44; Levine, supra note 44.
131. See infra Appendix.
132. See Business Cycles, supra note 62.
133. See infra Appendix; Business Cycles, supra note 62.
134. See infra Appendix; supra note 62.
135. See infra Appendix.
the decade, the problems facing some of the nation’s largest financial institutions captured national attention.

1. The First Wave

When the nation’s largest energy consortium, Enron Corporation, descended into bankruptcy during the fall of 2001, the nation was shocked. Following the shock was outrage, as the media reported details surrounding Enron’s collapse, and the pay packages and extravagant lifestyles of its executives. The public outcry sparked by Enron’s demise was exacerbated by subsequently revealed scandals at other large public companies. In the wake of these corporate scandals, Congress hurriedly passed legislation. In 2002, the Sarbanes-Oxley Act (“SOX”) was passed. It was viewed as the most significant piece of business legislation enacted since the Great Depression.


139. For a discussion of these subsequent scandals, see supra note 136 and accompanying text.


SOX has naturally been the subject of academic study, receiving mostly negative but some positive assessments. See id. For a further discussion of academia’s analysis, see infra note 204. See generally Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and it Just Might Work), 35 CONN. L. REV. 915 (2003); Jeffrey N. Gordon, Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley, 35 CONN. L. REV. 1125 (2003); Thomas L. Greaney, Looking Beyond The Evildoers: Sarbanes-Oxley and the Future of Corporate Law, 47 ST. LOUIS U. L.J. 961 (2003); Joseph F. Morrissey, Catching The Culprits: Is Sarbanes-Oxley Enough?, 3 COLUM. BUS. L. REV. 801 (2003); Steven A. Ramirez, A
SOX largely ignored executive pay matters, instead focusing mostly on issues related to corporate governance and corporate fraud.\textsuperscript{142} It did, however, contain three provisions addressing executive compensation issues raised by the specific scandalous events of the time. First, SOX prohibited companies from making personal loans to executives and directors.\textsuperscript{143} Second, SOX contained a “clawback” provision, requiring covered executives to reimburse the company for certain compensation paid in the event of a restatement of financial statements due to corporate misconduct.\textsuperscript{144} Third, SOX shortened the timing required for disclosure of the new stock option grants.\textsuperscript{145}

There were, however, other executive pay practices that received significant attention in the Enron aftermath that SOX did not address. In particular, executive deferred compensation plans, known as nonqualified deferred compensation (“NQDC”), were scrutinized when it was uncovered that Enron executives were able to withdraw more than $53 million in benefits from these plans within weeks of Enron filing for bankruptcy.\textsuperscript{146} In contrast, throughout the couple weeks that immediately preceded bankruptcy, Enron employees were prevented by normal administrative procedures from making changes to the investments in their qualified 401(k) retirement plans.\textsuperscript{147} Because many had invested a significant percentage of their plan balance in Enron stock and were restrained from offloading their Enron stock before it became essentially


\textsuperscript{143} SOX § 402.

\textsuperscript{144} Id. § 304.

\textsuperscript{145} Id. § 403 (requiring disclosures to be made within two business days of grant instead of previous forty-five days after company’s fiscal closing).

\textsuperscript{146} See JCT Enron Report, supra note 138, at 14, 627; Chason, supra note 136, at 349 (noting that Enron execs took early distributions of deferred benefits once downfall became apparent); see also Richard Ehrhart, \textit{Section 409A—Treasury “Newspeak” Lost in the “Briar Patch”}, 38 J. Marshall L. Rev. 743, 754 (2005) (noting that key Enron executives withdrew benefits from NQDC plans as corporation approached bankruptcy). These distributions drained Enron of available cash just prior to bankruptcy. See JCT Enron Report, supra note 138, at 636. They were, however, also recoverable under bankruptcy law. See Drennan, supra note 136, at 442–43 (2006); see also Gregg D. Polsky, \textit{Fixing Section 409A: Legislative and Administrative Options}, 57 Vill. L. Rev. 635 (2012).

\textsuperscript{147} See JCT Enron Report, supra note 138, at 38. A change in record keepers triggered the “blackout” period. Such changes are “a normal part of qualified retirement plan operations.” Id.
worthless, the end result was that many Enron employees not only lost their jobs, but also their retirement savings. 148

Congressional investigations into the matter showed that the tax law had allowed executives to make use of certain favorable income tax rules while enjoying the benefits of their NQDC plans. 149 In response, Congress enacted another tax penalty provision—section 409A—at the end of 2004 to limit the circumstances in which an executive participating in an NQDC plan can receive distributions. 150 Failure to comply with these


149. See JCT ENRON REPORT, supra note 138, at 14, 40 (discussing tax rules previously governing NQDC); Mullane, supra note 101, at 500–05 (providing discussion and illustration of those tax rules).

150. See I.R.C. § 409A(a) (2006). This executive compensation tax penalty, like others, has been greatly criticized. See, e.g., Chason, supra note 136, at 360 (critiquing § 409A); William A. Drennan, The Pirates Will Party On! The Nonqualified Deferred Compensation Rules Will not Prevent CEOs From Acting Like Plundering Pirates and Should Be Scuttled, 33 VT. L. REV. 1, 5 (2008) (illustrating ineffectiveness of § 409A); Ehrhart, supra note 146, at 744 (same); Hussey, supra note 142, at 439 (concluding “§ 409A does not adequately address the perceived abuses regarding nonqualified deferred compensation”); Yale & Polsky, supra note 136, at 573 (noting criticism that “captive boards of directors use [deferred compensation] for the primary purpose of passing tax benefits to executives (to the company’s tax detriment) under shareholders’ radar screens”); see also Polsky, supra note 146. Note, too, that some view this provision as less about regulating executive compensation per se and more about addressing the tax consequences, and potential resulting tax benefit, of deferred compensation. See, e.g., Yale & Polsky, supra note 136, at 574–75. In that regard, it is also important to note that application of § 409A is not limited to executives. Indeed, subject to exceptions, § 409A applies to any taxpayer who defers compensation outside of a qualified plan, such as a 401(k). See § 409A(d)(1), (3) (defining NQDC plan as “any plan that provides for the deferral of compensation”); Treas. Reg. § 1.409A-1(f) (2007) (defining service provider for purposes of § 409A); see also Treas. Reg. § 1.409A-2(a)(14) (2007) (excluding from § 409A’s reach some situations in which it is common practice for service provider, such as teacher, to receive annualized (or deferred) compensation for period of service that comprises less than full year); Drennan, supra, at 26 (“[Section] 409A applies to all employers and employees that defer compensation, including closely held corporations, subchapter S corporations, partnerships, and charities.”); Brian Kopp, New Rules for Nonqualified Deferred Compensation Plans, 21 J. COMPENSATION & BENEFITS, Jan.–Feb. 2005, at 5, 11 (“[T]he rules are a trap for the uninformed and may create more problems for small employers than large publicly traded companies.”); Polsky, supra note 146. Nevertheless, while deferred compensation is not limited to being paid to executives, it is a form of compensation, certainly in significant amounts, that is primarily available to executives. See Mullane, supra note 101, at 503–04. Further, it was controversy surrounding this aspect of executive compensation that ultimately led to the enactment of § 409A. See id.; Joy Sabino Mullane, The Unlearning Curve: Tax-Based Congressional Regulation Of Executive Compensation, 60 CATH. U. L. REV. 1045, 1062 (2011).
rules subjects the deferred compensation under the NQDC plan to less favorable federal income tax treatment.151 Section 409A also imposes a twenty percent penalty tax on the participant for the noncompliant NQDC.152

Throughout the recession and scandals of the early 2000s, there was a decline in executive pay.153 However, executive pay began climbing again shortly thereafter, beginning around 2003.154 Then, the second wave of economic turbulence and scandal hit just a few years later.

2. The Second Wave

In 2008, the United States financial markets experienced a series of events that led to what is perceived by many as “the worst financial crisis since the Great Depression.”155 The problems began when the housing bubble burst, leading to the collapse of the mortgaged-backed securities market.156 Financial institutions with significant exposure in this area sustained extraordinary financial losses.157 Indeed, several large and well-known financial institutions, such as Lehman Brothers, Bear Stearns, and Merrill Lynch, ultimately failed as a result.158

The losses incurred by financial institutions affected their ability to extend credit, which created liquidity problems and slowed economic activity.159 The federal government responded quickly to these events. The Emergency Economic Stabilization Act of 2008 (“EESA”) was enacted, providing the Treasury department with the ability to make loans to troubled financial institutions and otherwise provide equity to promote financial market stability.160 Specifically, the EESA authorized the Secretary of the Treasury to establish a Troubled Assets Relief Program (“TARP”) “to

151. See § 409A(a)(1) (subjecting noncompliant deferred compensation to current, rather than deferred, taxation, plus interest).

152. See id. § 409A(a)(1)(B)(i)(II).

153. MISHEL, BERNSTEIN & SHERHOLZ, supra note 44, at 220 (providing that pay ratio was 248 in 1999, 299 in 2000, 149 in 2002, 262 in 2005, and 275 in 2007—latest date covered by this source); LEVINE, supra note 44, at 3 (providing that pay ratio was 524 in 2000, 429 in 2001, 281 in 2002, 301 in 2003—latest date covered by this source).

154. For a discussion of executives’ rising pay, see supra, note 153.


158. See id. at 425.

159. See id.

purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with [the EESA] and the policies and procedures developed and published by the Secretary.\footnote{161}

Reminiscent of the RFC in the Great Depression era, TARP imposed a number of restrictions and requirements on the compensation paid to executives at companies participating in the program. Many of these rules were then expanded as part of the American Recovery and Reinvestment Act of 2009 ("ARRA") in reaction to news of executives at troubled institutions receiving bonuses and lavish perks.\footnote{162} The following year, more generally applicable legislation (i.e., application was not limited to firms receiving some form of government financial assistance) was enacted with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").\footnote{163}

In general, for those companies participating in the TARP program, executive compensation was subject to the following new rules. Deductibility under section 162(m) was further limited to $500,000 including performance-based pay.\footnote{164} Additionally, other exceptions to the limits of section 162(m) were eliminated or tightened.\footnote{165} Further, the amount of allowable—not just deductible—golden parachute payments to a company’s top executives was reduced or outright eliminated.\footnote{166} Companies were also required to examine the incentive compensation plans for their senior executive officers to ensure that the plans did not encourage undue risk-taking, and if so, to make appropriate modifications.\footnote{167} Under TARP, the compensation plans of senior executive officers also must contain a “clawback” provision that becomes effective in the event of material inaccuracies in a company’s “statements of earnings, gains, or other crite-
ria.168 Finally, ARRA added some new restrictions on luxury expenditures, the payment of bonuses, retention awards, or other incentive compensation, and provided shareholders with a non-binding vote on executive compensation.169

One executive compensation provision that was enacted as part of EESA was not limited in application to those receiving some form of assistance from the government. Section 457A addresses the tax treatment of nonqualified deferred compensation that is offered by certain specified entities such as offshore hedge funds.170 This Code provision functions in a manner similar to section 409A in that noncompliant compensation is subject to less favorable federal income tax treatment, with the potential for the imposition of a twenty percent penalty tax.171

Through the Dodd-Frank Act, Congress directed the SEC to promulgate a variety of rules affecting executive compensation plans at all publicly held companies.172 Included were provisions that would provide shareholders with a nonbinding vote on a company’s executive compensation plans, and expand the clawback rules enacted under SOX.173 Notably, among other amendments to SEC disclosure rules, companies were required to start disclosing a comparison of the CEO’s pay to the pay of the average employee.174

In accord with these events, executive pay contracted briefly in 2008 and 2009.175 However, executive pay levels were rising again by 2010.176

III. Analysis of the History of Executive Compensation

In a very real sense, the public did not care to engage in debates about executive compensation packages when no one knew the extent or

168. EESA § 111(b)(2)(B). ARRA expanded this rule to apply not only to senior executive officers but also the next twenty most highly compensated employees. ARRA §§ 7001, 111(b)(3)(B).
169. ARRA §§ 7001, 111(b)(3)(D)(i), 111(d), 111(e)(2) (bonus prohibition, luxury expenditure limitation, and non-binding say on pay, respectively).
171. Id. § 457A(a), (c)(1); see also Polsky, supra note 146 (discussing how § 457A is right response to problem it is addressing, unlike § 409A, which has created huge mess); Yale & Polsky, supra note 136, at 573–74 (discussing view of some that these types of provisions are more about addressing tax consequences and potential tax benefits of deferred compensation).
172. Although the Dodd-Frank Act is relatively recent, assessments and critiques of the Act are starting to appear in the scholarly literature. See, e.g., Christine Hurt, Regulating Compensation, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 21, 55–65 (2011); Murdock, supra note 136, at 573–74 (discussing view of some that these types of provisions are more about addressing tax consequences and potential tax benefits of deferred compensation).
174. See id. § 953(a)-(b).
176. See id. (reporting CEO pay in 2010 increased 23% from 2009).
content of those packages. Instead, the public was generally fascinated and enamored with executives and their lifestyle. All that changed with the Great Depression. Out of the Great Depression came knowledge, with that knowledge came criticism, and ultimately the first instances of executive pay regulation.

Thereafter followed a period of relative economic stability that lasted about thirty years. During that time, the ratio of executive pay to that of average workers remained fairly steady, as did the unemployment rate. Nevertheless, executives were still compensated handsomely in absolute terms.

The early 1970s saw the first significant recession since the Great Depression, and with it came a spike in the unemployment rate. During the 1970s, executive compensation also began rising notably in comparison to the pay of average workers. This increase occurred during a time when, despite recovery from the perspective of analysts, the public remained dissatisfied with the economy because of high inflation, an increased unemployment rate, and slow wage growth. Interestingly, there were no important movements to regulate executive pay at that time, and certainly no meaningful congressional regulation of executive pay. It is also noteworthy that there were no remarkable executive compensation controversies or scandals to galvanize public sentiment against executives and act as a focusing event for legislators.

177. For a discussion of the public’s lack of information regarding executive compensation, see supra notes 27–59 and accompanying text.

178. See id. One question we may never be able to answer with certainty is whether that knowledge would have prompted the same level of public and governmental response if the economy had continued to grow instead of faltering. Viewed differently, was the general public really upset that executives were making so much or was it more that the public was making so little or nothing at all? But see generally Wells, supra note 5, at 694 (arguing that “the fight over executive compensation in the 1930s engaged deep questions about the nature of the corporation and the rewards due labor, hinting that there was a limit to the pay any man could fairly demand”).

179. For a discussion of the emergence of executive pay regulation, see supra notes 20–59 and accompanying text.

180. For a discussion of this economic stability, see supra notes 60–63 and accompanying text.

181. For a discussion of the post-Depression unemployment rate, see supra notes 67–70 and accompanying text. For a comparison of executive pay levels to pay of the average worker, see supra notes 74–81 and accompanying text.

182. For discussion of executive compensation levels compared to average worker pay in the post-Depression era, see supra notes 74–81 and accompanying text.

