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CORPORATE TAXATION AND CORPORATE SOCIAL RESPONSIBILITY

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> *"The imposition of taxes and the expenditure of tax proceeds are governmental functions . . . . The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interests of his principal. This justification disappears when the corporate executive imposes taxes and spends the proceeds for 'social' purposes."*[1]

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1. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 122–26.

Introduction

This Article will address the question of whether publicly traded U.S. corporations owe a duty to their shareholders to minimize their corporate tax burden through any legal means, or if instead, strategic behaviors like aggressive tax-motivated transactions are inconsistent with corporate social responsibility ("CSR"). I believe the latter holds true, regardless of one's view of the corporation. Under the "artificial entity" view, such behavior undermines the constitutive relationship between the corporation and the state. Under the "real view," such behavior runs contrary to the normal obligation of citizens to comply with the law (even absent effective enforcement). And under the "aggregate view," such behavior differs from other more-acceptable forms of shareholder profit-maximization, in that it weakens the ability of the state to carry out those functions that the corporation is barred from pursuing. To contextualize and exemplify this analysis, I present a case study of profit-shifting at Caterpillar Inc. ("CAT").

By "aggressive" or "strategic" tax strategies and behavior, I mean transactions that are not motivated by a valid business purpose, even if a corporation dresses them up as such and believes it might survive potential litigation. Until the early 1990s, most large U.S. corporations did not engage in aggressive strategies designed primarily to reduce their U.S. tax obligations.[2] Instead, in my experience—as a tax lawyer in the late 1980s and early 1990s—corporations engaged tax counsel to advise them on the most tax-efficient structure of a deal that was motivated by valid business purposes.

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2. *U.S. Tax Shelter Industry: Role of Accountants, Lawyers, and Financial Professionals: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 108th Cong. 10 (2003) (statement of Sen. Frank Lautenberg), *available at* http://www.access.gpo.gov/congress/senate/pdf/108hrg/91043.pdf [hereinafter *2003 Tax Hearings*].

This situation changed in the past twenty-five years. Starting in the late 1980s, accounting firms and other promoters started selling sophisticated tax shelters to large corporate clients. These shelters were not motivated by business considerations. They were driven by tax and dressed up to appear as a valid business deal. The first major litigated case involving such a shelter was *ACM*—a partnership between Merrill Lynch (the promoter), Colgate, and a Dutch bank—designed to create an artificial capital loss.[3] In the period between 1990 and 2004, such corporate tax shelters designed by outside promoters were adopted by most large U.S. corporations. Ultimately, hearings before the U.S. Senate Permanent Subcommittee on Investigations in 2003 exposed the scope of the corporate tax shelter phenomenon.[4] This in turn led to changes in the tax law (including codification of the economic substance doctrine), changes in the ways accountants and lawyers are regulated, new disclosure rules, and a series of Internal Revenue Service (IRS) court victories which seem to have eliminated corporate tax sheltering for the time being.

The underlying problem persists. The prevailing attitude among large U.S. corporations currently seems to be that aggressive tax planning that is not motivated by business purposes is justified because of competitiveness considerations—"everyone does it, especially our foreign competitors"—and because it enhances shareholder value. Paying taxes is seen a cost that reduces corporate profits, and this negatively impacts the value of the shares.

Therefore, in the end, I believe that the only solution is to change the *attitude* of major U.S. multinationals back to where it was at the time of the Tax Reform Act of 1986. Back then, a tax director of a major U.S. multinational would typically reject aggressive tax-motivated transactions as inconsistent with CSR. I will show that today's permissive attitude towards tax-motivated transactions is unsustainable under any view of the corporation.

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3. ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189 (1997), *aff'd in part, rev'd in part*, 157 F.3d 231 (3d Cir. 1998).

4. *2003 Tax Hearings*, *supra* note 2, at 1–2.

I.
The Caterpillar Profit-Shifting Case Study

To render the subsequent discussion more concrete, Part I reprints a case study about corporate tax aggressiveness that I presented in my Senate testimony in the spring of 2014.[5]

Caterpillar, Inc. is "the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines and diesel-electric locomotives."[6] It was founded in 1925.[7] A major reason for Caterpillar's success has been its ability to service the equipment that it sells worldwide. Caterpillar promises to deliver any replacement part anywhere in the world within 24 hours from when a customer requests it. This puts Caterpillar far ahead of its competitors and generates much of its profit this way.[8] While Caterpillar's profit margin on selling equipment is typically below

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5. Although edited for this Article, the text of Part I *is* my Senate testimony, and its citations mostly mirror the citations included there (*vel non*), which involve many sources not available to the *Journal* staff or the public (such as files I read in, but was not allowed to remove from, the Permanent Subcommittee on Investigations' offices). *See Caterpillar Offshore Tax Strategy: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong. 1–6 (2014) (statement of Reuven S. Avi-Yonah, Professor of Law, University of Michigan Law School), *available at* http://www.hsgac.senate.gov/subcommittees/investigations/hearings/caterpillars-offshore-tax-strategy (scroll down and click the "Download Testimony" link under the "Reuven S. Avi-Yonah" heading) [hereinafter *Avi-Yonah PSI Testimony*].

6. *Caterpillar*, Caterpillar, http://www.caterpillar.com (last visited Oct. 5, 2014).

7. *History*, Caterpillar, http://www.caterpillar.com/en/company/history.html (last visited Oct. 5, 2014).

8. *See also Avi-Yonah PSI Testimony*, *supra* note 5, at 1 n.3 ("'Caterpillar Logistics Services, Inc. (Cat Logistics) has leveraged its relationship with parent company Caterpillar Inc. in developing true global supply chain management capabilities. Cat Logistics has grown to be the sixth largest North American based 3PL with $1.1 billion in net revenues in 2003. It has been attracting significant external business; Caterpillar, Inc. now accounts for approximately 50% of the Cat Logistics revenues. Plans are to grow external business at a compound annual growth rate of 26% over the next five years' (citation omitted). According to an internal CAT email from 2007, machines can consume profitable replacement parts for up to 20 years, and there was little or no competition for such parts.").

10%, its profit margin on parts is typically over 50%.[9] In one year, 80% of Caterpillar's profits derived from parts sales.[10]

Caterpillar's business model is based on a network of independent dealers, some of whom have been selling the company's products for over sixty years. Currently, there are 178 dealers worldwide—forty-eight outside the U.S.—and they employ 162,000 people. Caterpillar's dealer network is tightly controlled from the U.S., and the company has recently announced that it will centralize its supervision of the dealer network even more than before.

Before 1999, Caterpillar's purchased finished-parts business was run primarily from Morton, Illinois, where the company maintains its main parts warehouse.[11] Whether a part was manufactured in the U.S. or overseas, it would be shipped to Morton, and from Morton, it would be shipped either directly to a customer or to a dealer.[12] Caterpillar owned the parts in the Morton warehouse. This business model enabled Caterpillar to control the flow of parts and ensure that its promise of delivering parts to customers within 24 hours would be kept.

