University of Michigan Journal of Law Reform

Volume 48

2014

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https://doi.org/10.36646/mjlr.48.1.reconciling

RECONCILING TAX LAW AND SECURITIES REGULATION

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Issuers in registered securities offerings must disclose the expected tax consequences to investors investing in the offered securities ("nonfinancial tax disclosure"). This Article advances three arguments regarding nonfinancial tax disclosures. First, nonfinancial tax disclosure practice, as the Securities and Exchange Commission (the SEC) has sanctioned it, does not fulfill its intended regulatory purposes. Currently, nonfinancial tax disclosures provide irrelevant information, sometimes fail to provide material information, create unnecessary transaction costs, and divert valuable administrative resources to the enforcement of largely-meaningless requirements. Second, the practical reason for this failure is the SEC and tax practitioners' unsuccessful attempt to address investors' heterogeneous tax preferences. Specifically, nonfinancial tax disclosure practice assumes the existence of a "reasonable investor" who is also an "average taxpayer," and tax disclosures are drafted for the benefit of this average taxpayer. The concept of an "average taxpayer," however, is not defensible. Third, the theoretical reason for the regulatory regime's dysfunctionality is the misapplication of mandatory disclosure theory to nonfinancial tax disclosure requirements. Mandatory disclosure theory, even if accepted at face value, does not support the current regulatory framework, due to the special nature of tax laws. To remedy this failure, this Article describes the types of tax-related disclosures that mandatory disclosure theory would support. Under the proposed regulatory reform, nonfinancial tax disclosures will only include issuer-level tax items (namely, tax items imposed on the issuing entity) that affect how "reasonable investors" calculate their own individual tax liabilities. Under such a regime, there is no need to rely on the "average taxpayer" construct.

Introduction: Apple's Bond Offering as an Allegory

On May 1, 2013, Apple, Inc. (Apple) made financial history with its $17 billion bond offering,[1] the largest-ever debt issuance by a

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* Assistant Professor of Law, University of Florida Levin College of Law. For helpful guidance, comments and critique, I am grateful to Jennifer Bird-Pollan, Stu Cohen, David Gamage, Joan Heminway, Michael Knoll, Leandra Lederman, Tom Lin, Randle Pollard, Dexter Samida, Doug Shackelford, Danny Sokol, Emily Satterthwaite, and participants in conferences and workshops at the Northwestern University School of Law, the University of Tennessee College of Law, the 2013 SEALS Annual Conference, the 2013 Law and Society Annual Meeting, and the 8th Annual Junior Tax Scholars Workshop. For invaluable research assistance, I am indebted to Gus Gari. Any errors or omissions are my own.

1. *See generally* Apple, Inc., Prospectus Supplement (Form 424B2), at S-15 (May 1, 2013) [hereinafter Apple's Prospectus], *available at* http://investor.apple.com/secfiling.cfm?filingid=1193125-13-184506&cik=320193.

non-financial institution at the time.[2] On page S-15 of the offering document is a section titled "Certain U.S. Federal Income Tax Considerations."[3] This section provides information concerning the "U.S. federal income tax considerations of the ownership and disposition" of the bonds.[4]

Issuers in registered securities offerings are required to disclose all information that a reasonable investor would deem material when making an informed investment decision.[5] Since investors care about their after-tax returns on investments,[6] information about the tax costs associated with an investment could be considered material.[7] Indeed, registrants are required to disclose to investors all material tax consequences and to qualify the tax disclosure with an opinion.[8] The tax opinion must address each material tax issue discussed in the disclosure, express a legal conclusion about how the tax law applies to the facts of the particular offering and its effect on investors' tax consequences, and explain the basis

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2. John Balassi & Josie Cox, *Apple Wows Market With Record $17 Billion Bond Deal*, Reuters (Apr. 30, 2013), http://www.reuters.com/article/2013/04/30/us-apple-debt-idUSBRE93T10B20130430. In September of the same year, Verizon Communications smashed this record with a $49 billion bond offering. John Atkins, *Verizon Smashes Record with $49B, 8-Part Bond Offering*, Forbes.com (Sept. 11, 2013), http://www.forbes.com/sites/spleverage/2013/09/11/verizon-smashes-records-with-49b-8-part-bond-offering/ (last visited Aug. 21, 2014).

3. Apple Prospectus, *supra* note 1, at S-15.

4. *Id.*

5. *See* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 Duke L. J. 711, 741 (2006). The disclosure documents the SEC regulates "disclose information about the companies' financial condition and business practices to help investors make informed investment decisions." SEC, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Information*, http://www.sec.gov/about/whatwedo.shtml (last visited Aug. 1, 2014); *see also* Goshen & Gideon, *supra*, at 740 (providing SEC disclosure regulations allow for greater "public disclosure" and "leads to fewer instances of asymmetric information between traders" and more informed traders).

6. *See* Myron S. Scholes et al., Taxes and Business Strategy 2 (3d ed. 2004) (discussing why taxes influence investment decisions).

7. *See, e.g.*, SEC Staff Legal Bulletin No. 19, 2011 WL 4957889 11–13 (Oct. 14, 2011), *available at* http://www.sec.gov/interps/legal/cfslb19.htm (discussing when tax consequences are "material" to investors) [hereinafter SEC Legal Bulletin]; *see also* William B. Barker, *SEC Registration of Public Offerings Under the Securities Act of 1933*, 52 Bus. Law. 65, 105–06 (1996) (discussing the proper disclosure of federal income tax consequences in registered offering as part of a general discussion on the system of mandatory disclosure, which is intended to deliver investors with "accurate and current information" to support "fair and honest securities market"). At the time of publication, Barker was a Senior Counsel to the SEC's Division of Corporate Finance. William B. Barker, *SEC Registration of Public Offerings Under the Securities Act of 1933*, 52 Bus. Law 65, 65 (1996).

8. SEC Regulation S-K, 17 C.F.R. § 229.601(b)(8) (requiring issuers to disclose to investors the "material" tax consequences associated with purchasing, holding and disposing of the offered securities, and to support such disclosure with a legal opinion).

for such a conclusion.[9] Apple's tax disclosure section responds to this regulatory framework.

This Article suggests, however, that Apple's tax disclosure in the offering document does not provide any information that a "reasonable investor" would deem material. In fact, the disclosure provides little information at all, notwithstanding that the disclosure comprises four densely written pages. Specifically, the third sentence in Apple's tax disclosure makes it clear that any tax consequences discussed therein are only applicable to investors purchasing the bonds in the initial offering.[10] Investors in the secondary market received no guidance concerning the tax consequences of investing in the bonds.

In addition, Apple's tax disclosure explicitly excludes certain classes of investors, including—among others—dealers in securities, financial institutions, insurance companies, and other types of institutional investors.[11] It is well documented, however, that securities in initial offerings are mostly allocated to the classes of institutional investors excepted from Apple's tax disclosure.[12]

The result is rather remarkable: Apple's tax disclosure does not describe the tax consequences to the investors that—as a practical matter—are expected to purchase the bonds in the initial offering. The tax disclosure also does not describe the tax consequences to any investor that purchases the bonds in the secondary market. The logical inference is that Apple's tax disclosure section describes tax consequences that are applicable to no one (or at least to only very few). It is hard to imagine, therefore, that Apple's tax disclosure responds meaningfully to the rationales underlying mandatory tax

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9. SEC Legal Bulletin, *supra* note 7, at 12.

10. *See* Apple Prospectus, *supra* note 1, at S-15 ("Except where noted, this summary deals only with a note held as a capital asset by a beneficial owner who purchases the note on original issuance at the first price . . . .").

11. *Id.* ("This summary does not address all aspects of U.S. federal income taxes and does not deal with all tax consequences that may be relevant to holders in light of their personal circumstances or particular situations, such as . . . tax consequences to dealers in securities or currencies, financial institutions, regulated investment companies, real estate investment trusts, tax-exempt entities, insurance companies and traders in securities that elect to use a mark-to-market method of tax accounting for their securities.").

12. *See* SEC, *Initial Public Offerings: Why Individual Investors Have Difficulty Getting Shares?*, http://www.sec.gov/answers/ipodiff.htm (last visited Aug. 1, 2014). There is ample evidence that institutional investors are allocated most of the shares in IPOs (specifically on so called "hot" IPOs). *See, e.g.*, Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1808–15 (2002); *see also* Reena Aggarwal, Nagpurnanand R. Prabhala & Manju Puri, *Institutional Allocations in Initial Public Offerings: Empirical Evidence*, 57 J. FIN. 1421, 1422 (2002) (finding that "institutions dominate IPO allocations"); Leland E. Crabbe & Christopher M. Turner, *Does Liquidity of a Debt Issue Increase With Its Size? Evidence from the Corporate Bond and Medium-Term Note Markets*, 50 J. FIN. 1719, 1722 (1995) (finding both corporate bonds and medium-term notes "sold primarily to institutional investors").

disclosure. Nonetheless, Apple's tax disclosure likely meets the formal regulatory requirements applicable to nonfinancial tax disclosures, as interpreted by the SEC.[13]

Apple is hardly unique. Most issuers limit the applicability of their nonfinancial disclosures to investors purchasing securities in the initial offering.[14] At the same time, issuers draft the disclosures to exclude most classes of investors that are expected to participate in the initial offering.[15] Non-initial offering documents similarly contain language excluding most classes of investors from the scope of nonfinancial tax disclosure.[16] This makes the systemic utility of nonfinancial tax disclosure tenuous.

This Article proceeds as follows: Part I surveys nonfinancial tax disclosure practices to elaborate on the apparent meaninglessness of the regulatory framework. As a practical matter, issuers cannot draft nonfinancial tax disclosures addressing the tax consequences of all reasonable investors since reasonable investors are heterogeneous in their tax preferences.[17] To address investors' heterogeneity, issuers assume that all "reasonable investors" are also "average taxpayers" and draft nonfinancial tax disclosures for the benefit of these average taxpayers.[18] Part I shows, however, that drafting nonfinancial tax disclosures for the benefit of average taxpayers amounts to a description of tax consequences that rarely (if ever) matter to any investor.

Part II suggests that the "average taxpayer" concept is indefensible for three important reasons. First, any nonfinancial tax disclosure item could theoretically be favorable to one taxpayer but detrimental to another, even if both are "reasonable investors." Significantly, the operation of efficient markets depends, in part, on

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13. For a discussion of current practices as sanctioned by the SEC, see *infra* Part I.C.

14. *See* N.Y. Bar Ass'n Tax Section, Report on Tax Opinions in Registered Offerings, 3 (Apr. 4, 2012), *available at* http://apps.americanbar.org/buslaw/tribar/materials/20120813000000.pdf [hereinafter N.Y. Bar Report].

15. *Id.* at 3. ("Accordingly, it is customary for the tax disclosure to (1) clearly state that it does not address the tax consequences to such investors . . . ."). For examples of the exclusion of institutional investors from the scope of the tax disclosure, *see infra* note 70 and accompanying text.

16. N.Y. Bar Report, *supra* note 154, at 3.

17. This would necessitate "writ[ing] a treatise, which in addition to being cumbersome, would be useless (from the perspective of disclosure) at best and misleading at worst." Robert P. Rothman, *Tax Opinion Practice*, 64 Tax Law. 301, 383 (2010); *see also infra* notes 48–74 and accompanying text.

18. N.Y. Bar Report, *supra* note 154, at 2 ("Although certain potential investors in a registered offering are subject to special tax rules, the primary target of most tax disclosure in registered offerings is the average investor expected to invest in the offered security or whose vote is being solicited in connection with the offering, necessitating a balance between detail and clarity such that the disclosure can be readily understood by that investor.").

assuming that all market participants interpret the same piece of information identically.[19] This, however, is not a reasonable assumption in the nonfinancial tax disclosure context. Second, drawing on financial literature, Part II shows that the tax preferences of "average taxpayers" do not impact capital markets' efficient operation.[20] Finally, courts have repeatedly implicitly rejected the concept of the average taxpayer.

Part III identifies the theoretical source of the regulatory failure. Mandatory disclosure theory largely guides the SEC's regulatory paradigm and is grounded in the idea that issuers are best positioned to disclose—in the least socially-wasteful manner—relevant facts about the issuing entity to investors who trade based on information.[21] In the context of nonfinancial tax disclosure, however, a lot of the material information is either public or found with the investors, not with the issuing entity. Thus, mandatory disclosure theory—even if accepted at face value—does not support the current nonfinancial tax disclosure requirements.

Part IV proposes a remedy to the regulatory failure. Assuming that mandatory disclosure theory will guide securities regulation in the foreseeable future,[22] Part IV questions which types of nonfinancial tax disclosures the theory requires. Part IV suggests that mandatory disclosure theory only supports the disclosure of a nonfinancial tax item if it is a "dual-level" tax item. A dual-level tax item is an item that meets the following two requirements: (i) it is an issuer-level tax item (meaning, a tax attribute of the issuing entity),

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19. Eugene E. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383, 387–88 (1970) ("[A]ll agree on the implications of current information for the current price and distributions of future prices of each security . . . . And disagreement among investors about the implications of given information does not in itself imply market inefficiency unless there are investors who can consistently make better evaluations of available information than are implicit in market prices.").

20. *See* discussion *infra* Part II.B.

21. Goshen & Parchomovsky, *supra* note 5, at 755–66 (describing why mandatory disclosure is the method best suited to disseminating necessary information to the market); *see also* Henry T.C. Hu, *Reshaping Capital Markets: Twenty Years On*, 90 Tex. L. Rev. 1597, 1614–28 (2012) (describing such policy resulting in what he characterizes as the "intermediary depiction model"); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 638 (1984) (describing the benefits of mandatory disclosure in creating "substantial savings for informed traders by collectivizing some of the costs of acquiring, processing, and verifying information traders had expended"); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va. L. Rev. 717, 733–34 (1984) (describing mandatory disclosure theory as the principal method to reduce social waste and duplication of investor research of investments).

22. Joel Seligman, *The Historical Need for A Mandatory Corporate Disclosure System*, 9 J. Corp. L. 1, 8–10 (1983) (describing SEC disclosure regulations developed by mandatory disclosure theorists who believe that mandatory disclosure produces truthful information in the marketplace and deters fraud).

and (ii) such item may affect the calculation of investor-level tax liabilities.

The Conclusion calls on investors in registered securities to consult their own tax advisors. Though disclosure documents regularly include this advice, the SEC does not always view it favorably.[23] That advice is necessary, however, if mandatory tax disclosure is to enable investors to make informed investment decisions.

Many scholars have harshly criticized the assumptions underlying the efficient operation of capital markets, as well as the mandatory disclosure paradigm, primarily from the point of view of behavioral finance.[24] While this body of critique definitely applies in the tax context, it is not this Article's point of view. Rather, this Article argues that the problem with tax disclosure is more fundamental: due to the special nature of tax law, the current nonfinancial tax disclosure framework is not justifiable under the best possible theoretical assumptions that otherwise support mandatory disclosure.

I. The Failures of Nonfinancial Tax Disclosures

This Part demonstrates the functional failures of nonfinancial tax disclosure practice in registered securities offerings. Subpart A describes tax disclosure requirements and their intended purpose to support capital market efficiency. Subpart B explains the main hurdle practitioners face when drafting nonfinancial tax disclosures: investors' heterogeneous tax preferences. Subpart C surveys market practices responding to investors' tax heterogeneity and concludes that such practices do not advance market efficiency. Subpart D suggests that such practices are possibly detrimental to market efficiency.

A. *Tax Disclosure Requirements and Rationales*

Since the enactment of the 1930s Securities Acts, the SEC's regulatory paradigm has relied on the concept that information

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23. Robert P. Rothman, *supra* note 17, at 387 ("Recently, the author has encountered (and has heard anecdotal reports that others have encountered) resistance from SEC reviewers to telling people to consult their own tax advisors.")

24. *See, e.g.*, Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited,* 140 U. Pa. L. Rev. 851, 857–72 (1992); *see also* David A. Hoffman, *The "Duty" to Be a Rational Shareholder*, 90 Minn. L. Rev. 537, 545–62 (2006); Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 Stan. L. Rev. 1, 7–16 (2003); Tom C. W. Lin, *A Behavioral Framework for Securities Risk*, 34 Sea. U. L. Rev. 325, 336–49 (2011).

disclosure is the cornerstone of an efficient market.[25] The emergence and widespread acceptance of the Efficient Capital Market Hypothesis (ECMH) in the 1970s "bolstered the case for [a] robust informational foundation."[26] Under the ECMH, an efficient market is one in which securities prices " 'fully reflect' available information."[27] Thus, information supports accurate pricing of securities in the secondary market and helps prospective investors assess securities prices in the primary market.

Molded with ECMH assumptions as its building blocks, the U.S. securities regulatory regime requires issuers in registered securities offerings to disclose all information that a "reasonable investor" may deem "material" for the purposes of making informed investment decisions.[28] The disclosure must be accurate and concise.[29] Tax information is no exception. Taxes reduce the net return on an investment and may affect investment decisions. A reasonable investor could, therefore, consider the tax costs associated with an investment a material piece of information.[30]

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25. *See* Hu*, supra* note 21, at 1614 ("The federal regulation of capital markets and corporations, which began with the enactment of the Securities Act in 1933, has largely been animated by a single philosophy: disclosure"); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 39–40 (3d ed. 2003) (discussing the Wheat Report that the SEC adopt objective standards regarding registration and disclosure in the formation of the securities laws); Donald D. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10B-5*, 57 VAND. L. REV. 1639, 1639 (2004) (describing disclosure as the "heart" of the federal securities regulatory regime).