183. For a discussion of this recession and the rise in unemployment, see supra notes 64–67 and accompanying text.

184. For a discussion of the rise of executive pay during this time, see supra notes 79–80 and accompanying text.

185. For a discussion of public dissatisfaction at this time, see supra note 66 and accompanying text.
The early 1980s, however, saw a renewed interest in executive compensation matters. That growing interest coincided with a turbulent economy, a rising unemployment rate, and controversy surrounding compensating executives with golden parachutes. The presence of each of these factors at the same time stand out in contrast to the immediately preceding decades where there was remarkably less interest in executive compensation matters. With this backdrop, Congress enacted tax legislation attempting to limit golden parachutes: sections 280G and 4999. The foregoing suggest that it is the combination of a downward moving economy, rising unemployment, and scandalous news regarding executive pay that instigates significant public and policymaking attention on executive compensation, resulting in legislation.

In any event, as the economy and jobs recovered in the mid to late 1980s, public and policymaking interest in executive compensation matters waned. Of note, however, is that executive pay was rising significantly during this same time frame. Yet those pay increases did not garner extraordinary attention or elicit legislation until the next recession and controversy regarding executive pay hit in the early 1990s.

The 1990s are also interesting to consider. Once again, a recession coincided with rising unemployment to incite a public uproar over executive pay. This uproar reached new levels after President Bush traveled to Japan with leading American executives, which highlighted, among other things, the privileged and protected pay status of American executives vis-à-vis their foreign counterparts. The legislative response was another tax penalty provision—section 162(m)—that was enacted in 1993 to both limit executive pay and make it more responsive to job performance. Importantly, thereafter, the economy boomed along with executive pay at a rate not seen previously. During the six or so years of hugely escalating pay that followed section 162(m)’s enactment there was

186. For a discussion of the economy in the 1980s, see supra notes 82–105 and accompanying text. It is certainly plausible that the level of acquisitive activity would have drawn attention to golden parachute agreements absent a troubled economy. Conversely, it is possible that if the economy had been booming little attention would have been paid to golden parachute agreements. Neither proposition can be proved with certainty.

187. For a discussion of these tax code provisions and their effect on parachute payments, see supra notes 100–03 and accompanying text.

188. For a discussion of the increase in executive pay during this time, see supra notes 104–05 and accompanying text.

189. For a discussion of the recession and unemployment rate of the 1990s, see supra notes 106–09 and accompanying text.

190. For a discussion of President Bush’s trip to Japan, see supra notes 113–15.

191. For a discussion of § 162(m), see supra notes 124–25 and accompanying text.

192. For a discussion of this economic boom, see supra notes 126–30 and accompanying text.
no significant movement to regulate executive compensation. Again, that lack of focus changed with the next recession and catalyzing controversy.

The 2000s have been a tumultuous decade, fraught with scandal and two recessions. The country has yet to move beyond this point, and executive compensation has been at the forefront of the public agenda for most of the decade. Not surprisingly, legislation has been enacted in response to shape and rein-in executive pay: SOX, section 409A, section 457A, the TARP program, and the Dodd-Frank Act.

Reflecting on the above history shows that at those points in time that Congress has chosen to act to regulate executive pay, three factors have been present: an economic recession, a rising unemployment rate, and an executive pay controversy that acts as a focusing event. A closer examination also reveals that, alone, both a declining economy and rising unemployment rate are insufficient to trigger legislation regulating executive compensation. However, when combined with a pay controversy, historically, legislation has resulted.

The economy has continually fluctuated through peaks and troughs over the last hundred-plus years. Thus, there have certainly been recessions that were not accompanied by a significant movement to regulate executive pay, including a particularly notable recession in the early 1970s. Like the economy, the unemployment rate has also fluctuated over time, generally in rhythm with the economy. Accordingly, there have been times when the unemployment rate has risen without triggering executive pay regulation. Further, there were times during the 1940s-1970s when the country experienced a recession with an associated increase in unemployment but no major movement to regulate executive pay. Importantly, at those times there were no significant pay controversies to act as focusing events.

A significant executive pay controversy has occurred during each crucial time period that Congress has enacted legislation regulating executive pay: the revelation of exorbitant pay levels in the Bethlehem Steel and American Tobacco litigation and from congressional investigations in the early 1930s, the use of golden parachutes as a potential shield from corporate decision-making in the early 1980s, the receipt of high levels of executive pay seemingly unrelated to performance when contrasted with the pay of foreign counterparts in the early 1990s, preferential treatment for the

193. There were academic discussions and studies regarding § 162(m)’s effectiveness, or lack thereof, as well as mundane reporting on executive pay matters. For a discussion of these criticisms of § 162(m), see supra note 125.

194. For a discussion of the 2000s, see supra notes 131–76 and accompanying text.

195. For a discussion of this recession, see supra notes 64–66 and accompanying text.

196. Again, the 1970s are notable in this regard. See supra notes 60–81 and accompanying text.
deferred compensation of executives while the retirement savings of average employees was wiped out during the fall of Enron Corporation in the early 2000s, and aspects of another pay without performance controversy surrounding the pay, bonuses, and other perks received by executives at bailed out financial institutions in the late 2000s. These incidents not only predate legislative action, but also seemingly act as focusing events that intensify and rally public sentiment on executive pay matters. Indeed, legislative action either refers to particular scandalous events, involves investigations of such events, or both.

In that way, these controversial events seem so important to the executive pay regulation calculus that perhaps they, alone, are sufficient to trigger legislative action. However, in each instance where there has been legislative regulation of executive pay, there has also been economic turmoil and rising unemployment. It is thus difficult to examine the extent to which regulation would have still occurred in the absence of the

197. The role of the media is unclear, but should not be overlooked here. Some view the media as instigators of public focus on specific issues, directing which issues the public considers significant and then shaping individual views on those issues. See Maxwell McCombs, The Agenda Setting Function of the Press, in The Press: American Institutions of Democracy 156, 159–60 (Geneva Overholser & Kathleen Hall Jamieson eds., 2005). This is referred to as the agenda-setting theory. See id. (discussing this theory). Others view the media as more responsive to the issues on which the public is already focused. See Joseph E. Uscinski, When Does the Public’s Issue Agenda Affect the Media’s Issue Agenda (and Vice-Versa)? Developing a Framework for Media-Public Influence, 90 Soc. Sci. Q. 796, 799 (2009). This latter theory is the audience-driven model, and has been less well studied than the agenda-setting theory. Both theories have their supporters and detractors. See, e.g., W. Russell Neuman & Lauren Guggenheim, The Evolution of Media Effects Theory: A Six Stage Model of Cumulative Research, 21 Comm. Theory 169, 172 (2011) (discussing theory which considers media’s influence as minimal); see also Doris Graber, The Media and Democracy: Beyond Myths and Stereotypes, 6 Ann. Rev. Pol. Sci. 139, 145 (2003) (critiquing audience-driven theory). Pertinent to this Article, the underlying question is to what extent is the media provoking versus reflecting public sentiment toward executive pay. Again, scholarship assessing the media’s role is not of uniform opinion.

Interestingly, a former editor for The Economist, Matthew Bishop, has commented specifically about the role of the media in executive pay matters. According to Bishop, there is a correlation between the state of the economy and the tone of reporting on executive compensation due to the types of articles the public wants to read at those times. See Matthew Bishop et al., The Media and Executive Compensation: A Panel Discussion, 30 J. Corp. L. 795, 797–98 (2005) (discussing that while journalism has ability to influence debate over executive compensation, its role is not as effective as some might think because readers desire to read different types of stories depending on how economy is doing). In other words, when the economy is doing well, readers want to read positive stories and do not care as much about the salaries of CEOs. See id. Conversely, when the economy is doing poorly, readers want to read negative stories critical of executive compensation. See id.

198. For further discussion of this legislative action, see supra notes 29, 87, 121, 139 and accompanying text.

199. Professor Ribstein theorizes that stock market booms and bubbles have a natural tendency to encourage the public to be more trusting and overconfident, thus failing to notice or suspect fraudulent corporate and executive behavior.
latter two factors. Indeed, similar statements can be made with regard to each of the three important factors identified in this Article, which is the point: it is the convergence of these factors that seems to matter.

This still leaves for consideration the role of executive pay levels in triggering pay regulation. Executive pay levels are certainly not irrelevant. Nevertheless, as noted above, during the 1970s, 1980s, and 1990s, rising executive pay levels alone did not lead to a heightened focus on executive compensation. More importantly, executive pay has been escalating nearly constantly on average since the 1970s, unlike the economy and unemployment rate, which fluctuate, or scandalous events, which occur sporadically. Taken together, these facts suggest that pay levels do not play an overly important role in instigating criticism and regulation. Put differently, in recent times, escalating executive pay levels act more as a constant; it thus seemingly takes other variables to incite widespread public condemnation of executive pay resulting in legislative regulation:

Ribstein, supra note 5, at 81. Once the market goes bust, however, the blinders are taken off and the resulting revelations result in regulation. See id. at 81–82.

200. Indeed, one aim of some executive pay regulation has been reining it in. See, e.g., H.R. Rep. No. 103-111, at 646 (1993) (regarding Tax Code § 162(m), Senate Finance Committee believed “excessive compensation [would] be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations [was] limited”).

201. Pay levels have contracted briefly around recessionary times, but then they rebound and continue to grow. See MISHEL, BERNSTEIN & SHIERHOLZ, supra note 44, at 220; Frydman & Saks, supra note 44; LEVINE, supra note 75, at 2–3.

202. The historical context suggesting that soaring pay levels standing alone are not an important factor could be a product of a lagging effect, where it takes several years—or, in these instances, six or more—of escalating pay before the issue grabs a hold of public attention. Further, since those periods of escalating pay followed legislative and other regulatory actions, it is possible the public initially proceeds under the assumption that such regulation will be effective in responding to the public’s concerns and thus the passage of time is necessary to reveal that the legislation has not done so. As discussed briefly below, those seem like unlikely explanations.

As to the possibility of a lagging effect, one would think it would take less than six years of escalating pay for the public to take note and complain about executive compensation. In any event, the fact that pay levels were not the subject of intense criticism until the next recession and associated rise in unemployment is either very interesting timing or more than coincidence.

More complicated is the possibility that the public perceives that any enacted regulation will be effective in reining in or shaping executive compensation, and so the issue lays dormant for a period of time until it becomes clear that such regulation is not working. If that were the case, though, one would expect to see repeated attempts to regulate in the failed area. But, that is not the case. With each nexus of factors, the resultant legislation is tailored to the concerns that arose out of the relevant scandalous controversies of the time.

There is also the possibility that the importance of executive pay lays not in its level but in its structure. Thus, the relevance is the revelation that executive pay is not functioning in a manner the public finds acceptable. It is important to note, though, that negative public sentiment regarding executive pay has tended to exist prior to the revelation of any particular controversial compensation structure. Once revealed, however, those structures not only act as focusing events triggering regulation, but also become the subject of regulation.
namely, a turbulent economy, rising unemployment, and an executive pay controversy.\textsuperscript{203}

In the final analysis, executives have not been a constant focus of high levels of public animus. At those times when they have been, and Congress has also been moved to take action, three elements have been present: economic turmoil, increased unemployment, and a pay controversy to act as a focusing event. Each of these three elements typically evokes strong emotions from main-street Americans, particularly those who have lost their jobs or are otherwise struggling to make ends meet. Politicians are wise, certainly from a political perspective, to not idly ignore the masses calling for executive pay to be controlled in some manner.

Nevertheless, legislation enacted to regulate executive compensation has been roundly criticized for being ineffective and typically generating significant negative and unintended consequences.\textsuperscript{204} It is unlikely Con-

\textsuperscript{203} It should be noted that many other potential factors that might be relevant in triggering regulation were considered and discarded in the researching of this Article: for example, changes in wages after adjusting for inflation, the misery index, and the Gini coefficient. Certainly, the list of possible factors that one could consider is almost endless. However, most of the factors one might view as potentially relevant are measures of how the public is faring in terms of financial quality of life, much like the economy and general unemployment rate. In that regard, the most coincident factor appeared to be the unemployment rate, and a review of the historical data regarding other measures did not reveal any uniquely significant changes surrounding the relevant time periods.

Take, for example, the Gini coefficient—a measure of income inequality. The Gini coefficient has been continually trending upward since the Great Depression, indicating that America is in that way becoming more inequitable over time. See U.S. Census Bureau, U.S. Dep’t of Commerce, The Changing Shape of the Nation’s Income Distribution: 1947–1998 \textit{passim} (2000), \textit{available at} www.census.gov/prod/2000pubs/p60-204.pdf; Carmen DeNavas-Walt, Bernadette D. Proctor & Jessica C. Smith, U.S. Census Bureau, U.S. Dep’t of Commerce, Income, Poverty, and Health Insurance Coverage in the United States: 2009 \textit{40 tbl. A-2} (2010), \textit{available at} http://www.census.gov/prod/2010pubs/p60-238.pdf. Specifically, prior to 1974, the Gini coefficient experienced some measure of fluctuations. \textit{See id.} at 43. However, between 1974 and 1989 the Gini coefficient was continually on the rise with no periods of contraction. \textit{See id.} at 41–43. It declined in 1990 and 1991, before returning to a level above that in 1989 and thereafter climbing until 1997. \textit{See id.} at 41. There was another two-year decline in 1998 and 1999, before it returned to a level above that of 1997 and climbed until 2001. \textit{See id.} at 40–41. In 2002 and 2003, the Gini declined again before retuning in 2004 to the 2001 level and then climbing until 2006. \textit{See id.} at 40. The next decline occurred in 2007, but was climbing again by 2009, the most recent year for which this information is available. \textit{See id.}

In sum, the Gini coefficient does indicate an increase in inequality in the years preceding executive pay controversy and regulation, but it also shows that, but for brief periods generally coinciding with an economic recession, since 1974 it has been continually on the rise. Thus, similar to executive pay levels, in recent times growing income inequality is more of a constant and in that way cannot explain a sudden increased interest in executive pay.

\textsuperscript{204} For a criticism of legislation designed to regulate executive pay, see supra notes 103, 125, 142, 150, and 173. There has also been some praise for corporate governance legislation, but the weight of assessments has been more critical. \textit{See, e.g.}, Brian Kim, Sarbanes-Oxley Act, \textit{40 Harv. J. on Legis.} 235, 236
gress would repeal existing legislation, although perhaps some of it could be altered favorably. More importantly, though, there is nothing to suggest that the convergence of events that leads to such deficient legislation is not likely to occur again. This raises the question of what Congress should do—how it should respond—the next time.