In September 1998, PricewaterhouseCoopers ("PwC"), Caterpillar's auditor, presented a plan to Caterpillar management that was explicitly designed to reduce Caterpillar's U.S. effective tax rate. The first recommendation in the PwC plan was to restructure the parts business.[13] Under the pre-1999 structure, any profit that Caterpillar made from selling parts

9. *Id.* at 2 n.4. ("According to a PwC study from October 1999, Caterpillar's return on sales on 'prime,' or equipment, was 2%, while its return on purchased finished parts was 21%.")

10. *Caterpillar Offshore Tax Strategy: Hearing Before the Permanent Subcomm. on Investigations, S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong. 25 (2014) (Majority Staff Rep.) [hereinafter *Majority Staff Rep.*].

11. In 1999, 83% of Caterpillar's worldwide parts were exported from the U.S. *Id.* at 46.

12. *Caterpillar Offshore Tax Strategy: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong. 3–4 (2014) (statement of John P. Steines, Jr., Professor of Law, New York University School of Law), *available at* http://www.hsgac.senate.gov/download/?id=0a8110f0-0a75-4eaf-9f72-531f23100359 [hereinafter *Steines PSI Testimony*].

13. *Majority Staff Rep.*, *supra* note 10, at 2. ("Caterpillar paid over $55 million to PricewaterhouseCoopers (PWC) . . . to develop and implement the Swiss tax strategy, which was designed explicitly to reduce the company's taxes.") (internal citation omitted).

directly to customers in the U.S. or overseas was taxed by the U.S. Moreover, any profit that Caterpillar's foreign subsidiaries made on selling parts they acquired from Caterpillar to their customers was also taxed by the U.S. because it was "Subpart F income" and therefore resulted in a deemed dividend to Caterpillar under Internal Revenue Code (IRC) §§ 951–60. About 85% of the total profits were earned directly by Caterpillar, while the other 15% were Subpart F income.

PwC proposed to set up a Swiss entity, Caterpillar Sarl ("CSARL"), which would be treated as a corporation for Swiss tax purposes, but as a partnership for U.S. tax purposes. This was possible under the newly adopted "check the box" regime for classifying foreign entities for U.S. tax purposes. The partners in CSARL were two Swiss subsidiaries of Caterpillar. CSARL would then assume ownership of the parts in the Morton warehouse. If those parts were intended for the U.S. market, CSARL would sell them to Caterpillar at no profit, and Caterpillar would resell them and report the profits on its U.S. tax return like it did before 1999. However, if the parts were intended for customers overseas, CSARL would sell them to independent dealers, which would resell to the non-U.S. customers, with the bulk of the profit going to CSARL.

The purpose of this structure was to avoid paying U.S. tax on the profits from the sale of parts to non-U.S. customers by eliminating Caterpillar from the supply chain. CSARL would purchase the parts directly from suppliers and then sell them directly to the independent dealers overseas; ownership would never pass through Caterpillar. Accordingly, Caterpillar would avoid Subpart F because the subpart does not apply to sales by CSARL to unrelated parties outside Switzerland unless the parts are acquired from a related party (i.e., Caterpillar).

Despite this drastic change in tax liability, no elements of the physical process changed. The parts were still shipped by the suppliers to Morton, and shipped by Caterpillar from Morton to the independent dealers, without any involvement by CSARL.[14] Caterpillar still ran the logistics business as it had

14. According to Craig Barley, a senior CAT manager, in the early 2000s 85% of CAT's worldwide parts inventory was managed from Morton. The aim, however, was to increase the inventory managed from Morton to 100%. *Majority Staff Rep.*, *supra* note 10, at 33 n.163. A February 2012 memo to the board described the "as is" parts business as worldwide suppliers shipping

before, except that it now did so as an agent for CSARL—the owner of the parts destined for foreign markets. CSARL had no warehouse or inventory management system, and the parts business remained "U.S. centric."[15] Moreover, there was no physical distinction at Morton between parts destined for the U.S. market (and therefore sold to Caterpillar at zero profit) and parts destined overseas. All the parts were inventoried by Caterpillar as before, except that a "virtual inventory" was created to track (for tax purposes) whether any given part was owned by Caterpillar or by CSARL at any given moment.[16] Moreover, if a part intended for the U.S. or overseas was missing, Caterpillar would "borrow" the part from CSARL, or vice versa, and restore it later as new parts came in (of course, without affecting the physical movement of any part).[17] Currently, nearly 70% of the purchased finished parts that Caterpillar sells overseas come from the U.S., and the parts business continues to be led and managed from the U.S.[18]

From 2000 to 2012, this "business restructuring" enabled Caterpillar to shift over $8 billion from the U.S. to Switzerland without affecting the actual way in which the parts business was run.[19] In fact, it was important to Caterpillar not to change the successful business model of its parts and parts-delivery busi-

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parts to the "master distribution center" in Morton, from which they were shipped to distributors both in the U.S. and overseas. The memo discussed future plans to open more warehouses overseas (e.g., in Dubai) to reduce the shipping costs of this U.S.-centric structure. *Id.* at 33 & n.167.

15. *Majority Staff Rep.*, *supra* note 10, at 2. For example, the entire inventory in the Grimbergen facility in Belgium was controlled from Morton, about 5,000 of 8,000 employees involved in the parts business were in the U.S., and 10 of 19 parts warehouses were in North America. *Id.* CSARL has approximately 400 employees, *Steines PSI Testimony*, *supra* note 12, at 4, which is less than 1 percent of Caterpillar's global workforce. *Majority Staff Rep.*, *supra* note 10, at 56.

16. *Id.* at 58. Physically, the parts were indistinguishable and were kept in the "same bin." *Id.* (quoting Deposition of Robin Beran at 58, Schlicksup v. Caterpillar, Inc., 2011 WL 4007670 (C.D. Ill. 2011)).

17. Over time, CSARL also acquired parts from Caterpillar facilities in France and Belgium, which were shipped directly from these facilities to CSARL's customers. The French and Belgian suppliers were reimbursed on a contract-manufacturing basis. So once again, the bulk of the profit was allocated to CSARL as the "entrepreneur" in this transaction. *Majority Staff Rep.*, *supra* note 10, at 51.

18. *Id.* at 2.

19. *Majority Staff Rep*, *supra* note 10 at 16.

ness, and therefore the tax department reimbursed the parts and parts delivery segments of Caterpillar for any added costs resulting from the restructuring.[20] By doing so, the "accountable profits" of each segment of the business remained at pre-restructuring levels, which was crucial to achieving cooperation, since accountable profits formed the basis for setting compensation levels.[21] With regard to staffing, almost no senior Caterpillar personnel who were involved specifically in the parts business and had decision-making authority moved to CSARL when it took over as nominal owner of all the parts in Morton.[22]

In order to defend Caterpillar's restructuring from a potential transfer-pricing challenge by the IRS, PwC calculated a royalty rate of 15% (later reduced to the range of 4–6%) to be paid by CSARL to Caterpillar to compensate it for any value inherent in its contribution to CSARL's parts-related profits.[23] The royalty rate was based on a comparability study performed by PwC.[24] The result was to shift 85% of the total parts business profit from the U.S. (30.5% effective tax rate on Caterpillar) to Switzerland (4–6% effective tax rate on CSARL).[25] The total tax benefit to Caterpillar from this shift over the period from 2000 to 2012 was approximately $2.4 billion.[26]

The IRS never challenged this transaction, perhaps because they did not have access to all the relevant information at the time. Would this transaction have passed muster? In my opinion, the answer is no, because it does not have economic substance. The economic substance doctrine was a well-estab-

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20. *Steines PSI Testimony*, *supra* note 12, at 4.

