

The Economic Efficiency Case Against Business Tax Privacy

*Daniel Schaffa**

By statute, business tax returns are not publicly available. But with public access, investors would acquire useful information that would help them make better investing decisions; business tax compliance and planning would become more uniform, preventing tax-savvy firms from gaining an advantage over other relatively more productive firms; and businesses could learn from one another, which would spare firms the cost of redundantly developing the same tax strategies. In the long run, these efficiency gains could result in lower prices, higher wages, more innovation, more leisure, and better investment returns. In the debate over business tax privacy, these sorts of economic efficiency arguments have received surprisingly little attention. This Article argues that economic efficiency is central to the debate and may well change where we come out on business tax privacy.

* Assistant Professor of Law, University of Richmond. I thank Jim Hines and JJ Prescott for guidance and advice; Anne Choike, Chris Cotropia, Jessica Erickson, Ed Fox, Jim Gibson, Hayes Holderness, Dan Jaqua, Corinna Lain, Andrew Litten, Kyle Logue, Lil Mills, Orli Oren-Kolbinger, Anne Schaffa, Joel Slemrod, and John Vella for useful discussions; seminar participants at the University of Michigan, the University of South Carolina, the University of Miami, the University of Richmond, George Mason University, Washington and Lee University, the NTA 2016 Annual Conference on Taxation, the 2017 Canadian Law and Economics Conference, and the 2017 University of Oxford CBT Doctoral Conference for helpful comments; and Austin Chandler and Kurt Lockwood for excellent research assistance. I gratefully acknowledge support from the NIA training grant to the Population Studies Center at the University of Michigan (T32 AG000221). Any errors are my own.

INTRODUCTION	29
I.HIDDEN RETURNS.....	33
A. A Brief History of Tax Privacy	33
B. Business Tax Returns and Their Contents.....	35
C. The Value of Business Tax Returns	38
II.HIDDEN COSTS	40
A. Suboptimal Investing.....	40
1. Investing Decisions.....	41
2. Information Needs	42
3. Tax Information	46
B. Suboptimal Business Tax Planning and Compliance	52
1. Variation in Business Tax Outcomes.....	52
2. Firm Learning	53
3. Towards Tax Uniformity	57
III.A WORLD WITHOUT BUSINESS TAX PRIVACY	59
A. Economic Efficiency	59
1. Profitability and Productivity.....	59
2. An Illustration of Economic Efficiency.....	61
B. The Benefits of Eliminating Business Tax Privacy	63
1. Improving Investor Forecasts	63
2. Homogenizing Business Tax Outcomes	65
3. Reducing Tax Compliance Costs.....	69
C. The Potential Costs of Eliminating Business Tax Privacy.....	71
1. Lower Business Tax Revenue.....	71
2. Proprietary Business Information Made Public	72
3. Elimination of Tax-related Jobs.....	74
4. Reduced Tax Compliance	74
5. Antitrust Concerns	75
D. Alternatives to Eliminating Business Tax Privacy	75
CONCLUSION.....	77

INTRODUCTION

President Trump's tax returns are at the center of a growing tax privacy controversy.¹ These documents surely contain a treasure trove of information about President Trump's business empire.² If public, they would reveal how the Trump Organization interprets key elements of tax law, how it shelters its income from taxes, and how it structures some of its transactions—likely through a complicated network of parent, subsidiary, and affiliate entities.³ Of course, under current law, neither Trump's individual nor his business tax returns are accessible by the public.⁴

Since the 1920s, tax privacy has been the law of the land, but that is not to say that the wisdom of tax privacy is settled.⁵ Scholars have spilled much ink debating tax privacy, primarily focusing on corporate tax returns.⁶ Defenders of corporate tax privacy have posited an inherent right to privacy,⁷ voiced concerns about how corporations could lose their competitive advantage if forced to publish their returns,⁸ and predicted that eliminating corporate tax privacy might lead to tax shelter proliferation.⁹ Opponents of

¹ Interest in President Trump's tax returns stems from politically charged concerns that he has a business or foreign conflict of interest or may not be complying with tax law despite being the chief executive of the United States. Erica Werner & Damian Paletta, *Trump Defiant as Democrats Prep Push for His Tax Returns*, WASH. POST (Nov. 7, 2018), https://www.washingtonpost.com/business/economy/trump-suggests-he-wont-turn-over-tax-returns-even-if-democrats-demand-them/2018/11/07/396ae650-e2ad-11e8-ab2c-b31dcd53ca6b_story.html; Jeff Stein, *House Democrats Begin Hearings on Obtaining President Trump's Tax Returns*, WASH. POST (Feb. 7, 2019), <https://www.washingtonpost.com/business/2019/02/07/house-democrats-begin-hearings-getting-president-trumps-tax-returns/>.

² Tax privacy issues have received extraordinary attention since President Trump's campaign gained traction. See, e.g., Timothy O'Brien, *A New Reason for Trump to Release His Tax Returns: Helsinki*, BLOOMBERG (July 17, 2018), <https://www.bloomberg.com/opinion/articles/2018-07-17/helsinki-2018-putin-and-trump-s-tax-returns>.

³ Some of President Trump's 1995 tax return was leaked, showing a \$916 million-dollar loss that could be used to offset income. Pages from Donald Trump's 1995 Income Tax Records, N.Y. TIMES (Oct. 1, 2016), <https://www.nytimes.com/interactive/2016/10/01/us/politics/donald-trump-taxes.html>.

⁴ I.R.C. § 6103 (2019).

⁵ See *infra* Part IA.

⁶ See Joshua D. Blank, *Reconsidering Corporate Tax Privacy*, 11 N.Y.U. J.L. & BUS. 31 (2014); Marjorie E. Kornhauser, *Doing the Full Monty: Will Publicizing Tax Information Increase Compliance?*, 18 CAN. J.L. & JURIS. 95 (2005); David Lenter, Joel Slemrod & Douglas Shackelford, *Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives*, 56 NAT'L TAX J. 803 (2003).