26. Hu*, supra* note 21, at 1606. *Accord id.* at 1616 ("[ECMH] came to provide a social-science-based justification for the disclosure paradigm, and strongly influence the paradigm implementation").

27. Fama, *supra* note 19, at 384; *see also* Gilson & Kraakman, *supra* note 21, at 549 (describing the process by which information supports efficient markets and arguing the mandatory disclosure is the most efficient way to achieve the necessary dissemination of such information).

28. *See, e.g.*, 15 U.S.C. §§ 77k, 771 (1998) (providing causes of action based in untrue or omitted statements of material fact); 17 C.F.R. § 240.12b-2 (2009) ("The term 'material' . . . limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered."). For that purpose, information is "material" if "there is a substantial likelihood that a reasonable [investor] would consider it important," a standard that is met when the information at issue alters "the 'total mix' of information made available." TCS Indus., Inc. v. Northway, Inc., 426 U.S. 445, 449 (1976); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 983 (1988) (adopting the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context).

29. *See* 17 C.F.R. § 230.421(d)(2) (requiring issuers to present information "in a clear, concise and understandable manner").

30. Notwithstanding that tax information may be material to investors, there is a necessary second-order question: whether the disclosure of tax information should be mandatory or voluntary. The U.S. securities regulatory regime is a mandatory one. In this context, this Subpart asks whether the current framework of mandatory disclosure of nonfinancial tax items supports market efficiency. The Article later questions the contours of the theories

Mandated tax disclosures are broadly divisible into two categories: financial and nonfinancial disclosures.[31] These are discussed below.

The first category of tax disclosure is financial tax disclosure. A significant expense item that affects the issuer's value or creditworthiness is the issuer-borne taxes; for example, corporate taxes the corporate issuers paid.[32] Such considerations affect a reasonable investor's investment decisions.[33] Financial disclosure regulation, primarily Regulation S-X, requires issuers to account for their own income tax expenses in the financial statements.[34]

Generally, Regulation S-X requires that financial statements disclose the issuer's income tax benefits and expenses and explain why the issuer reported such benefits and expenses at this specific time.[35] Additionally, financial statements must disclose the entity's total income at the end of the taxable year and the taxes incurred for the year, including the applicable tax rates and the method the corporation used in computing the taxable amount.[36] Regulation S-X discusses little else, instead referencing Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 740 (entitled "Income Taxes") and directing that tax disclosure statements be consistent with the financial accounting standards therein.[37] This Article does not propose any changes relating to financial tax disclosures.[38]

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supporting mandatory disclosure, in order to describe the particular nonfinancial tax items that *should* be mandatorily disclosed to support market efficiency. *See infra* Part III.

31. Other than the general rules of nonfinancial tax disclosures, specific nonfinancial tax disclosure rules are applied in specific contexts. For example, mutual fund disclosures must report the *after tax* return to investors. *See* 17 C.F.R. § 230.482(d)(4).

32. *See* Richard D. Pomp, *The Disclosure of State Corporate Income Tax Data: Turning the Clock Back to the Future*, 22 Cap. U. L. Rev. 373, 408 (1993).

33. *See, e.g.*, Notice of Adoption and Amendment to Regulation S-X to Provide for Improved Disclosure of Income Tax Expense, SEC Release No. AS-149, 3 SEC Docket 155 (Nov. 28, 1973) ("The objectives of these disclosure requirements are to enable users of financial statements to understand better the basis for the registrant's tax accounting and the degree to which and the reasons why it is able to operate at a different level of tax expense than that which would be incurred at the statutory tax rate. By developing such an understanding, users will be able to distinguish more easily between one time and continuing tax advantages enjoyed by a company and to appraise the significance of changing effective tax rates. In addition, users will be able to gain additional insights into the current and prospective cash drain associated with payment of income taxes.").

34. 26 C.F.R. § 210.4-08(h).

35. 26 C.F.R. § 210.4-08(h)(1).

36. 26 C.F.R. § 210.4-08(h)(2).

37. 26 C.F.R. § 210.4-08(h)(3).

38. Other scholars have addressed such issues. *See, e.g.*, Linda M. Beale, *Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability*, 29 J. Corp. L. 219, 258–60 (2004) (suggesting increased SEC bans to prevent auditors from providing tax services to their clients in the wake of the Enron scandal); Gary A.

The second category of required tax disclosures is nonfinancial tax items, which SEC Regulation S-K Item 601(b)(8) primarily governs.[39] Under Item 601(b)(8), registered securities issuers are required to disclose to the investor—and to qualify such disclosure with a legal opinion—all material tax consequences associated with purchasing, holding, and selling the offered securities.[40] This includes taxes that investors are expected to pay on their own account (for example, taxes imposed on the investor for dividends received from the issuer). Several additional regulations require the disclosure of other types of nonfinancial tax information.[41] In addition, several basket provisions require the disclosure of any non-enumerated "material" information and thus may apply to nonfinancial tax items if they are material.[42]

While there is no explicit legal requirement to disclose nonfinancial tax consequences that are not "material," the SEC apparently takes the position that such tax consequences must be disclosed (though not necessarily supported by an opinion).[43] Indeed, it is standard practice to disclose certain nonfinancial tax items the SEC or tax practitioners consider immaterial.[44] For example, tax consequences associated with holding and selling common stock are not

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McGill & Edmund Outslay, *Did Enron Pay Taxes: Deciphering a Corporation's Tax Status Using Financial Statement Information* 9–11 (July 25, 2002) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=320240 (suggesting reforms to gaps between income reporting and a publicly traded corporation's tax status); *see also* Harold S. Peckron, *Watchdogs That Failed to Bark: Standards of Tax Review After Enron* 5 FLA. TAX REV. 853, 908–13 (2002) (highlighting greater scrutiny for tax review standards and suggested reforms for greater disclosure especially relating to tax shelters).

39. *See* SEC Regulation S-K, 17 C.F.R. § 229.

40. *Id.* § 229.601(b)(8). An alternative for an opinion is an IRS ruling on the matters described in the disclosure. *Id.*

41. *See, e.g.*, *id.* § 229.1016(h) (requiring the attachment of tax opinion supporting the tax consequences in M&A transactions); *see also id.* § 230.482(d)(4) (requiring mutual funds disclosure to contain after tax returns to unit holders).

42. These basket provisions, or "catch-all provisions," refer to any provisions in the disclosure statements that a "reasonable investor" might deem "material." For example, Rule 10b-5 makes it unlawful to make any material misstatement or the omission of a material fact. *Id.* § 240.10b-5(b). Additionally, Rule 14a-9 has a similar "materiality" standard in the context of proxy statements, making it unlawful to make any written or oral statement in a proxy statement or other communication that is either "false or misleading with respect to any material fact" or "omits to state any material face necessary in order to make statements . . . not false or misleading . . . or necessary to correct any statement." *Id.* § 240.14a-9(a).

43. *See* SEC Legal Bulletin, *supra* note 7, at 12 ("In such cases, while the registrant must provide accurate and complete disclosure concerning the tax consequences to investors, it does not have to expertize the disclosure by providing an opinion of counsel or accountant.").

44. *See* N.Y. BAR REPORT, *supra* note 14, at 4–5 (stating that "virtually any tax disclosure in a registered offering, whether or not the offering requires a tax opinion, will include a discussion of federal income tax consequences that are not 'material to an investor' as well as other factual information.").

considered material.[45] Nonetheless, disclosure documents for common stock offerings regularly contain a nonfinancial tax disclosure section.[46] Nonfinancial tax consequences are usually described in a dedicated section of the offering document, titled "Material Federal Income Tax Consequences."[47]

To summarize, tax disclosure is an integral part of the U.S. securities regulatory framework. Taxes affect the net return on an investment and, therefore, may be material to reasonable investors. Taxes imposed on the issuing entity are part of the issuing entity's financial statements. Taxes imposed on an investor relating to an investment in securities are disclosed in the nonfinancial tax disclosure section. The latter is the focal point of this Article.

B. Nonfinancial Tax Disclosures and the Problem of Investors' Tax Heterogeneity

The nonfinancial tax disclosure requirements put issuers in an impossible position. Even if investors are all "reasonable" and they all invest in the same security, different investors still face different tax consequences from their investments. For example, investors face different tax rates depending on their tax bracket, tax status,[48] or how long they held the security.[49] Some investors may have losses

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45. *See id.* at 5 (noting that "the 'plain vanilla' tax consequences to investors of holding and selling the common stock" are not required to be disclosed because they are not considered "material"). Notwithstanding their immateriality, the tax consequences of "plain vanilla" stock offerings are "typically describe[d]" in offering documents. *Id.*

46. *Id.* ("[A]lthough a mere offering of common stock issued for cash does not involve any tax consequences that are 'material' to an investor," the tax disclosure will typically describe the 'plain vanilla' tax consequences for non-U.S. investors of owning and selling the common stock.").

47. Other titles used are "Material Federal Income Tax Considerations" and "Material Federal Tax Consequences," among other similar titles.

48. For example, while most investors are only taxed upon realization (usually upon the disposition of securities), those who qualify as "dealers" in securities are taxed on a "mark-to-market" basis. *See* I.R.C. § 475 (all references herein to the IRC or the "Code" are to the Internal Revenue Code of 1986, as amended, 26 U.S.C. § 1986).

49. The gain on the disposition of capital asset (such as a publicly trade security) held for a period of more than a year is taxed at long-term capital gains rate (currently fifteen percent for most taxpayers and twenty percent for taxpayers in the top marginal tax bracket), while the gain on the disposition of a capital asset held for a year or less, is taxed at short-term capital gains rate (which is the same on the ordinary tax-bracket of the taxpayer). I.R.C. § 1(h).

they can use to offset gains[50] while others do not have losses or otherwise are unable to take advantage of such losses.[51] Some may face different tax regimes altogether because they are classified as "foreign" or "domestic" taxpayers.[52] Investors' classification as "corporations," "individuals," "partnerships,"[53] or any other tax law category, inevitably changes their tax consequences.

The sale of common stock in the public market demonstrates the difficulty of drafting tax disclosure for the benefit of a heterogeneous body of taxpayers. Generally, upon disposition of a capital asset, a taxpayer must recognize income in an amount equal to the difference between the amount realized and the taxpayer's tax basis in the asset.[54] The tax basis of a publicly traded stock is, in most cases, the amount paid for the stock.[55] While such a rule is easy to describe, including it in a disclosure is meaningless because the rule's application is heavily dependent on each investor's particular tax situation.

As an initial matter, not all investors are taxable upon the disposition of their securities. Certain categories of investors are tax-exempt, assuming they meet certain requirements.[56] Different tax-exempt statuses carry different requirements. An issuer cannot clearly and concisely describe in the tax disclosure section all the requirements that different types of investors must meet to be granted tax-exempt status. Assume for a moment that all investors are taxable investors; under such circumstances issuers could draft

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50. Taxpayers calculate their capital gains and losses on a netting basis. I.R.C. § 1222. For example, a taxpayer who realized a long-term capital loss on the disposition of one security will be able to use such loss to shield income from the disposition of another security, which is expected to generate long-term capital gains. A taxpayer with no such loss offset, is expected to carry a heavier tax burden on the disposition of the same security at a gain. In addition, individuals are allowed to offset up to $3,000 of capital losses against their ordinary income. I.R.C. § 1211(b). Unused capital losses can be carried over to future years (indefinitely), and can be carried back (on a limited basis) to offset capital gains income. I.R.C. § 1212.

51. I.R.C. § 172.

52. While domestic taxpayers are taxed in the United States on all income from whatever source derived, foreign taxpayers are generally taxed only on income sourced within the United States. I.R.C. §§ 871, 881. In most cases, income from the disposition of stock is sourced at the place of residence of the seller. *See* I.R.C. § 865(a). Thus, income from the disposition of security listed for public trading will be taxed to a U.S. resident, but exempt to a foreign resident.

53. Different types of entities may face different tax rules. Thus the entity classification of an investor can affect the tax results. *See* discussion *infra* note 230 and accompanying text.

54. I.R.C. § 1001(a).

55. *See* I.R.C. § 1012(a).

56. Multiple types of entities that qualify for tax-exempt status actively participate in financial markets such as pension funds, university endowments, charitable organizations, governmental entities, and so on.

a disclosure under that assumption.[57] Drafters can add qualifying language to exclude tax-exempt taxpayers from the scope of the disclosure.[58]

However, excluding tax-exempt investors from the scope of the disclosure does not make the drafting task easier. Gains from the sale of a capital asset (such as publicly-traded stocks) are subject to various tax rates. Capital gains are taxed at preferential rates, provided the security was held for longer than a year.[59] If the security is held for one year or less, then the investor's gains are considered short-term capital gains and taxed at the investor's marginal tax rate.[60] An issuer drafting a disclosure cannot know how long an investor will hold the stock before selling it. A disclosure addressing such an issue must take an algorithmic approach: "If your holding period in the stock is 'X,' then the tax consequence is 'Y;' if your holding period is 'N,' then the tax consequence is 'M,' " and so on. Practitioners sometimes use this approach, which substantially complicates disclosure drafting.[61]

Even if one further simplifies by assuming that all investors purchase and sell the security on the same day, not all investors face the same tax consequences. Drafting remains difficult since different types of taxable investors face wholly different tax regimes. For example, dealers in securities must mark-to-market their securities each year and pay tax to the extent the securities appreciated in

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57. Not all investors are necessarily taxable investors because tax-exempt investors are major players in the U.S. securities markets. For example, a recent Goldman Sachs survey suggests that nontaxable retirement funds own as much as seventeen percent of the entire value of the U.S. equity market. *See* David J. Kostin et al., Goldman Sachs, 2013 U.S. Equity Outlook: Selectivity Seeking Growth 17 fig. 24 (Nov. 28, 2012), *available at* http://www.mauldineconomics.com/images/uploads/overmyshoulder/Goldman_Sachs_-_US_Equity_Outlook.pdf. Pension funds also own six percent of the total U.S. bond market. *Id.* at 19 fig. 31. On the whole, as recently as 2003, institutional investors controlled over 59.2 percent of the equity market ($7.97 trillion) versus 28.4% ($376 billion) in 1980. Thomas J. Chemmanur et al., *The Role of Institutional Investors In Seasoned Equity Offerings*, 94 J. Fin. Econ. 384, 385 (2009). These institutions included multiple types of tax-exempt investors, such as university endowments, pension funds, and governmental entities.

58. Carve-outs and qualifications are explicitly allowed under the regulations, as long as the tax opinion qualifying the disclosure clearly describes such carve-outs. *See* SEC Regulation S-K, 17 C.F.R. § 229.601(b)(8) ("Such tax opinions may be conditioned or may be qualified, so long as such conditions and qualifications are adequately described in the filing.").

59. *See* discussion *supra* note 49 and accompanying text.

60. *See supra* note 49.

61. *See, e.g.*, Groupon, Inc., SEC Registration Statement: Material United States Federal Tax Consequences 133 (Form S-1) (Aug. 10, 2011) ("Upon the sale or other disposition of our Class A common stock, you will generally recognize capital gain or loss equal to the difference between the amount realized and your adjusted tax basis in such stock. Such capital gain or loss will generally be long-term capital gain or loss *if your holding period in respect of the stock is more than one year*." (emphasis added)) [hereinafter Groupon Registration Statement].

value,[62] regardless of whether the securities are sold.[63] When dealers eventually sell the securities, they make adjustments to account for gains or losses previously recognized under the mark-to-market method.[64] Thus, the taxable gain to a dealer is necessarily different than the taxable gain of non-dealers who sold the securities at the same time, for the same price.

Dealers in securities are only one example of many particularly classified taxpayers who are subject to unique tax rules.[65] In order to make a tax disclosure accurate, issuers must theoretically disclose the different tax consequences different types of investors face. It is doubtful that such a disclosure could be made "concise."

The description above is only the tip of the iceberg and does not discuss innumerable issues that may cause investors' tax preferences to diverge. The bottom line, however, is clear: the tax consequences of securities investments vary among investors, even if all are "reasonable investors," and even if one makes numerous simplifying assumptions.

C. The Market-Created Construct of the "Average Taxpayer"

Practitioners, obviously, cannot draft tax disclosures that explain all conceivable tax consequences and account for each investor's particular tax position. This would necessitate "writ[ing] a treatise, which in addition to being cumbersome, would be useless (from the perspective of disclosure) at best and misleading at worst."[66]

In the face of overwhelming tax heterogeneity, a practical drafting approach was needed. A recent New York State Bar Association (NYSBA) report articulated the Tax Bar position that "the primary target of most tax disclosure in registered offerings is the *average*

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62. Generally, under a mark-to-market (MTM) method of accounting a taxpayer is deemed to have sold the asset subject to MTM for the asset's fair market value (FMV) at the end of the taxable year. The taxpayer then recognized gain or loss equal to the difference between the FMV of the asset and the taxpayer's basis in the asset. The taxpayer's basis is consequently adjusted to account for the deemed sale. For example, assume a dealer in securities bought a share for $10 on Day One of Year One. On the last day of Year One the share's FMV is $12. The dealer is deemed to sell the stock on the last day of Year One and immediately repurchase it for the share's FMV. Thus, the dealer must recognize gain of $2 in Year One ($12 FMV minus a basis of $10). As of Day One of Year Two the dealer's new basis in the stock is $12.