21. *See Majority Staff Rep.*, *supra* note 10, at 92.

22. *See id.* at 78 & n.440.

23. *Steines PSI Testimony*, *supra* note 12, at 5.

24. *See* CATERPILLAR FISCAL YEAR 2000 U.S. TRANSFER PRICING DOCUMENTATION REPORT II-27-II-33, PRICEWATERHOUSECOOPERS (2001); *see also Majority Staff Rep.*, *supra* note 10, at 80 & nn.484–85. The fixed royalty rate assumes that Caterpillar did not transfer any intangibles to CSARL and therefore was not subject to the "super royalty" rule of IRC § 367(d) and 482 (which would require an adjustable royalty commensurate with the income attributable to a transferred intangible unless a cost-sharing agreement was in effect). *Majority Staff Rep.*, *supra* note 10, at 5 (discussing lack of a super royalty), 12 (discussing effect of IRC § 367(d)).

25. *Majority Staff Rep.*, *supra* note 10, at 80–81 (indicating the income shift and the effective Swiss tax rate).

26. *Id.* at 41.

lished part of tax law long before it was codified as IRC § 7701(o) in 2010. The courts determined that in order for a transaction to be respected for tax purposes, it must satisfy either or both prongs of the economic substance test, which are: (a) the subjective prong, i.e., that the taxpayer or its agents believe that the transaction has a valid non-tax business purpose, and (b) the objective prong, i.e., that the transaction has a reasonable possibility of generating a profit regardless of the tax consequences. Under the doctrine's codified version, a transaction must satisfy *both* prongs.

The IRS could argue that the Caterpillar restructuring fails to meet either prong. On the subjective prong, the PwC documentation from 1998 onward makes clear that the main purpose of the restructuring was to reduce Caterpillar's effective tax rate by removing the parent company from the parts supply chain, thereby avoiding Subpart F deemed dividends and achieving deferral for CSARL's profits.[27] Moreover, a senior Caterpillar executive was asked under oath whether "there [was] any business advantage to CAT to have this arrangement put in place other than the avoidance or deferral of income taxation at a higher rate," and he answered in the negative.[28]

On the objective prong, while CSARL's parts business is very profitable, it is hard to see what the non-tax reason could be for changing the structure from sales by Caterpillar to sales by CSARL. The entire restructuring was done so as not to change the business model of the parts business. No significant employees were moved to CSARL, the parts continued to be shipped to and from Morton by Caterpillar, and the physical parts were indistinguishable. Moreover, although the actual inventory remained in Caterpillar, steps were taken to separate the ownership for tax purposes under the "virtual inventory." Even after factoring in that overtime, CSARL assumed ownership of more parts that were not shipped through the U.S., but it is still hard to see what was and is the business

27. *Majority Staff Rep.*, *supra* note 10, at 43; *see also, e.g.*, CATERPILLAR INC., GLOBAL TAX OPTIMIZATION CASE FOR ACTION, PRICEWATERHOUSECOOPERS (1998); CATERPILLAR INC., GLOBAL TAX OPTIMIZATION RISK ADJUSTED BENEFIT ANALYSIS, PRICEWATERHOUSECOOPERS (1998); DELIVERING VISION 2020, CATERPILLAR (2009) (explaining the tax advantage of the restructuring).

28. *See Majority Staff Rep.*, *supra* note 10, at 72 (citation omitted).

purpose of CSARL nominally owning the parts shipped via Morton, including the parts it sells at cost to Caterpillar.

Caterpillar's ex post changes do little to strengthen an argument that the restructuring had economic substance. Ten years after the restructuring, Caterpillar tried to bolster CSARL against a potential IRS challenge by moving some employees (including a "Worldwide Parts Manager") to Geneva to "provide[ ] further [entrepreneurial] substance to preserve annual parts benefit of $300m."[29] The delay and small scope of these late efforts, coming ten years after the restructuring, only reinforce the sense that the original transaction lacked economic substance, especially since the parts business continued to be managed from the U.S.[30]

Caterpillar could attempt to rebut an IRS challenge by relying on the *United Parcel Service of America, Inc. v. Commissioner,* an 11th Circuit decision from 2001.[31] In *UPS*, the taxpayer transferred its lucrative package insurance business to an unrelated insurer, which then reinsured it with the taxpayer's affiliate in Bermuda. The net result was to shift the profits of the business—which were very high, since UPS almost never loses packages—from the U.S. to Bermuda. The Court of Appeals acceptance of the taxpayer's argument that the underlying business was profitable satisfied the objective prong, without regard to whether the transfer was motivated by anything other than tax considerations. But *UPS* is distinguishable both because of the intervening unrelated insurer and because there was nothing left in the U.S. Those two facts stand in contrast with the Caterpillar restructuring, where CSARL remained heavily involved in the U.S., and the Caterpillar and CSARL parts businesses were completely intermingled after the transaction.

In addition, it is far from clear whether *UPS* remains good law. There have been many economic substance cases since then which took a broader view of the doctrine. In particular, recent cases indicate that a taxpayer cannot imbue a tax-driven

29. *Id.* at 77–78. *See also id.* at 39.

30. *Steines PSI Testimony*, *supra* note 12, at 5 ("[M]uch of the purchasing and logistical functions relating to outbound PFRP continued after the restructuring to be carried out by Caterpillar personnel located in the United States.").

31. 254 F.3d 1014 (11th Cir. 2001).

transaction with economic substance merely by using profitable investments as part of it, because the key question is whether these profits would have been earned without the transaction.[32] This clearly would have occurred in Caterpillar's case.

Thus, in my opinion, the IRS would have had a strong case to challenge Caterpillar's original restructuring on economic substance grounds. However, the IRS did not do so, and the relevant tax years are now closed and protected from further audit. Thus, Caterpillar succeeded in its tax strategy. The question thus becomes: should Caterpillar have done this in the first place? Put differently, does the tax strategy's ex post success justify its ex ante implementation? No, and to see why, we need to address the knotty problem of corporate taxation and CSR.

II.
Taxation and Corporate Social Responsibility

Should Corporations Pay Tax? The usual understanding of this question relates to the debate on whether there should be a corporate tax. Many observers have recently criticized the corporate tax and some have defended it, but that is not the focus of this article.[33] Instead, I will assume that the state wants to tax corporations, for whatever reason (a safe assumption, at least in the short- to medium-run). Given this assumption, I will address whether corporations should cooperate and pay the corporate tax or, instead, engage in "strategic" tax behavior designed to minimize or eliminate their corporate tax burdens.