⁷ Tax Executives Institute, *TEI Opposes Public Disclosure of Corporate Tax Returns*, 58 TAX EXECUTIVE 241, 241 (2006) (arguing that "[p]rivacy is a core American value").

⁸ This information includes "revenue and expense information by legal entity, jurisdiction, and functional category." *Id.* at 242.

⁹ Blank, *supra* note 6, at 38. This Article turns Blank's argument on its head by arguing

corporate tax privacy have countered that public access to corporate returns would increase detection of illegal tax evasion,¹⁰ result in shaming of unethical corporate behavior,¹¹ catalyze beneficial policy changes,¹² and generally increase the public's understanding of tax law.¹³

The scholarship behind the corporate tax privacy debate is insightful but misses two key points. First, there is little reason to focus solely on corporate tax returns. Corporations comprise only a tiny fraction of US businesses.¹⁴ Eliminating corporate tax privacy would reveal nothing new about non-corporate business entities, including partnerships and LLCs, and thus would miss many of the benefits of eliminating business tax privacy.¹⁵ Moreover, if only corporate returns were made public, some businesses

that there may be economic benefits to having tax shelter proliferation and public access to business tax return information more broadly. Blank focuses only on the possible effect of eliminating business tax privacy on government revenue, while this Article looks at the economy's productivity and the efficiency of tax collection.

¹⁰ Kornhauser, *supra* note 6, at 99. Tax evasion is the illegal underreporting of tax liability. Tax avoidance is at least plausibly legal behavior designed to minimize tax liability. There is some evidence that tax compliance is higher for publicly traded firms and firms in heavily regulated industries, suggesting that non-IRS eyes can affect compliance. Eric M. Rice, *The Corporate Tax Gap: Evidence on Tax Compliance by Small Corporations*, in *WHY PEOPLE PAY TAXES: TAX COMPLIANCE AND ENFORCEMENT* 125–62 (Joel Slemrod ed. 1992).

¹¹ Walgreens opted not to pursue an inversion when it merged with a foreign competitor, and its stock price immediately fell over fourteen percent. Kim Hjelmgaard & Kevin McCoy, *Walgreen's Stock Smacked After Tax Inversion Out*, USA TODAY (Aug. 6, 2014, 7:13 AM), <https://www.usatoday.com/story/money/business/2014/08/06/walgreens-alliance-boots-chicago/13659809/>. See also Michelle Hanlon & Joel Slemrod, *What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News About Tax Shelter Involvement*, 93 J. PUB. ECON. 126 (2009) (offering suggestive evidence that investors respond positively to tax management); Mihir A. Desai & James R. Hines Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409, 423 (2002) (reporting that the share values of Stanley Works jumped when it announced plans to invert).

¹² Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by the Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 16 (1990). *E.g.*, Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, for example, was partially a response to a public outcry over the number of wealthy individuals that were using shelters to pay little or no tax.

¹³ Kornhauser, *supra* note 6, at 103. Many individuals, however, do not increase their understanding of tax law, even in cases where it is in their personal financial interest to do so. See Saurabh Bhargava & Dayanand Manoli, *Psychological Frictions and the Incomplete Take-Up of Social Benefits: Evidence from an IRS Field Experiment*, 105 AM. ECON. REV. 1 (2015) (finding evidence that many taxpayers that are eligible for the EITC do not claim it).

¹⁴ Only 5% of businesses file corporate tax returns. Corporations do, however, account for 62% of business receipts. Andrew Lundeed & Kyle Pomerlau, *Corporations Make up 5 Percent of Businesses but Earn 62% of Revenues*, TAX FOUND. (Nov. 25, 2014), <https://taxfoundation.org/corporations-make-5-percent-businesses-earn-62-percent-revenues/>.

¹⁵ The Trump Organization, for example, is likely comprised of mostly non-corporate business entities.

would respond by converting to non-corporate forms.¹⁶ Second, and more importantly, business tax privacy harms the economy. In most tax policy debates, the economic efficiency of competing policies is central.¹⁷ Yet the business tax privacy debate has paid almost no attention to the economic efficiency implications of tax privacy.¹⁸

This Article argues that eliminating business tax privacy would improve the allocation of economic resources by making important information publicly available. This information could be put to good use in two ways. First, investors could use business tax return information to build more accurate financial models. Using these improved models, investors would direct more capital to more deserving firms.¹⁹

Second, firms could learn from each other's tax returns, which would have two benefits.²⁰ One, it would make tax outcomes more uniform across firms. Uniform tax outcomes are economically efficient because they prevent tax-savvy firms from having an advantage over non-tax-savvy firms. Economic output is maximized when investing decisions are made on the basis of the relative productivity of firms and not confounding factors such as how adept a firm is at outrunning the IRS.²¹ Two, if firms learned from each other's tax returns, each firm would spend fewer resources developing its own tax strategies because each would have at least partial access to the strategies of all the others. This would reduce wasteful and redundant expenditure, allowing businesses to spend more on wages and research or to pass savings on to consumers and investors.²²

These efficiencies overwhelm many of the business-centric arguments in favor of business tax privacy.²³ While businesses lose the advantage of keeping their own returns private, they gain the advantage of having access to the universe of business tax returns.²⁴ Being forced to disclose only its returns would place a business at a severe disadvantage. Simultaneously gaining access to all other business returns, however, would entirely negate that disadvantage on average while also making tax avoidance cheaper.

¹⁶ Lenter, Slemrod & Shackelford, *supra* note 6, at 826.

¹⁷ This is true in academic circles where scholars attempt to find the deadweight loss of taxes and is also true in political circles where putatively bad tax policies are labeled job killers.

¹⁸ For the purposes of this Article, efficiency is efficiency in allocation. For a definition see PAUL KRUGMAN & ROBIN WELLS, MICROECONOMICS 29 (3rd ed. 2013).

¹⁹ See *infra* Part IIA and Part IIIB1.

²⁰ See *infra* Part IIB.

²¹ See *infra* Part IIIB2.

²² See *infra* Part IIIB3.

²³ See *infra* Part IIIC4.