63. *See supra* note 48 and accompanying text.

64. *See id.*

65. Other types of investors subject to specific taxation rules include, *inter alia*, Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), insurance companies, and tax-exempt investors.

66. Rothman, *supra* note 17, at 383.

investor expected to invest in the offered security."[67] Practitioners draft investor-level tax disclosures for the benefit of an imaginary investor facing average tax consequences. This Article refers to this market-created construct as the "average taxpayer."[68] The "average taxpayer" construct lacks an official definition and is created using elimination. In practical terms, the average taxpayer-investor represents what remains after accounting for all the limiting language and qualifications regularly used in disclosure statements.

The market pares down the body of investors and their tax concerns to reach the "average taxpayer" in three ways: (1) limiting the personal scope of investors to "average" taxpayers; (2) limiting the substantive scope of taxes described to "average tax consequences" that "average taxpayers" face; and (3) limiting the scope of investors' reliance (allowing taxpayers to rely on the disclosure only to the extent that the tax consequences described are indeed "average"). The following discussion shows that the three qualifications functionally remove most of the significance from nonfinancial tax disclosures.

1. Limiting the Personal Scope of Nonfinancial Tax Disclosures

The most obvious way issuers limit the scope of nonfinancial tax-disclosures is excluding certain "non-average" taxpayers from the disclosure's application. Issuers do so in two ways. First, in initial offering disclosures, issuers almost always limit the disclosure's applicability to investors who purchased the securities in the initial offering.[69] Second, in both initial and non-initial offerings, as well as periodic disclosure documents, disclosures are made expressly inapplicable to certain types of "sophisticated investors" who are subject to unique tax rules (generally, institutional investors).[70] For

67. *See* N.Y. Bar Report, *supra* note 14, at 2 (emphasis added).

68. The N.Y. Bar Report does not use the term "average taxpayer." Rather, it refers to the "average" tax consequences a "reasonable investor" faces. This Article does not use the term "average investor" in order to avoid confusion with the term "reasonable investor."

69. *See, e.g.*, Third Point Reinsurance Ltd., SEC Registration Statement: Certain Tax Considerations (Form S-1), 171 (Jul. 15, 2013); *see also* Stock Building Supply Holdings, Inc., SEC Registration Statement: Certain U.S. Federal Income Tax Considerations to Non-U.S. Holders (Form S-1), 125 (Jun. 14, 2013) ("The following is a discussion of certain U.S. federal income tax consequences of the purchase, ownership and disposition of our common stock . . . in this offering."); *see also*, SFX Entertainment, Inc., SEC Registration Statement: Material United States Tax Considerations for Non-United States Holders of Common Stock (Form S-1), 128 (Jun. 25, 2013).

70. *See, e.g.*, Sophiris Bio Inc., *SEC Form S-1: United States and Canadian Income Tax Considerations*, 125 (Feb 15, 2013); *see also* Third Point Reinsurance Ltd., SEC Registration Statement: Certain Tax Considerations (Form S-1), 171 (Jul. 15, 2013).

example, excluded investors include insurance companies that face specific tax rules applicable only the insurance industry.[71] Also excluded are Real Estate Investment Trusts (REITs),[72] Regulated Investment Companies (RICs),[73] dealers in securities,[74] and other entities the Internal Revenue Code (IRC) specifically defines.[75]

On its face, this exclusionary approach fails to meet the basic requirement that disclosures address the material tax consequences for reasonable investors. While the identity of the reasonable investor remains elusive,[76] it is clearly a generic term, intending to represent "the idealized, utility-maximizing person from neoclassical economic theory."[77] Excluding specific types of investors, the disclosure no longer addresses all material tax information. Any taxpayer facing "non-average" tax consequences may nevertheless count as a "reasonable investor," yet the tax consequences material to such an investor are not described in the disclosure.

For example, a very limited number of investors are able to participate in initial offerings; most purchase and trade in the secondary market.[78] Thus, limiting a disclosure's scope to investors in the initial offering makes the disclosure applicable only to an extremely narrow set of market participants, excluding most "reasonable investors."

Excluding institutional investors from initial public offering (IPO) disclosures further exacerbates the problem. While institutional investors are understandably not regarded as "average," they are usually the investors in initial offerings.[79] In practice, therefore, IPO nonfinancial tax disclosures do not describe the tax consequences for the investors purchasing the securities in the IPO. Additionally, the disclosures fail to describe tax consequences for an investor that purchases the securities in the secondary market. In other words, the tax consequences described in initial offering disclosures are, for the most part, applicable to no one. Whether

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71. *See* I.R.C. §§ 801-848.

72. *See* I.R.C. §§ 856-859.

73. *See* I.R.C. §§ 851-855.

74. *See* I.R.C. § 475.

75. Indeed, according to the NYSBA Report, an "average" taxpayer is not a taxpayer subject to special tax regimes "such as, for example, insurance companies, financial institutions, dealers in securities, certain traders in securities, tax exempt organizations, partnerships and equity owners of partnerships, and investors that hold the security as part of an integrated transaction, hedge or straddle." N.Y. BAR REPORT, *supra* note 14, at 4–5.

76. *See* Tom C. Lin, *The New Investor*, 60 UCLA L. REV. 678, 694–96 (2013).

77. *Id.* at 695; *see also* Hoffman, *supra* note 24, at 540–42 (discussing the traits of the "reasonable investor").

78. *See, e.g.*, *supra* note 12 and accompanying text.

79. *See, e.g.*, *id.*

such an insubstantial disclosure performs any meaningful regulatory function is questionable.

Exclusion of many types of investors from non-initial offering documents, such as periodic disclosures or disclosures involving exchange offers, mergers, and other transactions, is also difficult to rationalize. Apparently, the SEC does not object to practices limiting the personal scope of nonfinancial tax disclosures.[80]

2. Limiting the Substantive Scope of Nonfinancial Tax Disclosures

Issuers commonly limit the scope of nonfinancial tax disclosures to federal income tax consequences alone.[81] Other taxes are explicitly excluded from the scope of the disclosures. From a practical point of view, this makes sense since federal income taxes are probably most broadly applicable for securities traded in U.S. markets.[82] Federal income taxes apply to most U.S. investors and could be regarded as "average" tax consequences.

The problem, however, is that this approach excludes many other types of taxes that may have "material" effects on the after-tax value of a security.[83] For example, state and local taxes may have a material effect on the return of an investment[84] but are regularly excluded from the disclosure's scope.

80. The SEC even implicitly approved such practices when it states issuers could condition tax disclosures "provided the conditions or qualifications are adequately described in the registration statement." *See* SEC Legal Bulletin, *supra* note 7.

81. *See, e.g.,* Pattern Energy Group, Inc., SEC Registration Statement Material U.S. Federal Income Tax Considerations for Holders of Our Class A Common Shares (Form S-1), 190 (Aug. 9, 2013), http://www.sec.gov/Archives/edgar/data/1561660/000119312513329269/d564947ds1.htm ("The effects of other U.S. federal tax laws, such as estate and gift tax laws, and any applicable state, local or foreign tax laws are not discussed."); *see also* Ringcentral, Inc., SEC Registration Statement: Material U.S. Federal Income Tax Consequences to Non-U.S. Holders of Our Class A Common Stock (Form S-1), 144 (Aug. 26, 2013), http://www.sec.gov/Archives/edgar/data/1384905/000119312513346260/d310247ds1.htm ("This discussion is not a complete analysis of all potential U.S. federal income tax consequences relating thereto, nor does it address any estate and gift tax consequences or any tax consequences arising under any state, local or non-U.S. tax laws, or any other U.S. federal tax laws.").

82. For example, U.S. residents own eighty-seven percent of the value of the U.S. equity market. *See* Kostin et al., *supra* note 57, at 17 (showing that foreign investors own only thirteen percent of U.S. equity markets). As such, federal income taxes are broadly applicable to investors in U.S. markets.

83. *See, e.g.*, *supra* note 76 and accompanying text.

84. *See* Pomp, *supra* note 32, at 373 (1993); *see also* Giles Sutton et al., *State Tax Issues Regarding FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes*, J. Multistate Tax & Incentives 26–27 (Jan. 2007).

Whether language limiting the scope of the disclosure to federal income tax consequences meets the regulations' literal requirements is unclear. Item 601(b)(8) of Regulation S-K clearly prescribes that an opinion must accompany nonfinancial tax disclosures, "where the *tax consequences* are material to an investor."[85] The requirement, on its face, is not limited to federal tax or income tax matters.

The SEC apparently accepts the use of such substantive limitations. In a recent Legal Staff Bulletin (the Bulletin), the SEC suggests that the tax opinion (and hence the disclosure) must cover "only material federal tax consequences."[86] Thus, the SEC permits nondisclosure of any material *non-federal* tax consequences. Distinguishing between the disclosure of material federal taxes and the nondisclosure of material non-federal taxes is inconsistent with the regulatory regime's underlying purposes, because the regulatory rationale calls for the disclosure of all material consequences.

Nonetheless, the SEC's approach engenders sympathy. Practically, issuers cannot meet the regulations' literal requirements. For example, the disclosure of state tax consequences could only meet the literal requirements of the regulations if the tax consequences to residents of all fifty states are described. Such a disclosure would be unmanageable, and the SEC's guidance provides much-needed relief in this context. Unfortunately, no principled standard exists, either in practice or in the SEC's guidance, to explain the inclusion of certain types of tax consequences but the exclusion of others. The tentative conclusion, therefore, is that the substantive limitation on the scope of disclosed tax consequences is not in line with the purposes of securities disclosure. At the same time, correcting this problem as a matter of practice is difficult.

3. Limiting the Scope of Reliance on Tax Disclosure

"It is an article of faith among tax advisors that any opinion prepared for the benefit of a large number of third parties who may have different individual tax postures should include language urging each such third party to consult his own tax advisor."[87] Practically every tax disclosure in securities offerings contains such

85. SEC Regulation S-K, 17 C.F.R. § 229.601(b)(8).

86. SEC Legal Bulletin, *supra* note 7 (proscribing that opinions should address all federal income tax consequences and prohibiting limiting the opinion to "certain" or "principal" tax consequences as it "raise[s] a concern that the author of the opinion may be omitting a material tax consequences").

87. Rothman, *supra* note 17, at 386.

language urging investors to seek tax advice tailored to their own particular tax circumstances.[88] Effectively, this language reduces an investor's possible reliance on the disclosure and suggests that any disclosed tax item may apply differently to each investor.

The SEC views reliance-limiting language negatively, however.[89] On the one hand, the SEC acknowledges that the cautionary language is intended to address investors' tax heterogeneity.[90] On the other hand, it does not accept qualifying language that, in effect, disclaims investors' reliance on the tax matters described in the disclosures.[91] The SEC's approach assumes that investors are able to rely on issuers' disclosures.[92] As previously indicated, however, current disclosure practice essentially describes tax consequences that are relevant to no (or only a few) investors. Therefore, there is little in nonfinancial tax disclosures upon which a reasonable investor can rely, with or without consulting his own tax advisor.

If anything, urging investors to consult their tax advisors is necessary. An investor's own tax advisor is arguably the only source for individually relevant, reliable nonfinancial tax information regarding federal, state, and local income and non-income tax consequences.

As described above, disclosures contain very limited nonfinancial tax information. The disclosed information applies only to a very narrow category of investors. Moreover, it is unclear to what extent investors can rely on the disclosed information. Thus, it is difficult to see how current tax disclosure practices respond meaningfully to the U.S. securities regulation regime's most basic rationales.

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88. *Id.* ("Typically, tax disclosure includes (often as part of the introductory boilerplate) a general statement to the effect that persons should consult their own tax advisors as to the application to them of the rules discussed therein.").

89. *Id.* at 387–88 (describing the SEC negative view of disclosure language urging investors to consult their own tax advisors).

90. SEC Legal Bulletin *supra* note 7, at 14 ("It is common practice, however, for an opinion to recommend that investors consult their own tax advisors or counsel, particularly with respect to the personal tax consequences of the investment, which may vary for investors in different tax situations.").

91. *Id.* ("The staff does not object to this practice so long as the recommendation does not disclaim reliance for tax matters on which counsel has opined.").

92. *Id.* ("Investors are entitled to rely on the opinion expressed. . . . The staff does not object to this practice [of suggesting that investors should seek their own tax advisors] so long as the recommendation does not disclaim reliance for tax matters on which counsel has opined.")

D. Current Nonfinancial Tax Disclosure is Detrimental to the Regulatory Rationale

The description above demonstrates that, given investors' heterogeneous tax preferences, it is impossible to comply in practice with the current regulatory regime controlling nonfinancial tax disclosures. In turn, market practice and SEC guidance undermine most of the disclosure's relevance to any particular investor in seeking to make drafting manageable.

This does not mean that the disclosure is completely meaningless. Arguably, a "reasonable investor" should be able to discern which parts of the disclosure are relevant given the investor's particular position. In that sense, the disclosure usefully put investors on notice regarding certain tax information, even though most of the information does not apply to the investor reading it.

Regulatory reform is still needed, however. Specifically, this Article argues that current nonfinancial tax disclosure practices fail to support, and may actually disrupt, the dissemination of information to the market, create unnecessary transaction costs, and divert valuable regulatory resources to the enforcement of largely-meaningless requirements.

1. Material Information is Not Disclosed and Disclosed Information May be Misleading

As Subparts A through C show, very few reasonable investors can find useful information in tax disclosures. This void reasonably suggests that some information that *is* material is sacrificed for the sake of practical drafting. For example, once the drafter excludes certain institutional investors from the disclosure's scope, the drafter does not need to describe tax consequences, even material ones, that affect only those investors. The alternative—to disclose all conceivable tax consequences—is also undesirable as those disclosures would be enormous, extremely costly to issuers, and more likely to confuse than help most investors.[93]

Moreover, investors that do read current disclosures may erroneously assume that the tax consequences described therein apply to them. It is doubtful that all "reasonable investors" are also tax experts. It is more likely that reasonable investors do not completely

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93. *In re* Progress Energy, Inc., 371 F. Supp. 2d 548, 553–54 (S.D.N.Y. 2005) (reasoning that an "excruciatingly lengthy and complicated disclosure" may confuse investors and represent a practically unfeasible amount of disclosure for issuers to handle).

comprehend the intricacies of U.S. tax rules. For example, whether an investor is subject to the Alternative Minimum Tax (the AMT) may affect the tax consequences associated with investment in securities. Because of the AMT's unique consequences, disclosure documents regularly exclude taxpayers who are subject to the AMT from the disclosure's scope.[94] Thus, a reasonable investor, unaware that she is subject to the AMT, may erroneously rely on disclosed nonfinancial tax information. In that sense, the SEC rule results in potentially misleading disclosures. Any incorrect action based on the disclosure is not the fault of the issuer but of the so-called "average taxpayer" who fails to realize the potential variances created by an incredibly complex system of tax laws.

2. The Practice is Wasteful for Both Issuers and Investors

Nonfinancial tax disclosures carry costs for both issuers and investors. Investors must spend time sifting through nonfinancial tax disclosures in order to identify which of the disclosed consequences are applicable to them. Issuers must pay lawyers and other tax professionals to draft the disclosures and distribute the information to the public.[95]

Drafting costs are likely not extravagant when the disclosure uses boilerplate language. But this assumption cannot stand in the context of corporate transactions, exchange offers, certain distributions or issuances of preferred stock, convertible debt, or structured derivative instruments. Investors' tax calculations in such cases can be very complicated, depending on the structure of a corporate transaction or the offered security. The process of developing the tax disclosures is long and tedious—initial information gathering, collecting required documents from the company, analyzing applicable tax provisions, and, finally, drafting a disclosure delivering relevant information to investors.[96]

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94. *See infra* note 138. *See also* Forward Pharma A/S, Registration Statement Under the Securities and Exchange Act of 1933 (Form F-1) 157 (Aug. 8, 2014) ("In addition, [this document] does not describe all of the tax consequences that may be relevant in light of a U.S. Holder's particular circumstances, including alternative minimum tax consequences . . . ."); AR Capital Acquisition Corp., Registration Statement Under the Securities and Exchange Act of 1933 (Form S-1) 110 ("This discussion does not address . . . taxpayers subject to the alternative minimum tax provisions of the Code.").

95. Manuel Utset separates out the shares, bonds, notes, etc. being made available to the public into two categories, in which lawyers spend a significant amount of time, the design and production of the product, and the "information bundle" that goes alongside the product. Manuel A. Utset, *Producing Information: Initial Public Offerings, Production Costs, and the Producing Lawyer*, 74 Or. L. Rev. 275, 299–300 (1995).