The answer to this question is related to the voluminous debate around CSR.[34] From the perspective of the corpora-

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32. *E.g.*, Salem Fin. Inc. v. United States, 112 Fed. Cl. 543 (2013); Bank of N.Y. Mellon Corp. v. Comm'r, 140 T.C. 15 (2013).

33. For my view on this debate, as well as a review of the extensive literature, *see* Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 Va. L. Rev. 1193 (2004).

34. For a review of this debate, *see* Reuven S. Avi-Yonah, *The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility*, 30 Del. J. Corp. L. 767 (2005). For previous literature, *see, e.g.*, Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 Bus. Ethics Q. 235 (2002); *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and*

tion, if engaging in CSR is a legitimate corporate function, then corporations can also be expected to pay taxes to bolster society as part of their assumption of CSR. If, on the other hand, CSR is illegitimate, there is a question whether corporations should try to minimize their tax payments as part of avoiding CSR and maximizing the profits of their shareholders.

The answer to the question of whether corporations should try to minimize their tax payments by any legally permissible means thus depends on our view of CSR. That view, in turn, depends on our view of the corporation. Historically, three views of the corporation have emerged and rotated in cyclical fashion. The first is the view that the corporation is primarily a creature of the state (the "artificial entity" view). The second is that the corporation is an entity separate from both the state and its shareholders (the "real entity" view). The third is that the corporation is merely an aggregate of its individual members or shareholders (the "aggregate" or "nexus-of-contracts" view).[35] Each of these three views has different implications for the issue of tax and CSR.

Under the artificial entity view, the corporation owes its existence to the state and is granted certain privileges in order to be able to fulfill functions that the state would like to achieve.[36] Thus, engaging in some forms of CSR is part of the

Ownership Structure, 3 J. FIN. ECON. 305 (1976). For different perspectives on CSR in general, *see, e.g.*, William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261 (1992); Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1 (2004); Michael J. Phillips, *Reappraising the Real Entity Theory of the Corporation*, 21 FLA. ST. U. L. REV. 1061 (1994); C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-first Century*, 51 U. KAN. L. REV. 77 (2002); Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705 (2002).

35. There has also been considerable philosophical debate on the corporation as a moral person. *See, e.g.*, MICHAEL E. BRATMAN, FACES OF INTENTION (Ernest Sosa et al. eds., 1999); MARGARET GILBERT, JOINT COMMITMENT: HOW WE MAKE THE SOCIAL WORLD (2014); Peter French, *The Corporation as a Moral Person*, 16 AM. PHIL. Q. 207 (1979); Christian List & Philip Pettit, *Group Agency: The Possibility, Design, and Status of Corporate Agents*, 122 ETHICS 608 (2012).

36. *See generally supra* note 35.

corporation's mission, and paying corporate tax is one way of fulfilling the corporation's CSR obligations.

Under the real entity view, the corporation is similar to an individual citizen in its rights and obligations. Just like an individual citizen does not have a legal requirement to aid her fellow citizens but is praised if she does so, the corporation may not be required to engage in CSR, but corporate management should be encouraged if they do so. As for taxes, just like an individual citizen, a corporation is legally required to pay taxes and is expected to not engage in over-aggressive tax planning in an attempt to minimize its tax obligations.[37]

The most interesting debate is under the aggregate or nexus-of-contracts view of the corporation, which is the dominant view among contemporary corporate scholars.[38] Under this view, CSR would be an illegitimate attempt by managers to tax shareholders without their consent, and lead to managers being unaccountable to the shareholders that elected them. If so, management arguably has a responsibility to maximize shareholder profits by minimizing corporate taxes as much as possible.

This view, when taken to extremes, is misguided. If corporations are not permitted to engage in CSR, then all social responsibility functions devolve onto the state. Both taxing and spending become, to use Milton Friedman's language, purely governmental functions. But if corporate managers are re-

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37. *See generally supra* note 35.

38. *See, e.g.*, Kenneth J. Arrow, *Social Responsibility and Economic Efficiency*, 21 Pub. Policy 303, 303–07 (1973); Friedrich A. Hayek, *The Corporation in a Democratic Society: In Whose Interest Ought It and Will It Be Run?*, *in* Management in the Corporation: 1985 99 (Melvin Anshen & George L. Bach eds., 1960); Friedman, *supra* note 1. The classic case affirming this "shareholder primacy" doctrine is Dodge v. Ford Motor Co., 170 N.W. 668, 684 (1919). The shareholder primacy doctrine has become a mainstay of modern corporate law. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439, 441, 449–51 (2001) (shareholder primacy likely to dominate future development of corporate law); Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 12 (1991) (stating that shareholders, as residual claimants, have implicitly contracted for promise that firm will maximize profits in long run); Henry G. Manne & Henry C. Wallich, The Modern Corporation and Social Responsibility (1972) (noting that social responsibility of corporations is shareholder wealth maximizing); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 Harv. L. Rev. 1911 (1996) (arguing that principal goal of corporate law is to maximize shareholder wealth).

quired to minimize tax payments as much as possible, that could mean that the state is left without adequate resources to fulfill its governmental function. Thus, the aggregate view of the corporation, taken to its logical extreme, is self-defeating, because it could mean that neither corporations nor the government can fulfill their responsibilities to society. That is not an acceptable outcome.

III.
The Three Views of the Corporation: A Historical Perspective

Historically, the corporation evolved from its origins in Roman law in a series of four major transformations. First, the concept of the corporation as a separate legal person from its owners or members developed; this was only completed with the work of the civil law commentators in the fourteenth century. By the end of the Middle Ages, the membership corporation—i.e., a corporation with several members who chose others to succeed them, legal personality (the capacity to own property, sue and be sued, and even bear criminal responsibility), and unlimited life—was well established in both civil and common law jurisdictions. The next important step was the shift from nonprofit membership corporations to for-profit business corporations, which took place in England and the U.S. in the eighteenth and nineteenth centuries. The third transformation was the shift from closely-held corporations to corporations whose shares are widely held and publicly traded, as well as the rise of limited liability and freedom to incorporate, which took place by the end of the nineteenth century and the beginning of the twentieth. Finally, the last major transformation was from corporations doing business in one country to multinational enterprises whose operations span the globe. That began after World War II and is still going on today.

Each of these four transformations (as well as a smaller, more temporary one which occurred in the U.S. in the 1980s with the advent of hostile takeovers) was accompanied by changes in the legal conception of the corporation. What is remarkable, however, is that throughout all of these changes spanning two millennia, the same three theories of the corporation can be discerned. Recall that those theories are the aggregate theory, which views the corporation as an aggregate of its members or shareholders; the artificial entity theory, which views the corporation as a creature of the state; and the real entity theory, which views the corporation as neither the sum of its owners nor an extension of the state, but as a separate entity controlled by its managers.[39]

Each of these theories has different implications for the legitimacy of CSR, as indicated in the following table:

TABLE 1: THEORIES OF THE CORPORATION AND CSR

	Theory	Aggregate	Artificial	Real
Type of CSR	For long-run benefit of shareholders	Yes	Yes	Yes
	Not for shareholders	No	Yes	Yes
	Not for shareholders, corporations not responsible	No	No	Yes

The first type of CSR involves activities that can clearly and demonstrably benefit shareholders in the long run. For example, actions that prevent environmental disasters or comply with legal and ethical rules can have a significant positive effect in preventing disastrous corporate calamities, even if they are costly in the short run. Thus, even proponents of the aggregate theory—the currently dominant theory of the corporation in academic circles—would support this type of CSR.