²⁴ Essentially, this argument is framed in what economists would call partial equilibrium as opposed to general equilibrium. They are thinking only of only one moving part but would come to a different conclusion were they to step back and observe the entire machine.

Some firms would be losers, including those that currently prevent investors from finding adverse information available in tax returns and those that have a comparative advantage in tax sheltering. But businesses in aggregate would benefit.

Before proceeding, two points merit mention. First, these arguments do not depend on whether one thinks tax sheltering itself is beneficial for the economy as a whole. Rather, they suggest that in a world with widespread tax sheltering it is better to lower the barriers that impede the flow of business tax information.²⁵ This approach prevents firms that are particularly good at tax sheltering from having an economic advantage over firms that are not. It also limits the wasteful and redundant spending on securing tax-sheltering advantages, while providing investors with valuable information.

Second, this analysis only applies to businesses, and most especially to large businesses. There are stronger privacy interests that warrant keeping the tax returns of individuals private.²⁶ And there is little if any economic efficiency upside to making individual tax returns public.²⁷

The Article proceeds as follows. Part I provides the necessary background by explaining how tax privacy came to be, the basics of business tax returns, and what information business tax returns contain that is nowhere else publicly available. Part II shows how business tax privacy causes investors to experience adverse outcomes and businesses to have non-uniform tax planning. Part III considers the aggregate economic impact of adverse investor outcomes and non-uniform business tax planning, demonstrating the economic inefficiencies caused by business tax privacy. Part III also discusses the potential downsides of eliminating business tax privacy, including why these downsides may not outweigh the benefits. Finally, Part III argues that eliminating business tax privacy by changing a small section of the Internal Revenue Code is preferable to other more complicated and politically fraught solutions that might have similar economic benefits.

Tax privacy has recently received an astounding volume of media coverage. But while access to presidential tax returns may dominate the headlines, access to business tax returns generally is where we should focus

²⁵ Moreover, public access to returns would decrease the returns to developing new tax shelters. See Christopher A. Cotropia & James Gibson, *The Upside of Intellectual Property's Downside*, 57 UCLA L. REV. 921, 940–50 (2010); see generally Brant J. Hellwig, *Questioning the Wisdom of Patent Protection for Tax Planning*, 26 VA. TAX REV. 1005 (2007).

²⁶ See *infra* Part IA and Part IB.

²⁷ Greater individual income tax transparency could reduce compliance costs if individual taxpayers learned from one another. Software such as TurboTax, however, has reduced individual taxpayer compliance costs substantially, and many of the most vexing tax issues on individual tax returns relate to business activities.

our attention.

I. HIDDEN RETURNS

Before exploring the economic efficiency implications of business tax privacy, it is important to understand the information contained in business tax returns and the laws currently shielding these documents from public view. This Part first provides a brief history of business tax privacy, noting the original legislative impulse to make corporate tax returns public and the Supreme Court cases that have held there is no constitutional right to tax privacy. Then, this Part explains what business tax returns are and demonstrates why even the most promising sources of other information, namely financial statements, fall far short of providing the data available on business tax returns.

A. *A Brief History of Tax Privacy*

Whether businesses in the United States should be entitled to tax privacy is a question as old as the corporate tax, and US law has answered this question in different ways at different times.²⁸ In 1909, when Congress enacted the first incarnation of the corporate income tax (a one percent excise tax on corporate net income in excess of \$5,000), corporate tax returns were intended to live in the public record and be subject to public inspection.²⁹ The overarching justification for the public record provision was that it would aid in the regulation of corporations. Indeed, for progressives like President Taft, the primary appeal of the corporate income tax was not the additional government revenue but rather the benefits stemming from public access to corporate tax returns.³⁰

Public inspection, however, never came to be. In 1910, the Commissioner of the IRS ruled that since Congress had not appropriated sufficient funds, the IRS was not obligated to maintain corporate tax returns in a searchable fashion.³¹ Eventually Congress did appropriate funds but simultaneously restricted corporate tax inspection to those authorized by

²⁸ See generally Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990). For brief accounts of the early legislative history of corporate tax privacy in the United States, see Lenter, Slemrod & Shackelford, *supra* note 6, at 807–10; Blank, *supra* note 6, at 42–45.

²⁹ Payne-Aldrich Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 116. The tax was an excise and not an income tax to avoid falling afoul of *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429 (1895), reh'g granted, 158 U.S. 601 (1895) (holding that the 1894 federal income tax was unconstitutional because the tax was not levied in proportion to each state's population).

³⁰ Marc Linder, *Tax Glasnost' for Millionaires: Peeking Behind the Veil of Ignorance Along the Publicity-Privacy Continuum*, 18 REV. OF L. & SOC. CHANGE, 951, 976–77 (1990).

³¹ *No Publicity Now in Corporation Tax*, N.Y. TIMES, Feb. 17, 1910, at 1; Kornhauser, *supra* note 6, at 101.

order of the President.³²

The 1920s saw the tax privacy pendulum swing back and forth. In a provision of the Revenue Act of 1924, Congress made the amount of income tax paid by individuals and corporations public information.³³ Objectors—including President Coolidge—raised privacy concerns,³⁴ and in 1926 a revised revenue act mandated that only names and addresses, but not taxes paid, be public record.³⁵

The most recent legislation making tax data publicly available came in the early 1930s in response to a Congressional investigation that brought to light significant corporate tax evasion.³⁶ Congress responded by including a provision in the Revenue Act of 1934 that required individuals and corporations to attach a pink slip to their returns.³⁷ The pink slips were public information and recorded the taxpayer's name, address, gross income, amount of deductions, net income, and tax liability.³⁸ Again, objectors raised privacy concerns and also argued that revealing proprietary information on tax returns could harm corporations.³⁹ In protest, opposed constituents sent fake pink slips to their Congressmen, and Congress repealed the law before it took effect.⁴⁰

Meanwhile, presidents retained the power to authorize the inspection of returns. Some presidents, including Nixon, wielded this power as a weapon against political opponents.⁴¹ When the public became aware of this presidential abuse of power in the fallout from the Watergate scandal, Congress eliminated the presidential prerogative to authorize tax return inspection.⁴²

Since 1976, Section 6103 of the Internal Revenue Code has ensured that returns remain confidential with access limited to a handful of parties, including (1) persons with material interest, (2) certain government

³² Later revisions allowed shareholders to examine the returns of the corporations they were invested in and anyone to examine the returns of publicly traded companies, but only at the Commissioner's office. Kornhauser, *supra* note 6, at 126–31.