96. *Id.* at 301–03.

In many cases, disclosure costs represent justifiable expenses, as they are the least costly method of disseminating necessary information to the market.[97] However, in the tax context, where opinions and disclosures contain little relevant information for investors, the benefit to investors does not justify the issuer's transaction costs.

3. The Practice Depletes Valuable Administrative Resources

The SEC spends valuable resources enforcing securities regulations in the United States. The magnitude of the task is enormous, and the thinly-staffed SEC must prioritize its tasks. Chairman White has stressed that the Dodd-Frank Act's increased regulatory mandates and the resulting rules are stretching the agency's already meager staff and budget.[98] The SEC petitioned Congress for a twenty-seven percent increase in its budget in the coming fiscal year and requested an additional 676 full-time staff, a fifteen percent increase.[99] 131 of these new staff positions would go to the enforcement section.[100]

The SEC staff expends a great deal of time and resources ensuring compliance with regulatory requirements applicable to nonfinancial tax disclosures.[101] Using valuable resources to enforce a regulatory regime that does not support its intended purpose is socially wasteful. It also potentially diverts valuable administrative resources away from more necessary, and presumably more useful, enforcement functions.

II. THE "AVERAGE TAXPAYER" IS NOT A DEFENSIBLE CONSTRUCT

To start remedying the regulatory failure identified in Part I, it is necessary to uncover its roots. Part II discusses the failure of the market's practical solution to draft nonfinancial tax disclosures for the benefit of a "reasonable investor" who is also an "average taxpayer." This Part demonstrates that the "average taxpayer" concept

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97. *See supra* Part I.D.1., for an illustration of the rationale behind disclosure as supporting market efficiency.

98. John Olson & Gregg Wirth, *SEC Chairman White Asks Congress to Pony Up Cash for the SEC*, 17 No. 6 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 3 (June 2013).

99. Peter Feltman, *SEC Hopes for Big Budget Increase, Congress Skeptical*, CQ ROLL CALL 2013 WL 72099192 (May 16, 2013).

100. *Id.*

101. A review of EDGAR revealed sixty-three comment letters, written by the SEC to issuers in the first six months of 2013 alone, addressing possible issues with nonfinancial tax disclosure. On file with author.

is not defensible. Financial models explaining the connection between asset prices and investor-level taxes further discredit the "average taxpayer" as a viable legal construct, and courts routinely reject it. Part II concludes that the U.S. regulatory system should dispose of this concept.

A. *The Conceptual Failure: There Cannot be an "Average Taxpayer"*

One requirement for efficient market operation is that all market participants must "agree on the implications of current information for the current price and distributions of future prices of each security."[102] In the context of investor-level taxes, it is not obvious that such a condition could be met. As explained below, different investors face different tax costs from investing in identical securities. Thus, everything else being equal, it is unreasonable to assume that two reasonable investors with different tax positions would assign the same net-value to a publicly-traded asset. A couple of examples best illustrate this point:

Example 1. Assume that FCo. is a publicly-traded foreign corporation. FCo.'s stock is traded on the public market for $100. On Day 1, FCo. announces that on Day 2 it will distribute a dividend in the sum of $20 per share to shareholders of record on Day 2.

Ignoring taxes for the moment, once the distribution is made, the stock is expected to drop in value to $80 ($100 minus the $20 cash dividend distributed out of FCo.'s current assets). Post distribution, any shareholder who held a $100 stock at distribution will hold a stock valued at $80 and cash proceeds of $20, for a total net value of $100. Thus, prior to the dividend distribution, the value of the stock is not expected to change, as long as tax consequences are ignored.

Taxes change this outcome. Most tax systems in the world impose withholding taxes on dividends paid to foreign residents. Assume that the jurisdiction in which FCo. is domiciled imposes withholding taxes at a rate of twenty-five percent. The withholding tax on a $20 dividend distribution is thus $5. Post distribution, any "foreign" shareholder (i.e., shareholder who does not reside in FCo.'s jurisdiction) will have at hand a stock valued at $80, but only $15 net, after-tax cash proceeds, for a total net value of $95.

Assume that TE is a U.S. taxpayer, who is tax-exempt for U.S. tax purposes, and is also a "reasonable investor." TE holds the stock of FCo. on Day 1. Immediately after FCo.'s dividend announcement

102. *See* Fama, *supra* note 19, at 387.

(i.e. prior to the distribution), TE is approached by NE, another U.S. taxpayer, who is a reasonable individual but *not* tax-exempt. NE offers to buy TE's stock for $95. As explained above, because foreign withholding taxes are expected to be detrimental to the stock value to the extent of the tax imposed (i.e., $5), TE agrees.

Now consider the tax picture from NE's point of view. Under the IRC, certain U.S. taxpayers are entitled to receive credit against foreign taxes paid and use such credit against their U.S. income tax liability.[103] NE—being a taxable investor—has U.S. income tax liability from various sources. NE, therefore, expects to use any tax credit the U.S. government offered to reduce its U.S. tax liability dollar-to-dollar. TE, on the other hand, as a tax-exempt taxpayer, does not have any U.S. taxable income against which to apply a foreign tax credit. For TE, the foreign tax credit is meaningless.

From NE's point of view, the value of the stock should remain unchanged: $100 (notwithstanding that NE was able to buy the stock for only $95). After the distribution, NE expects to hold a stock valued at $80, plus gross proceeds of $20. Like in the case of TE, the foreign jurisdiction imposes withholding taxes on NE of $5, so the net cash proceeds for NE are also $15. Unlike TE, however, NE is granted $5 foreign tax credit for the foreign withholding taxes, which NE can use to shield NE's U.S. taxes. The credit offsets the withholding taxes. The total value of the stock to NE is thus $100. NE is able to make an arbitrage gain of $5 due to its particular tax position, which is different from TE's tax position.

NE could potentially monetize the arbitrage in the following manner: once the distribution is made, the stock price falls to $80 as explained above. NE could then turn and sell the FCo. stock back to TE for the market price of $80. Since TE bought back the stock for $15 less than it sold the stock pre-distribution, TE is compensated for the loss of the $15 net distribution (NE received the distribution as the shareholder on record at the time of the distribution).

NE, on the other hand, bought the stock for $95, sold it for $80 (for a loss of $15), but received dividend distribution valued at $20 ($15 net distribution *plus* $5 foreign tax credit). The U.S. Treasury essentially financed a $5 economic gain for NE through the foreign tax credit.[104]

103. *See* I.R.C. § 901.

104. Note that the loss from the sale of the stock offsets any possible U.S. taxable income on the distribution NE received.

These facts are not hypothetical. They are a simplified version of the transaction described in the seminal case, *Compaq v. Commissioner*, where Compaq and a tax-exempt investor engaged in a transaction of the sort described above.[105] This transaction was made possible because the two investors valued the stock differently due to their individual tax positions. Congress has now amended the IRC to prevent such perceived abuse.[106] The example is illustrated in Table 1.

Table 1: Stock Values for TE and NE After Dividend Announcement, as Affected by Their Individual Tax Positions

	TE (tax exempt)	**NE (taxable)**
Trading value (before dividend)	$100	$100
Gross dividend expected to be received by the shareholder	$20	$20
Expected effect of the distribution on stock value	-$20	-$20
Foreign withholding taxes expected to be imposed on the dividend (25%)	-$5	-$5
Foreign tax credit (on account of withholding taxes)	n/a[107]	$5
Economic value	$95	$100

Example 2. A more complex example produces even more dramatic differences in investors' interpretation of tax information. This example will reappear throughout the rest of the Article. Assume that Divicorp is a foreign corporation for tax purposes and that its common stock is publicly traded on the New York Stock Exchange. On Day 0, Divicorp's stock is traded at $100 per share. That same day, Divicorp announces its intention to distribute, on Day 2, a dividend in the amount of $10 per share to shareholders on record as of Day 1.

105. Compaq Computer Corp. and Subsidiaries v. C.I.R., 277 F.3d 778, 780–83 (5th Cir. 2001). For a thorough discussion on how taxes created price variations in the *Compaq* case, see generally Michael Knoll, *Compaq Redux: Implicit Taxes and the Question of Pre-Tax Profit*, 26 Va. Tax Rev. 821 (2007).

106. I.R.C. § 901(k)(1) (disallowing the use of a foreign tax credit on withholding taxes paid by a foreign corporation the stock of which is held by the recipient of the dividend for certain minimum periods).

107. The foreign tax credit is only useful to taxpayers with taxable income. As such, the foreign tax credit is irrelevant to TE, who is tax exempt.

On Day 0, FC, a foreign corporate-investor (who is assumed to be a "reasonable investor" residing in a jurisdiction other than Divicorp's jurisdiction), considers buying a substantial portion of Divicorp's stock. If it buys the stock before Day 1, it will be a shareholder on Day 1, entitled to receive the dividend to be distributed on Day 2.

Assume that the dividend is subject to a twenty percent withholding tax in Divicorp's home jurisdiction. FC knows that upon the distribution of the dividends, the value of the Divicorp stock is expected to decrease by the gross amount of the distribution.

Upon distribution, FC will have on hand a stock valued at $90, and a gross dividend distribution of $10, for a total *gross* value of $100. However, FC will bear the burden of withholding taxes imposed on the dividend. After the twenty percent withholding tax is imposed on the $10 distribution, FC will be left with an $8 net distribution on hand. FC thus values the stock at $98 ($90 share value post distribution plus $8 net distribution). In other words, FC—as a reasonable investor—interpreted the information about the forthcoming dividend distribution as detrimental to the stock's value ($2 net decrease to share value).[108]

Assume that FC is not further taxed in its home country on distributions from foreign corporations. This is reasonable since many jurisdictions largely exempt dividends received from foreign corporations from taxation.

DC is another corporate investor assumed to be a "reasonable investor." It also considers purchasing a sizable stake in Divicorp on Day 0. Unlike FC, however, DC is a domestic U.S. corporation. Like FC, DC will bear the burden of the twenty percent withholding tax in Divicorp's jurisdiction. However, as explained in the previous example, DC will also be entitled to a corresponding foreign tax credit from the U.S. government, which means that DC is generally indifferent to withholding taxes. Foreign residents, like FC, are generally not entitled to receive foreign tax credits from the U.S. government.

At this point, this example diverges from the previous example. Unlike many other jurisdictions in the world, the United States taxes distributions from foreign corporations. Assume that DC is subject to a twenty percent U.S. corporate tax rate on its income

108. For simplicity, it is assumed that no income tax treaty applies. In reality, income tax treaties will reduce withholding rates on dividends. For U.S. treaties withholding rate on dividends is generally between five percent and fifteen percent. *See* United States Model Income Tax Convention, 1996, 1 Tax Treaties (CCH) art. 10.1(b), (Nov. 15, 2006), *available at* http://www.irs.gov/pub/irs-trty/model006.pdf.

(including income from foreign dividends). At the same time, DC expects the dividend distribution to carry with it an *additional* favorable tax attribute: a foreign *deemed-paid* tax credit.

This calls for some explanation. Under the IRC, upon the distribution of dividends by foreign corporations, certain domestic corporate shareholders (like DC) may receive credit, not only for withholding taxes the foreign jurisdiction imposed, but also for foreign income taxes that *the distributing corporation paid* on the income from which the distribution is made.[109] Under section 902 of the IRC, the amount of the net distribution is grossed up by the amount of any foreign income taxes the distributing corporation paid. A tax credit is then given to the domestic corporate investor for those taxes. Essentially, any income from which the distribution is made (i.e., income the distributing corporation earned) is treated as if the corporate-shareholder receiving the distribution earned it directly. Any foreign income tax that the distributing corporation paid is deemed paid by the receiving shareholder (the grossed-up amount thus equals the amount distributed *plus* any corporate income taxes that the issuer paid on the corporate earnings from which the distribution is made). The deemed-paid credit is not available to foreign taxpayers like FC.

Assume that Divicorp was previously subject to a 33.3% corporate income tax rate in its home jurisdiction. Therefore, the distribution of $10 to DC is grossed up by the amount of taxes previously paid by Divicorp on the income underlying the distribution. The grossed up amount is calculated as follows: [(net distribution) / (1-t)], or $10 / 1 *minus* 0.33 = $15.

In other words, Divicorp had $15 gross corporate income in the foreign jurisdiction. That income was subject to a 33.3% corporate income tax in its own jurisdiction, generating a $5 tax liability to Divicorp, leaving $10 net income available for distribution. After grossing up, DC is *deemed* to receive—for United States federal income tax purposes—$15 of dividends (even though it only got $10 gross distribution).[110]

With the twenty percent U.S. corporate income tax on a deemed distribution of $15, DC is subject to a $3 tax in the U.S. However, the distribution carries with it a deemed-paid tax credit in the amount of $5 (the corporate income taxes actually paid by Divicorp

109. *See* I.R.C. § 902. Only corporate shareholders who hold at least ten percent of the voting stock of a foreign corporation are entitled to deemed-paid credit. *See id.* Such shareholders must also meet certain holding period requirements to be eligible for the deemed-paid credit. *See id.*

110. The net distribution is "grossed up" by adding back the $5 corporate tax paid in the foreign jurisdiction.

in the foreign jurisdiction), which DC can use to offset its taxable income from other sources.

After the dust settles, DC expects to have at hand a stock valued at $90 (the stock value is decreased by the amount of actual gross distribution, or $10) and a $10 gross distribution. A corresponding direct credit from the U.S. government (the same as in Example 1) will economically offset any withholding taxes imposed in the foreign jurisdiction ($2). In addition, DC will have a U.S. tax liability of $3 on the grossed-up distribution (twenty percent of $15) and will receive $5 of deemed-paid credit, for a net share value of $102. Thus, DC interprets the information about the forthcoming dividend distribution to be favorable (increasing the stock value by $2) and is, therefore, willing to pay more than current market price. Table 2 illustrates this example.

Table 2: Stock Values After Dividend Announcement, as Affected by FC and DC's Particular Tax Positions

	FC (foreign)	DC (domestic)
Trading value (before dividend)	$100	$100
Gross dividend expected to be received by the shareholder (for foreign tax purposes)	$10	$10
Expected effect of the distribution on stock value	-$10	-$10
Foreign withholding taxes expected to be imposed on the dividend (20%)	-$2	-$2
Direct foreign tax credit granted by the U.S. (for withholding tax)	n/a[111]	$2
U.S. income tax on grossed-up distribution (20 % on $15)	n/a	-$3[112]
Deemed paid foreign tax credit granted by the U.S. (for foreign corporate taxes paid by Divicorp)	n/a	$5[113]
Economic value	$98	$102

Both FC and DC are reasonable investors and wish to maximize their net profits. They both consider their after-tax returns. However, as demonstrated, both interpreted the same piece of information differently due to their own tax status. FC viewed the

111. The foreign tax credit is generally only granted to U.S. taxpayers. Therefore, the foreign tax credit is irrelevant to FC who is a foreign taxpayer.

112. The twenty percent U.S. tax rate is applied against deemed dividend income of $15 (and not $10). The gross amount is calculated by (net distribution) / (1-t). In this case $10/ 1-0.33 = $15.

113. The $5 corporate income tax Divicorp paid in the foreign jurisdiction is deemed paid by DC, which entitles DC to a credit.

forthcoming dividend distribution as detrimental to the stock price while DC interpreted it favorably.

The examples discussed above show that ECMH's assumption—that all investors interpret all information similarly—is highly questionable in the tax context. There is no "class" of average taxpayers who interpret tax-related information similarly. Importantly, the ECMH acknowledges that there may be inconsistencies in the interpretation of market information.[114] However, the ECMH suggests that markets will nevertheless remain efficient, as long as interpretation gaps are relatively rare, and no single class of investors is consistently better informed or better positioned to interpret market information.[115] This remedial mechanism is inapplicable in the case of investor-level taxes. As long as FC is a foreign corporate taxpayer and DC is a domestic corporate taxpayer, they will remain inconsistent in their interpretation of tax-related information. In fact, it is difficult to imagine any pair of investors whose tax positions and consequences are identical. It is therefore unreasonable to accept the idea that an "average" tax preference exists.

B. The Preferences of "Average Taxpayers" Do Not Affect Market Efficiency

The examples in Subpart II.A demonstrate that taxpayers interpret nonfinancial tax information differently. Market prices, however, are eventually set. Investment decisions are made. If market participants are "reasonable," they will take into account tax costs. Whose tax preferences actually matter, then? Financial literature suggests that the significant tax preferences are not those of "average taxpayers."

Economic, finance, and accounting scholars have extensively studied the effect of investor-level taxes on the price of publicly-traded assets.[116] Multiple studies have attempted to model the effect of heterogeneous tax preferences on market prices and to use empirical research to support such models. Unfortunately, such literature appears to have had little effect on the regulatory framework. This Subpart seeks to highlight the impact such studies *could* have on the regulatory structure governing nonfinancial tax disclosure.

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114. *See* Fama, *supra* note 19, at 383.