The second type of CSR involves activities that are designed to mitigate social harms the corporation was responsible for, even when there is no direct legal responsibility and no demonstrable benefit to the shareholders. Under the aggregate theory, such activities should not be permitted because they do not benefit shareholders. But the artificial entity theory, since it emphasizes the benefits of corporate existence derived from the state, infers an implicit contract that the corporation will help the state in mitigating harms that it causes, even in the absence of legal responsibility. Otherwise, the state will have to bear this burden imposed by the corporation it created.

Finally, the third type of CSR involves activities like AIDS prevention, for which the corporation is not responsible and which in most cases do not directly benefit (most of) its share-

39. These three theories are the standard ones in the literature. For a full exposition of these developments, *see* Avi-Yonah, *Cyclical Transformations*, *supra* note 34, at 771.

holders, even in the long run. This type of CSR would not be permitted under the aggregate or artificial entity theories. But under the real entity theory, since the corporation is regarded as a person, it is permitted to act philanthropically just like individuals would, and should in fact be praised to the extent it does so.[40] Thus, under the real theory, even CSR activities that have nothing to do with benefiting shareholders or direct corporate responsibility are permitted.

The aggregate or nexus-of-contracts theory has been dominant in U.S. academic circles in recent years,[41] but less so elsewhere.[42] A comparative perspective explains why. Political economists distinguish among three types of advanced capitalist societies. Under the "varieties of capitalism" framework, economies can be differentiated by their comparative institutional advantages.[43] In general, economies can be characterized as liberal (market economies, such as the U.S. and the U.K.), corporatist (organized market economies that rely on tightly integrated private and networked associations to resolve significant dilemmas of economic integration, such as Germany and Japan), or statist (economies that depend on hierarchical solutions in resolving coordination problems, such as France).[44]

The "varieties of capitalism" framework suggests that firms in each of the three models of economic governance will distinguish themselves in different fields. In liberal market economies, the advantages of a flexible regulatory structure benefit industries targeting low costs and those operating in sectors characterized by radical innovation (e.g., software, biotechnology).[45] In corporatist economies, high business coordination benefits those sectors that rely on long-term contracts, and firms tend to specialize in high-quality, scale-intensive, and specialized supplier industries (e.g., autos, machine tools,

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40. James Boyd White, From Expectation to Experience: Essays on Law and Legal Education (1999).

41. Avi-Yonah, *Cyclical Transformations*, *supra* note 34, at 817.

42. *Id.*

43. *Id.* at 816.

44. Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (Peter A. Hall & David Soskice eds., 2001).

45. Orfeo Fioretos, *Varieties of Capitalism, Institutional Change, and Multilateralism in Post-War Europe* at 11–12 (2004) (unpublished manuscript) (on file with author).

chemicals).[46] Statist economies favor large scale-intensive industries that have long time horizons or require major capital investment (e.g., autos, transport).[47]

There is an obvious correlation between the three varieties of capitalism described by political economists and the three historical theories of the firm outlined above. The liberal model of the U.K. and the U.S., with its emphasis on arm's-length relationships and public trading, best fits the aggregate theory of the firm. The statist and hierarchical model of France, with its emphasis on the relationship between the firm and the state, best fits the artificial entity model. And the German and Japanese style corporatist model best fits the real entity theory.

This relationship can also explain why CSR is much less controversial in Europe than in the U.S. Practically every European Union government (including even the U.K.) has programs designed to foster CSR.[48] These programs are hard to imagine in the U.S., given the widespread hostility to CSR here.

IV.
Implications of the Three Views for CSR and the Corporate Tax

What are the implications of the three views of the corporation summarized above for the question with which we began, i.e., whether corporations should pay the corporate tax (assuming that a corporate tax is imposed)?

This is not just a theoretical question, because in fact corporations have significant leeway about whether they should pay the tax imposed on them. In the U.S., revenues from the corporate income tax amounted to about a quarter of all federal tax revenues in 1965; today the tax accounts for less than 10% and shrinking.[49] A major reason for this decline is the

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46. *Id.* at 12.

47. *Id.* at 11–12.

48. European Commission, Corporate Social Responsibility: National Public Policy in the European Union (2004).

49. Corporate tax rates were higher before 1986, but the base was narrower, so that the Tax Reform Act of 1986 (which reduced the rate from 46% to the current 35%) actually raised taxes on corporations. However, the effective tax rates today are close to what they were before 1986. *See* George

growth of a corporate tax shelter industry, where some of America's best minds scour the Internal Revenue Code for ways to reduce corporate tax liabilities by various transactions and then sell these transactions to corporate clients for high fees.[50] Estimates of the revenue loss vary, but there is a consensus that it is significant.[51]

There are two reasons why the decline in corporate tax revenues is even more pronounced world-wide, especially among developing countries that have traditionally relied on the corporate tax for a much higher percentage of total revenues than OECD member countries.[52] The first reason is an

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K. Yin, *Getting Serious about Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209 (2001); George K. Yin, *How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500*, 89 VA. L. REV. 1793 (2003).

50. *See, e.g.*, Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775 (1999); David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 SMU L. REV. 73 (2001); George K. Yin, *Getting Serious about Corporate Tax Shelters*, 54 SMU L. REV. 209 (2001).

51. Most estimates of the revenue loss from tax shelters are around $10 billion each year. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-171, TAX SHELTERS: SERVICES PROVIDED BY EXTERNAL AUDITORS 6–8 (2005); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-104T, INTERNAL REVENUE SERVICE: CHALLENGES REMAIN IN COMBATING ABUSIVE TAX SHELTERS 10–11 (2003) (statement of Michael Brostek, Director, Tax Issues); DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS & LEGISLATIVE PROPOSALS 31 (1999); 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, 231 (Winter 2004); Mihir A. Desai, *The Divergence Between Book Income and Tax Income*, *in* 17 TAX POLICY AND THE ECONOMY 169–208 (James Poterba ed., 2003); Joel Friedman, *The Decline of Corporate Income Tax Revenues*, CENTER ON BUDGET & POLICY PRIORITIES (Oct. 24, 2003), *available at* http://www.cbpp.org/files/10-16-03tax.pdf; David A. Weisbach, *Ten Truths about Tax Shelters*, 55 TAX L. REV. 215, 243–44 (Winter 2002).