³³ Revenue Act of 1924, ch. 234, § 257 (b), 43 Stat. 253, 293.

³⁴ These concerns applied mostly to individuals and not corporations. In particular, objectors feared that the information would make it easier for criminals to kidnap or scam wealthy individuals. Richard D. Pomp, *The Disclosure of State Corporate Income Tax Data: Turning the Clock Back to the Future*, 22 CAP. U. L. REV. 373, 392–94 (1993).

³⁵ *Id.* at 396–97.

³⁶ *Id.* at 398.

³⁷ Revenue Act of 1934, ch. 277, § 55(b), 48 Stat. 680, 698.

³⁸ *Id.*

³⁹ Pomp, *supra* note 34, at 401.

⁴⁰ Pomp, *supra* note 34, at 400.

⁴¹ Mark Berggren, *I.R.C. 6103: Let's Get to the Source of the Problem*, 74 CHI.-KENT L. REV. 825, 825–26 (1999).

⁴² *Id.*

employees for tax administration purposes, and (3) government agencies pursuing a non-tax criminal investigation.⁴³ This confidentiality is, however, purely statutory. The U.S. Supreme Court has held that there is no constitutional right to tax privacy.⁴⁴ In other words, Congress could easily hark back to original corporate tax law and make business tax returns public.

Other jurisdictions entitle businesses to less tax privacy. A few states currently make parts of the state corporate income tax return public, and property tax information is often public in the United States.⁴⁵ Some countries make public select corporate return information, and a subset of these countries specifically release the identities of corporations that have committed fraud or other violations in reporting their tax information.⁴⁶

B. *Business Tax Returns and Their Contents*

If business tax returns were public, what information would be revealed? The answer depends on the particular business's legal classification. For tax purposes, there are three main business types: corporations, partnerships, and sole-proprietorships.⁴⁷

Corporations stand apart because, in addition to having distinct tax-reporting requirements, corporations must pay corporate income tax.⁴⁸ To report their tax liability to the government, corporations are required to annually file a corporate tax return. The mainstem of the corporate tax return is Form 1120, which records a corporation's sources of income, allowable deductions, taxable income, tax liability, and taxes owed. Underlying Form

⁴³ The law was amended in the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520. Persons with material interest are exempted in I.R.C. § 6103(e)(1)(D) (2012); certain government employees for tax administration purposes in I.R.C. § 6103(d)(2) (2012); and government agencies conducting criminal investigations in I.R.C. § 6103(d)(1) (2012).

⁴⁴ *United States v. Dickey*, 268 U.S. 378 (1925) (holding that a newspaper could print tax return information). *See also* *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911) (noting the beneficial effects of the public having access to corporate tax returns and suggesting that government publication of tax documents did not violate the Constitution, in particular the Fourth and Fifth Amendments).

⁴⁵ *See* Lenter, Slemrod & Shackelford, *supra* note 6, at 810–813. Non-profits in the US are required to file Form 990 which is publicly available.

⁴⁶ *Id.* Japan, Norway, Sweden, and Finland make some information public, but none of them make all relevant documents publicly available. Australia has also recently changed its tax regime to require more public tax disclosures. Jeffrey L. Hoopes, Leslie Robinson & Joel Slemrod, *Public Tax-return Disclosure*, 66 J. ACCT & ECON 142, 142–44 (2018).

⁴⁷ Other tax classifications include S corporations, trusts, and not-for-profit organizations. S corporations are pass through entities, similar to partnerships but with slightly different rules. *See* I.R.C. Subchapter S. This analysis applies to them. To the extent that a business could be operated through a trust or a not-for-profit organization, this analysis also applies to them.

⁴⁸ Most non-corporate business organizations, including partnerships and LLCs, are not required to pay the corporate income tax but may elect to be treated as corporations for tax purposes. Treas. Reg. § 301.77-1-3.

1120 are schedules that tally the corporation's cost of goods sold, compensation to corporate officers, dividend income, capital gains net income, and depreciation, among many other tax-relevant items.⁴⁹

Beyond these basic financial items, corporations must report information about their domestic and foreign subsidiaries and, in some cases, they must document foreign ownership.⁵⁰ Given that corporations may have hundreds or even thousands of interconnected entities, linked by complex affiliation structures across many different tax jurisdictions, this documentation may account for a substantial portion of their tax filings. Corporations must also file documentation flagging certain activities and positions that the IRS may wish to subject to additional scrutiny.⁵¹

Unlike corporations, partnerships (which for tax purposes include LLCs and associations) are not subject to a separate tax. Instead, partnerships are "pass-through entities" for federal tax purposes.⁵² All of a partnership's income, deductions, and credits are recorded on Form 1065 and then allocated to its members, who must then include their allocation in their own tax computations. Just as with corporations, several additional schedules underlie Schedule 1065 that record relevant partnership business activity.

Sole-proprietorships also do not have a separate tax imposed on them. For federal tax purposes, sole-proprietorships are "disregarded entities"—their business activity appears on the tax return of their owners.⁵³ The owner's tax return includes the relevant forms that record this activity, such as Schedule C, which reports the profit or loss from business, or Schedule F, which reports profit or loss from farming.

The arguments in this Article in favor of eliminating business tax privacy apply most strongly to corporations, but there are three reasons why eliminating business tax privacy more broadly would be advantageous. First, the vast majority of businesses in the US are partnerships for tax purposes.⁵⁴ Second, at least some corporations would consider reclassifying

⁴⁹ Cost of goods sold is reported on Form 1125-A; compensation to corporate officers is reported on Form 1125-E; dividend income is reported on Schedule C; capital gains net income is reported in Schedule D; depreciation is reported on Form 4562.