115. *Id.*

116. Michelle Hanlon & Shane Heitzman, *A Review of Tax Research*, 50 J. Accounting. & Econ. 127, 160–68 (2010).

1. The Irrelevance View

The irrelevance view suggests that taxes are irrelevant for pricing publicly-traded assets. According to this theory, nontaxable actors, such as pension funds and educational institutions' investment funds, set market prices.[117] These institutional investors are frequent traders, are always in a better arbitrage position[118] than taxable investors, and, therefore, always set market price. Tax-exempt investors are willing to pay more than other investors for the same risk-adjusted (but not tax-adjusted) returns because they do not expect to incur any investor-level tax burdens.

Assuming the purpose of nonfinancial tax disclosures is to support accurate market pricing, there is little justification for nonfinancial tax disclosures if tax-exempt investors set market prices. In this case, tax consequences are simply an irrelevant piece of information. More importantly, tax-exempt investors are not "average taxpayers." The "average taxpayer" is assumed to be a taxable investor.[119] Indeed, tax-exempt institutions are specifically carved out from the scope of nonfinancial tax disclosures.[120]

2. Marginal Investors and Clientele Effects

In recent years, the irrelevance view has lost traction.[121] Multiple studies have found that investor-level taxes affect asset prices and have suggested various models to explain the mechanism of tax capitalization and its effects on asset pricing.[122]

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117. *See generally, e.g.*, Fischer Black & Myron Scholes, *The Effects of Dividend Yield & Dividend Policy on Common Stock Prices and Returns*, 1 J. FIN. ECON. 1, 1 (1974) (finding no evidence that expected returns on high yield common stocks differ from the expected returns on low yield common stocks either before or after taxes); Merton H. Miller & Myron S. Scholes, *Dividends and Taxes: Some Empirical Evidence*, 90 J. POL. ECON. 1118, 1130–31 (1982) (criticizing empirical studies that show evidence of the effects of dividend taxes on market prices, concluding it is not convincing); Gene Amromin, Paul Harrison & Steven Sharpe, *How Did the 2003 Dividend Tax Cut Affect Stock Prices?*, (Fed. Reserve Bd., Working Paper 2005-61, 2006) (finding no overall statistically significant effect of the 2003 dividend tax cut on stock prices).

118. "Arbitrage position" means the ability to take advantage of a pricing differential between two similar assets (in terms of risk adjusted return) not available to other investors.

119. *See* N.Y. BAR REPORT, *supra* note 14, at 2–3 (noting tax exempt investors as one category of "non-average" investors).

120. *See* discussion *supra* note 56 and accompanying text.

121. Hanlon & Heitzman, *supra* note 116, at 164 ("There is growing evidence that the irrelevance view does not hold and that taxes matter in pricing stocks.").

122. *See id.* at 160–61 (2010), for a recent of summary of mechanisms of dividend tax capitalization. For a recent of summary of mechanisms of capital-gains tax capitalization, see generally Zhonglan Dai et al., *Capital Gains Taxes and Asset Prices: Capitalization or Lock-in?*, 63 J. FIN. 709 (2008).

One body of studies suggests that a single, identifiable marginal investor, whose tax preferences determine the rate at which taxes are capitalized, sets the market price.[123] Marginal investors are frequent traders (such as dealers in securities and other financial institutions) who are indifferent between purchasing two securities with similar risk profiles that are taxed differently.[124] In such a case, the tax profile of an asset is the marginal consideration in the investment decision.

Under such a view, issuers could rewrite investor-level tax disclosures to target marginal investors, but only if they could identify the marginal investors. Financial literature has yet to provide conclusive evidence of the identity of marginal investors as a "class."[125] Moreover, the identity of the marginal investor can theoretically vary for different trades. This implies that investor-level taxes are detrimental to market equilibrium because they facilitate arbitrage opportunities.[126]

Returning to Example 2, with FC and DC, in Subpart II.A: in the absence of taxes, DC may be indifferent between purchasing Divicorp stock, and the stock of another corporation, Eurocorp, operating in the same industry segment as Divicorp. Assume that Eurocorp's stock is also valued at $100 per share as of Day 0, and that Eurocorp also intends to distribute a $10 dividend. If Eurocorp, however, did not previously pay corporate tax in a foreign jurisdiction, no deemed-paid foreign tax credit is expected to flow to DC with the distribution. If both shares are offered on the market for their current price of $100, DC would prefer Divicorp's stock over Eurocorp's solely because of the different tax profiles. As explained, DC would pay as much as $102 for Divicorp's stock. Any

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123. For a summary of the potential role of marginal investors in tax capitalization, see Douglas A. Shackelford & Terry Shevlin, *Empirical Tax Research In Accounting*, 31 J. Acct. & Econs. 321, 349–50 (2001).

124. Scholes et al., *supra* note 6, at 130. For example, an investor subject to a thirty percent tax rate is indifferent between purchasing a taxable security that is expected to generate a ten percent pre-tax risk-adjusted return (meaning, that the after-tax net return, after a thirty percent tax, will be seven percent) or a tax-exempt security expected to generate a seven percent non-taxable risk-adjusted return.

125. *See* Hanlon & Heitzman, *supra* note 116, at 129–30 (discussing the elusive identity of the marginal investor). Different studies have identified different classes of investors as "marginal investors." *Compare, e.g.*, Leonie Bell & Tim Jenkinson, *New Evidence of the Impact of Dividend Taxation and on the Identity of the Marginal Investor*, 57 J. Fin. 1321, 1341 (2002) (arguing that pension funds are the marginal investors), *with* Douglas J. Lamdin & Craig Hiemstra, *Ex-Dividend Day Share Price Behavior: Effects of the Tax Reform Act of 1986,* 75 Rev. Econs. & Stats. 778 (1993) (arguing that the marginal investors are short-term traders). Most scholars agree, however, that marginal investors are institutional investors.

126. *See* Hanlon & Heitzman, *supra* note 116, at 165.

lower price would be a bargain. Thus, DC will be the marginal investor setting Divicorp's stock price because it is willing to pay more than other investors, and the seller will sell to the highest bidder.

If the marginal investor view is accepted, investor-level tax disclosure is not a practical endeavor. The identity of the marginal investor is dynamic, and different tax information is relevant at different times, depending on the particular identity and tax status of the marginal investor in any given trade. This makes the practicability of disclosure questionable. Either all information must be disclosed in advance (which, as explained in Part I, is impossible), or tax disclosures should be dynamic and change as the identity of the marginal investor changes.

Even setting aside practical difficulties, however, financial literature makes it clear that "marginal investors" are not "average taxpayers." They are financial institutions, which are usually subject to various specific tax regimes.[127] In tax disclosure practice, such investors are not regarded as "average taxpayers."[128]

While the marginal investor approach explains how individual investors determine market prices, it is unlikely that many investors are marginal investors in practice. It is unreasonable to expect that many investors could consistently find "a pair of securities with identical risk that vary *only* on the tax treatment of the returns."[129] Investors, who are not the marginal investors, would nonetheless favor investments that are expected to maximize their after-tax return.[130] The resulting tax-induced capital allocation is known as the Tax Clientele Effect.[131]

For example, under the clientele approach, tax-exempt investors are expected to invest in dividend-paying firms, where they enjoy a current and steady stream of untaxed cash.[132] Conversely, taxable investors prefer to defer taxation as long as possible and tend to invest in growth companies, which seldom distribute taxable dividends. Taxable investors eventually pay taxes upon disposition of the security at preferential long-term capital gain rates. Thus, based

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127. *See supra* note 120 and accompanying text.

128. *See* N.Y. BAR REPORT *supra* note 14, at 3 n.4.

129. Hanlon & Heitzman, *supra* note 116, at 165 (emphasis added).

130. SCHOLES ET AL., supra note 6, at 130.

131. For a discussion of various types of Tax Clientele Effects and their potential effects on asset pricing, *see generally* Philip H. Dybvig & Stephen A. Ross, *Tax Clienteles and Asset Pricing,* 41 J. FIN. 751 (1986); *see also* Yair Listokin, *Taxation and Liquidity,* 120 YALE L.J. 1682, 1720–22 (2011) (examining the effect of income taxes on the premium paid for illiquid assets, creating a shift based on how the tax distorts the clienteles' tax preferences).

132. SCHOLES ET AL., supra note 6, at 130.

on the nature of the company's distribution policies, different companies often have different tax clienteles.[133]

Looking back at the FC, DC, Divicorp, and Eurocorp example, domestic investors who have use of foreign tax credits—like DC—are attracted to Divicorp's stock. As shown in Table 2, *supra*, after the initial arbitrage opportunities resulting from the dividend announcement are exploited, Divicorp's share price is expected to stabilize at $102 per share. It is also expected that all new Divicorp investors are domestic corporate taxpayers. Foreign corporate investors like FC are attracted to Eurocorp's stock, the price of which is expected to stabilize at $98.

Investor-level tax disclosure could make theoretical sense if issuing entities "know" who their tax clienteles are and regulators apply different disclosure requirements to each issuing entity, based on the entity's tax clientele. Whether this is a practical approach is unclear. Not only would issuers have to draft multiple different disclosures, but each issuer's tax clientele can change over time, making disclosures become outdated. More importantly, however, tax clientele literature strongly advices against the use of the "average taxpayer" concept as a linchpin for nonfinancial tax disclosure. If the Clientele Effect is real, then a class of "average taxpayers" does not exist. The Clientele Effect supports the view that different classes of taxpayers affect the prices of different securities. The market environment is, therefore, dotted with multiple classes of "average" taxpayers.

3. Portfolio Basis Approach

Finally, another group of studies suggests that market equilibrium is achieved because investors price assets on a portfolio basis (rather than a single asset basis).[134] This approach assumes that each investor aggregates various tax consequences resulting from

133. *See* Edwin J. Elton & Martin J. Gruber, *Marginal Stockholder Tax Rates and the Clientele Effect*, 52 REV. ECON. STAT. 68, 72–74 (1970) (finding clientele effects based on a company's dividend policy, particularly for corporations because of the deduction, rather than tax-exempt institutions); *see also* Franklin Allen et al., *A Theory of Dividends Based on Tax Clienteles*, 55 J. FIN. 2499, 2501 (2000) (asserting that high-dividend policy will attract more institutional investor clienteles and send a signal of a "quality" firm and management); Robert H. Litzenberger & Krishna Ramaswamy, *The Effect of Personal Taxes and Dividends on Capital Asset Prices*, 7 J. FIN. ECON. 163, 192 (1979) (finding evidence of a clientele effect for stockholders in higher tax brackets choosing stocks with lower dividend yields).

134. *See generally, e.g.,* M. J. Brennan, *Taxes, Market Valuation And Corporate Financial Policy*, 23 NAT'L TAX J. 417 (1970) (developing an after-tax Capital Asset Pricing Model (CAPM)); Roger H. Gordon & David F. Bradford, *Taxation and the Stock Market Valuation of Capital Gains*

investment in securities with different tax profiles into the pricing of all securities in the portfolio. If true, then nonfinancial tax disclosures must theoretically describe all relevant tax information to all investors. Thus, different investors can aggregate the tax information from different issuers to construct their desired "tax portfolio." It seems that regulations currently ask issuers to do this. Part I already discussed the impossibility of meaningful compliance with such a requirement.[135]

More importantly, under a portfolio basis approach, the tax preferences of "[i]nvestors with the greatest wealth and least risk aversion" are expected to affect market prices.[136] Such investors are, by definition, not "average investors." Investors that hold the largest portfolios and are not risk-averse are usually institutional investors[137] or otherwise extremely wealthy investors that are specifically excluded from the scope of nonfinancial tax disclosures.[138]

It is difficult to summarize financial literature on investor-level taxes and their effects on investment behavior. Financial models and empirical studies have yet to produce conclusive results about the identity of investors whose tax preferences actually affect market prices. The studies, however, are very telling because there is one type of investor whose preferences likely matter very little (if at all): the "average taxpayers." They are largely irrelevant in the operation of capital markets, so it makes little sense to draft tax disclosures solely for the benefit of such taxpayers.

The only relatively safe bet stemming from the financial literature is that the tax preferences of institutional investors or other

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and Dividends: Theory and Empirical Results, 14 J. PUB. ECON. 109 (1980) (showing that dividends do not affect pricing differently from capital gains, which implies that the relative valuation is an aggregate consequence of portfolio choices).

135. *See* discussion *supra* Part I.B.

136. Hanlon & Heitzman, *supra* note 116, at 165.

137. Due to institutional investors' diversification and increased risk-aversion, some studies have shown their ownership to be synonymous with volatility in the stock price of a firm (since institutional investors can benefit from such volatility). Richard W. Sias, *Volatility and the Institutional Investor,* 52 FIN. ANALYSTS J. 13, 13–14 (1996); *see also* Ryan T. Ball, *Does Anticipated Information Impose a Cost on Risk-Averse Investors? A Test of the Hirshleifer Effect*, 51 J. ACCOUNTING RESEARCH 31, 55 (2013) (using institutional investor ownership as a proxy to explain volatility in a firm's stock price).

138. While nonfinancial tax disclosure sections do not explicitly exclude high net-worth individuals from the scope of the disclosure, all such disclosure sections exclude taxpayers that are subject to Alternative Minimum Tax (AMT). Recent data suggests that AMT applied to the top 4.2 percent of taxpayers in 2013. *Aggregate AMT Projections, 2012–2023*, Table T13-0209, Urban-Brookings Tax Policy Center Microsimulation Model (Aug. 26, 2013), *available at* http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0209.pdf. Thus, most (if not all) high net worth individuals are subject to AMT, and, as such, excluded from the scope of the disclosure.

wealthy investors are the ones that affect market prices. Institutional investors are regularly excluded from the scope of nonfinancial tax disclosures. Current nonfinancial tax disclosure practice thus excludes investors that matter and includes investors that do not (i.e., "average taxpayers").

C. Courts' Adjudication and the "Average Taxpayer"

This Subpart shows that court decisions dealing with nonfinancial tax disclosures also support the conclusion that the concept of the "average taxpayer" is questionable.

Court decisions addressing alleged misstatement or omission of facts in nonfinancial tax disclosures are rare.[139] This is not surprising: given the numerous carve-outs in nonfinancial tax disclosures, very few investors have something upon which to act, even if they feel misled. In the few cases on point, courts have generally found that an investor's individual tax outcome from securities transactions is not actionable. These courts have concluded that "discussions of the personal tax ramifications of proposed corporate transactions are beyond the scope of the securities laws."[140] Courts distinguish tax consequences that depend *solely* on the stakeholder's tax consequences from tax consequences that "flow directly from the corporate transaction itself," making only the latter actionable.[141]

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139. This Subpart only addresses litigation outside the context of tax shelters. In tax shelter offerings, the securities are offered primarily for the tax benefits associated with them, and investors sue when such benefits do not materialize. The assumption is that securities tailored to create a specific tax benefit will only attract investors that, considering their personal tax position, would to be able to take advantage of the benefits suggested. Such investors could not be regarded as "average taxpayers." For a discussion on the tax shelter industry as well the responses of Congress and the IRS. *See, e.g.*, Martin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet* 105 Colum. L. Rev. 1939 (2005). The brief survey therein assumes that taxes are simply another cost of investment (not the reason for investment) that one must account for.

140. *See* Minzer v. Keegan, No. 97-CV-4077, 1999 WL 33972459, at *11 (E.D.N.Y. Jan. 25, 1999), *aff'd*, 218 F.3d 144 (2d Cir. 2000); *see also* Lewis v. Oppenheimer & Co., 481 F. Supp. 1199, 1206 (S.D.N.Y. 1979) ("The income tax situation of each stockholder is personal business, and absent injury to the corporation, is irrelevant to damage claims under the federal securities laws.").

141. *See* Mendell v. Greenberg, 927 F.2d 667, 676 (2d Cir. 1990) ("Expanding the requirements of SEC Rule 14a–9 to insist upon disclosure of incidental tax benefits—benefits that do not flow directly from the corporate transaction itself but rather from the individual shareholder's personal tax situation—goes beyond the purposes of the Rule."), *amended by* 938 F.2d 1528 (2d Cir. 1990); *see also* Shaev v. Hampel, No. 99 Civ. 10578(RMB), 2002 WL 31413805, at *6 (S.D.N.Y. Oct. 25, 2002), *aff'd*, 74 F. Appx. 154 (2003).

The distinctions between tax consequences that do or do not "flow through directly" from a transaction usually arise in litigation brought under SEC Rule 14a-9, relating to alleged insiders' benefits from proposed transactions.[142] Rule 14a-9 prohibits proxy solicitations from being "false or misleading with respect to any material fact, or which omits to state any material fact."[143] Management and other insiders' interests in a transaction or plan for which shareholder votes are solicited could be material to an investor weighing its vote and thus should be disclosed.[144] Insider interests may also include tax benefits that may result from the transaction, and in certain circumstances the issuer must explicitly disclose those benefits.[145] Shareholders sometimes allege that proxy statements failed to accurately describe insiders' anticipated tax consequences and that an accurate statement would have exposed a tax-interest conflict between insiders and other shareholders.