IV. TAX-BASED REGULATION OF EXECUTIVE COMPENSATION: A CASE STUDY AND A PRESCRIPTION

Legislators seemingly feel compelled to act at those key moments when the three factors identified in this Article coalesce. However, for a variety of reasons their actions are seriously flawed. There are several solutions to this paradox, although none of them are easy. Legislators could resist the call to action, but that would risk their position if voters viewed them as aligned with executives or otherwise unsympathetic to the


205. For a discussion suggesting Congress will not repeal its corporate governance legislation, see infra notes 207–15 (regarding political considerations involved in repealing executive pay legislation). Note, too, that although the jury is out as to whether the amendments were positive, the Dodd-Frank Act did amend portions of SOX. See, e.g., Jessica Luhrs, Note, Encouraging Litigation: Why Dodd-Frank Goes Too Far in Eliminating the Procedural Difficulties in Sarbanes-Oxley, 8 HASTINGS BUS. L.J. 175, 180–85 (2012) (describing Dodd-Frank amendments to SOX).

206. Indeed, over time, these pivotal moments have occurred at more frequent intervals.

207. Common reasons proffered are inherent flaws in the method of regulation, the swiftness with which legislation was enacted raising concerns regarding both time to appropriately consider legislation and extent to which legislation is merely symbolic, and a narrowly tailored response to events not likely to occur again. See, e.g., Mullane, supra note 150, at 1066–68 (discussing inherent flaws of using tax penalties to regulate executive compensation); Zelinsky, supra note 97 (criticizing use of tax penalties); see also, e.g., Lisa M. Fairfax, Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act, 55 RUTGERS L. REV. 1 (2002) (claiming that officer certification provisions of SOX are merely symbolic); Jill E. Fisch & Kenneth M. Rosen, Is There a Role for Lawyers in Preventing Future Enrons?, 48 VILL. L. REV. 1097, 1098 (2003) ("[A]greement was reached rapidly on [SOX]."); Larry E. Ribstein, SARBOX: The Road to Nirvana, 2004 Mich. St. L. Rev. 279, 282–83 ("Congress hurriedly passed Sarbanes-Oxley."); Ribstein, supra note 5, at 82 ("[B]ecause the frauds of the next boom are unlikely to resemble those of the previous one, regulations imposed that are designed to deal with such frauds will not prevent future schemes."); Miriam Miquelon Weismann, Corporate Transparency or Congressional Window Dressing? The Case Against Sarbanes-Oxley as a Means to Avoid Another Corporate Debacle: The Failed Attempt to Revive Meaningful Regulatory Oversight, 10 STAN. J.L. BUS. & FIN. 98, 101–02 (2004) (criticizing SOX in light of “failed legislative reform paradigm” of corporate self-regulation).
plight and pleas of voters. Alternatively, legislators could enact legislation that effectively meets stated goals and has minimal, insignificant side effects, but such a regulatory vehicle seemingly has yet to be discovered by legislators.\footnote{This assumes legislators are genuinely interested in enacting effective, as opposed to merely symbolic, legislation.} Another possibility is that perhaps legislators could at least be convinced to not go down the least fruitful paths.

Tax-based regulation of executive pay provides a basis for an interesting case study. Scholars have considered the use of tax penalties to regulate executive compensation from various angles and have found their use severely lacking.\footnote{For a discussion of this criticism of tax penalties, see supra notes 103, 125, 150 and accompanying text.} This Article shows more concretely that such tax regulation appears to be reactionary legislation appealing to populist anger in times of economic turmoil. Combined with other research showing that tax penalties on executive compensation have been ineffective methods of regulation, create negative unintended consequences, and cause indiscriminate harms, the conclusion that this form of regulation needs to cease is inescapable.\footnote{For a discussion concluding that tax-based executive compensation regulation will prove ineffective, see supra notes 103, 125, and 150. Use of tax incentives to encourage desirable compensation levels or structures has yet to receive serious consideration—an area this author plans to explore in future writing.} Indeed, it is time to consider more deeply—in light of history and experience—the extent to which regulation of executive compensation is needed, what the goals of any regulation should be, and, if achievable, how best to attain those goals.

Notwithstanding the foregoing, convincing Congress to either forego use of the Tax Code or examine its use more deeply is challenging. To begin, with so much business before Congress covering vast areas of expertise, it is difficult for legislators to be fully informed about the content of all pieces of legislation, much less any surrounding academic literature. Furthermore, imposing tax penalties on executive compensation above certain levels or on certain types of pay has strong symbolic appeal. The Tax Code is uniquely positioned to seemingly punish executives financially by increasing their tax burden. That result may be particularly appealing to average Americans during recessionary times when many are out of work.

Interestingly, the most realistic option for dealing with the conundrum of regulating executive compensation derives from a common practice in enacting tax legislation. Congress could be encouraged to enact executive pay legislation with a sunset provision.\footnote{For example, several significant tax acts have been enacted with sunset provisions. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107–16, 115 Stat. 38; Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108–27, 117 Stat 752; Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296.} In that way, if Con-
gress took no steps to renew or modify the existing legislation prior to its sunset date, the law would automatically expire and revert to its prior state.

Although use of a sunset provision is not without its downsides, it could provide several countervailing benefits in this context. To begin, a sunset provision would allow Congress to act without necessarily permanently enshrining bad law. When it comes to regulating executives, even if a law is ineffective and causing other harms, legislators risk appearing as though they are benefiting executives if they vote in favor of repealing such legislation. Even though that would not be the case with such flawed legislation, the appearance of granting special favors to executives is something legislators may want to avoid even during those times when negative public sentiment is not rampant. A sunset provision allows for time to pass, and with it distance from emotionally charged events. With that time and distance, the political environment could be such that legislators would be in a position to remain passive, and let bad legislation expire without being forcefully charged by the press, public, or candidates from other parties with claims of favoritism. Thus, a sunset provision provides opportunities for a change in the rhetoric or posturing surrounding the removal of legislation.

A sunset provision allows not only time for the political environment to settle, but also encourages reflection on, and an examination of, legislative results. Such post-hoc study ideally would inform Congress’s con-

212. The principal criticisms of using sunset provisions in tax legislation are as follows: (1) they are a means of subverting congressional budgetary rules, (2) they are “rent-extracting mechanisms,” and (3) they impair stability and thus affect the ability of taxpayers to make long term plans in affected areas. Rebecca M. Kysar, The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code, 40 GA. L. Rev. 335, 340–42 (2006). The first of those criticisms is the most significant, but is mostly relevant in the context of tax legislation that reduces revenue (e.g., tax rate cuts), and thus a sunset provision is used as a vehicle for enacting legislation on a temporary basis that budgetary rules would not permit to be enacted permanently. That particular concern is not relevant in the context of executive pay regulation, as such regulation generally takes the form of tax differences that, if applicable, raise revenue. However, the potential revenue-raising function of such executive pay provisions could present budgetary challenges for a Congress considering allowing those provisions to sunset. The second of the delineated criticisms is a valid concern, and it is certainly possible that interest groups will prevent these provisions from expiring or legislators will use expiring provisions for political purposes. Nevertheless, with a sunset provision there is a stronger chance for a more positive outcome. The third criticism is discussed below.

213. See, e.g., Polsky, supra note 17, at 926 (“Perhaps the worst aspect of § 162(m) is its likely permanence. It would be politically difficult, if not impossible, to repeal the provision. Proponents of repeal would be criticized for trying to make it easier for firms to pay executives more than $1,000,000 in performance- insensitive pay.”).

214. One of the drawbacks of sunset provisions is that they make it difficult for affected parties to make long term plans. That cost may, however, be worth it to reap the benefits outlined above of sunset provisions in this context. However, due to the potential for a subsequent change in the law, one corporate response to a sunset provision might be for the company to continue its practices to whatever extent possible, as if the law had not been enacted. Taking a wait-and-see ap-
sideration of whether legislation should be extended, modified, or allowed to expire. Further, a sunset provision could provide a mechanism for possible refinements to legislation that may be beneficial primarily due to changes in the executive compensation and corporate governance environment.215

V. Conclusion

This Article has considered the socio-political context of congressional regulation of executive pay from its beginnings in the Great Depression era through to modern times. In doing so, it shows that Congress produces regulatory legislation when three factors coalesce: economic turmoil, rising unemployment, and an executive pay controversy. This does confirm casual observations that the state of the economy and jobs are important factors surrounding any movement to regulate executive pay. Nevertheless a more considered study of business and unemployment cycles shows those factors alone are not sufficient to elicit legislation. Legislation results, historically, when those factors are combined with an executive pay controversy that acts as a focusing event.

Given the nature and increasing frequency with which the convergence of these events has been occurring in modern times, it is reasonable to conclude that they are likely to occur again. When that happens, the best-case scenario would be Congress enacting legislation that effectively meets its stated goals and has no, or only neutral, side effects. If history is a guide, however, the results are more likely to be ineffective and create negative unintended consequences. As a precautionary measure for the latter scenario, Congress should enact such future legislation with a sunset provision.

215. See Lund & Polsky, supra note 16, at 677 (arguing that “in light of evolving corporate governance mechanisms, the marginal net benefit of incentive-laden pay packages is both smaller than appreciated and getting smaller over time. As a result, the assumption that higher proportions of incentive pay are beneficial is no longer warranted,” and at minimum performance-based pay exception in § 162(m) should be repealed).
## Appendix

### United States Average Unemployment Rate of the Civilian Labor Force

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FIXING SECTION 409A: LEGISLATIVE AND ADMINISTRATIVE OPTIONS

GREGG D. POLSKY*

IN 2004, in response to perceived deferred compensation abuses by Enron executives,1 Congress enacted section 409A.2 Section 409A imposes a significant tax penalty on deferred compensation arrangements that do not meet its numerous technical requirements.3 Thus, the effect of Section 409A is strict federal regulation of deferred compensation arrangements. This Article argues that the strict regulation of deferred compensation under section 409A is an unqualified mistake and presents various options for improvement.

While some deferred compensation arrangements generate substantial tax benefits as compared to analogous current compensation, others are not tax-advantaged.4 Section 409A still allows tax-advantaged deferred compensation arrangements to generate their tax benefits; it simply requires that the plans satisfy its technical requirements.5 Thus, section

* Gregg D. Polsky is a Willie Person Mangum Professor at University of North Carolina School of Law. Thanks to Alfred Brophy, John Coyle, Brant Hellwig, and Steven Sholk for their comments; all errors are mine.

1. See Dana L. Trier, Rethinking the Taxation of Nonqualified Deferred Compensation: Code Sec. 409A, the Hedging Regulations and Code Sec. 1032, TAXES, Mar. 2006, at 141, 165 (noting that section 409A was stimulated by Joint Committee on Taxation’s Report on Enron).


3. See id. Technically, section 409A imposes the penalty on noncompliant nonqualified deferred compensation arrangements. See I.R.C. § 409A(d)(1)(A) (exempting qualified plans). Qualified deferred compensation arrangements, such as 401k plans, provide an explicit tax subsidy in exchange for satisfying a number of technical conditions. An important condition is that the plans must not discriminate in favor of highly compensated employees. In addition, the amount of compensation that can be deferred under qualified plans is substantially limited. Nonqualified plans, on the other hand, do not receive an explicit tax subsidy (though, as discussed below, they still may be tax-advantaged), can (and usually do) discriminate in favor of highly compensated employees, and are not subject to limitations as to amounts that can be deferred. Because section 409A applies only to nonqualified plans, when this Article uses the term “deferred compensation,” it means only nonqualified deferred compensation.

4. See Gregg D. Polsky & Brant J. Hellwig, Taxing the Promise to Pay, 89 Minn. L. Rev. 1092, 1142-44 (2005) (providing example where, because of equivalent tax rates for employer and employee, deferred compensation and current compensation are taxed identically); Ethan Yale & Gregg D. Polsky, Reforming the Taxation of Deferred Compensation, 85 N.C. L. Rev. 571, 579 n.23 (2007) (noting that, if employer’s investment income tax rate is higher than employee’s investment income tax rate, deferred compensation will be tax disadvantageous).

5. See Eric D. Chason, Deferred Compensation Reform: Taxing the Fruit of the Tree in its Proper Season, 67 Ohio St. L.J. 347, 349 (2006) (“Perhaps at the margin, fewer
409A does not remove the tax advantage of deferred compensation in the vast majority of cases. Furthermore, section 409A applies to even those deferred compensation arrangements that are not tax-advantaged; in those cases, section 409A merely adds significant compliance costs without any corresponding benefit to the tax system. In addition, section 409A’s scope is extremely wide, capturing a large number of non-tax-motivated arrangements that many people would not characterize as deferred compensation, which results in a trap for the unwary or unsophisticated. Finally, section 409A’s requirements are extremely intricate and complex. The intricacy means that taxpayers lose the flexibility to structure deferred compensation arrangements that best meet their legitimate business objectives, while the complexity means that even careful, well-advised taxpayers may commit costly technical violations.

In short, section 409A does not even come close to solving the tax problems associated with deferred compensation. At the same time, it tightly regulates all deferred compensation plans, an extremely large and varied group of contractual arrangements, resulting in large costs with very little corresponding benefit to the tax system. Section 409A is a failure.

This Article discusses the section 409A failure and explores the various options that Congress and the tax administrators have for dealing with it. Part I describes the concept of deferred compensation, the pre-section 409A taxation of deferred compensation, the potential tax benefits of deferred compensation, and the impetuses for Congress’s enactment of section 409A. Part II summarizes section 409A’s provisions, while Part III catalogues its problems. Part IV discusses the options for reforming section 409A. Part V concludes.

I. BACKGROUND

A. Traditional Taxation of Deferred Compensation

In tax parlance, deferred compensation generally refers to compensation that is received and taxed after the services giving rise to the right to compensation have been performed. For instance, an employer might agree to pay an employee $100,000 in ten years for work performed this year. In that case, the employee, despite earning the right to income this year, would receive and be taxed on the compensation in Year Ten.

To achieve deferral of taxation, taxpayers historically had to successfully navigate around the tax doctrines of constructive receipt and economic benefit. If they did, then the following tax consequences generally

executives and corporations will bother passing through § 409A’s gates. For those who make it through, the economics are unchanged.”); Trier, supra note 1, at 165 (noting that section 409A left intact traditional nonqualified deferred compensation regime).

6. See PAUL R. MCDAENEL ET AL., FEDERAL INCOME TAXATION 1078–80 (6th ed. 2008). Another doctrine, the cash equivalence doctrine, is also relevant, though it
would result: (1) the service provider would not realize gross income until she received cash, (2) during the deferral period, the service recipient would include in gross income the investment yield on amounts set aside to pay the deferred compensation, and (3) upon payment of the deferred compensation, the service recipient would take a deduction in the amount of the payment. In contrast, if current compensation were paid (or if either of the tax doctrines were triggered), then (1) the service provider would realize immediate gross income in an amount equal to the present value of the payment rights, (2) during the deferral period, the service provider would include in gross income the investment yield on this present value, and (3) the service recipient would receive an immediate deduction equal to the present value of the payment rights. These results are summarized in the table below.