⁵⁰ This information may be found in Form 5471.

⁵¹ *See, e.g.*, the Reportable Transactions Statement, Form 8886, on which corporations must report certain avoidance activities; and Schedule UTP, Uncertain Tax Positions, on which a corporation must report tax positions if that corporation either has created a financial reserve for that position or plans to litigate it.

⁵² I.R.C. § 701.

⁵³ Treas. Reg. § 301.77-1-3.

⁵⁴ Only 5% of businesses file corporate tax returns. Corporations do, however, account for 62% of business receipts. Lundeed & Pomerlau, *supra* note 14.

as partnerships if only corporate tax privacy were eliminated.⁵⁵ Third, there are business transactions that make use of both corporate and partnership structures to achieve favorable tax outcomes. For these transactions, interested parties cannot see the whole picture without access to partnership returns.⁵⁶

The case for maintaining the tax privacy status quo is strongest for sole-proprietorships and small partnerships, especially those that do not have limited liability.⁵⁷ The tax information of these businesses would reveal information about the persons who owned them.⁵⁸ If there were an exception allowing some businesses to retain tax privacy, it should only apply to simple companies—those that have no subsidiaries or affiliates, and are owned only by a small number of individuals. Broader exceptions are too likely to be abused. We should also be wary of any right that businesses have to redact any content from their returns prior to publication.

For all business entities, the broadest definition of a return includes documents transmitted to the IRS subsequent to the initial tax filing. These documents reveal the dialogue between the IRS and the taxpayer. For example, if the IRS believes a business's initial return contains errors, the IRS may send the business a notice of proposed adjustment to a tax return or proposed changes to income. If the business agrees, it may respond with a form consenting to the collection of deficiencies.⁵⁹ If the business does not

⁵⁵ Lenter, Slemrod & Shackelford, *supra* note 6, at 826.

⁵⁶ See Gladriel Shobe, *Supercharged IPOs and the Up-C*, 88 U. COLO. L. REV. 913 (2017) (describing several transactions that make use of corporate and partnership entities to minimize tax liability for the business and its owners).

⁵⁷ The case for tax privacy is far stronger for individuals than for corporations for at least three reasons. First, there is a plausible public policy concern that individual tax return information could aid criminals interested in perpetrating various pecuniary crimes. See 79 CON. REC. 2690 (1935) (statement of Rep. Robert L. Bacon) (stating concern that conmen would use the individual return information to compile "sucker lists"). See also Pomp, *supra* note 34, at 401; *Income Publicity Called Kidnap Aid*, N.Y. TIMES, Feb. 25, 1935, at 2. Second, the information on an individual return would reveal far more intimate details about the taxpayer than business tax returns would reveal about the various stakeholders in the businesses. The sensitive information might include medical expenses, marital status, and number of dependents. Third, the relative availability of business financial information implies that social norms are less concerned with making business financial information available.

⁵⁸ There are some who claim that as a first principle businesses and individuals should be entitled to the same rights under the law. *Tax Executives Institute*, *supra* note 7, at 241 (arguing that "[p]rivacy is a core American value"). There are meaningful distinctions, however, between corporations and individuals that make the case for parity tenuous if not specious.

⁵⁹ A notice of proposed adjustment to a tax return may be made using Form 5701; proposed changes to income may be made using Form 4549; consent to the collection of deficiencies may be made on Form 870; Form 1120X explains the changes made in an amended corporate return; Form 1065X explains the changes made in an amended partnership return; Form 1040X explains the changes made in an amended individual return.

agree, it may appeal to the IRS Office of Appeals and beyond that to the federal court system.⁶⁰ If the business would like to alter its initial tax filing, it may file an amended return.⁶¹

Taken together, these documents reveal a great deal about a business. For all businesses, they state the business's income, deductions, and credits and how the business arrived at those figures. For corporations, they also state the corporation's corporate income tax liability and how that corporation arrived at its tax liability figure. Moreover, these documents disclose business structures and transactions, including information about the relevant tax jurisdictions and also subsequent interactions with the IRS. In short, an observer would gain substantial insight into a business's interpretation of tax law and that business's tax strategies.

C. *The Value of Business Tax Returns*

The information contained in business tax returns has value because no publicly available records contain comparable information. No publicly available information sheds light on business tax planning and compliance strategies, explains the details of corporate tax liability, or even reveals what a given corporation's tax liability is.⁶²

The only public documents that come close to disclosing corporate tax liability are the financial filings that the SEC requires of public corporations.⁶³ Of course, only a small fraction of businesses are corporations and only a small fraction of corporations are publicly traded.⁶⁴ And even for public corporations the financial statements are a poor

⁶⁰ INTERNAL REVENUE SERVICE, U.S. DEP'T OF TREASURY, PUB. NO. 5, YOUR APPEAL RIGHT AND HOW TO PREPARE A PROTEST IF YOU DON'T AGREE (1999), <https://www.irs.gov/pub/irs-pdf/p5.pdf>.

⁶¹ INTERNAL REVENUE SERVICE, U.S. DEP'T OF TREASURY, PUB. NO. 556, EXAMINATION OF RETURNS, APPEAL RIGHTS, AND CLAIMS FOR REFUND 8–9, 11 (2013), <https://www.irs.gov/pub/irs-pdf/p556.pdf>.

⁶² There is no such thing as non-corporate business tax liability because the tax relevant items of a business are allocated to its owners.

⁶³ See 17 C.F.R. § 210 (2016) (outlining additional details about the filing requirements of public corporations). The financial statements do include changes in deferred tax assets and liabilities, a global effective tax rate, net operating losses, permanently reinvested earnings, and penalties and material risks. Blank, *supra* note 6, at 45–48; Michelle Hanlon, *What Can We Infer About a Firm's Taxable Income from Its Financial Statements*, 56 NAT. TAX J. 831, 838 (2003). In extreme cases, financial reporting requires some reconciliation between the financial statements and the tax return, but even the reconciliation's numbers may be aggregated to the point of uselessness. Hanlon, *supra*, at 837. Most firms use the indirect method for their Statement of Cash Flows, in which case the financial statements will not reveal cash taxes paid.