For example, in *Mendell v. Greenberg*, a shareholder sued several corporate insiders in connection with a proxy statement soliciting votes to approve a proposed merger.[146] The plaintiff argued that the proxy statement failed to disclose certain incidental tax benefits controlling shareholders expected to receive from the transaction.[147] In denying the claim, the Second Circuit reasoned that since personal tax benefits are speculative in nature, a requirement to disclose them is more likely to confuse than to inform.[148] The court noted that "the practical difficulties involved in computing speculative personal tax consequences—especially since those consequences depend upon indeterminate, often difficult to predict variables—precludes any requirement that potential incidental tax benefits need be disclosed."[149]

142. *See* 17 C.F.R. § 240.14a-9.

143. *Id.*

144. *See* 17 C.F.R. § 240.14a-101 (outlining the information to be disclosed in connection with proxy solicitations). For example, Item 7 outlines the information required in the proxy relating to any action for the election of directors or executive officers while Item 8 directs disclosure of information relating to the compensation of directors and executive officers. *Id.*

145. In the case of compensation plan involving options in the registrant, Schedule 14A requires the disclosure of "the federal income tax consequences of the issuance and exercise of such options to the recipient and the registrant." 17 C.F.R. § 240.14a-101, Item 10.

146. 927 F.2d 667, 670–71 (2d Cir. 1990).

147. *Id.* at 671.

148. *Id.* at 677 ("Here [the Insider's] failure to disclose the personal tax consequences resulting to her from the merger were speculative in nature and may not be deemed a material omission. To hold otherwise would require that major shareholders include speculative predictions of their personal finances in a proxy statement that is more likely to confuse than enlighten other stockholders.").

149. *Id.* at 676.

In *Lewis v. Dansker*, the plaintiff argued that that a proxy statement failed to accurately account for the value of a proposed transaction to insiders.[150] Specifically, the disclosed value to insiders did not account for insiders' anticipated deductible losses resulting from the transaction.[151] Such deductible losses increased the transaction's net value to insiders beyond the par value disclosed in the proxy solicitation. The court rejected the argument and found that "the usability of such losses will vary—not exclusively according to the source of the deduction—*but also according to the individual's other income, offsets to income, and tax bracket*."[152] As such, any disclosure was speculative in nature. Moreover, in questioning whether such information would have been "material" to shareholders' votes, the court suggested that incidental tax benefits to insiders is an irrelevant piece of information to shareholders, as long as the corporation's interest is not harmed.[153]

In *Freedman v. Barrow*, a shareholder brought a derivative action against a corporation in respect of proxy statements soliciting votes regarding a compensation plan for the corporation's employees.[154] The plan included incentive compensation in the form of stock appreciation rights (SARs). The plaintiff argued that the proxy statement failed to accurately disclose the set of incentives and disincentives to employees in exercising their rights under the plan.[155] Specifically, the plaintiff suggested the proxy statement failed to adequately describe the tax consequences to employees in exercising the SARs.[156] Rejecting the argument, the court reasoned that the decision to exercise a stock option "necessarily depends on individual factors such as the employee's own financial situation, his ability and willingness to borrow, and *his tax consequences*."[157] Therefore, any disclosure in this respect was not required as it would have amounted to a "speculative assertion."[158]

Another notable case is *Zemel v. Philips*.[159] There, a plaintiff alleged that a proxy statement failed to disclose that a liquidation plan was structured to achieve favorable tax outcomes to insiders. In concluding that such information is not "material," the court

150. 357 F. Supp. 636, 638–40 (S.D.N.Y. 1973).
151. *Id.* at 640–41.
152. *Id.* at 643 (emphasis added).
153. *See id.* at 643.
154. 427 F. Supp. 1129, 1134–38 (S.D.N.Y. 1976).
155. *See id.* at 1139–40.
156. *Id.* at 1143.
157. *Id.* at 1144.
158. *Id.*
159. Zemel Family Trust v. Philips Int'l Realty Corp., No. 00 Civ. 7438 MGC, 2000 WL 1772608 (S.D.N.Y. Nov. 30, 2000).

reasoned that "[the] plaintiff ha[d] provided no evidence that the interests of the shareholders were compromised by the tax-efficient outcome for [insiders], and so has failed to show that the alleged non-disclosure was material."[160]

This body of cases contradicts the existence of an average group of taxpayers. If tax outcomes are a result of personal tax positions, as courts have suggested, they are not "average."[161] Even tax benefits to the "class" of insiders cannot count as "average" to that class because not all insiders share the same tax preferences. Even if all insiders receive tax benefits from the transaction, disclosure is not necessarily required since insiders' tax benefits do not necessarily harm investors. These cases, however, do not address the issue of "tax averageness" in the context of a direct tax detriment to stakeholders resulting from inaccurate disclosures. Very few cases address direct tax-related injuries to investors, but these cases also show the legal irrelevance of the "average taxpayer" construct.

For example, in *Minzer v. Keegan*, shareholders of a target corporation brought action to recover damages resulting from a merger of the target corporation with an acquirer.[162] The plaintiffs alleged that the proxy solicitation failed to adequately disclose that the tax consequences from the merger were detrimental *to shareholders*, compared to the tax consequences that would have resulted from a different bid.[163] Specifically, shareholders of the merged corporation were paid seventy-five percent in the acquiring corporation's stock and twenty-five percent in cash, with the cash portion being immediately taxable to the shareholders.[164] Another bidder, whose bid the board rejected, proposed a full stock-for-stock merger, in which shareholders of the target corporation would have received

160. *Id.* at *4 (S.D.N.Y. Nov. 30, 2000).

161. For additional cases making the distinction between personal tax consequences and tax consequences that flow directly from the transaction in the context of proxy solicitation, *see* Lewis v. Oppenheimer, 481 F. Supp. 1199, 1206–10 (S.D.N.Y. 1979); *see also* Shaev v. Hampel, No. 99 Civ. 10578(RMB), 2002 WL 31413805, at *5 (E.D.N.Y. Oct. 25, 2002) (shareholders brought action against a corporation and its officers suggesting that in soliciting a vote for the approval of a stock incentive plan failed to "'disclose all the federal tax consequences' of granting an option, particularly the fact that 'under the U.S. federal estate tax, gift tax, and generation-skipping transfer tax, these stock options and SARs are treated as taxable.'" The court rejected the argument since the described benefits are personal and do not "flow directly" from the transaction). *Id.* at *6, *aff'd*, 74 F. Appx. 154 (2003); Seinfeld v. Bartz, No. C01-2259 TEH, 2002 WL 243597, at *4–5 (N.D. Cal. Feb. 8, 2002) (no material omission in failure to disclose "all federal tax consequences" of an option plan), *aff'd*, 322 F.3d 693 (9th Cir. 2003).

162. Minzer v. Keegan, No. 97-CV-4077, 1999 WL 33972459, at *1–6 (E.D.N.Y. Jan. 25, 1999), *aff'd*, 218 F.3d 144 (2d Cir. 2000).

163. *Id.* at *5.

164. *Id.*

only stock in the acquirer in return for their stock in the target.[165] A stock-for-stock exchange would have been tax-free for the shareholders at the time of the transaction. Failing to disclose the favorable tax consequences of the other bid allegedly resulted in a direct tax injury to the shareholders.

The court rejected the argument for two reasons. First, on factual grounds, the court stated that the disclosure did include the requisite description of the structural difference between the two offers.[166] Second, the court also added that because the "true value of each bid depends on the tax situation of individual shareholders,"[167] the other offer cannot necessarily be considered "materially higher."[168] Thus, the court implicitly rejected the idea that personal tax consequences resulting from corporate transactions are "average" to all shareholders.

In cases where courts granted shareholders a remedy for a tax-related injury, relief was granted due to a misstatement relating to a *corporate-level* piece of material information rather than the tax injury itself. The corporate misstatement denied shareholders the information required to calculate their own tax liabilities.

For example, in *Herbst v. ITT*, a merger was structured to achieve tax-free treatment.[169] In seeking a ruling from the IRS that the merger was indeed tax-free, however, the corporation failed to disclose relevant information.[170] A class plaintiff claimed that this failure created a risk that the IRS would not respect the tax-free treatment of the merger and that the corporation should have disclosed that risk in the proxy statement.[171] In response, the defendants argued, *inter alia*, that the plaintiff could not stand as a class representative.[172] They argued that if the merger is deemed taxable, different investors might face different tax consequences, depending on their personal tax positions.[173]

165. *Id.*

166. *Id.* at 11 ("In suggesting that the shareholders needed to be told that different transaction structures would result in different tax treatments, plaintiffs ignore the Supreme Court's admonishment that the purpose of the securities laws is to disclose, not to treat the shareholders like 'nitwits' or to 'attribute to investors a child-like simplicity.'" quoting Basic, Inc. v. Levinson, 485 U.S. 224, 234 (1988)).

167. *Id.*

168. *Id.*

169. Herbst v. Int'l Tel. & Tel. Corp., 495 F.2d 1308, 1310–11 (2d Cir. 1974).

170. *Id.* at 1316.

171. *Id.* at 1314 ("Herbst claims that ITT should have informed the holders of Hartford stock that there was a risk that the exchange might be a taxable event because of the fraud allegedly perpetrated by ITT in getting the favorable ruling from the IRS.").

172. *Id.*

173. "ITT also contends that Herbst cannot represent the large, tax-exempt, institutional shareholders. As noted above, all those who exchanged their shares would have benefited

In approving the claim as a class action, the court reasoned that, had the merger been taxable, all shareholders would have been affected, regardless of their tax position.[174] Since certain shareholders would have rejected the merger because of the tax detriment, it would have compelled the bidder to offer a better price for the shares, which would have been available to *all* shareholders.[175] While the court seemed to agree that shareholders' tax consequences vary, it was not the tax effects that created the "class." Rather, it was the benefit to all shareholders in the form of a higher bid.[176] The *Herbst* defendants' problem was failing to disclose that the transaction might be taxable, not the specific potential tax consequences for shareholders of a taxable transaction. Such results are personal to each shareholder.

Similarly, in *Swanson v. Wabash*, the court found a corporation liable for shareholders' personal tax consequences resulting from a stock purchase transaction.[177] The plaintiff alleged that the stock purchase transaction's structure denied him the benefits of long-term capital gains (LTCG) tax treatment because he was forced to dispose of his stock before he reached the requisite holding period.[178] Obviously, the holding period of shareholders in their stock is a completely personal attribute. Nonetheless, the plaintiff proved that certain shareholders were allowed, under a special arrangement, to hold on to the stock longer than other shareholders, specifically so they could enjoy LTCG treatment upon disposition.[179] The court found the corporation liable not because of the plaintiffs' specific tax loss (in fact, the plaintiff failed to prove he suffered any tax-related injury)[180] but because the opportunity to hold on to the stock was not made available to all shareholders.[181] Had it been, each shareholder would have made his or her own calculations—considering personal tax positions—as to whether to hold on to the stock or sell it immediately.

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from a higher price. Under Herbst's claims all shareholders, large and small, tax-exempt or not, would benefit equally and so her claim is typical." *Id.*

174. *Id.*

175. *Id.*

176. *Id.* at 1322 ("The effect of this misrepresentation was to induce some Hartford Fire shareholders to exchange their shares on terms less favorable than those which would have been offered if the tax consequences had been properly represented, the tax-exempt shareholders may well have been damaged as much as the non-tax-exempt shareholders since the single exchange offer was made equally to all shareholders without regard to their status quo taxpayers").

177. Swanson v. Wabash, Inc., 577 F. Supp. 1308, 1317 (N.D. Ill. 1983).

178. *Id.* at 1312.

179. *Id.* at 1317–18.

180. *Id.* at 1324.

181. *Id.* at 1323–24.

A final group of cases dealing with the approval of settlements in securities fraud class action suits also supports the difficulty of categorizing reasonable investors into a single class of average taxpayers. For example, in *Ikon Office Solutions*, parties to a class action and a related derivative suit sought approval of a settlement.[182] Several class members objected to the proposed settlement, arguing that "the Settlement Notice impermissibly failed to inform claimants of the tax consequences of any disbursement."[183] The court rejected the argument, noting that different claimants may face different tax consequences.[184] The court concluded that it was preferable that claimants consult their own tax advisor rather than seek disclosure of their tax consequences in the settlement notice.[185]

In sum, current case law aligns with the view that an "average taxpayer" does not exist. Reasonable investors can act on misstated tax information only where the issuer failed to disclose that tax consequences were associated with the offering. Omitted or misstated tax information is not actionable where it only fails to describe *the tax consequences* for each investor. Courts' adjudication is, therefore, in line with financial literature, as well as with the examples with which this Part began. The "average taxpayer" does not represent any real-life or theoretical investor whose tax preferences might be important to market efficiency. When this conclusion becomes plain, the logic of drafting nonfinancial tax disclosure for the benefit of average taxpayers falls apart. The next Part explores the theoretical aspects of the failure.

III. Mandatory Disclosure Theory and Nonfinancial Tax Information

The arguments in Parts I and II were positive ones; they identified the current state of tax disclosure practices and explained its functional failures in advancing market efficiency. Part III identifies the theoretical source of the regulatory failure. The Article thus takes a normative turn at this point: the question is what kind of

182. *In re* Ikon Office Solutions, Inc., Sec Litig, 194 F.R.D. 166, 170–72 (E.D. Pa. 2000).
183. *Id.* at 188.
184. *Id.*
185. *See id.* at 188 ("All things considered, singling out one of many potential tax consequences seems more likely to create than alleviate confusion. Generic language stating that it is advisable to consult a tax specialist is preferable."); *accord* In re Cendant Corp. Sec. Litig., 109 F. Supp. 2d 235, 255 (D.N.J. 2000) (concluding that personal tax consequences to claimants need not be disclosed because such disclosure related to individual information), *aff'd sub nom.*, 264 F.3d 201 (3d Cir. 2001).

nonfinancial tax information registered offerings *should* disclose under the guiding principle of U.S. securities regulations-mandatory disclosure.

A. Mandatory Disclosure and the Intermediary Depiction Model

Whether issuers in registered securities offerings should be subjected to mandatory disclosure requirements is a long-lasting, voluminous debate in securities regulation literature.[186] This Article's purpose is not to add to this discussion. It is clear, however, that the mandatory disclosure theory largely guides the structure of the U.S. securities regulatory regime.[187] This Article assumes that mandatory disclosure theory is persuasive and likely to guide the U.S. securities regulatory framework for the foreseeable future.

According to this theory, mandatory disclosure is necessary to deliver the required information to support efficient markets. The result is the "intermediary depiction model" for securities regulation regime.[188] Under this regulatory model, "[a]n intermediary—for instance, a corporation issuing shares—stands between the investor and an objective reality."[189] The intermediary, *i.e.* the issuer, describes reality to investors, and regulatory efforts ensure that the depiction is complete and accurate.[190] Obviously, the completeness and accuracy of the information depicted could not possibly "entail consideration of the entire variety of economic, political, social, and other aspects of the real world that could affect the fortunes of

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186. Sharon Hannes, *Comparisons Among Firms: (When) Do They Justify Mandatory Disclosure?*, 29 J. CORP. L. 699, 700 (2004) ("The justifications for the mandatory nature of federal securities disclosure regulation have been thoroughly examined in the literature, during a long lasting debate . . . ."); Lawrence A. Cunningham, *Capital Market Theory, Mandatory Disclosure, and Price Discovery*, 51 WASH. & LEE L. REV. 843, 845 (1994) ("the proper scope of the mandatory disclosure rules has been debated almost continually since the enactment of the 1934 Act").

187. *See* Roger J. Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective,* 46 MD. L. REV. 1197, 1205–06 (1987) (highlighting the debate over mandatory disclosure and the rationale of mandatory disclosure as the "bulwark" of the regime against "securities fraud"); *see also* Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 678–82 (2002) (describing structural entry into the SEC system through the mandatory disclosure requirements of the federal securities regime).

188. Hu*, supra* note 21, at 1614–28 (2012) (describing the history of securities regulation and the rise of the intermediary depiction model).

189. *Id.* at 1608.

190. *Id.* at 1623.

a company's investors: the mandate has long centered on firm-specific matters."[191]

To examine whether mandatory disclosure theory and its primary instrument—the intermediary depiction model—actually advance market efficiency in the tax context, deconstruction of the concept of market efficiency into its main components is necessary. Generally, market efficiency is understood to have two main determinants: accurate pricing mechanisms and financial liquidity.[192] This Subpart discusses nonfinancial tax disclosures within each context.

1. Mandatory Disclosure and Accurate Pricing in the Tax Context

While disclosure could theoretically be voluntary,[193] mandatory disclosure is economically justified because it is the least costly way to disseminate the optimal level of information to the market.[194] First, mandatory disclosure reduces the cost of generating information because it is cheaper for the issuer to disclose information it holds anyway, rather than for the outside investor to unearth such information.[195] In the context of tax consequences to investors, however, the issuer does not have all the relevant tax information.[196] Much of this pertains to investors' tax attributes, which the issuer is unlikely to be able to discover. From a practical point of view, it would be extremely costly for issuers to approach all of their investors in order to obtain all the relevant tax information. This is especially true considering the frequent trading that occurs in the public market. From a legal standpoint, privacy safeguards protect most taxpayer information, which makes it impossible to acquire

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191. *Id.*; *see also* Allen Ferrel, *Mandatory Disclosure and Stock Returns: Evidence from the Over-the-Counter Market*, 36 J. Leg. Stud. 213, 213–14 (2007).