<table>
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<th>Deferred Taxation</th>
<th>Immediate Tax Consequences Upon Earning of Deferred Compensation</th>
<th>Taxation of Investment Yield During Deferral Period</th>
<th>Tax Consequences Upon Payment of the Deferred Compensation</th>
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<tbody>
<tr>
<td>No tax consequences to either party</td>
<td>Service recipient taxed on the investment yield</td>
<td>Service provider taxed on the payment; service recipient receives corresponding deduction</td>
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<tr>
<td>Current Taxation</td>
<td>Service provider taxed on the fair market value of the compensation; service recipient receives corresponding deduction</td>
<td>Service provider taxed on the investment yield</td>
<td>No tax consequences to either party</td>
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is much more narrow, and therefore much less significant, than the other two. For discussion of the cash equivalence doctrine, see Polsky & Hellwig, supra note 4, at 1113–15.

7. See McDaniel et al., supra note 6, at 1077.

8. Note that the investment yield would be taxed when it is realized under the service provider’s method of accounting; likewise the service recipient would be taxed on the investment yield when it is realized under the service recipient’s method of accounting if the arrangement satisfied the requirements for deferred taxation. Thus, if the deferred compensation were invested in stock that later appreciates, the investment yield (i.e., gain) would generally be taxed only when the stock is sold.
B. Constructive Receipt and Economic Benefit

To achieve the desired treatment, deferred compensation has to avoid current taxation under the doctrines of constructive receipt and economic benefit.\(^9\) The constructive receipt doctrine provides that taxpayers are deemed to be in receipt of an item of income before they actually receive the item. The constructive receipt doctrine applies when an item of income is made available to the taxpayer without substantial restriction or limitation.\(^{10}\) To avoid implicating the constructive receipt doctrine, deferred compensation plans generally require that any decision to defer income be made before the related services are performed, and the decision must be irrevocable. Thus, an election to irrevocably defer $100,000 of Year Two salary (for example, until Year Ten\(^{11}\)) would typically have to be made in Year One. While an expansive application of the constructive receipt doctrine might have captured such a deferral election, the IRS has blessed timely initial deferral elections.\(^{12}\)

To avoid the economic benefit doctrine, rights to future payment must be “unfunded.”\(^{13}\) This means that the service provider must remain in the position of a general unsecured creditor. Any attempt to secure the promise or otherwise insulate the service provider from the risk of the service recipient’s insolvency triggers the economic benefit doctrine, resulting in current taxation of the rights to future payment.

The classic economic benefit situation is where the service recipient pays the deferred amounts into a trust or escrow account either to secure the service provider’s right to future payment or to serve as the source of the future payment.\(^{14}\) In either case, the service provider is insulated

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9. For a full discussion of these doctrines as they relate specifically to deferred compensation, see Brant J. Hellwig, Nonqualified Deferred Compensation and the Pre-Statutory Limits on Deferral, in FEDERAL INCOME TAXATION OF RETIREMENT PLANS 13–19 to 13–34, 13–37 to 13–57 (Alvin D. Lurie ed., 2008).


11. The amount paid in Year Ten would be the $100,000 of compensation deferred plus a specified yield on that amount. The yield can be fixed or variable.

12. See Rev. Proc. 92-65, 1992-33 I.R.B. 16. While the law regarding initial deferral elections is relatively clear, this is not the case for agreements to postpone income beyond the original due date. Several cases have allowed taxpayers to extend original due dates without triggering constructive receipt as long as the decision to defer was made before the due date. See generally Comm'r v. Oates, 207 F.2d 711 (7th Cir. 1953) (holding that constructive receipt doctrine did not apply where extension of original due date was requested as result of non-tax business exigencies); Veit v. Comm'r, 8 T.C. 809, 818 (1947) (holding that constructive receipt doctrine did not apply where supplemental agreement to further defer payments was “bona fide” and made at “arm’s length”). The line of reasoning in these cases has the potential to undermine basic principles behind the constructive receipt doctrine because of the great flexibility it affords.

13. See Polsky & Hellwig, supra note 4, at 1116–25.

14. See Rev. Rul. 60-31, 1960-1 C.B. 174 (providing example of professional football player who negotiates for signing bonus to be placed in escrow for subsequent distribution to him; ruled that player realized current economic benefit when funds were contributed to escrow account).
against the risk of the service recipient’s insolvency. As a result, the economic benefit doctrine applies.

In summary, to avoid current taxation, deferred compensation arrangements historically had to provide for timely and irrevocable deferral elections and ensure that service providers bore the risk of the service recipient’s insolvency during the deferral period. These conditions were relatively easy to satisfy if the parties desired deferred taxation treatment.

C. The Tax Advantage of Deferred Compensation

Parties can be expected to negotiate for deferred compensation (as compared to current compensation) when the tax benefits from deferred compensation outweigh its non-tax costs. The costs are easy to see. First, given the irrevocable nature of the deferral election, the service provider loses the liquidity and flexibility that she would have if she instead had received current compensation and directly invested the current compensation for her own account. Second, deferred compensation arrangements require the service provider to put her current compensation at the risk of the service recipient’s insolvency, which is often not a desirable position for the service provider.

Describing the tax benefit from deferred compensation is more complicated. To evaluate the tax benefit, one must look at both sides of the transaction. As several commentators have shown, any net benefit to the parties generally stems from the difference in the tax rate that applies to the investment yield during the deferral period. If the employee receives current compensation, then she invests that compensation for her own account, and the investment yield is taxed at the employee’s rate. If the employee receives deferred compensation, then the employer invests the compensation for the employee’s account, and the investment yield is taxed at the employer’s rate. While the top marginal tax rates for individual employees and corporate employers are both currently thirty-five per-

15. If, however, the assets of a trust are, by the trust’s terms, available to the service recipient’s creditors, then there is no such insulation and the economic benefit doctrine does not apply. Trusts with such terms are called “rabbi trusts.” See Yale & Polsky, supra note 4, at 576 n.16.

16. Instead, in a deferred compensation arrangement, she has effectively invested her current compensation indirectly through her employer, with a resulting loss of liquidity and flexibility during the deferral period.

17. This is not a desirable position because service providers make a large investment of human capital in the employer resulting in suboptimal diversification. See Gregg D. Polsky, Controlling Executive Compensation Through the Tax Code, 64 Wash. & Lee L. Rev. 877, 889 (2007). Deferred compensation arrangements exacerbate this problem.

cent, their effective tax rates on investments sometimes differ. A corporation may have net operating losses, which drive down its effective tax rate on income recognized in the current year. Corporations are allowed a dividends-received deduction, which drives its effective tax rate on dividends below that of the fifteen percent tax rate currently enjoyed by individuals. Corporations also pay no tax on the gains from the sale of their own shares, while individuals pay a fifteen percent tax rate on those gains.

Thus, deferred compensation is tax-advantaged if the employer’s investment tax rate is lower than the employee’s investment tax rate. In all other cases, the taxation of deferred compensation is the same as that of current compensation or else deferred compensation is tax-disadvantaged. Given the non-tax costs of deferred compensation described above, one would expect to see deferred compensation only when it is tax-advantaged.

Several commentators have explored ways to neutralize the tax treatment of current and deferred compensation. The tax laws could be changed to impose the accrual method on employees who have rights to deferred compensation. Alternatively, a proxy tax could be imposed on the employer’s investment income attributable to compensation that is deferred. This proxy tax would approximate the tax that would have been imposed on the employee had she received current compensation and then invested the compensation for her own account. Each of the two methods—accrual taxation or a proxy tax—would in theory neutralize the tax consequences between current and deferred compensation. However, neutralization would be somewhat complex. While simplifying assumptions and exceptions (particularly for defined benefit plans) would be necessary to make either method administratively feasible, these nods to administrability would make the proposals not perfectly neutral in prac-

21. See id. § 1(h)(11).
22. See id. § 1032.
23. However, it is possible that in some cases cognitive error may cause transacting parties to have a tax preference for deferred compensation even in situations where deferred compensation is not tax advantaged or may in fact be tax disadvantaged, based on the intuition that paying tax later is always better than paying tax earlier. Cf. Gregg D. Polsky, *High Volatility, Negative Correlation, and Roth Conversions*, 130 Tax Notes 821, 821 (2011) (suggesting that taxpayers may irrationally choose not to make Roth conversions based on intuitive preference for paying tax later rather than earlier, even though Roth conversions are often wealth-maximizing).
24. See, e.g., DOoran, supra note 18. Sections 457(f) and 457A impose accrual method taxation on certain nonqualified deferred plans set up by tax-indifferent service recipients, like tax-exempt organizations or foreign taxpayers.
25. See, e.g., Halperin, supra note 18. For a comparison between the accrual tax and proxy tax approaches, see Yale & Polsky, supra note 4, at 592–99.
tice. Nevertheless, the proposals would go a long way towards reducing the tax advantage of deferred compensation but they would introduce additional complexity into the tax system.

D. The Perceived Enron Abuses

Despite the potential tax advantage of deferred compensation and its easy availability, no legislative proposals to fundamentally change the tax treatment of deferred compensation were seriously considered until the Joint Committee of Taxation’s investigation into the collapse of Enron.26 That investigation uncovered a number of tactics that Enron employed to allow its executives to receive the tax advantage of deferred compensation while substantially mitigating the associated nontax costs.27 Recall that the nontax costs of deferred compensation are (i) the inflexibility that stems from irrevocable deferral decisions, and (ii) the subjecting of the deferred compensation to the risk of employer insolvency.

Enron sought to mitigate these costs in two ways. First, Enron allowed its executives to take early distributions at their election so long as they took a ten percent forfeiture or “haircut.” These arrangements arguably avoided the constructive receipt doctrine because, while funds could be received at any time, the ten percent haircut was thought to constitute a substantial restriction or limitation on early distributions. Second, Enron allowed its executives to make subsequent deferral elections that extended payouts beyond their original distribution date as long as they made the elections sufficiently in advance of these dates. Various court cases had held that subsequent deferrals could be made without triggering constructive receipt,28 and Enron’s subsequent deferral arrangements were arguably sanctioned by these cases, though the IRS might have disagreed.

Accelerated distributions and subsequent deferrals reduced the nontax costs from deferring compensation. Both added flexibility. Accelerated distributions allowed participants to withdraw money whenever they wanted (subject of course to the ten percent haircut), while subsequent deferrals allowed participants to extend the initial deferral period. Accel-

26. See Trier, supra note 1, at 165 (noting that enactment of section 409A was most significant development in taxation of nonqualified deferred compensation in past twenty-five years). There has been some legislative tinkering around the edges with regard to nonqualified deferred compensation plans of tax-indifferent service recipients. In 1978, Congress enacted section 457, which imposed accrual taxation on certain deferred compensation plans of state and local governments, and in 1986, extended section 457 to apply to certain plans of other tax-exempt service recipients. In addition, shortly after section 409A was enacted, Congress passed section 457A, which imposes accrual taxation on nonqualified deferred compensation arrangements of certain foreign employers.


28. For a further discussion of cases that address the triggering of constructive receipt, see supra note 12 and accompanying text.
erated distributions also reduced the risk of insolvency because participants could accelerate distributions if the service recipient’s financial prospects appeared dim. Instead of going down with the ship, participants could bail out early and forfeit only ten percent of their account balance.

The accelerated distribution provisions seemed particularly egregious in the context of the Enron collapse. The Joint Committee investigation had found that $53 million had been distributed to Enron insiders within the two months preceding bankruptcy. Under bankruptcy law, however, these accelerated distributions were preferences that could be recouped for the benefit of all creditors. And, in fact, these accelerated distributions were attacked as preferences by Enron’s bankruptcy estate.29 Thus, while it might have initially appeared that the deferred compensation participants could bail out early and get ninety cents on the dollar, they ended up being treated like all other unsecured creditors.

It is thus very ironic that Enron became the poster child of nonqualified deferred compensation abuse. In hindsight, the deferred compensation participants (and certainly all of those who took accelerated distributions on the eve of bankruptcy) would have been far better off had they initially elected to receive current compensation.30 In other words, Enron’s deferred compensation participants gambled—to get the tax advantage of deferred compensation—and lost badly.

Nevertheless, Enron became Exhibit A for the proposition that the nonqualified deferred compensation rules were broken and stimulated the supposed legislative solution of section 409A.

II. SUMMARY OF SECTION 409A

As the previous section described, the pre-409A conditions for achieving deferred taxation treatment for compensation were very easy to satisfy. Participants had to make timely and irrevocable elections to defer, and they had to subject their future payment rights to the risk of the service recipient’s insolvency. Section 409A tightened up these conditions, providing for extremely detailed rules regarding the timing of the deferral election,31 permissible distribution dates and events,32 and the location of assets that would be the source of future payments.33 Any failure to satisfy

29. See Motion of the Official Employment-Related Issues Committee for an Order, Pursuant to Sections 105(a), 1103(c) and 1109(b) of the Bankruptcy Code, Expanding Scope and Mandate and Granting Standing and Authority to Commence Certain Avoidance Actions on Behalf of Debtors’ Estates, In re Enron Corp., No. 01-16034, (Bankr. S.D.N.Y. May 16, 2003) (asserting preference claims to recover $53 million in accelerated distributions from Enron’s nonqualified deferred compensation arrangements).

30. This assumes, of course, that these participants would have had the good sense to not invest all or most of the current compensation in Enron stock.


32. See id. § 409A(a)(2)–(3).

33. See id. § 409A(b).
these technical conditions resulted in immediate taxation (and corresponding immediate deduction for the service recipient) and the imposition of an additional twenty percent income tax and interest charges.34

To be section 409A compliant, deferred compensation plans must restrict the timing of distributions to fixed dates or upon certain specified events35 and cannot permit accelerated distributions (i.e., distributions that occur before the designated date or payment event).36 Distributions may be made upon the service provider’s separation from service, disability, or death, or upon the occurrence of an unforeseeable emergency (such as a medical emergency) or of a change of control of the service recipient. Distributions may be made at a specified time or pursuant to a fixed schedule. The purpose of the permissible distribution rules was to ensure that, once compensation is deferred, it may not be easily accessed by the service provider earlier than the normal distribution date or deferred beyond that date. In other words, the permissible distribution rules ensured that deferral elections were more or less irrevocable. Thus, a plan like Enron’s that allowed for early distributions at the election of the participants with a ten percent haircut would not be compliant.

Section 409A also provides detailed rules for the timing of initial and subsequent deferral elections.37 Again, the purpose of these rules is to restrict the flexibility of participants in deferred compensation plans.

III. THE PROBLEMS WITH SECTION 409A

A. Section 409A Did Not Solve the Deferred Compensation Tax Problem

It is still very easy to obtain the tax benefits from deferred compensation in those circumstances in which such benefits are available. Section 409A explicitly provides the roadmap to do so. To be sure, section 409A does reduce the flexibility of plan participants. But in cases where deferred compensation is tax-advantaged the reduced flexibility is often not a significant impediment. This is consistent with anecdotal evidence that the response to section 409A among tax planners was to make deferred compensation plans 409A compliant and not to do away with deferred compensation plans. Thus, the result is that section 409A simply provided more hoops to jump through to get the tax benefit of deferred compensation, and everyone is jumping through them rather than opting out.