⁶⁴ Mary Ellen Biery, *4 Things You Don't Know About Private Companies*, FORBES (May 26, 2013), <https://www.forbes.com/sites/sageworks/2013/05/26/4-things-you-dont-know-about-private-companies/#556e49dd291a>.

substitute for corporate tax returns for at least three reasons.⁶⁵ First, financial statements and tax returns are prepared under very different accounting rules.⁶⁶ Examples of differences include that the financial statements have different standards for consolidation,⁶⁷ are only required to show tax information for continuing operations,⁶⁸ and expense stock options as they vest.⁶⁹

Second, in most instances, discretion in disclosure rules makes it difficult to infer exactly what the financial statement numbers mean and how they relate to the tax return information.⁷⁰ Scholars who have compared corporations with similar business activities have found large discrepancies between how those activities were accounted for on the financial statements and on tax returns.⁷¹

Third, the two sets of documents are unlikely to be prepared at the same time because the 10-K is due ninety days after the end of a firm's fiscal year,⁷² whereas the tax return need not be filed until eight and a half months have elapsed.⁷³ Thus when the financial statements are released, the tax return liability need not even have been computed.

These differences matter. Regression analysis has shown a significant disparity between financial statement and tax return numbers.⁷⁴ On average, for every dollar of current tax expense on the financial statement, there is

⁶⁵ See Hanlon, *supra* note 63, at 831; Petro Lisowsky, *Inferring U.S. Tax Liability from Financial Statement Information*, 31 J. AM. TAX'N ASS'N 29 (2009).

⁶⁶ This is not surprising. The financial statements apply Generally Accepted Accounting Principles (GAAP) to present information in a way that will help interested parties make financial decisions. The corporate tax return records the information necessary to determine tax liability.

⁶⁷ Hanlon, *supra* note 63, at 845–46. Under Financial Accounting Standard 94, firms are required to consolidate financial statements for any subsidiaries they control and report income from any subsidiaries they have at least a 20% ownership interest in. Under I.R.C. § 1504 consolidation may be elected if the ownership interest in the subsidiary is at least 80%. Thus, ownership stakes of between 20% and 80% may lead to different incomes due to consolidation. For tax purposes, income is recognized when there is a dividend paid under I.R.C. § 862.

⁶⁸ See Hanlon, *supra* note 63, at 843.

⁶⁹ Hanlon, *supra* note 63, at 839. Corporations may claim a deduction for employee stock options when they are exercised under I.R.C. § 422.

⁷⁰ Hanlon, *supra* note 63, at 836. For example, the provision for uncertain tax positions should accrue probable tax losses and note possible tax losses, but the financial statements are often opaque with regard to these reserves. *Id.* at 842. There is evidence that the requirement that firms disclose these tax reserves led more firms to settle with the IRS. Jennifer L. Blouin, Cristi A. Gleason, Lillian Mills & Stephanie A. Sikes, *Pre-empting Disclosure? Firms' Decisions Prior to FIN No. 48*, 85 ACCT REV. 791 (2010).

⁷¹ Lisowsky, *supra* note 65, at 29.

⁷² In some cases, less than 90 days after the end of a firm's fiscal year. 17 C.F.R. § 210.3-01 (2016).

⁷³ I.R.C. § 6072(d). See also Hanlon, *supra* note 63, at 835.

⁷⁴ Lisowsky, *supra* note 65, at 30.

only seventy cents of tax liability on the corporate tax return.⁷⁵ Anyone who had access to financial statements, but not corporate tax returns, could at best make a poor guess at that corporation's tax liability.

More importantly, a business tax return reveals how a business interacts with tax law. It sheds light on how a business decides to comply with the requirements of tax law, how a business strategically plans its structures and activities to minimize its tax liability, and how well that business executes its compliance and planning strategies.⁷⁶ Without access to business tax returns, any interested party will not understand business tax compliance and planning strategies and the execution of those strategies.

In sum, for most businesses, no tax-related information is publicly available. For the small fraction of corporations that are publicly traded, an interested party would be able to find financial statement tax liability—a poor proxy for the actual tax liability stated on returns. And even with this poor proxy, the interested party would not be able to meaningfully infer much about a business's tax planning and compliance strategies.

II. HIDDEN COSTS

The previous Part showed that a great deal could be learned from business tax returns. But if business tax returns were made public, who would use return information, how would they use it, and what ultimately would the impact of that usage be? This Part looks at how two groups could use business tax returns. Part IIA explains how investors could use business tax return information to improve their financial models. Part IIB explores how firms could use business tax return information from other firms to improve their tax compliance and planning. The fact that investors and firms do not have access to business tax returns causes both of these groups to suffer adverse outcomes and results in businesses having non-uniform tax compliance and planning. This analysis sets the stage for the discussion in Part III about the widespread benefits of eliminating business tax privacy.

A. *Suboptimal Investing*

This Subpart first shows how investors use information to forecast the future risks and returns of their investments. It then demonstrates how more detailed business activity information would materially improve these forecasts. This Subpart concludes by arguing that without business tax return information, investors will make suboptimal investing decisions.

⁷⁵ *Id.*

⁷⁶ Joshua D. Blank, *Reconsidering Corporate Tax Privacy*, 11 N.Y.U. J.L. & BUS. 31, 35 (2014).

1. Investing Decisions

The literature on investor behavior is extensive, and at its heart lies portfolio theory.⁷⁷ Portfolio theory explores how investors allocate their money, often called capital, across different investments.⁷⁸ The fundamental objective of any investment is the money that investment pays out, often called (confusingly for our purposes) a return. All other things equal, investors prefer a higher return to a lower return. Returns are, however, not the only consideration. Investments also vary in their risk.⁷⁹ Thus investors must weigh the risk and return of each investment opportunity before deciding which ones are best.