52. In developing countries the corporate tax paid can amount to as much as 25% of total tax revenues. *See* WORLD BANK, TAX POLICY HANDBOOK 165 (Parthasarathi Shome ed., 1995). There, the average corporate tax from 1990 to 2001 was 17%, as opposed to 7% in developed countries. Michael Keen & Alejandro Simone, *Is Tax Competition Harming Developing Countries More Than Developed?*, 34 TAX NOTES INT'L 1317, 1324 (2004). Keen and Simone show that from 1990 to 2001 corporate tax rates have declined in both developed and developing countries. *Id.* However, while in developed countries this decline in the rates was matched by a broadening of the tax base, so that no decline in revenues can be observed, in developing countries the same period witnessed a decline of corporate tax revenues by about 20% on average.

increase in aggressive tax behavior among corporations, especially in developing countries that lack the resources to effectively counter strategic tax-planning behavior, such as abusive transfer pricing. The second is tax competition among countries to attract corporate investments, which has grown significantly in the last two decades.[53] This competition enables companies like Intel to pay no tax at all on its non-U.S. income. The most recent manifestation of this trend has been inversion transactions, in which U.S.-based corporations nominally move their headquarters to a tax haven like Bermuda. This can result in a dramatic decrease in worldwide effective tax rates for the inverting corporation.[54] It nominally becomes a subsidiary of a foreign parent (typically in Bermuda) with no substantive change in their business (the headquarters stayed in the U.S.), stripping profits out of the U.S., reducing the U.S. effective tax rate, and raising share values.

In what follows, I will discuss the implications of each of the three views of the corporation for the attitude that the corporation should take to paying the corporate tax.

A. *The Artificial Entity View*

For the artificial entity view, the corporation is a creature of the state. The state creates it and bestows various legal advantages on it, such as legal personality and limited liability. The state also creates the conditions for the corporation to operate in the market by providing defense and a property rights regime, as well as building infrastructure and educating workers.

The implication of this view for CSR, as noted above, is that the corporation is obligated not to impose additional burdens on the state that created it. Thus, to the extent that the corporation's own activities result in additional burdens (e.g., by creating pollution), the corporation is obligated to remedy that situation.

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53. *See* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000); Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543 (2001).

54. Reuven S. Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, 95 TAX NOTES 1793, 1794 (2002).

Whether the artificial entity view requires or permits corporations to engage in CSR that is unrelated to their activities is less clear. While historically the state created corporations "imbued with a public purpose,"[55] developments since the mid-nineteenth century (such as general incorporation and the decline of *ultra vires*) have led to the view that the corporation fulfills its purpose sufficiently in engaging in its normal for-profit activities, and should not be required to do more.

However, that limitation also has implications for the corporate tax. To the extent that the corporation is free to pursue purely for-profit activities, as long as those do not impose a burden on the state, the state is left with the obligation to carry the weight of social responsibility on its own. For example, if there is a health crisis that the corporation did not contribute to creating, such as AIDS, then the state, and not the corporation, has the obligation to address it. But this means that the state needs resources, and a major way of obtaining these resources is to impose taxes, including the corporate tax.

I would therefore argue that under the artificial entity view, corporations have an affirmative obligation not to engage in aggressive tax planning designed to reduce their tax burden. The state created the corporation and the conditions for its operation in the market. In return, the state may legitimately expect corporations not to impose additional burdens on it. But since the state and not the corporation bears the burden of most social obligations under this model, the state can also expect the corporation to contribute its fair share to the ability of the state to fulfill its obligations to its citizens. This means that when the corporation engages in aggressive tax planning such as corporate tax shelters or abusive transfer pricing, it is breaching an implicit bargain with the state that created it, gave it legal rights, and created the conditions for it to make those same profits it is attempting to shield from tax.

Of course, this begs the question of how to distinguish abusive tax evasion from legitimate tax avoidance. While this is a hard question to answer from the government's perspective, or in a court of law, it is clearer from the corporation's perspective. Most corporate tax managers know very well when a

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55. *See* William J. Novak, *The Public Utility Idea and the Origins of Modern Business Regulation*, *in* THE CORPORATION AND AMERICAN DEMOCRACY (Naomi Lamoreaux & William Novak eds., forthcoming 2015).

transaction is tax- or business-motivated. Thus, it is legitimate to expect a corporation to police its own behavior in this regard, without worrying too much about where the line should be drawn.[56]

B. *The Real Entity View*

Under the real entity view, the corporation is similar to an individual. It is an entity made up of people (corporate managers and employees) and is separate from both the state and from its shareholders.[57] The implication for CSR is that our view of CSR activities that are unrelated to the corporation, but which are beneficial to society at large, should be the same as our view of such behavior by individuals: it should not be legally required, but is praiseworthy and should be encouraged when it happens. This is the view most management takes of CSR, and judging by their advertising, the view of the general public as well.

What are the implications of the real view for corporate strategic tax behavior? Judge Learned Hand famously stated in 1935 that there is "not even a patriotic duty"[58] for citizens to pay their taxes; instead, it is the state's obligation to force them to do so. But even if that statement could be taken liter-

56. The exception would be tax competition, which arguably represents legitimate business planning from the corporation's perspective.

57. As one sociologist has stated, "[t]he recurrent problem in sociology is to conceive of corporate organization, and to study it, in ways that do not anthropomorphize it and do not reduce it to the behavior of individuals or of human aggregates." Guy E. Swanson, *The Tasks of Sociology*, *in* 192 SCIENCE 665–67 (1976). A whole branch of economic sociology centers on the study of organizations, and there are numerous books devoted to the topic. *See, e.g.*, JAMES D. THOMPSON, ORGANIZATIONS IN ACTION: SOCIAL SCIENCE BASES OF ADMINISTRATIVE THEORY (Transaction Publishers, 5th ed. 2003); W. RICHARD SCOTT, ORGANIZATIONS: RATIONAL, NATURAL, AND OPEN SYSTEMS (Prentice Hall, 5th ed. 2002); JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE (Stanford Univ. Press, 1st ed. 2003); THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS (Walter W. Powell & Paul J. DiMaggio eds., 1991); THE HANDBOOK OF ECONOMIC SOCIOLOGY (Neil J. Smelser & Richard Swedberg eds., 1994). Most of these books revolve around the study of large corporations, since these are the dominant forms of organization in this society.

58. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."), *aff'd*, 293 U.S. 465 (1935).

ally in 1935 (and there are grounds to doubt that Judge Hand meant it that way), it certainly cannot be applied in the post-World War II environment, in which the obligation to pay the income tax was shifted from the rich to the middle class.[59] While much of the success of the U.S. in collecting the income tax stems from its sophisticated use of withholding and information reporting, it is by no means true that nobody pays taxes voluntarily. If that were the case, the estimates for compliance in the absence of withholding or information reporting would be far below 70%. The U.S. tax system could not work unless the majority of its citizens were trying to abide by the law, not evade it.

The importance of voluntary compliance can also be demonstrated by the contrast between the U.S. and countries in which there is no tax-paying "culture." The U.S. is far more successful in collecting the taxes due than countries like Italy or most developing countries, where the citizens indeed follow Judge Hand's dictum (or even regard it as their patriotic duty *not* to pay taxes).[60] The reason for the relative success of the U.S., even in an era of sharp cutbacks in IRS audit and enforcement activity, is that most U.S. citizens do regard it as their duty to try to comply with the tax law. That is also the reason why the U.S. can depend on most residents filing a tax return and self-assessing their tax liability every April 15th, even though the refunds they typically get are without interest and means that they have been giving the government interest-free loans.