The theoretically optimal solution would be to neutralize the taxation of deferred compensation with that of current compensation. This would remove any tax advantage, while leaving the parties free to construct the deferred compensation arrangement that best suits their non-tax business needs. As noted before, however, neutralization would be somewhat complex—but at least that complexity would solve the tax problem. Section

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34. See id. § 409A(a)(1)(B), (b)(5).
35. See id. § 409A(a)(2).
36. See id. § 409A(a)(3).
37. See id. § 409A(a)(4).
409A introduces extraordinary complexity (as described below) without solving the tax problem.

B. **Section 409A Introduced an Immense Amount of Complexity**

Despite not solving the basic tax problem, section 409A managed to introduce a tremendous amount of complexity into the Code. Section 409A and its regulations provide extremely detailed rules outlining the permissible distribution dates and events.\(^{38}\) They define, with inordinate specificity, “separation from service,” “disability,” “change in the ownership or effective control of the corporation,” “unforeseeable emergency,” and “specified time or fixed schedule.” There are also very complex rules defining deferred compensation\(^{39}\) and outlining permissible initial and subsequent deferral election procedures.\(^{40}\)

C. **Being Section 409A Compliant Is Costly**

After the enactment of section 409A, all deferred compensation plans had to be reformed to comply with its technical conditions.\(^{41}\) And, given the inordinate complexity of the rules, full compliance is not an easy task.

D. **It Is Possible for Even Diligent Plan Drafters and Administrators to Commit Technical Violations**

Even diligent deferred compensation plan drafters and administrators can accidentally commit technical “foot-fault” violations. The rules are extremely intricate, complex, and lengthy. In addition, the subject matter of most of the rules appears totally benign, which can cause people to become lackadaisical in drafting or complying with them. For example, the definitions of “separation from service” or “disability” seem benign, yet failure to comply with section 409A’s extremely precise definitions\(^{42}\) will have disastrous tax consequences.

E. **Section 409A’s Federalization of Deferred Compensation Plans Can Undermine Legitimate Non-Tax Business Goals**

Section 409A also effectively federalized all deferred compensation plans. The additional twenty percent income tax is so significant—relative to the limited tax benefit of deferred compensation—that the only options are either to be 409A compliant or to not pay deferred compensation. Thus, after the enactment of section 409A, all deferred compensation plans have effectively been designed by federal tax regula-

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\(^{38}\) See generally Treas. Reg. § 1.409A-3 (2007).
\(^{39}\) See generally id. § 1.409A-1.
\(^{40}\) See generally id. § 1.409A-2.
\(^{41}\) As noted above, plans could in theory instead be jettisoned in favor of additional current compensation, but this seems not to have been the reaction by tax planners.
tors. This limits the flexibility of companies to design plans that best suit their business objectives, even in cases where the tax advantage of deferred compensation is minimal or non-existent.

For example, the section 409A regulations generally apply to non-qualified stock options because the service recipient’s income realization occurs when the options are exercised, which can occur in taxable years after the year of receipt of the option.\footnote{See id. § 1.409A-1(b)(5)(i)(A).} However, the regulations exclude from the definition of deferred compensation stock options that have an exercise price at least equal to the value of the underlying stock at the time of grant.\footnote{See id.} Thus, the only stock options that are subject to section 409A are “in-the-money” stock options or “indexed” options (options whose exercise price is indexed to a particular benchmark like the Dow Jones Industrial Average). And because stock options may generally be exercised at any time (i.e., exercise is not limited to the specified permissible distribution dates or events), in-the-money or floating stock options per se violate section 409A and trigger the additional twenty percent tax. As a result, in-the-money or indexed stock options are never issued. Yet, as David Walker has explained, there may be very good non-tax business reasons to issuing in-the-money stock options,\footnote{See generally David I. Walker, The Non-Option: Understanding the Dearth of Discounted Employee Stock Options, 89 B.U. L. REV. 1505 (2009).} and many have advocated indexed options as a more precise instrument with which to compensate employees.\footnote{See Polsky, supra note 17, at 921.} The federalization of deferred compensation has nevertheless outlawed them.

F. The Scope of Section 409A Is So Expansive that It Captures Arrangements that Are Not Tax-Motivated

Section 409A applies to any deferred compensation arrangements. Many deferred compensation arrangements are obvious, such as salary or bonus deferral plans. But other deferred compensation arrangements are less obvious. For example, consider a small business owner who promises to give a loyal employee a share of the sales proceeds if and when he eventually sells his business. This is a deferred compensation plan that violates section 409A because the eventual payment date is not a permissible distribution date or event.\footnote{It is possible that the sale of the company is a condition that rises to the level of a substantial risk of forfeiture, but this is by no means clear. See Treas. Reg. § 1.409A-1(d)(1) (2007). If it does, then the arrangement would not violate section 409A.} Or consider a schoolteacher who has the option to receive her ten-month salary over twelve months. This would be a deferred compensation arrangement that violates section 409A unless the arrangement complies with the deferral election rules.
Subjecting “accidental deferred compensation” plans to section 409A is problematic for two reasons. First, because these arrangements are not typically thought of as deferred compensation plans, they are a trap for the unwary. If a taxpayer wants to set up a formal deferred compensation plan, she would go to a lawyer who would (hopefully) know about section 409A. But if the taxpayer simply wants to promise to pay a future bonus to her employee, she might do that without legal advice or without consulting a lawyer who is sufficiently aware of the details of section 409A. Second, accidental deferred compensation arrangements are by definition not tax-motivated. The parties do not consider the arrangement deferred compensation, and it is not paid in lieu of current compensation. It is a bona fide business arrangement that happens to fall within section 409A’s expansive definition of deferred compensation.

IV. FIXING SECTION 409A

The previous part described the major deficiencies of Section 409A. Its beneficial effect—tightening up the conditions for deferred taxation—is small relative to these problems. This part discusses options for reforming section 409A, starting with legislative reforms that would require congressional action followed by regulatory changes that could be adopted by the Treasury without congressional involvement.

A. Legislative Options

Congress has two main options in fixing section 409A. It could go for full-fledged reform by attempting to neutralize the tax treatment of deferred and current compensation. It could do this by imposing accrual taxation on the service providers who receive deferred compensation or by imposing a special tax on the service recipients who pay deferred compensation. Once neutralized, there would be no need to distinguish between “good” deferred compensation plans and “bad” ones and no need to penalize the bad ones. Conceptually, this is clearly the best approach; the issue is whether the administrative burdens of neutralization are worth the benefits.

Congress could instead decide to tighten the doctrines of constructive receipt and economic benefit, which is what it attempted to do in enacting section 409A, without imposing significant unnecessary costs. One option would be to keep section 409A as it is, but limit its application to compensation paid by public companies. Such a refocusing of section 409A would make sense. Smaller businesses are far less likely to have substantial

48. At the same time, Congress should limit the application of section 409A to compensation paid to employees or directors, as the current regulations largely provide. However, the statutory basis for this approach under current section 409A is questionable, as section 409A seems to apply, by its terms, to all compensation regardless of employee or independent contractor status. If Congress amends section 409A, it should codify the current regulation’s approach of limiting its scope to employee and director compensation.
formal deferred compensation for a number of reasons. Smaller businesses are at the same time more likely to have “accidental” deferred compensation plans that run into section 409A problems because they lack the sophistication and controls of a large company. Further, the marginal compliance burden of section 409A on public firms will be relatively small because they have accounting, legal, and tax departments that already must review deferred compensation arrangements. In addition, because small businesses are often organized as flow-through tax entities, the effective marginal tax rates of employees and employers (i.e., the owners of small businesses) are likely to be similar, thereby reducing the tax advantage of deferred compensation. In short, refocusing section 409A on large employers better targets the companies that award large amounts of deferred compensation to exploit differing tax rates, while limiting the marginal section 409A compliance burden.

Congress should also remove the additional twenty percent income tax on non-compliant deferred compensation plans. Accrual taxation of “bad” deferred compensation plans is sufficient to take away any tax advantage from deferred compensation; the twenty percent additional tax is nothing but overkill.

Legislative tweaking of section 409A, while a move in the right direction, is not ideal. Deferred compensation arrangements are too varied and fluid for section 409A’s unyielding and comprehensive technical rules. On the other hand, the pre-409A standards of constructive receipt and economic benefit are appropriately flexible. Accordingly, the best legislative approach (absent fundamental deferred compensation reform) would be for Congress to replace the comprehensive rules in section 409A with an explicit grant of authority to the Treasury Department and the IRS to issue rules and regulations to fulfill the purposes of the constructive receipt and economic benefit doctrines by requiring an appropriate level of irrevocability and inflexibility in deferred compensation arrangements. This grant of authority would allow the tax administrators the flexibility to devise new technical rules in problem areas or to simply leave in place the broad common law standards. The flexibility would also allow the tax administrators to choose whether to promulgate general prophylactic regulations or fact-specific rulings (to, for example, deal with specific abusive transactions that have been uncovered). Importantly, the failure to comply with the new rules and regulations would not trigger the additional twenty percent tax. Instead, it would result in immediate taxation (and, depending on the circumstances, the general negligence or substantial understatement penalties that apply to underreported income).

49. Here are a couple of reasons. Employees of small businesses may have less faith than employees of public companies that the company will be around long enough to satisfy their long-term promises. Small businesses are less likely to have the sophistication and legal advice necessary to draft and implement deferred compensation plans.
I would recommend that, if given this grant of authority, the Treasury promulgate prophylactic regulations governing the timing of initial deferral elections and subsequent deferrals. These could look much like the timing rules in section 409A as it currently exists (without the twenty percent additional tax). The Treasury should also promulgate regulations tightening up the economic benefit doctrine to ensure that assets in rabbi trusts are both legally and practically available to creditors of the service recipient in the event of insolvency. Instead of issuing detailed rules setting forth permissible distribution dates and events, I would suggest leaving the pre-409A constructive receipt standard in place. That standard—that amounts cannot be made available to taxpayers without substantial restriction or limitation—is generally sufficient. If the IRS wants to show taxpayers how it interprets the “substantial restriction or limitation” standard, it could do so in Revenue Rulings. For instance, if a ten percent haircut is believed to be a problem (recall that bankruptcy preference law seemed to have taken care of much of the perceived Enron problem), the IRS could issue a revenue ruling describing its view that a ten percent haircut is not substantial enough to prevent the application of the constructive receipt doctrine.

B. Regulatory Options

Congress has not done very well in the executive compensation tax arena.50 Sections 162(m) and 280G are consensus failures, and section 409A surely fits that mold. Given this history, it is unlikely that Congress will take appropriate action with respect to section 409A. In the absence of legislation, the Treasury and IRS have three options. They can apply section 409A literally as written, disregarding the fact that it is awful policy. The faithful servant approach is the one they have taken in drafting section 409A guidance to date. The only benefit of that approach is that it tees up quite nicely for Congress and everyone else how much of a mess section 409A really is, which (optimistically) could stimulate Congress to enact one of the legislative fixes described above.

Alternatively, the tax administrators could announce that they will not enforce section 409A. The IRS could issue a notice announcing that it will not enforce section 409A until further notice, while expecting never to issue that further notice. Such an explicit contravention of statutory language by the tax administrators is not unprecedented. In 1997, the Treasury Department promulgated the check-the-box regulations allowing non-corporate business entities to elect their classification. This allows substantively identical entities to be classified differently, despite statutory language that precludes such a result.51 Much more recently, the IRS is-

51. See 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.08 at 3-102 (4th ed. 2007) (arguing that statutory language precludes check-the-box regulations’ elective regime); Susan Pace Hamill, A Case for Eliminat-
sued a series of notices contravening the explicit text of section 382, which limits the availability of loss carry-forwards and built-in losses held by companies that undergo a change in ownership. 52

The taxpayer standing doctrine precludes legal challenges of counter-textual agency interpretations as long as the interpretations are favorable to the taxpayer. The taxpayer standing doctrine prevents anyone from litigating anyone else’s tax liability, on the ground that general taxpayer status does not result in a cognizable injury for standing purposes. This doctrine effectively allows the Treasury and the IRS to issue whatever guidance they would like, regardless of what the relevant statute requires, so long as the departure from the statute results in a benefit to the taxpayer. If the departure is unfavorable to the taxpayer, then it would quickly be challenged in court by an affected taxpayer.

Even though a policy of section 409A non-enforcement would be immune from legal challenge, there are several potential problems with that approach. There would be political risk in publicly disavowing a very recently enacted statute that was stimulated by the Enron collapse. And, the disavowal could be viewed by unsophisticated observers as a giveaway to corporate executives, since they are the biggest beneficiaries of nonqualified deferred compensation benefits. In addition, there is the potential for serious whipsaw of the IRS. While the application of section 409A is generally adverse to the taxpayer, this will not always be the case. Government disavowal of section 409A would allow taxpayers to selectively apply the provision whenever it suited them. Service recipients could assert the application of section 409A to claim deductions earlier than they would otherwise be allowed, and service providers could assert the application of section 409A to claim income realization in years that have been closed by the statute of limitations.

For example, consider a situation where an employee defers compensation in Year One which is payable in Year Ten. If the deferral arrangement is not section 409A compliant, then under the statute the compensation is included in the employee’s income (and deductible by the employer) in Year One, rather than Year Ten when it is paid out. Absent section 409A enforcement, the income and deduction realization would occur in Year Ten (assuming that the traditional constructive receipt and economic benefit doctrines are satisfied). But the employer would argue that the statute entitles it to a deduction in Year One if that deduction is more beneficial than waiting until Year Ten. Similarly, in

52. For a full discussion of these notices and how they were inconsistent with section 382, see J. Mark Ramseyer & Eric B. Rasmusen, Can the Treasury Exempt its Own Companies from Tax? The $45 Billion GM NOL Carryforward, in 1 CATO PAPERS ON PUBLIC POLICY (Jeffrey Miron ed. 2011), available at http://rasmusen.org/papers/gm-ramseyer-rasmusen.doc.
Year Ten, the employee could argue that section 409A required income inclusion in Year One (a year that is now closed by the statute of limitations), which would reduce the income inclusion in Year Ten. In those cases, the IRS would not be able to defend its position that section 409A does not apply because the statute requires its application.

To mitigate the whipsaw problem, the IRS could put conditions on its non-enforcement policy. The IRS could condition non-enforcement on consistency with that approach by the employer and, going forward, by the employee. It could do so by inviting taxpayers to check a box on their tax returns waiving the right to claim section 409A treatment. Failure to check the box would invite the IRS scrutiny to determine compliance with section 409A.

Besides political and whipsaw concerns, there is another drawback of an explicit non-enforcement policy. Such a policy would effectively leave the pre-409A doctrines of constructive receipt and economic benefit in place as they existed before section 409A was enacted, without any tightening up of the conditions for deferral. It would be awkward, to say the least, for the Treasury and the IRS to tinker around the edges of these doctrines while explicitly disregarding a statute designed to reinforce them.

A middle-ground approach, between literal interpretation and non-enforcement, would be for the Treasury and the IRS to recognize that section 409A is a legislative calamity when drafting guidance. Congress explicitly gave the Treasury specific authority to “prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section [409A].” This specific delegation could be used to re-focus section 409A exclusively on the deferred compensation arrangements of extremely large employers, which were the types of arrangements that triggered its enactment.