One possible approach to simultaneously considering the risk and return of an investment entails the investor adjusting the return of each investment by a factor that accounts for the risk.⁸⁰ This adjustment depends on the preferences of the investor—some will accept more risk to increase their return and others will not. After this adjustment, investors should aim to allocate their capital to maximize these risk-adjusted returns.

The pursuit of better risk-adjusted returns explains most investing behavior, from a hedge fund buying distressed debt at a discount hoping to collect through the courts, to an individual investor picking a few stocks as a hobby. Investors will have different beliefs about what will happen in the market, vary in the sophistication of their methods, and span the wealth distribution, but all are attempting to maximize their returns after adjusting for risk.⁸¹

What makes investing challenging is that no one knows what the future performance of a business will be. A business that performed well last year

⁷⁷ See generally Harry M. Markowitz, *The Early History of Portfolio Theory: 1600-1960*, 55 FIN. ANALYSTS J. 5 (1999); Hal Varian, *A Portfolio of Nobel Laureates: Markowitz, Miller and Sharpe*, 7 J. ECON. PERSP. 159 (1993).

⁷⁸ This literature has produced several intricate and influential mathematical models. See, e.g., William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN., 425 (1964); John Lintner, *The Valuation of Risky Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets*, 47 REV. ECON. & STAT. 13 (1965); Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952); HAL VARIAN, MICROECONOMIC ANALYSIS 371–76 (3rd ed. 1992).

⁷⁹ There are many ways to measure risk. Common metrics include standard deviation and market beta. Whereas every investor prefers higher returns, attitudes towards risk can vary. When selecting investments, investors may have to tradeoff between risk and return. A typical investor will require a higher return to take on greater risk, but for the same increase in risk different investors might require different increases in return. Varian, *supra* note 77, at 177.

⁸⁰ This adjustment will depend on the risk preferences of the investor. Risk-averse investors require a higher return to take on greater risk; risk-seeking investors will bear a lower return for access to greater risk. *Id.*

⁸¹ Varian, *supra* note 77, at 190. The exception is a risk-neutral investor, who is indifferent to risk.

may perform poorly this year and vice-versa.⁸² Thus, before investors can optimize their portfolios, they must estimate the risk and return associated with each investment. This entails forecasting the range of possible outcomes for a business and the likelihood of each outcome. Sophisticated investors make these estimations using analytical methods and high-performance computers. Other investors may simply have a gut feeling about a particular stock, which while informal is still a forecast. But before making an investment, all investors have a belief about that investment's future performance—its risk and return.

2. Information Needs

The beliefs that investors have about an investment's future performance do not simply appear to the investor out of thin air. Forecasting future risks and returns requires information. The information could range from a firm's past financial statements, to management interviews, to an overheard conversation on a subway, to a broadcast of Jim Cramer's Mad Money television show. At one extreme, an investor might have insider information. At the other extreme, an investor might know little more than a stock's ticker symbol. Just as importantly, investors vary in their ability to use information. Some have intricate computer models, some are trained Form 10-K readers, and some have neither specialized equipment nor training. Without information, investors cannot make forecasts—even informal ones.⁸³

To explore how more information could improve an investor's forecast of future returns, consider the following series of examples. An investor observes that GM earned \$100 in 2016 and \$140 in 2017, as shown in the table below.

⁸² Past performance is no guarantee of future performance. *See generally*, BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET: THE TIME-TESTED STRATEGY FOR SUCCESSFUL INVESTING* (9th ed. 2007). Of course, the arguments in this Article assume investing returns are not entirely random and that information can improve investing strategies.

⁸³ More information is not necessarily better. Misinformation is unlikely to improve an investor's decisions and even good information could result in information overload. *See, e.g.*, Julie R. Agnew & Lisa R. Szykman, *Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice, and Investor Experience*, 6 J. BEHAV. FIN. 57 (2005) (looking at how information overload affects the decision to accept the default option in retirement plans). Not every investor, however, need use information correctly to improve investment allocation—a critical mass of investors will suffice.

2019]

CASE AGAINST BUSINESS TAX PRIVACY

43

GM limited information			
<i>Year</i>	<i>2016</i>	<i>2017</i>	<i>Forecast</i>
Income	\$100	\$140	\$196

The investor is considering investing in GM and decides to forecast GM's 2018 income to see if GM would be a profitable investment.⁸⁴ Given that GM's income grew by 40% from 2016 and 2017, a simple but reasonable predictive model would forecast that GM's income will again grow 40% from 2017 to 2018.⁸⁵ In that case, the investor would forecast an income of \$196 for GM in 2018.⁸⁶

Now assume that the investor has additional information about GM as in the table below. In addition to seeing GM's income, the investor can see GM's sales, manufacturing costs, and rent. GM's income is equal to its sales less its manufacturing costs and rent: \$100 in 2016 and \$140 in 2017, just as in the limited information scenario.

GM additional information version 1			
<i>Year</i>	<i>2016</i>	<i>2017</i>	<i>Forecast</i>
Sales	\$500	\$550	\$605
Manufacturing Costs	-100	-110	-121
Rent	-300	-300	-300
Income	\$100	\$140	\$184

Again, the investor would like to forecast GM's 2018 income, now using this additional information. The investor can see that in both years manufacturing costs as a percentage of sales were 20% and rent was fixed at

⁸⁴ For simplicity, this example assumes that the income of the business entity is the income of the investor. A more complete analysis would take into consideration all the ways in which investors can profit from businesses, including capital gains, dividends, and share repurchases. The simplification used in this analysis does not change the results.

⁸⁵ $\frac{\$140 - \$100}{\$100} = 40\%$. These examples assume growth rates remain the same. Presumably a sophisticated investor's forecast would apply mean reversion and other principles to arrive at a superior forecast. The basic point made in these examples holds nonetheless.

⁸⁶ $\$140 + \$140 \times 40\% = \$196$.