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59. Judge Hand's statement was dicta in the context of the most famous case shutting down an avenue of tax avoidance, *Gregory*. As Assaf Likhovski has shown, this statement (and the whole opinion) should be understood against the background of the contemporary hearings into tax evasion by rich and famous Americans such as Andrew Mellon. It seems that if pressed, even Judge Hand would acknowledge that the tax system could not work if everybody tried as hard as Mellon did to avoid paying taxes. Assaf Likhovski, *The Story of Gregory: How Are Tax Avoidance Cases Decided*, *in* BUSINESS TAX STORIES 89 (Steven A. Bank & Kirk J. Stark eds., 2005)

60. Mark D. Phillips, *Individual Income Tax Compliance and Information Reporting: What Do the U.S. Data Show?*, 67 NAT'L TAX J. 531 (2014). *See generally* Assaf Likhovski, *Is Tax Law Culturally Specific? Lessons from the History of Income Tax Law in Mandatory Palestine*, *Comparative Tax Law and Culture*, *in* 11 THEORETICAL INQUIRIES IN LAW 725 (2010).

In general, the modern literature on tax enforcement assumes that there exists an "enforcement pyramid."[61] At the bottom are the majority of citizens whose inclination is to try to comply with the tax law. As you go up the pyramid, the appetite for avoidance increases and the number of citizens decreases, and the type of enforcement changes from cooperation and the provision of information to increasingly harsher enforcement measures. Where the pyramid is reversed and most citizens do not cooperate, enforcement fails. In that way, tax law is no different than other laws: a modern state cannot exist unless most citizens could be expected to comply with the law most of the time.

From that perspective, if the real view of the corporation is the correct one, the implication is that the corporation should behave like an ordinary citizen. The corporation should try to comply with the tax law to the best of its ability. Thus, it is legitimate for corporations to try to minimize taxes paid on ordinary business transactions, but it is not legitimate to deliberately engage in strategic tax behavior designed solely to minimize its taxes. As stated above, while this line is difficult for the government or a court to draw from the outside, it is not so hard to discern from the perspective of the corporation.

Strangely (at least from today's perspective), most corporations held this attitude towards tax compliance before the 1990s. In my experience, the tax function was not viewed as a profit center, and while corporations tried to minimize tax costs, large publicly held corporations did not engage in tax shelters, and were in fact quite conservative in tax matters. It was part of the corporation's general responsibility to society to pay its taxes—just like it is part of an individual's responsibility—and under the real view, CSR is generally legitimate even if there is no connection between the uses of the funds and the corporation's own activities.

This attitude changed by the mid-90s, and today, major corporations like General Electric or Colgate-Palmolive have lost important tax shelter cases.[62] Presumably, this shift in attitude was accompanied by a shift in the corporation's view of itself, as the aggregate view came to dominate the discussion

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61. JOHN BRAITHWAITE, RESTORATIVE JUSTICE AND RESPONSIVE REGULATION (2003).

62. *ACM P'ship*, 73 T.C.M. at 2189.

and shareholder profit maximization became the sole legitimate goal of corporate activity. To this view, which poses the hardest challenge to CSR, we now turn.

C. *The Aggregate View*

How does strategic tax behavior appear from the aggregate perspective on the corporation? Under this view, the sole legitimate function of the corporation is shareholder profit maximization, and any CSR activity that is not related to long-term profit maximization is an illegitimate "tax" imposed by management on the shareholders, without the accompanying democratic accountability.

It is easy to see how this view can lead to strategic tax behavior. If tax is considered a cost like any other cost imposed on the corporation, it behooves the management to try to minimize this cost, or even turn it into a profit. Thus, the goal of shareholder profit maximization can naturally lead to corporations trying to minimize taxes and thus enhance earnings per share.

In the early 1990s, two factors led an increasing number of corporations to adopt this view. First, management compensation was linked to earnings per share via stock options. Although this led to abuses in some cases (even leading to corporations like Enron paying additional taxes on fictitious earnings), in most cases the mechanism worked properly, inducing management to focus exclusively on increasing earnings per share. Second, consolidation in the accounting field led the "Big Four" accounting firms to try to move beyond their traditional audit functions to devising tax strategies to be sold to individual corporate clients.

Increasing competition among corporations and increasing pressure on top management to deliver higher earnings per share explains the rest. In my experience, once some firms adopted aggressive tax strategies and saw their effective global tax rate plunge and their earnings per share increase, management in other firms came under pressure to deliver similar results. It became commonplace for the CEO and CFO, who never bothered to look at a lowly cost center like taxes before, to summon the tax director and require an explanation as to why their global effective tax rate was several percentage points higher than the competition. The tax director, who was already under pressure from the accounting firms to try out novel tax strategies, usually succumbed. Thus, a significant number of conservative firms came to adopt aggressive tax strategies.[63] The rhetoric of shareholder profit maximization came to provide a convenient cover and rationalization for this activity.

A good example of the spread of this type of strategic tax behavior is the saga of inversion transactions. Before 1997, most corporate managers assumed that shareholders would not tolerate a publicly traded U.S. corporation reincorporating in Bermuda, despite the fact that such transactions could significantly reduce the overall effective tax rate.[64] However, after Tyco inverted in 1997 and its stock price went up, there was increased pressure on competitors, resulting in about fifteen more inversions soon after.[65] The inversions were defended in the name of shareholder profit maximization, even though, as Desai has shown, they may also have made it easier to fudge corporate accounts and harm shareholders.[66] This wave only stopped after September 11, 2001, when public outcry against "unpatriotic" corporations and ensuing changes to the tax law blocked the phenomenon—at least temporarily.[67] In the past three years, however, there has been a new wave of inversions, with over twenty U.S. firms establishing a new foreign parent in jurisdictions with more favorable tax laws like Ireland, the U.K., or Canada.[68] In order to avoid Section 7874, which was enacted in 2004 to stop the last wave of inversions, these transactions are structured as mergers with foreign corporations that are at least 20% of the combined entity. How-

63. *See* Bankman, *supra* note 50, at 1784.

64. *See* Avi-Yonah, *For Haven's Sake*, *supra* note 54.

65. *Id.* at 1793–94.

66. Mihir A. Desai & Dhammika Dharmapala, *Earnings Management, Corporate Tax Shelters, and Book-Tax Alignment,* 62 NAT'L TAX J. 169, 180 (2009).

67. Avi-Yonah, *For Haven's Sake*, *supra* note 54, at 1793–94.

68. *See, e.g.*, Jacob L. Lew, *Close the Tax Loophole on Inversions*, WASH. POST (July 27, 2014), http://www.washingtonpost.com/opinions/jacob-lew-close-the-tax-loophole-on-inversions/2014/07/27/2ea50966-141d-11e4-98ee-daea85133bc9_story.html; Paul Krugman, *Corporate Artful Dodgers, Tax Avoidance du Jour: Inversion*, N.Y. TIMES (July 27, 2014), http://www.nytimes.com/2014/07/28/opinion/paul-krugman-tax-avoidance-du-jour-inversion.html?_r=0; Daniel Shaviro, *Understanding and Responding to Corporate Inversions*, DAN SHAVIRO.BLOGSPOT.COM (July 28, 2014), http://danshaviro.blogspot.com/2014/07/understanding-and-responding-to.html.

ever, the headquarters of the combined firm typically remain in the U.S. and the business activities of the U.S. firm remain unaffected, suggesting that the principal motivation of these "mergers" is tax reduction rather than a business-motivated combination.