For example, the Treasury could interpret “compensation” for purposes of section 409A to refer only to compensation earned by employees of publicly traded entities. As discussed above, such a refocusing of section 409A would make eminent sense for a number of reasons. One problem with this approach is that it is difficult to reconcile it with the statutory language, though it is obviously more faithful to the statutory language than a policy of non-enforcement. “Compensation” as used in the text of section 409A is not limited in any way, while the suggested interpretation limits the scope of compensation to that issued by public companies. But because the suggested interpretation is a taxpayer-favorable interpretation, it usually would be protected by the taxpayer standing doctrine. In addition, the current regulations effectively reinterpret “compensation” to refer only to employee compensation, thereby exempting independent contractor compensation from the scope of section 409A despite the absence of any statutory ground for making the distinction.53 Thus, the current regulations reflect an awareness that the scope of section 409A is

overbroad, and they attempt to cabin its effect to arrangements that are problematic. The suggested interpretation merely extends this massaging of statutory text to the next logical place.

Whipsaw of the IRS would be a concern with this approach too. Non-public employers and their employees could assert section 409A in those cases where it suits them, while the IRS would be prevented from applying the provision to these taxpayers. However, the check-the-box procedure previously discussed could mitigate the whipsaw concern.

V. Conclusion

Section 409A is a failure. It fails to neutralize the tax treatment of deferred compensation with that of current compensation. At the same time, it imposes significant compliance costs on sophisticated taxpayers, and it is a dangerous trap for unwary taxpayers. It applies to a host of innocent transactions, while tax-advantaged deferred compensation plans persist as long as the “i’s” are dotted and the “t’s” are crossed.

Ideally, Congress should repeal section 409A and replace it with a system that taxes deferred compensation neutrally. Failing that, Congress should either replace section 409A with a broad grant of authority to the tax administrators to beef up the pre-409A constructive receipt and economic benefit doctrines or amend section 409A to limit its scope to employee compensation paid by public companies.

If Congress fails to act, the tax administrators should interpret “compensation” as used in section 409A to include only compensation paid by public companies to their employees or directors. This counter-textual interpretation of the statute creates the potential for whipsaw of the IRS by non-public companies and their employees, but this problem is outweighed by the benefits derived from cleaning up section 409A.
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I. INTRODUCTION

MANAGERIAL agency costs are ubiquitous in the modern public corporation. Agency costs arise from the separation of ownership and control and reflect the divergence between share-value-maximizing actions of managers and managers’ actual actions, plus the monitoring and bonding expenditures (including contracting costs) undertaken to reduce that divergence.\(^1\) Agency costs vary firm by firm, but regulatory actions and even business practices can have a systematic impact on agency costs. For example, increased or decreased enforcement of insider trading rules can affect agency costs across a wide spectrum of companies.

Who bears the burden of corporate agency costs? Who gains or suffers when agency costs rise or fall systematically?\(^2\) To the extent that corporate governance experts have considered this question, they have assumed, explicitly or implicitly, that shareholders bear these costs as the recipients of residual corporate returns.\(^2\)
This Article suggests that, from an incidence perspective, managerial agency costs can be analogized to the corporate income tax. Both can be thought of as differential taxes on investment in corporate equity. Fifty years of research on the incidence of corporate income taxes suggests that the view that shareholders bear the entire cost or enjoy the entire benefit of changes in agency costs is too simplistic. Both theoretical and empirical work on incidence indicate that corporate taxes, and, if the analogy holds, agency costs, may be borne over the long run by suppliers of capital and labor to the general economy to a significant degree. Exactly how much of the burden is borne by investors and how much by workers is a hotly contested question, but the evidence suggests that shareholders are unlikely to bear the full burden.

In keeping with the theme of this section of the symposium, this Article focuses on the incidence of one particular manifestation of managerial agency costs—excessive executive pay—while recognizing that the implications of the analysis are much broader. Although the point is contested, many commentators and analysts believe that executive pay at U.S. public companies reflects systematic market failure, and, as a result, executives receive more compensation than they would in a well-functioning market. For the purposes of this Article, I accept the premise of systematic market failure and ask at whose expense this excess pay is extracted. The answer, I believe, is that some fraction of the cost of systematically excessive executive pay is likely to be shifted from shareholders to other investors, labor, or both.

Of course, the extraction of excessive executive pay is likely to have other adverse consequences beyond the transfer of funds from shareholders, other investors, and workers to executives. The managerial power view of the executive compensation setting process implies that the design of executive pay packages will be distorted from the most efficient design.

3. See infra notes 45–68 and accompanying text.


5. Although I accept this premise for the purposes of this Article, I recognize that the premise is by no means universally accepted. See, e.g., Stephen M. Bainbridge, Is “Say on Pay” Justified?, 32 REG. 42, 42–44 (2009) (questioning premise of “say on pay”); John E. Core et al., Is U.S. CEO Compensation Inefficient Pay Without Performance?, 103 MICH. L. REV. 1142, 1144 (2005) (arguing that case for systematic market failure has not been made with respect to executive pay); Xavier Gabaix & Augustin Landier, Why Has CEO Pay Increased So Much?, 125 Q. J. ECON. 49, 50 (2008) (developing model involving competitive matching of CEO talent and firms that can explain most observed patterns in CEO pay).
in order to camouflage executive pay and deflect outrage.\(^6\) To the extent
that it is transparent, excessive executive pay may adversely affect worker
morale at lower levels in the organization.\(^7\) Excessive pay in the public
company sector may result in increased executive compensation in the pri-

tive company context and even in the non-profit sphere.\(^8\)

This Article will touch on these ancillary costs of excessive executive
pay, but its primary focus is on detailing the likely transfer of value to
executives from capital and labor and the assumptions underlying the
analysis.\(^9\) This Article also will consider the policy implications of the idea
that shareholders may not bear the full economic “tax” imposed by exces-
sive executive pay. For example, continuing the tax analogy, a transfer of
value from shareholders to executives would be modestly regressive, but a
transfer from labor to executives would be much more so. Recognizing
the likely incidence of excessive executive pay and the fact that suppliers
of non-corporate capital and labor do not even have a representative at
the executive pay bargaining table may provide a rationale for additional
executive pay regulation or a different type of regulation.\(^10\)

The remainder of this Article is organized as follows. Part I provides
data on executive compensation and describes why pay levels may be ex-
cessive systematically. The incidence analysis is developed in Part II. Part
III briefly considers other costs of systematically excessive executive pay,
while Part IV discusses the implications of a conclusion that shareholders
are unlikely to bear the full cost of excessive executive pay. The conclu-
sion to this Article briefly considers the application of the incidence analy-
sis developed herein to managerial agency costs generally.

II. THE EXECUTIVE PAY PROBLEM

A. Description of the Problem

The traditional view of the executive pay-setting process is an efficient
or “optimal” contracting view first propounded by Jensen and Meckling.\(^11\)
Under this model, a board of directors that cannot perfectly observe the
effort, focus, and effectiveness of its agent (the CEO) negotiates a contract
that minimizes such agency costs as (1) monitoring the executive, (2)

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\(^6\) See Bebchuk et al., supra note 2, at 754.
\(^7\) See infra notes 77–78 and accompanying text.
\(^8\) See infra note 76 and accompanying text.
\(^9\) This is not to suggest that these other costs are small. It is certainly possible
that costs resulting from distorted pay design exceed the inefficiencies resulting
from the transfer of value to executives from other stakeholders. See Bebchuk et
al., supra note 2, at 785.
\(^10\) Shareholders are represented by a corporation’s directors. Of course, af-
iliates or “inside” directors are conflicted as to the determination of their com-
ensation, but the unaffiliated, or “outside,” directors are charged with
representing shareholder interests in negotiating executive pay. The extent to
which outside directors serve as faithful shareholder representatives is taken up in
the next Part.
\(^11\) See Jensen & Meckling, supra note 1.
bonding by the executive to maximize shareholder value, and (3) the residual divergence between the actions selected by the executive and share-value-maximizing actions. According to this view, executive compensation is a tool that is used by directors to minimize agency costs.

The competing managerial power view of the executive pay-setting process posits that the outside directors who are charged with negotiating executive pay lack the proper incentives and tools to bargain effectively and that their independence is undermined by executive influence over the board and by small group dynamics. This does not mean that there are no constraints on executive pay. The managerial power view posits that outrage among investors and financial analysts will limit the amount of executive pay and shape its composition. Under this view, executive compensation is a manifestation of agency costs, rather than or in addition to being a tool to minimize those costs.

Of course, the managerial power view and the optimal contracting view of the pay-setting process may coexist, providing relatively more or less explanatory power at particular firms. Moreover, under both theories there is an overriding cap on managerial value extraction that is determined by external market forces—markets for corporate control, capital, products, and even the managerial labor market. However, external market forces are thought to permit considerable slack, leaving one to question the extent to which such forces actually limit executive rent extraction.

This Article assumes that the managerial power view accurately describes the pay-setting process at a significant number of U.S. public companies. That view suggests two major sources of inefficiency. The focus of much of the literature is on the distortions in compensation design that follow from an outrage constraint. Under the managerial power view, transparency and salience of pay are critical. If all channels of compensation were perfectly transparent and equally salient to investors and the financial press, channels would be irrelevant under this model. Outrage simply would be a function of total appropriation and, although total pay

12. See id.
13. See Bebchuk et al., supra note 2.
14. See id. A third view characterizes the compensation setting process as a team production problem in which the board serves as a mediating hierarch among competing stakeholders—the executives, employees, creditors, and shareholders—who make firm-specific investments in the company. This theory predicts that compensation arrangements would not be designed to maximize shareholder value, but to balance the interests of the stakeholders. See Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 83 VA. L. REV. 247 (1999).
15. See Bebchuk et al., supra note 2.
16. See, e.g., Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 64–66 (2004); Lucian Arye Bebchuk & Jesse M. Fried, Executive Compensation as an Agency Problem, 17 J. ECON. PERSP. 71, 75–76 (2003); Bebchuk & Grinstein, supra note 4, at 300–01; Bebchuk et al., supra note 2, at 786–88; Core et al., supra note 5.
would remain excessive, firms would structure pay to minimize agency costs and maximize shareholder value. But appropriation is not transparent. Managers may be able to increase their pay by camouflaging compensation and avoiding outrage. Doing so, however, results in compensation choices that are not share value maximizing.17

The second source of inefficiency relates to the transfer to executives of excessive compensation and the distortions in investment behavior that result. Executives receive more pay than they would in a well-functioning market. In all likelihood, there is both a systematic and a firm-specific element to excessive compensation. Managers, boards, and negotiating processes are heterogeneous. Some boards may negotiate effectively with respect to executive pay. Importantly, however, as long as executives receive excessive pay at a significant number of firms, pay levels will be systematically higher.

Systematically excessive pay levels would result from the ubiquitous practice of setting compensation based on the pay practices of peer companies, i.e., “benchmarking.”18 As a result of benchmarking, lax pay practices at some firms tend to drive up executive pay levels generally. The problem is exacerbated by the Lake Wobegon effect.19 Because no board is willing to publicly admit that its executives are below average, firms generally seek to pay their executives at or above the fiftieth percentile.20 This practice of benchmarking with targets above the fiftieth percentile leads to upward ratcheting in executive pay.21 Perversely, the upward ratcheting problem may have been exacerbated by enhanced executive compensation disclosure requirements promulgated by the SEC over the last twenty years. Evidence suggests that enhanced disclosure may have


18. This process is driven in large part by compensation consultants whose role is to collect, organize, and report (in redacted form) comprehensive pay information. See John M. Bizjak et al., Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?, 90 J. Fin. Econ. 152, 154–55 (2008).

19. See The News from Lake Wobegon, Prairie Home Companion, http://prairieradio.publicradio.org/about/podcast/ (last visited Mar. 29, 2012) (describing Lake Wobegon as fictional Minnesota town where “all the women are strong, all the men are good looking, and all the children are above average”).

20. Bizjak et al., supra note 18, at 155 (finding that vast majority of S&P 500 firms sampled “target[ed] pay levels at or above the 50th percentile of the peer group”). In addition, companies often select peer groups with an eye towards justifying high executive pay levels. See John Bizjak et al., Are All CEOs Above Average? An Empirical Analysis of Compensation Peer Groups and Pay Design, 100 J. Fin. Econ. 538 (2011); Michael Faulkender & Jun Yang, Inside the Black Box: The Role and Composition of Compensation Peer Groups, 96 J. Fin. Econ. 257, 259 (2010).

done more to increase below average elements of pay at lagging firms than to reduce above average pay levels or elements.\textsuperscript{22}

B. \textit{Executive Pay Levels and Growth in Executive Pay}

Reports of big executive compensation packages certainly provoke outrage, but is executive pay economically significant? Is there reason beyond mollifying an outraged public to worry about excessive pay and who bears the cost? The answer to all of these questions appears to be “yes.” Top executive pay represents a very significant fraction of corporate earnings, a fraction that has been growing over time along with executive pay levels generally and with the growing gap between executive pay and the compensation of rank and file workers. Even if only a small fraction of executive pay is in a sense “unearned,” the stakes are significant.

Compensation data for senior public company executives is readily available. For many years, U.S. public companies have been required to disclose in their annual proxy statements pay data for their “top five” executives, currently defined as the CEO, CFO, and three most highly compensated executives other than the CEO and CFO. S&P’s Execucomp database collects this data for executives at over two thousand public companies.\textsuperscript{23} For 2008, aggregate executive compensation for roughly 10,000 Execucomp executives totaled $25 billion, an average of about $2.5 million per top executive.\textsuperscript{24}

Senior executive pay and, in particular, CEO pay, has been increasing over the last several decades. According to a recent report, the median value of 2010 CEO compensation at the 350 largest U.S. public companies was $9.3 million, an increase of over 10% from the previous year.\textsuperscript{25} CEO

\textsuperscript{22} For example, Grinstein, Weinbaum, and Yehuda find that after disclosure requirements were enhanced for perks, firms that provided a low level of perks compared with their peers increased perks in the second year after enhanced disclosure was mandated, while firms that provided a relatively high level of perks did not reduce them. The authors provide additional evidence suggesting that the increase in perks by formerly low-perk firms reflected actual ratcheting rather than simply increased disclosure. Yaniv Grinstein et al., The Economic Consequences of Perk Disclosure (Apr. 3, 2011) (Cornell Univ. Johnson Sch. Research Paper Series), No. 06-2011, available at http://ssrn.com/abstract=1108707.

\textsuperscript{23} The Execucomp universe includes current and former members of the S&P 1500.