192. Goshen & Parchomovsky, *supra* note 5, at 714.

193. *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L.J. 2359, 2374–76 (1998) (discussing voluntary disclosure by firms when issuing stock and overall disclosure of "significant amounts of information beyond that mandated by securities regulators"); Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 Colum. Bus. L. Rev. 1, 5–7 (1999) (investors' disclosure demands would "govern the supply of information," i.e., "issuers in public offerings often disclose information . . . to increase investor confidence"); Mark Lang & Russell Lundholm, *Cross-Sectional Determinants of Analyst Ratings of Corporate Disclosures*, 31 J. Acct. Rsrch. 246, 269 (1993) (demonstrating that firms with higher disclosure scores had better returns, better earnings, and issued securities); *but see* Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future,* 51 Duke L.J. 1397, 1416–23 (2002) (highlighting the inadequacy of voluntary corporate disclosure before the passage of the Securities Acts).

194. *See* Goshen & Parchomovsky, *supra* note 5, at 738.

195. *Id.*

196. *See supra* Part I.B.

such information without a waiver from investors.[197] Returning to the FC and DC example, Divicorp could not reasonably be expected to know that DC can utilize a foreign tax credit to offset income it has from sources unrelated to DC's investment in Divicorp's stock.

Second, absent mandatory disclosures, it is unlikely that outside investors without inside access can discover all the relevant information, even if the outsiders are willing to pay high costs.[198] In the tax context, such an argument may or may not be relevant. Much of the important tax information is already found with the investors. For example, DC already knows it can use foreign tax credits to its benefit. In fact, DC is the only one in a position to know whether foreign tax credits are available for it to use.

Third, unless disclosure is standardized and mandatory, investors might engage in duplicative efforts to unearth the same undisclosed information. In essence, the standardized, mandatory disclosures make it easier and cheaper for investors to compare investment alternatives.[199] In the context of nonfinancial tax information, this justification is weak. Each investor is uniquely situated for tax purposes and does not need the same information. For example, DC may wish to uncover whether Divicorp's dividend distribution carries a foreign tax credit. FC, on the other hand, does not care, since it cannot use the foreign tax credit.

Fourth, mandatory disclosure serves as a collective subsidy for all investors who trade based on information.[200] This is unlikely for nonfinancial tax disclosures related to investor-level attributes because they are costly for the issuer to obtain but costless to investors, who already hold the information. The subsidy argument could theoretically apply to information that relates to issuer-level nonfinancial tax attributes (such as whether the issuer paid foreign taxes for which a foreign tax credit may be granted).

197. Multiple Code provisions protect taxpayers' information. The main underpinning of tax privacy is found in section 6103 of the IRC that protects the confidentiality of "tax returns" as well as "return information," two broadly constructed concepts. For a full description of the legal framework of tax privacy in the United States, *see generally* Joshua D. Blank, *United States National Report on Tax Privacy*, in *Tax Secrecy and Tax Transparency—The Relevance of Confidentiality in Tax Law* 1163 (Eleonor Kristoffersson et. al., eds. 2013).

198. Goshen & Parchomovsky, *supra* note 5, at 738; *see also* Hannes, *supra* note 186, at 705 (noting that "[a]nother common argument for disclosure regulation is that management has incentives to suppress unfavorable information-to withhold adverse information and to undertake preemptive buyouts of its own firm. As a result, investors will not have sufficient data concerning the market and will be unable to distinguish quality differences among traded firms).

199. *See* Hannes, *supra* note 186, at 706–07.

200. *See* Goshen & Parchomovsky, *supra* note 5, at 740.

2. Mandatory Disclosure and Liquidity in the Tax Context

Mandatory disclosure supports liquidity in the market by ensuring symmetrical access to information.[201] In the absence of mandatory disclosure, less-informed investors might lose confidence in the market because they are always at a disadvantage.[202] Asymmetrical information might make less-informed investors reluctant to trade or more likely to suggest lower bidding prices or higher asking prices for their securities. Mandatory disclosure thus allows less-informed investors a "free ride" on the market prices set by informed investors.[203]

However, a "reasonable investor" cannot rationally rely on the market interpretation of nonfinancial tax information related to investor-level tax consequences. The market's pricing of assets reflects the tax preferences of specific classes of investors, not all investors.[204] If an investor wishes to invest in a specific security, she cannot reasonably assume that her tax preferences are reflected in market prices. Thus, a reasonable investor must consider her own tax status and must not free-ride market interpretation of tax consequences. She must spend time and resources in order evaluate how taxes may affect her own particular situation. The best way to do so is probably to consult her tax advisor.[205]

B. The Partial Failure of the Intermediary Depiction Model in the Context of Nonfinancial Tax Disclosure

The discussion of nonfinancial tax disclosure above suggests that the intermediary depiction model is not always best suited to disseminate nonfinancial tax information. The intermediary depiction model requires that an issuer disclose information about itself. In the context of nonfinancial tax disclosures, much of the "material" information relates to *the investor*, in which case the issuer is not an "intermediary" standing between objective reality and the investor.

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201. Christian Leuz & Peter Wysocki, *Capital-Market Effects of Corporate Disclosures and Disclosure Regulation*, 2 Task Force to Modernize Securities Legislation in Canada: Research Studies 183, 196 (Jun. 26, 2006), *available at* http://faculty.chicagobooth.edu/christian.leuz/research/papers/Capital-Market-Effects-of-Corporate-Disclosures-and-Disclosure-Regulation.pdf (mandatory disclosure as a "commitment" tool for companies to reveal the same amount of information and mitigate informational asymmetries); Goshen & Parchomovsky, *supra* note 5, at 740.

202. *See* Goshen & Parchomovsky, *supra* note 5, at 740.

203. *Id.*

204. *See* discussion *supra* notes 117–138 and accompanying text.

205. *See supra* notes 88–92 and accompanying text.

At best, an issuing entity is in a position to assess the relevant tax provisions that may apply to a particular offering but cannot possibly assess the applicability of such provisions to any particular investor. Nonfinancial tax disclosures could potentially describe the relevant legal authorities in the abstract, but such disclosure would simply be a restatement of the tax laws. Securities law generally does not require disclosure of public knowledge.[206]

Conversely, in the case of financial tax disclosures, the issuer is an intermediary standing between relevant tax information and the investor. Whether a corporation paid foreign taxes, which would trigger foreign tax credits for domestic investors, is information for which the corporation is an intermediary. The financial tax disclosure required under the current regulatory regime would include that information.

It is also possible, however, to identify instances in which the issuer is an intermediary for nonfinancial tax disclosures as well. For example, certain foreign corporations owned by "U.S. shareholders" are classified under the IRC as "controlled foreign corporations" (CFC).[207] If a CFC earns income that is classified as "subpart F income,"[208] such income is deemed distributed to the CFC's "U.S. shareholders."[209] This means that U.S. shareholders are taxed on the dividend deemed distributed to them from the CFC, notwithstanding the fact that no actual distribution occurred. Whether income is "subpart F income" is a matter of law and depends largely on the nature of the activities of the corporation earning the income. Therefore, issuers that are CFCs probably do stand between the relevant fact—whether they earned "subpart F income"—and the investor, who would want to know whether he or she is taxed on his or her own account as a result of the corporation's activities.[210]

To summarize, the intermediary depiction model is not always suited for nonfinancial tax disclosures. It is not helpful when the

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206. *See* In re Progress Energy, Inc., 371 F. Supp. 2d 548, 552–53 (S.D.N.Y. 2005) ("It is well-established law that the securities laws do not require disclosure of information that is publicly known . . . .").

207. A CFC is a foreign corporation if more than fifty percent of its voting stock is held by "U.S. shareholders." I.R.C. § 957.

208. Subpart F income is generally income from passive sources. *See* I.R.C. § 954.

209. A "U.S. shareholder" is a United States resident holding ten percent or more of the total combined voting power of the corporation. I.R.C. § 957.

210. Practice in this regard is mixed. However, some issuers disclose the fact that they may qualify as CFCs. *See, e.g.*, Arizona Chemical Ltd., SEC Registration Statement (Form S-1), at 163 (Apr. 12, 2010) (discussing the application of CFC rules to the offering), *available at* http://www.sec.gov/Archives/edgar/data/1489057/000095012310034000/y82079sv1.htm.

tax information at issue relates to investors' individual tax attributes. It might be relevant, however, for information relating to issuers' tax attributes, which investors need to know in order to calculate their own tax liabilities. Building on this conclusion, the final Part proposes a reform to the regulatory framework controlling nonfinancial tax disclosures. The reform disposes of the "average taxpayer" construct and argues for the disclosure of nonfinancial tax items justified by mandatory disclosure theory, meaning tax information for which the intermediary depiction model makes sense.

IV. Reforming Nonfinancial Tax Disclosure Regulation

As explained above, mandatory disclosure theory may support market efficiency to the extent that the disclosure (i) describes relevant information about issuers and (ii) is similarly applicable to all investors (i.e., information is not related to investors' own individual tax position). Under current practices, however, disclosed nonfinancial tax information (i) is not always about the issuer (but sometimes about the investors) and (ii) does not apply generically to all investors (but only to "average" taxpayers). For these reasons, the regulatory regime fails.

Mandatory disclosure theory remains the guiding principle of securities regulation and underlies this Article's proposed reform. This reform aims to ensure that issuers disclose all (and only!) nonfinancial tax information that mandatory disclosure theory justifies disclosing. Using this approach, the market-created average taxpayer construct is irrelevant and nonfinancial tax disclosures are broadly applicable.

Current nonfinancial tax disclosure practice and regulation categorize all nonfinancial tax information as a single category of disclosure pertaining to tax consequences at the investor level.[211] This Part proposes drawing a clear line between two types of nonfinancial tax information: nonfinancial investor-level tax information and nonfinancial dual-level tax information. As explained below, the mandatory disclosure theory supports disclosure of only the latter.

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211. *See* discussion *supra* Part I.A.

A. Nonfinancial Investor-Level Tax Disclosures Should be Eliminated

Investor-level tax information is any information that (i) the investor rather than the issuer has and (ii) pertains to tax consequences where the value of a security depends on each investor's individual tax attributes. Mandatory disclosure theory cannot justify the disclosure of nonfinancial *investor-level* tax information.

Unfortunately, the current regulatory regime seems to require the disclosure of such information. Item 601(b)(8) of Regulation S-K mandates a disclosure, qualified by an opinion, "supporting the tax matters and consequences . . . as described in the filing when such tax matters are material."[212] Such "material" consequences may include (or depend on) investor-level tax items.[213]

As discussed in Part I, nonfinancial tax disclosures that meet the literal breadth of Item 601(b)(8) are impossible to draft as a practical matter. Moreover, the literal requirements are not practiced or enforced. Courts consistently do not impose liability on registrants who failed to accurately state investor-level tax outcomes. In addition, it seems that practitioners implicitly adopt the view that issuers should not disclose some investor-level tax items. For example, the Tax Bar takes the position that the "tax consequences of owning and selling common stock . . . are not 'material to an investor' "[214] because the tax consequences associated with such transactions are regarded as "plain vanilla" consequences.[215] By doing so, the New York State Bar Association implicitly suggests that such issuers do not need to disclose such information under the current regulatory framework, though such information is sometimes disclosed voluntarily.[216]

Information about the tax consequences of holding and selling common stock is a perfect example of an investor-level tax disclosure that mandatory disclosure theory does not support. The effects of taxable gain or capital loss associated with stock disposition strictly relate to each investor's particular position and, in most cases, do not relate to actions the issuing entity has taken.[217]

Although issuers should not disclose the tax consequences of owning and selling common stock, the reason is not that these consequences are immaterial. The cost of capital gains taxes associated with the disposition of the stock, which can be as high as twenty

212. SEC Regulation S-K, 17 C.F.R. § 229.601(b)(8).
213. *See* discussion *supra* Part I.A.
214. *See* N.Y. BAR REPORT, *supra* note 14, at 5.
215. *Id.*
216. *See supra* Part I.
217. *See* discussion *supra* notes 49–50 and accompanying text.

percent on the net gain,[218] is very material to "reasonable investors." In fact, the tax costs associated with stock disposition have been empirically proven to affect investment decisions.[219]

The diversity of practice in determining "materiality" in the context of common stock disposition confirms the confusion with respect to the materiality standard. For example, three recent major initial offerings of common stock completely diverged in their scope of the nonfinancial tax disclosure and qualifying opinion. Groupon, Inc.'s pre-IPO registration statement included a rather expansive disclosure addressing the tax consequences associated with holding and disposing of the offered stock.[220] Facebook, Inc.'s IPO disclosure, however, contained a significantly narrower disclosure, which only addressed the tax consequences to non-U.S. shareholders.[221] Finally, Google, Inc.'s registration statement did not include any nonfinancial tax disclosure addressing tax consequences associated with the ownership and disposition of its common stock.[222]

This Article argues that the tax consequences associated with stock dispositions are material. The real justification not to disclose such consequences is that the material information pertaining to tax consequences of stock dispositions is information about the investor, not the issuer. Under the same logic, it is justifiable not to disclose, for example, state tax consequences. The SEC currently approves nondisclosure of state tax consequences,[223] though it seems clear that nothing in Item 601(b)(8) exempts such information from disclosure.[224] It should not be disclosed simply because the issuer does not have such information. Only investors are in a position to appreciate which states' taxes may be relevant to their investment decisions.

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218. *See* discussion of the capital gains tax rates *supra* note 49.

219. *See* Zhonglan Dai et al., *supra* note 122, at 710, 738 (finding a "lock-in effect" and investors holding onto capital gains due to decreased supply after a reduction in the capital gains rate); *see also* Peter Klein, *The Capital Gain Lock-In Effect and Long-Horizon Return Reversal*, 59 J. Fin. Econ. 33, 57 (2001) (testing an asset pricing model where long-horizon investors will realize gains they have "locked-in" due to accrued capital gains in high tax periods during low periods at the end of a long horizon).

220. *See* Groupon Registration Statement, *supra* note 61, at 139.

221. *See* Facebook, Inc., SEC Registration Statement: *Material U.S. Federal Tax Considerations for Non-U.S. Holders of Class A Common Stock* (Form S-1), at 140 (Feb. 1, 2012), *available at* http://www.sec.gov/Archives/edgar/data/1326801/000119312512034517/d287954ds1.htm#toc287954_18.

222. *See* Google, Inc., SEC Registration Statement Class A Stock (Form S-1), (Apr. 29, 2004), available at http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm#toc.

223. *See* discussion *supra* notes 84–86 and accompanying text.

224. *Id.*

The SEC should amend Item 601(b)(8) (and any other nonfinancial tax disclosure provisions) to explicitly state that issuers are not required to disclose information relating solely to investor-level tax items.

B. Nonfinancial Dual-Level Tax Disclosures Should be Expanded

1. Dual-Level Nonfinancial Tax Disclosure Explained

Dual-level tax disclosure refers to issuer-level tax information that directly affects how investors calculate their tax liabilities and the resulting tax cost associated with the investment.[225] One example of dual-level information is whether an issuer is a CFC and, if so, whether it earned "subpart F income."[226] In order to calculate their tax liability, certain investors must know both pieces of information. If we accept mandatory disclosure theory, then the disclosure of subpart F income is justified because the issuer is best positioned to know that information. Investors, however, should figure out for themselves the effect of subpart F income to their stock value and tax liability.

It is not clear to what extent Item 601(b)(8) currently requires issuers to disclose dual-level tax consequences. The SEC has said, for example, that tax information related to "mergers or exchange transactions where the registrant represents that the transaction is tax-free (e.g., spin-offs, stock-for-stock mergers)" is "material" and thus required to be disclosed and qualified by an opinion.[227] This is logical because whether a merger qualifies for tax-free treatment is a question the issuer is best positioned to answer.

In some cases, however, the SEC does not require disclosure of dual-level nonfinancial tax items. For example, the SEC stated that "when a registrant represents that an exchange offer or merger is a

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225. Tax law, not securities regulations, occasionally requires such "dual-level" disclosure. The rationale driving such disclosures is to ensure consistency of the tax treatment between the issuer and the holder. For example, issuers of instruments with original issue discount (OID) must report the OID income tax accruals to holders of the debt instrument on IRS form 1099-OID; issuers of contingent payment debt instruments (CPDIs) are required to disclose to holders the projected payment schedule on the CPDI. Treas. Reg. § 1.1275-4(b)(4)(iv); Treas. Reg. § 1.1275-2(e). In this Article, the main focus is the securities regulation rationale although it may occasionally overlap with the tax rationale. *See* discussion *infra* notes 210–212 and accompanying text.

226. *See* discussion *infra* notes 207–209 and accompanying text.

227. SEC Legal Bulletin, *supra* note 7, at 12.

taxable transaction," the representation is not "material."[228] It follows that, under the plain language of the regulations, the issuer need not disclose the item. This approach is inconsistent with mandatory disclosure theory.[229] The fact that a transaction may be taxable is a material fact for reasonable investors across the board, regardless of the fact that the tax consequences for each investor may be different.