What is wrong with reducing taxes as a way of maximizing shareholder returns? The basic problem is that, under the aggregate view, most CSR activities are illegitimate. This necessarily means that the responsibilities devolve upon the state, which is supposed to use its legitimate taxing function to raise money to fulfill these obligations.[69] But if all corporations engage in strategic tax behavior, the state probably will not be able to raise sufficient money to fulfill its exclusive social responsibility functions.

An immediate counter-argument is that this scenario is unrealistic: since in OECD member countries the corporate tax amounts to less than 10% of total tax revenue, the state can replace the lost revenue from corporate tax avoidance by raising other taxes. But even if one sets aside issues of distribution and fairness (lowering taxes on capital usually means higher taxes on labor), this answer is inadequate for three reasons. First, there may be political constraints to raising other taxes—especially in the U.S. It seems glib to say that politicians could respond to a decline in the corporate tax by raising individual tax rates. Second, individual tax rates may already be set so high that it becomes highly inefficient and potentially counterproductive to raise them further. If individual rates are set very high, there will be an impact on both the labor/leisure tradeoff and on individuals' willingness to pay, on which the system depends. Finally, in many non-OECD countries, as well as in some OECD members like Japan, the corporate tax amounts to a far higher percentage of total revenues.[70] It has been

69. In developed countries, the state may delegate some of its social responsibility to the non-profit sector. But this is no solution, since under the aggregate view for-profit corporations are prohibited from donating funds to non-profits as well, unless it can be shown that such contributions enhance shareholder returns (which is doubtful). Moreover, the non-profit sector is weak or non-existent in developing countries, where the CSR issue is most acute.

70. OECD, Revenue Statistics—Comparative Tables, (data extracted on Oct. 1, 2014, 12:26 PM), http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial.

shown that tax competition, which is itself a form of strategic tax behavior, has resulted in significant declines in tax revenues in developing countries, which have not been offset by tax increases elsewhere.[71]

It can also be argued that strategic tax behavior by corporations is positive in situations where the government is ineffective or corrupt, and therefore the funds can be put to better use in the private sector. This is precisely the reason that under the real view, CSR is acceptable, because in many situations, corporations are better situated than the government to address social problems. But this argument cannot be made under the aggregate view, because there, almost all CSR is illegitimate, and solving social problems is the exclusive responsibility of the government.

Thus, it seems there is an internal contradiction in Milton Friedman's argument,[72] just as the corporate tax shelter wave of the 1990s demonstrated. If the sole function of corporations is profit maximization, it seems to follow that corporations should maximize profits by minimizing their taxes. But if all corporations avoid paying taxes, the result can be inadequate revenue for the government to fulfill those obligations for which, under the aggregate view, it bears the responsibility. The result would be that neither corporations nor the government can address social problems, and I do not think most would regard that outcome as desirable.

First, U.S. corporations somehow managed to do without such aggressive tax planning for many decades without impeding either their competitiveness or their market valuation. Second, there is no clear evidence that a reduction in the effective U.S. tax rate translates into higher share values. Stock market prices are influenced by many factors, and there are plenty of publicly traded U.S. corporations that derive most of their profits from the U.S. and pay a high U.S. effective tax rate, but nevertheless have high stock prices.

I would thus argue that even under the extreme version of the aggregate view, corporations do have an affirmative obligation to pay their taxes, so as to enable the state to carry out those functions that they are barred from pursuing since they are unrelated to the goal of shareholder profit maximization.

71. Keen & Simone, *supra* note 52, at 1317.
72. *Contra supra* text accompanying note 1.

This, in fact, can be seen as another justification of imposing tax on the corporation—rather than bear any social responsibility, the corporation can, by paying its taxes, shift that responsibility to the state, where it belongs.

Thus, strategic tax behavior seems to be inconsistent with *any* view of the corporation. Under the artificial entity view, it undermines the constitutive relationship between the corporation and the state. Under the real view, it runs contrary to the normal obligation of citizens to comply with the law even in the absence of effective enforcement. And under the aggregate view, it is different from other forms of shareholder profit maximization, in that it weakens the ability of the state to carry out those functions that the corporation is barred from pursuing. It would thus seem that whatever view management takes of its relationship to the shareholders, to society, and to the state, it is never justified in pursuing tax strategies that have as their only goal minimizing the corporation's tax payments to the government.

CONCLUSION: JUST SAY NO

The prevailing attitude among large U.S. corporations seems to be that aggressive tax planning that is not motivated by business purposes is justified because of competitiveness considerations and because it enhances shareholder value. The argument seems to be that paying taxes is a cost that reduces corporate profits and this negatively impacts the value of the shares. At bottom, this traditional defense of reducing corporate tax in order to benefit shareholders leans hard on the aggregate view of the corporation.

I have argued that under *any* of the major views of corporations, corporations should not be permitted to engage in strategic behavior designed solely to minimize its taxes. From an artificial entity perspective, such behavior undermines the special bond between the state and the corporations it created. From the real entity perspective, it is as unacceptable as it would be if all individual citizens engaged in it. Further, from an aggregate perspective, strategic tax behavior does not leave the state with adequate revenues to fulfill the increased obligations imposed on it by forbidding corporations to engage in CSR.

There are strong moral arguments against this strategic tax behavior that I have not covered in depth here. Passing the buck by shifting the tax burden to others, including taxpaying shareholders, hardly seems "responsible" in the moralistic sense. Even if competitors, especially foreign ones, practice reducing taxes as close to zero as possible, popularity does not justify immoral behavior.

Thus, what are the implications for a case like Caterpillar? Most U.S. corporations nowadays acknowledge that—in addition to maximizing profits and value for their shareholders—they also have a responsibility to other stakeholders such as their employees and customers, as well as to U.S. society. It is rare to find a U.S.-based multinational corporation that does not declare on its website that it is committed to CSR, despite the critiques launched against CSR in academic circles.

I do not think the various post-2003 changes will prevent a new wave of corporate tax shelters. The IRS cannot be expected to overcome a determined effort to reduce taxes by any means by most large public U.S. corporations. For example, inversions are already back—the IRS has the power to combat the type of tax aggressiveness exemplified in the Caterpillar case, but it failed to do so, perhaps because it was deluged with even more aggressive shelters, and it did not have access to all the information that became public at the 2014 Senate hearing. I suspect that there are other cases, too, in which major corporations were able to engage in tax strategies that they knew lacked economic substance and were not adequately challenged by the IRS.

Therefore, in the end, I believe that the only solution is to change the attitude of major U.S. multinational corporations back to where it was at the time of the Tax Reform Act of 1986. The proper response of a corporate tax director to a proposed transaction that he or she knows is not motivated by a valid business purpose—even if it can be dressed up like one and even if he or she thinks it might possibly prevail in litigation—is to just say no.