\textsuperscript{24} These figures are based on the Execucomp variable TDC1. TDC1 is a grant date measure of executive pay and includes salary, bonus payments, long term incentive payouts, perks, and the grant date value of stock options and restricted stock. Execucomp also includes a rough measure of realized compensation, coded as TDC2. TDC2 replaces grant date option values with realized option values. For this group of executives, aggregate compensation as measured by TDC2 for 2008 was $28.4 billion.

pay has increased in real terms by 500% or more over the last thirty years.\textsuperscript{26} The compensation of other senior executives has also risen rapidly, although not as rapidly as CEO pay.\textsuperscript{27}

The fraction of corporate earnings being devoted to compensating senior executives also has been increasing over time. Bebchuk and Grinstein collected pay data for Execucomp listed executives over the 1993 to 2003 period and estimated pay for U.S. public companies with market capitalization in excess of $50 million that were not listed on Execucomp. Over the entire period, they estimated that top executive pay constituted 6.6\% of earnings. However, between 1993 and 1995, top executive pay absorbed only about 5\% of earnings. Between 2001 and 2003, the fraction of earnings devoted to top executive pay had increased to almost 10\%.\textsuperscript{28}

The growth of executive pay can also be seen in the growing disparity between top executive pay and the compensation of rank and file workers.\textsuperscript{29} In 1980, the ratio of average CEO pay to average rank and file worker pay was 42 to 1. By 1990, that ratio had increased to 100 to 1. At the peak of the dot-com bubble in 2000, the ratio exceeded 500 to 1. The ratio declined as executive pay moderated during the financial crisis, but even in 2009 it continued to exceed 250 to 1.

Analysts have struggled to explain the rapid growth in U.S. executive pay. Equity compensation, which did not become significant until the 1980s, accounts for almost all of the growth.\textsuperscript{30} Operating within an optimal contracting approach, Holmstrom and Kaplan argue that the addition of this risky pay necessitated an overall increase in compensation of risk-averse executives.\textsuperscript{31} Frydman and (separately) Murphy and Zabojnik explain the growth in CEO pay as following from a shift in the requisite skill companies. To be sure, pay levels in 2009 were somewhat depressed as a result of the financial crisis, but the trend remains steadily upward.


\textsuperscript{28} Bebchuk & Grinstein, supra note 4, at 302.


\textsuperscript{30} Frydman & Jenter, supra note 27, at 77–80.

Formerly, firm-specific skills dominated, limiting outside opportunities, but, increasingly, general management skills dominate, which leads to greater competition for talent and to managers capturing greater rents. Recently, Gabaix and Landier have proposed a model involving competitive matching of CEO talent and firms. The model predicts that average compensation should move with firm size, and the model explains the increase in pay over time, as well as cross-industry and cross-country pay observations. The authors find very little dispersion in CEO talent at the largest firms, but given the tremendous amount of assets under management and a multiplier effect, the model can explain large pay differentials.

On the other hand, Bebchuk and Grinstein analyzed increases in executive pay between 1993 and 2003 and concluded that the growth in pay could not be explained by changes in firm size, performance, and industry mix. Taking the managerial power approach, they suggested that the bull market of the 1990s weakened the outrage constraint, allowing boards to increase executive pay, and that the design of equity compensation reduced the salience of this pay, permitting transfers of value that would have been inconceivable if paid in cash.

The bottom line is that top executive pay is economically significant and increasingly so. Bebchuk and Grinstein estimate that top executive pay at non-Execucomp firms with market capitalization in excess of $50 million is in aggregate about two-thirds of executive pay reported in Execucomp. Using that figure, a ballpark estimate for 2008 top executive pay for U.S. public companies with market capitalization in excess of $50 million is about $40 billion. Note, moreover, that these figures include


34. Bebchuk & Grinstein, supra note 4, at 302.

35. Id. at 301–02. In a similar vein, Jensen, Murphy, and Wruck argue that the favorable accounting treatment of options in the 1990s led boards to systematically undervalue this form of compensation. See Michael C. Jensen et al., Remuneration: Where We’ve Been, How We Got to Here, What Are the Problems, and How to Fix Them, 39 (European Corporate Governance Inst., Working Paper No. 44, 2004), available at http://ssrn.com/abstract=561305; Kevin J. Murphy, Stock-Based Pay in New Economy Firms, 34 J. ACCT. & ECON. 129, 143–45 (2003).

36. Bebchuk & Grinstein, supra note 4, at 297.

37. $25 billion aggregate compensation for Execucomp executives plus two-thirds times $25 billion equals $41.7 billion.
only the top five executives at each company. There are likely to be more than five “senior” executives at many large, public companies, and thus this figure likely understates the aggregate amount of senior executive pay. Also, bear in mind that these figures represent annual flows to company executives, not one-time transfers.

III. WHO BEARS THE COST OF EXCESSIVE EXECUTIVE PAY?

The corporate governance literature assumes, explicitly or implicitly, that excessive executive pay comes at the expense of shareholders who bear residual corporate gains and losses.38 This section analogizes systematically excessive pay to a corporate-level tax and explores the implications of that analogy within the extensive literature on the incidence of the corporate tax. If this analogy holds, we must conclude that it is far from clear that shareholders bear the cost of systematically excessive executive pay and that non-corporate capital and/or labor are likely to bear a significant fraction of the burden.

A. Systematic and Firm Specific Excess Executive Pay

In thinking about the incidence question it is useful to conceptually divide excess executive pay between firm-specific excesses and systematic excesses. To the extent that executive pay is greater at a particular firm because of a particularly strong CEO or particularly lax outside directors, the cost is likely to be borne entirely by that firm’s shareholders. If we assume that the firm is engaged in competitive products and labor markets (below the executive level),39 it would be difficult for existing shareholders to pass on such firm-specific costs to consumers or employees. If the firm collects monopoly rents, those rents will simply be reduced by the excessive compensation. Lenders to the firm—bondholders or banks—will not be affected by excessive pay that does not materially threaten solvency. New suppliers of equity—either purchasers of a new issuance of shares, or purchasers of outstanding shares—will demand a discount to reflect the reduction in equity returns caused by extraction of excessive compensation. Thus, existing shareholders, i.e., “old” equity, should bear the cost of existing excessive pay and of any firm-specific increase in executive pay.

But what about executive pay that is at a higher level, systematically, than would prevail in a well-functioning market? Systematically higher pay that results from lax governance at some firms, comparative benchmarking, and an executive labor pool that is infected by these practices would seem to be analogous to a corporate-level income tax. Like an actual tax, the economic tax created by systematically excessive pay reduces net shareholder returns across the board. If the “tax” may be avoided by shifting

38. Bebchuk et al., supra note 2.
39. Note that there is no inherent inconsistency in assuming market failure in the executive labor market and assuming an efficient rank and file labor market.
investment into other domestic sectors or by shifting capital abroad, those capital flows will affect the incidence of systematically excessive pay.

Of course, there are differences between actual corporate taxes and this economic tax that might affect the incidence analysis. First, the actual corporate income tax is exogenously determined, while executive pay levels are to a large extent endogenous. But the argument here is that, to some extent, excessive executive pay at any particular firm is exogenous. Second, the design of the actual corporate tax (a percentage of profits) is quite different from the design of the economic tax arising from excessive executive pay (which may provide useful incentives). Third, the corporate income tax is relatively transparent, while excessive compensation is much less transparent. Nonetheless, as further discussed below, it is not obvious that any of these differences seriously weakens the analogy between the corporate tax and systematically excessive pay.

For the sake of pursuing and unpacking the analogy, let us suppose that there has been an economic shock that has loosened the outrage constraint and allowed executives to extract increased pay across the board. We can use Bebchuk and Grinstein’s suggestion that the bull market of the 1990s loosened the outrage constraint and allowed for increased pay. The question, then, is what is the incidence of the systematic increase in executive pay?

The increase in pay comes directly from the corporate treasury, but of course the treasurer does not bear the cost. As with a corporate tax, we must look beyond the legal fiction of the corporation to determine which individuals bear the cost of the increase in executive pay. In the first instance, shareholders bear the cost. Shareholders will be unable to shift the burden of the increase in compensation in the short term because labor and other contracts are fixed. Over time, however, the incidence of increased systematic excess pay may shift as a new investment equilibrium develops. In order to consider how that equilibrium might evolve, it will be helpful to delve into the literature on the incidence of the corporate income tax.

40. The corporate tax rules are perfectly transparent. Corporate tax returns are not public documents, however, and it can be difficult to reconcile actual tax liabilities with accrued tax liabilities reported in company financial statements. See, e.g., Michelle Hanlon & Terry Shevlin, Book-Tax Conformity for Corporate Income: An Introduction to the Issues, 19 TAX POL’Y & ECON. 101, 106 (2005) (describing why company financial disclosures do not provide clear picture of tax liabilities).

41. Bebchuk & Grinstein, supra note 4, at 300–01.

42. The incidence of a baseline level of excessive pay and of a change in excessive pay may differ. Because policy choices would affect the extent of excessive pay, it seems most useful to focus on the incidence of a change in excessive compensation. See Alan J. Auerbach, Who Bears the Corporate Tax? A Review of What We Know, 20 TAX POL’Y & ECON. 1, 2 (2006) (noting that analysis of incidence of corporate tax changes is more meaningful than overall tax incidence analysis).


44. Cf. Auerbach, supra note 42.
B. A Brief Review of the Theory and Evidence on the Incidence of Corporate Taxes

The corporate income tax incidence literature goes back fifty years to the seminal work of Arnold Harberger.\textsuperscript{45} For many years, incidence analysis was mainly theoretical. Unfortunately, theoretical approaches have failed to resolve the question of who bears the burden of corporate taxation, as results are highly dependent on assumptions. Recent years have seen an increase in empirical analyses of corporate tax incidence, but these studies are also open to various criticisms that limit their persuasiveness. Nonetheless, we do know more about corporate tax incidence than we once did, and it is fair to say that the consensus among economists is that it is unlikely that shareholders bear the entire burden of an increase in corporate taxes in an open economy and that it is likely that non-corporate capital and labor bear a significant fraction of the burden.\textsuperscript{46}

In the early 1960s, Harberger analyzed corporate tax incidence employing a general equilibrium model that included two sectors (corporate and non-corporate) and two factors of production (labor and capital).\textsuperscript{47} Harberger assumed a closed economy and a fixed supply of labor and capital. In Harberger’s model, a tax on the corporate sector was borne not by corporate shareholders alone but by all holders of capital in the economy. Joel Slemrod and Jon Bakija explain the Harberger model by analogizing to the imposition of a toll on one of two parallel highways.\textsuperscript{48} At first, those who drive on the road with the new toll bear the entire cost. However, over time, drivers abandon the toll road for the non-toll road, which increases congestion and the cost of using the non-toll road and reduces the congestion and cost of using the toll road. In equilibrium, the total cost of driving on the toll and non-toll roads must be the same. Similarly, when a tax is imposed on investors in one sector of the economy, reducing returns to that sector, capital will shift into the non-taxed sector, depressing returns in that sector and increasing returns in the taxed sector, until after-tax returns equilibrate.\textsuperscript{49}

The Harberger model of corporate tax incidence is quite elegant, but its assumptions of a closed economy and fixed factors of production are unrealistic. Much of the theoretical work since Harberger has been focused on exploring the incidence question under more realistic, open

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46. See Altshuler et al., supra note 17, at 360-70 (summarizing theoretical and empirical work on corporate tax incidence).
47. Harberger, supra note 45.
48. SLEMROD & BAKIJA, supra note 43.
49. One may ask why workers bear none of the burden under the Harberger model. The answer, in a nutshell, is that Harberger assumes that workers receive pay equal to the marginal product of their labor and that the marginal product is a function of the amount of capital invested in the economy. Under his model, the total amount of capital invested in the economy is fixed, labor can move between the corporate and non-corporate sectors, and thus total returns to labor are fixed.
\end{flushright}
Recent theoretical work typically assumes that capital is more or less mobile internationally, but that labor is not.

Randolph, for example, shows that in an open economy setting, an increase in the domestic corporate tax rate causes capital to shift abroad. Total returns to capital are maintained on a world-wide basis, but foreign labor benefits because increased foreign capital improves productivity and wages, while domestic labor suffers for the opposite reason. Randolph’s base estimate is that domestic labor bears about 70% of the cost of an increase in the corporate tax, while domestic capital bears about 30%. The burden borne by capital increases, however, as the size of the domestic economy increases relative to the world economy and as the size of the domestic corporate sector increases relative to the overall domestic economy. This analysis assumes, of course, that a change in the corporate tax rate in one country is not matched in other countries. If corporate income tax rates rise and fall in unison around the world, open economy models collapse into closed economy models, and Harberger’s results return to the fore.

The incidence determined by open economy models is very sensitive to other underlying assumptions. Gravelle and Smetters show that Randolph’s results are highly sensitive to assumptions concerning the degree to which domestic and foreign traded goods substitute for one another and the degree to which investors substitute between domestic and foreign investments. They replicate Randolph’s results when they assume perfect substitutability along both dimensions. But when they employ more reasonable (in their view) assumptions about these factors, their model indicates that domestic capital bears 70% to 90% of the burden of the corporate income tax.

Alan Auerbach introduces further complications into the theoretical analysis of corporate tax incidence, many of which suggest that shareholders may in fact bear a considerable portion of the burden of additional corporate-level taxes. For example, Auerbach stresses the importance of timing. He explains that an increase in corporate taxes reduces asset val-

51. Id. at 44.
52. Id. at 36–38.
55. Id. at 25 tbl.2.
56. Auerbach, supra note 42.
ues and future rates of return. The cost of the former is borne by existing shareholders. The cost of the latter is borne by new shareholders, other providers of capital, labor, or all three constituencies, depending on the considerations modeled by Harberger, Randolph, Gravelle and Smetters, and others. The degree to which the tax is borne by existing shareholders depends on the responsiveness of capital to the imposition of a tax.\footnote{57} Auerbach also suggests several reasons that shareholders may not be able to shift the burden of taxes even over the long run. For example, to the extent that the corporate tax is a tax on economic rents, such as monopoly profits, or on other advantages that are specific to the corporate form, shareholders will not be able to shift the burden of the tax.\footnote{58} As Altshuler, Harris, and Toder suggest, given Auerbach’s insights, it is possible that shareholders bear most (or even all) of the long-run costs associated with an increase in the corporate income tax.\footnote{59}

Given the indeterminacy of the theoretical literature on incidence, several economists have attempted to get at the question from an empirical angle. Most have found that an increase in corporate tax rates burdens labor to a significant extent. For example, using cross-country differences in corporate income tax rates and wage rates, Hassett and Mathur found that a one percent increase in corporate income tax rates was associated with a one percent reduction in wage rates.\footnote{60} Desai, Foley, and Hines utilized data from American multinational firms in estimating that between 45% and 75% of the burden of corporate taxes is borne by labor, with the balance borne by capital.\footnote{61}

Unfortunately, empirical work in this area is also subject to criticism. Gravelle and Hungerford have criticized the methodology employed in these studies,\footnote{62} and they and others have raised broader concerns.\footnote{63} For example, burden shifting should be a long-term phenomenon, but these studies capture relatively short-run effects. Moreover, some recent empirical studies provide implausibly large burdens on labor.\footnote{64} It is not clear how much weight should be placed on these empirical studies.\footnote{65}

In sum, setting aside the special considerations discussed by Auerbach, the consensus among economists is that the burden of a corporate income tax in an open economy is shifted to a significant degree to non-corporate capital and to labor. But at that point the consensus ends. The lack of agreement is seen in the various approaches taken by government agencies in estimating the distribution of the overall burden of taxes. In its analyses, the Treasury Department assumes that the burden of the corporate income tax is borne by all holders of capital.66 The Congressional Budget Office utilizes various assumptions ranging from 100% of the burden borne by capital to 100% borne by labor.67 The Joint Committee on Taxation ignores the incidence of the corporate tax altogether in determining the overall incidence of U.S. taxes,68 an approach that is clearly wrong, but somewhat understandable under the circumstances.