The SEC should rewrite Item 601(b)(8) to require disclosure of any nonfinancial tax item that (i) is an issuing entity-level tax item not already disclosed in the financial statements[230] and (ii) may affect how investors calculate their own tax liabilities, despite the fact that each investor's actual tax liability may be different.

If the SEC adopts this rule, then nonfinancial tax disclosures can be applicable to all investors, regardless of their "averageness," and the drafters can dispose of the concept of the "average taxpayer." There will be no need to exclude any investor from the scope of tax disclosure, regardless of whether an investor is subject to a unique tax regime or purchased the security in the initial offering or the secondary market. All investors, average and non-average, will find in dual-level disclosures the information that—together with their personal tax information—allows them to calculate the tax cost associated with the investment.

2. Some Examples for Dual-Level Nonfinancial Tax Disclosure

This Subsection provides examples of the types of tax information mandatory disclosure theory justifies. While the examples may appear random to the untrained eye, all relate to tax information found with the issuer that investors must know to calculate their own tax liabilities. Market practice is to disclose some, but not all, of the examples discussed below. The proposed regulatory regime calls for clearly defining dual-level tax disclosures, which should make practice consistent.

a. Whether an Issuer is a Corporation or Partnership for Tax Purposes

Under the U.S. "classical system" of corporate taxation, corporate entities are opaque for tax purposes. Taxes are imposed at the

228. *Id.*
229. *See* discussion *supra* Part IV.
230. This is to prevent duplicative disclosure of information that is required under Regulation S-X.

corporate level (and then again on the investors upon distribution of dividends or the disposition of stock). Shareholders do not bear corporate taxes directly.[231] Therefore, corporate tax expenses are part of financial statements, not nonfinancial disclosure.

Partnerships, on the other hand, are generally transparent for tax purposes. Any income the partnership earned is not taxed at the partnership level but rather "flows through" to the investor (as do most other partnership tax attributes).[232] Thus, investors must know whether the issuing entity is a corporation or is a partnership for tax purposes. For a partnership, investors should expect to report partnership earnings on their own tax returns, regardless of whether the partnership distributes anything to the investors.[233] Such disclosure is part of current practice.

b. Whether an Issuer Qualifies for a Special Tax Status

Under the IRC, if the issuing entity meets certain requirements shareholders may become subject to a unique taxation regime. For example, capital gains are normally non-taxable in the U.S. to non-U.S. residents.[234] However, if a domestic corporation's value comprises mostly of real estate located in the United States, the entity becomes a United States Real Property Holding Corporation (USRPHC).[235] Upon the disposition of stock in a USRPHC, certain foreign shareholders,[236] like U.S. residents, must pay taxes on any gain from the disposition.[237] Since an issuing entity is best positioned to know whether it owns enough U.S. real estate to qualify as a USRPHC, regulations should require issuers to disclose whether they are USRPHCs or not. Disclosure practice in this area is mixed.[238]

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231. In fact, the question of who bears the burden of corporate taxes is a highly contentious issue in academic literature.

232. *See* I.R.C. § 701.

233. Under section 7701 of the Code, a publicly traded partnership must meet certain requirements in order not to be treated as a corporation for tax purposes. Whether the issuing entity qualifies for partnership treatment would be material for any reasonable investor.

234. *See* I.R.C. §§ 865, 871.

235. *See* I.R.C. § 897(c).

236. Disposition of publicly traded stock is exempted from the scope of the rule to the extent the owner owns less than five percent of such class of publicly traded stock. I.R.C. § 897(c)(3).

237. *See* I.R.C. § 897(c).

238. In the author's experience, some issuers may offer disclosure in that respect, suggesting that they may or may not be USRPHCs for tax purposes. Other issuers simply ignore this issue.

Another example is the Passive Foreign Investment Company (PFIC). A PFIC is a foreign corporation that meets certain thresholds of passive earnings or passive assets holdings.[239] If a corporation is a PFIC, shareholders may elect to mark-to-market their holdings each year and report their taxes as if they have sold their PFIC stock.[240] Shareholders may also elect to include the PFIC's deemed earnings in their own income on an ongoing basis regardless of whether distributions were made, provided investors have enough information about corporate earnings.[241] Finally, shareholders may do nothing and then pay heavy interest on back taxes when an actual distribution occurs or the PFIC stock is disposed of.[242] An issuing entity is best positioned to know if it is a PFIC because it can assess the value of its passive-income-generating assets or the amount of its passive income. PFIC disclosure practice is mixed, and issuers often resort to noncommittal language, such as: "to the best of the issuer's knowledge" it is or is not a PFIC.[243]

The suggested regulatory regime would require issuers to clearly state whether they are PFICs and whether they will provide information to allow investors to report deemed-distributed income on an ongoing basis. Multiple other examples exist for entity classification that affects investor-level tax liabilities. Such examples include, but are not limited to, CFCs as discussed above, Real Estate Investment Trusts (REITs), and Regulated Investment Companies (RICs).

c. *Whether a Distribution Qualifies as a "Dividend" for Tax Purposes*

Whether a distribution qualifies as a dividend for tax purposes affects the investor's tax treatment. A "dividend" distribution

239. I.R.C. § 1297 (providing the basic threshold requirements for classification as a PFIC of seventy-five percent or more of the gross income is passive income and the average percentage of assets that produce passive income is at least fifty percent).

240. *Id.* § 1296.

241. *Id.* § 1293.

242. *Id.* § 1291.

243. *See* Harmony Gold Mining Company, Ltd., SEC Registration Statement: Additional Information (Form F-20), at 140 (Oct. 25, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1023514/000119312513411617/d612311d20f.htm ("We believe that we will not be a passive foreign investment company, or PFIC, for US federal income tax purposes for the current taxable year. However, we cannot assure you that we will not be considered a PFIC in the current or future years."); *see also* LiveReel Media Corp., SEC Registration Statement: Additional Information (Form F-20), at 42 (Oct. 28, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1168981/000107997413000671/lievreel20f63013.htm ("We do not believe that LiveReel has previously been, or currently are a PFIC. However, there can be no assurance that the IRS will not challenge our determination concerning our PFIC status or that we will not be a PFIC for the current or any future taxable year.").

subjects investors to a tax on dividend income.[244] A non-dividend distribution is treated as a return of capital, not taxable to the extent of the investor's basis in the security, and thereafter subject to capital gains taxes.[245] Whether a distribution qualifies as a "dividend" for tax purposes is clearly a dual-level disclosure item because only distributions made out of earnings and profits (E&P) are "dividends" for tax purposes.[246]

Significantly, whether a corporation has enough E&P to support a dividend is a determination made at the end of the tax year. Distributions to shareholders, however, are made throughout the year, before an E&P determination can be made. In certain circumstances, tax law requires a corporation making a distribution before year-end to make a "reasonable estimate" in order to determine whether a mid-year distribution constitutes a dividend.[247] This estimate is based on the "anticipated amount" of E&P,[248] which, in turn, depends on the corporation's forward-looking expectations of its business performance between the time of distribution and the end of the year. Thus, only the distributing entity can determine whether there will be enough E&P to support a dividend treatment, not the investors. Investors, however, must know if a distribution is a "dividend" in order to calculate their tax liability, so disclosure of this information should be mandatory.

d. The Expected Tax Treatment of a Structured Financial Instrument

Different types of securities are subject to different tax treatments. Debt is treated differently than equity and equity derivatives. Different types of debt tax classifications may carry different tax results. It is no wonder that issuers discuss at length in their disclosure documents whether offered debt instruments should be treated as Variable Rate Debt Instruments (VRDIs) or Contingent Payment Debt Instruments (CPDIs). In the context of equity derivatives, it is notoriously difficult to differentiate between "Reverse Convertible," "Variable Prepaid Forward Contract," "Contingent Convertible," or one of a multitude of other variations, all subject to different tax treatments.

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244. I.R.C. § 316, 301(c)(1).
245. *See id.* §§ 301(a), 301(c)(2), (c)(3).
246. *See id.* §§ 312, 316.
247. *See* Treas. Reg. § 1.1441-3(c).
248. *See id.*

While the classification of a debt instrument is not a per se issuer-level item, two main justifications support disclosing the classification. First, an instrument's classification often depends on the likely occurrence of a future event, the materialization of a specific risk, or other events unrelated to the investors.[249] The issuer who tailored the specific instrument is much better prepared to analyze the likelihood that such events may occur than any prospective investor and, consequently, to opine on the instrument's most likely tax classification.

Second, while issuers and investors are not required to agree on an instrument's tax classification,[250] inconsistent treatment creates problems for investors. For example, if an issuer classifies an instrument as debt for tax purposes, payments on the instrument are likely to be regarded as interest, creating a deductible expense to the issuer. The IRS expects the investor to report a corresponding inclusion of interest income. If the investor believes, however, that the instrument is an equity derivative, he or she may regard any payments as a nontaxable return of capital. The IRS is sure to dislike the discrepancy and may try to recharacterize the payments. An investor who argues for a specific classification of an instrument may find itself at odds with the IRS, if the issuer takes a different position.[251] Requiring issuers to disclose their intended classification of securities is therefore justified. Such disclosure is part of current practice.

249. *See* Omri Marian & Andrew Moin, *Taxation of Structured Debt in a Low Rate Environment* 135 Tax Notes 323, 324–25 (2012) (explaining how fluctuation of indices and market borrowing rates may affect the tax treatment of debt instruments).

250. As noted above, tax law occasionally requires issuers of financial instruments to disclose certain tax items in respect of the instruments to investors, in order to assure issuer and holder's consistent treatment. *See* discussion *supra* note 225.

251. C.I.R. v. Danielson, 378 F.2d 771, 777–78 (3d Cir. 1967) (holding that absent proof that negates the agreement (i.e. fraud, duress, etc.), taxpayers may not report income in a manner inconsistent with the agreement). Consequently issuers regularly insert language in nonfinancial disclosure sections binding investor to report the security in a particular way for federal income tax purposes. *See, e.g.,* Barclays PLC, SEC Preliminary Pricing Prospectus Supplement Phoenix Autocallable Notes (Form 424B1) at pps-6 (Jul. 19, 2013), *available at* http://www.sec.gov/Archives/edgar/data/312070/000110465914001599/a14-1048_15424b2.htm ("Pursuant to the terms of the Notes, Barclays Bank PLC and you agree, in the absence of a change in law or an administrative or judicial ruling to the contrary, to characterize your Notes as a contingent income-bearing derivative contract with respect to the Reference Asset.").

3. The Possibility of "Check-Listing" Dual-Level Nonfinancial Tax Disclosures

It is possible to reform the regulatory requirements using a generic definition of the items needing disclosure. As explained above, a generic approach will require the disclosure of any issuer-level nonfinancial tax information that may affect how investors calculate their own tax liabilities (namely, "dual-level tax items"). It is not inconceivable, however, to generate a checklist covering all tax items meeting such qualifications. A taskforce could be formed to survey the tax code and create a list of all dual-level items in order to standardize nonfinancial tax disclosures and create a "check-the-box" SEC form. Various disclosure events probably need specific checklists. For example, a different checklist would apply to a proxy solicitation in the context of a merger than would apply to IPOs or periodic disclosures.

The following example illustrates how a checklist might work. In its annual report to shareholders, an issuer must answer "yes" or "no" to whether it is a CFC at the time of the report. If "yes," then the issuer will have to report the amount of Subpart F income for the period:

> **Item [x]**: Is the registrant a controlled foreign corporation (CFC) within the meaning of Section 957 of the Internal Revenue Code? □ Yes; □ No.
>
> **Item [x](i)**: If the registrant is a CFC, enter the amount of Subpart F income as defined in Section 952 of the Internal Revenue Code, for the reported period: $_______

While the task of generating such checklists may seem daunting, the end result would be clear and concise nonfinancial tax disclosures, useful to all investors. Regulators, academics, and the tax bar should consider mounting such an effort.

4. Dual-Level Nonfinancial Tax Disclosure is Beneficial Compared to the Current Regime

Finally, the proposed regime is likely to be far more effective and efficient than the current state of affairs. This benefit is important because SEC rulemaking requires an extensive cost-benefit analysis before adopting a regulatory change.[252] It is beyond this Article's scope to analyze the costs and benefits of the proposed dual-level tax disclosure regime, although the analysis likely will support the proposal's adoption.

Generally speaking, the SEC analyzes four factors during the rulemaking process. First, it must identify "the need for the rulemaking and [explain] how the proposed rule will meet that need."[253] This Article identified the need to revise current nonfinancial tax disclosures. It explained how current disclosures fail to achieve the perceived purposes of the U.S. securities regulation regime.[254] The Article also explained how dual-level tax disclosure would support the regulatory rationale.[255]

Second, a cost-benefit analysis requires the SEC to articulate the "economic baseline against which to measure the proposed rule's likely economic impact (in terms of potential benefits and costs, including effects on efficiency, competition, and capital formation in the market(s) the rule would affect)."[256] The proposal assumes that the baseline is the current regime, which does not effectively promote market efficiency.[257]

The third requirement is to clearly identify and evaluate "reasonable alternatives to the proposed regulatory approach."[258] This Article identified two alternatives: a generic rule requiring dual-level nonfinancial tax disclosures and more detailed "check-listing" of dual-level tax disclosures. The development of the checklist alternative is beyond this Article's scope.

Lastly, the heart of the rulemaking process is comparing the costs and benefits of the proposed alternatives against the baseline.[259] Part I outlined the costs of the current regime.[260] Both the generic alternative and the "checklist" alternative of dual-level tax disclosures will probably fare better than the current regime when comparing costs and benefits.

In terms of the benefits, dual-level tax disclosures should enhance disclosure of tax information that is relevant for efficient

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252. *See generally* SEC Staff of the Rulewriting Divisions and Offices, Memorandum on Current Guidance on Economic Analysis in SEC Rulemaking (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf [hereinafter Rulewriting Memorandum].

253. *Id.* at 1.

254. *See* discussion *supra* Part I.

255. *See* discussion *supra* Part IV.B.

256. Rulewriting Memorandum, *supra* note 252, at 1.

257. *See* discussion *infra* Part I.D.

258. *See* Rulewriting Memorandum, *supra* note 252, at 1.

259. *Id.* at 1–3.

260. *See* discussion *supra* Part I.D.

markets and eliminate the disclosure of irrelevant information. All investors should find dual-level nonfinancial tax information relevant (as opposed to very few investors under current regime).

In terms of costs, dual-level tax disclosures should reduce costs for investors, issuers, and the SEC. Investors will have access to previously undisclosed information, and therefore information-gathering costs are expected to decrease. Issuers will not be required to generate any new information because they already hold all the dual-level tax information. On the other hand, the regulation would not require issuers to disclose information they do not have (namely, investor-level tax information). Under the checklist method, disclosure will be particularly cost-effective to issuers, as a "check-the-box" type form will replace the current lengthy tax narratives. The SEC should also find that its costs in enforcing nonfinancial tax disclosure rules shrink as the framework of required dual-level tax disclosures becomes clearer. The only significant new cost would be a onetime outlay to generate the proposed checklist, a cost that a better disclosure regime should outweigh.

CONCLUSION: CONSULT YOUR OWN TAX ADVISOR

Nonfinancial tax disclosure regulation aims to ensure that "reasonable investors" receive all the "material" information related to the investors' tax consequences from a registered securities investment. This regulatory regime reflects the widespread acceptance of the efficient capital markets hypothesis and the mandatory disclosure framework it supports.

This Article argued that even if we accept the current regulatory rationale without reservation, the regulatory framework does not support the rationale. Specifically, investors in publicly-traded securities have varying tax preferences, even if all are "reasonable investors." Thus, drafting nonfinancial tax disclosures to address all the tax effects that a reasonable investor may deem material becomes impractical.

The market, in response to this practical difficulty, drafts nonfinancial tax disclosures for the benefit of a "reasonable investor" who is also an "average taxpayer." This Article showed that the concept of the average taxpayer is indefensible. No "average" taxpayer exists because tax laws, by definition, create rules of particular applicability to each taxpayer. Moreover, financial literature reveals that the tax preferences that actually make a difference in capital market operations are the preferences of taxpayers who are not classified as "average." The result is that current nonfinancial tax disclosures describe tax consequences that are largely irrelevant to the regulatory rationale.

The Article also showed that the regulatory framework fails to account for the special nature of tax information required to determine investors' tax consequences. Mandatory disclosure theory calls for the disclosure, by issuers, of information about themselves. However, much of the information that determines a securities investment's tax outcome is about the investors, which the investors alone already know. This Article, therefore, advocates reforming the regulatory framework to require disclosure only of nonfinancial tax information about the issuers that investors may need to calculate their own tax liabilities. The disclosure could be formatted as a checklist.

In all likelihood, even assuming market participants' best intentions, issuers cannot be expected to disclose all material nonfinancial tax information to investors with heterogeneous tax preferences. To the extent relevant information relates to investor-level tax consequences, seeking personal tax advice is the only prudent course of action. This Article ends, therefore, with generic advice to all investors in publicly-traded securities: consult your own tax advisor. It is the best piece of advice issuers regularly include in tax disclosures. Follow it.