C. The Incidence of Systematically Excessive Executive Pay

This section explores the implications of the admittedly indeterminate corporate tax incidence literature for systematically excessive executive pay. If systematically excessive executive pay is analogous to a tax on the corporate sector, the primary implication is that shareholders may bear a portion of the cost for the reasons suggested by Auerbach, but that otherwise the burden is shared by non-corporate capital, labor, or both. This section considers various reasons that the analogy might or might not be sound, but concludes that the analogy is reasonably persuasive.

If the analogy is sound, the implication of the Harberger model would be that the cost of systematically excessive executive pay would at first be borne by shareholders, but that over time capital would shift to sectors that do not suffer from excess executive pay. In equilibrium, Harberger’s model predicts that corporate shareholders would bear the incidence of excess executive pay pro rata with other suppliers of capital in the economy.69

An important assumption in maintaining the analogy between the corporate income tax and systematically excessive executive pay under the Harberger model is that the executive pay excesses do not infect the entire economy. In other words, it is important that investors be able to avoid an increase in executive pay by shifting their capital to other sectors. This seems to be a reasonable assumption. It seems likely that excesses in the public company executive pay market would infect pay levels at some private companies and perhaps at non-profits. But non-profits, of course, are not an investment target. More importantly, there would seem to be a

66. Slemrod & Baks, supra note 43.
67. Id.; Jensen & Mathur, supra note 55, at 1083.
68. Jensen & Mathur, supra note 53, at 1083.
69. This is not to suggest that these are necessarily different individuals. Many shareholders will also hold non-corporate investments.
large amount of investment capital that would not be tainted, such as owner occupied housing.

Another important assumption is that markets other than the executive labor market are reasonably efficient. There is little reason to think that market failure in the executive pay-setting process results in inefficiencies in the products, capital, or (non-executive) labor markets. It may be true that executives with power are able to pay their underlings at an above market rate, but executives with power should have the same interest as shareholders in optimizing compensation below the executive suite.

The analogy between the corporate tax and excessive pay appears to remain strong as we move from a closed to an open economy setting. A systematic increase in U.S. executive pay that reduces returns on domestic shares should lead to an exodus of capital that reduces domestic wage rates in equilibrium. The degree to which this will be the case, and the degree to which domestic capital and labor bear the burden, would depend on the substitutability of foreign and domestic traded goods just as it does in the corporate tax incidence analysis.

Of course, one might think a reduction in domestic labor productivity and wages associated with a flight of capital abroad would negatively impact executive compensation, and this would be true in a competitive executive labor market in which executives received compensation equal to the marginal product of their labor. If so, capital flight would act as a self-correcting brake on excessive executive pay. But the assumption here is that this particular market is not efficient and that an outrage constraint rather than marginal productivity caps compensation.

The open economy model would collapse into a closed economy model if changes in systematically excessive U.S. executive pay were matched abroad, but despite the fact that executives are more mobile internationally than rank and file workers, cross-country differences in executive compensation suggest that there is not a global executive labor market. Cross country comparisons of executive pay practices suggest that U.S. executive pay remains exceptional, with U.S. executives receiving more compensation than their international peers at comparably sized companies and with U.S. executives receiving a much larger fraction of their compensation in the form of equity. These differences do not in

themselves confirm that U.S. executive pay is excessive. Some commentators have suggested that because of differences in ownership structure or culture, executives may be more important to the success or failure of U.S. firms than foreign firms. Nonetheless, increases or decreases in systematically excessive executive pay in the United States are unlikely to be matched abroad.

What about the other differences between the economic “tax” of systematically excessive executive pay and our actual corporate tax? As noted above, the apparent difference in exogeneity does not survive close scrutiny. Once one understands how excessive pay levels at poorly governed firms infect other firms through the benchmarking process, excessive pay appears to be no less exogenous than the corporate tax. To be sure, corporate directors could adopt another approach. They could screen potential benchmark firms based on the quality of their corporate governance. But given current practices, systematically excessive pay is, to a large degree, exogenous.

Even if boards are price takers in terms of the overall level of executive pay, they have some flexibility to design compensation to optimize incentives. In this respect, the economic tax of excessive pay differs from the corporate tax. But the difference seems unimportant from an incidence perspective for two reasons. First, given the interest of executives and boards in camouflaging excessive pay, design discretion may be limited. Second, efficient design can only mitigate the cost of excessive pay; it cannot totally eliminate it.

Finally, there is the difference in certainty and transparency. The corporate tax is relatively certain and transparent; excessive pay is less so. But, once again, this difference does not seem to undermine the incidence analogy. Investors cannot exactly calculate excessive compensation, but, at the margin, excessive pay will reduce returns in the corporate sector, and investors will respond to those returns. Presumably, the effect would be similar to the impact of insider trading on equity markets. Commentators generally agree that equity investors would respond to increased insider trading by reallocating their capital away from the infected market.

In sum, the analogy between the corporate income tax and systematically excessive executive pay seems reasonably sound, which suggests that the incidence of systematically excessive pay is similar to that of the corpo-

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rate income tax. The corporate tax incidence question has not been resolved and may never be resolved, but assuming that the analogy is a good one, the latest thinking on incidence suggests that it would be inappropriate to assume that shareholders necessarily bear the entire cost of excessive executive pay.

IV. OTHER COSTS OF SYSTEMATICALLY EXCESSIVE EXECUTIVE PAY

The primary thrust of this Article concerns the incidence of systematically excessive executive pay. But incidence analysis only tells us who is at the other end of the transfer to executives. There are also social costs of systematically excessive executive pay, which arise from inefficiencies that are created as a result of this transfer.

Whatever its incidence, systematically excessive executive pay dampens incentives to invest in the U.S. corporate sector. As Auerbach explains, the corporate income tax and, by analogy, systematically excessive executive pay distort the allocation of capital between either the corporate sector and the domestic non-corporate sector (under the Harberger model) or between domestic and foreign investments (under open economy models). Unless the shift is offsetting some other distortion, a tax on one sector of production introduces unnecessary deadweight loss.

As noted above, there are other costs and distortions associated with excessive executive pay at large, public companies. First, there may be externalities. Systematically excessive pay at large public companies may infect pay levels at private companies and even in the non-profit sector, if these organizations compete with public companies for the same pool of executives. The extent to which the executive labor pool is common to these organizations is unclear. Closely held, family-owned companies may not compete for the same pool. On the other hand, one would think that portfolio companies owned by private equity, venture capital, and hedge funds often would compete for the same pool of executives, as would some large non-profits, such as hospitals, that are in the same product market as for-profit organizations.

Excessive executive pay in these sectors represents a transfer and may distort capital allocation, as well. To some extent, however, the infection of these other markets may mitigate the distortions created in the public company sector. If capital fleeing one market faces the same economic “tax” in an alternative market, there would be no distortion. Ultimately, whether infection of other markets magnifies or mitigates capital alloca-

73. Auerbach, supra note 42.
74. Id.
75. See id. at 9 (explaining that more general tax on capital income would not create this distortion).
tion distortion is an empirical question that turns on international capital mobility and similar factors.

A more direct ancillary cost of excessive executive pay in the public company sector arises from diminished morale of workers below the senior executive suite.\textsuperscript{77} Evidence suggests that vertical pay inequity leads to increased employee turnover and reduced product quality, and systematically excessive pay exacerbates pay inequity.\textsuperscript{78}

Finally, to the extent that executive pay is limited by an outrage constraint, firms and executives are motivated to adopt compensation design practices that obscure the amount of compensation delivered. Because salience plays no role in efficient compensation design, this distortion tends to reduce share value. Commentators have pointed to heavy reliance on stock options, which are difficult to value, and on pension benefits, which formerly were poorly disclosed, as examples of this distortion. Of course, this effect is not a result of excessive pay. Systematically excessive pay and distortions in pay design both flow from defects in the executive pay bargaining process. Hence, further elaboration of this point lies beyond the scope of this Article.

\section*{V. Implications}

The main message of this Article is that we should not assume that excessive executive pay necessarily comes at the expense of shareholders. The burden may be shifted in part to other investors and to labor. If one accepts this conclusion, how would one think differently about corporate governance and corporate governance regulation?

First, for some, the possibility that labor bears a significant fraction of the cost of excessive pay will make regulation more attractive because the stakes are greater, or at least different. One way to think of this is that, distortions aside, a transfer from shareholders to executives represents a transfer from the rich to the super rich. Even accounting for shares held by mutual funds, pension funds, and other institutions, share ownership is heavily skewed towards the wealthiest U.S. households.\textsuperscript{79} Continuing the


tax analogy, a transfer from shareholders to executives is modestly regressive. On the other hand, a transfer from labor to executives would be highly regressive. A transfer from all holders of capital in the economy, including holders of owner-occupied housing, would likely fall somewhere in between.

If labor or some mix of labor and capital bear the burden, systematically excessive executive pay contributes in two ways to the growing inequality of wealth in this country. Of course, the executive class is wealthier as a result of the transfer. But wages and returns on all sorts of investments may be lower following the shift in equilibrium investing in an open economy. Recognition of this two-sided impact on inequality may increase the impetus for a regulatory response to excessive executive pay. We might be more eager to attempt to rein in pay, given a better understanding of the distributional consequences, despite the difficulty and potential unintended consequences of doing so.80

Second, recognizing that labor and non-corporate capital may bear a large chunk of the burden of excessive compensation may affect our approach to pay regulation. To the extent that the cost of excessive pay is borne solely by shareholders, regulatory responses aimed at increasing shareholder power vis-à-vis management, such as mandating shareholder “say on pay,” may be reasonable and effective. But, shareholder-centric approaches to improving pay processes may be less compelling to the extent that shareholders are able to pass on the costs. To be sure, shareholders would still have a strong incentive to rein in firm-specific excess pay, the cost of which is not passed on, and as a result, shareholders may still be in the best position to address executive pay generally. However, viewing the impact on labor and non-corporate capital as an externality suggests that shareholders may be inadequately motivated to address executive pay excesses and that different or additional regulatory responses may be dictated.81

80. Regulation of executive pay is perilous, and is not to be undertaken lightly. As discussed above, even the apparently innocuous act of requiring enhanced disclosure of executive pay may have contributed to upward ratcheting in pay levels. See supra note 22 and accompanying text. More intrusive regulation, such as the adoption of I.R.C. § 162(m), which limited the deductibility of senior executive pay that is not performance based, often results in unintended consequences. I.R.C. § 162(m) (2011). In the specific case of § 162(m), the intervention is thought to have contributed substantially to the widespread adoption of stock option compensation, which led to excessive levels of pay during the 1990s stock market boom and which may have encouraged excessive risk taking, contributing to the financial crisis of 2008/2009. Elsewhere, I argue that despite these cautionary tales, a tax based approach to regulating executive pay may be warranted. See David I. Walker, A Tax Response to the Executive Pay Problem (Boston Univ. Sch. of Law, Working Paper No. 11-50, 2011) available at http://ssrn.com/abstract=1944115.

81. A similar issue has been identified in the context of regulating executive pay in the financial industry. In that context, the idea is that bank shareholders have a socially suboptimal incentive to manage risk-taking incentives because taxpayers, as a result of explicit or implicit guarantees, bear a portion of losses but not
VI. Conclusion

Let me conclude by briefly considering the broader implications of the incidence analysis that is the heart of this Article. According to the managerial power view of the compensation setting process, excessive executive pay is just one manifestation of the agency costs that arise from the separation of ownership and control in the modern U.S. public company. Is there any reason to think that the incidence of other agency cost manifestations, such as insider trading or self-dealing, in general, would differ? I think the answer is “no.” Changes in legal rules, enforcement efforts, and perhaps even in business practices that increase managerial agency costs will be borne by shareholders in the first instance. Assuming, however, that these costs are perceived by investors and that they are unique to or are of significantly greater consequence in the corporate sphere, over time investors will respond by reallocating capital away from the more heavily “taxed” corporate sector. When that happens, returns to capital, corporate and non-corporate, domestic and international, will be affected, as will the productivity of labor and returns to labor. The incidence of corporate agency costs should mirror that of the corporate tax.

This is not an entirely new observation. Many commentators, including Clark and Scott, have argued that shareholders would respond to more prevalent insider trading by demanding a greater rate of return and that capital allocation would be impacted.82 What is new, I think, is the suggestion that the impact would not be limited to company founders, managers, and shareholders, but might be felt by other suppliers of capital to the economy and by labor.

Consider the following examples. Sticking first with insider trading, recent, high profile prosecutions in the U.K. apparently have led to a reduction in insider trading in that country.83 We have also witnessed a number of high profile insider trading prosecutions within the last year on this side of the pond, including the conviction of Galleon head Raj Rajaratnam, which resulted in a record eleven year prison term.84 In all likelihood, these prosecutions have led to reduced insider trading in this country, as well. If so, the benefit may extend beyond shareholders to other investors and labor. Second, enhanced SEC disclosure regulations of gains associated with risky bets. See, e.g., Frederick Tung, Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation, 105 NW. U. L. REV. 1205, 1214 (2011). The issues are similar, but not identical. An asymmetry in the context of general oversight of executive pay would arise as a result of shareholders bearing a larger fraction of monitoring costs (through personal time and effort) than of residual losses resulting from suboptimal monitoring.

82. Clark, supra note 72, at 274; Scott, supra note 72, at 808.

83. See Brooke Masters, Suspicious Pre-Deal Trades Fall Sharply, FIN. TIMES (London), June 14, 2011, at 1-1 (reporting on drop in suspicious trading activity before U.K. mergers and acquisitions after high-profile Financial Services Authority prosecutions).

have placed greater pressure on executive perks. Although the dollar amounts are relatively small, the benefit likely flows beyond shareholders. Third, suppose that the Delaware legislature were to amend “rules of the road” provisions, such as those dealing with midstream charter amendments or staggered boards, which would affect agency costs generally. Again, there is little reason to think that the costs or benefits would be limited to founders, managers, and shareholders.

Extending the tax incidence analogy to corporate agency costs generally does not change the underlying message; it simply amplifies it. Individuals outside the founder-manager-shareholder circle have a stake in minimizing corporate agency costs; shareholders may be inadequately motivated to minimize these costs; and agency costs likely contribute more to inequality of wealth in the United States than we previously realized.