\$300.⁸⁷ The investor can also observe that sales grew by 10% between 2016 and 2017 and can use that information to make a more sophisticated income forecast by assuming that sales continue to grow at 10%, the cost of manufacturing as a percentage of sales remains constant at 20%, and rent remains \$300.⁸⁸ Under those assumptions, the investor would forecast 2018 sales of \$605,⁸⁹ manufacturing costs of \$121,⁹⁰ and rent of \$300. Finally, by subtracting manufacturing costs and rent from sales, the investor would arrive at a forecast of \$184 for 2018 income.⁹¹

The additional information allowed the investor to distinguish between fixed and variable costs. The investor had evidence that rent stayed fixed even as sales grew, but manufacturing costs grew in proportion to sales. The first 2018 income forecast, \$196, would imply at least one of the following: (1) sales growth increased, (2) the cost of manufacturing cars decreased, or (3) the rent decreased.⁹² Since there is no basis for any of those assumptions, the second forecast is likely better.⁹³

Being able to distinguish between fixed and variable costs is not the only benefit that arises from having access to more detailed information. To see why, consider a different additional information scenario, as shown in the table below, in which the investor observes that GM had one-time lawsuit income of \$80 in 2017. GM's recurring income is equal to its sales less its manufacturing costs and rent: \$100 in 2016 and \$60 in 2017, but GM also has the lawsuit income in 2017. Taking the lawsuit income into account, GM has total income of \$100 in 2016 and \$140 in 2017, just as in the limited information scenario.

⁸⁷ $\frac{\$100}{\$500} = 20\%$; $\frac{\$110}{\$550} = 20\%$.

⁸⁸ $\frac{\$550 - \$500}{\$500} = 10\%$ is the rate of sales growth.

⁸⁹ $\$550 + \$550 \times 10\% = \$605$.

⁹⁰ $\$605 \times 20\% = \121 .

⁹¹ $\$605 - \$121 - \$300 = \184 .

⁹² Assuming no other sources of income or cost.

⁹³ The two estimates differ by $\frac{\$196 - \$184}{\$184} = 6.5\%$.

GM additional information version 2			
<i>Year</i>	<i>2016</i>	<i>2017</i>	<i>Forecast</i>
Sales	\$500	\$450	\$405
Manufacturing Costs	-100	-90	-81
Rent	-300	-300	-300
Recurring income	\$100	\$60	\$24
Lawsuit income	+0	+80	+0
Total income	\$100	\$140	\$24

Again, the investor would like to forecast GM's 2018 income. The investor can see that in both years manufacturing costs as a percentage of sales were 20% and rent was fixed at \$300.⁹⁴ Now, the investor observes that sales fell 10% between 2016 and 2017 and can use that information to make a more sophisticated income forecast by assuming that sales continue to fall at 10%, the cost of manufacturing as a percentage of sales remains constant at 20%, and rent remains at \$300.⁹⁵ Under those assumptions, the investor would forecast 2018 sales of \$405,⁹⁶ manufacturing costs of \$81,⁹⁷ and rent of \$300. Finally, by subtracting manufacturing costs and rent from sales, the investor would arrive at a forecast of \$24 for 2018 income.⁹⁸

The additional information allowed the investor to distinguish between recurring and non-recurring income. GM's total income did grow between 2016 and 2017, but that was only because it received one-time lawsuit income in 2017. Its recurring income was in fact decreasing, but this would have not have been apparent without the additional information.

In all three examples, GM's 2016 and 2017 income was the same. Yet, in each example, the forecasted 2018 income was very different. More information changed the forecast, likely making it more accurate. In the first additional information scenario, the improvement came from forecasting more elements forward—being able to distinguish between fixed costs and variable costs. In the second additional information scenario, the improvement came from being able to distinguish between one-time and

⁹⁴ $\frac{\$100}{\$500} = 20\%$; $\frac{\$90}{\$450} = 20\%$.

⁹⁵ $\frac{\$450 - \$500}{\$500} = -10\%$ is the rate of sales growth (or decline in this case).

⁹⁶ $\$450 - \$450 \times 10\% = \$405$.

⁹⁷ $\$405 \times 20\% = \81 .

⁹⁸ $\$405 - \$81 - \$300 = \24 .

recurring items. These examples used fairly simple forecasting methods, but the same theory applies to more intricate models. More relevant, accurate information used appropriately will yield better forecasts.

The above examples focused on forecasting income, but more information also improves the estimates of all financial measures, including risk. Measuring risk is more involved because it requires forecasting multiple possible future outcomes and also estimating how likely each of those possible future outcomes is. More information would make it easier to determine what these possible future outcomes might be and also their likelihood. For example, more information about all of GM's car product lines would allow an investor to forecast how the price of oil would affect each of its products. The investor could then determine how much GM would benefit from declining oil prices or be harmed by increasing oil prices, ultimately using that information to estimate GM's risk related to the price of oil.

3. Tax Information

Additional tax information is no different: it would improve investors' estimates of the risks and returns associated with different investments. Tax return information would make it easier to forecast future tax liability and it would also provide otherwise unobservable data that would aid in the forecasting of sales, costs, and many other relevant financial measures. Similarly, tax return information would help an investor uncover how risky the tax strategies of a business are, and it would also make it easier to estimate many other risks.

Tax information would be particularly useful for investors that invest in publicly traded corporations, a roughly \$30 trillion market.⁹⁹ When an investor is interested in investing in a small LLC, that LLC might well allow the investor to review its tax returns. An investor making a similar request of Facebook would be ignored. Investors of modest means may benefit disproportionately from eliminating business tax privacy because they tend to invest heavily in publicly traded equities.¹⁰⁰

Estimating future tax liability comes with its own challenges because a medley of interrelated factors determines a corporation's tax liability. Some corporations with low effective tax rates today will have low effective tax rates in the future. For example, firms in industries that have easy access to tax credits and deductions will have lower effective tax rates today and

⁹⁹ WORLD BANK DATA, <https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?end=2018&locations=US&start=2010&view=chart> (last visited Sept. 26, 2019).

¹⁰⁰ Even if investors of modest means do not understand how to use tax return information in their investing, they may invest in mutual funds that do.

tomorrow.¹⁰¹ This also applies to firms that can consistently use effective tax sheltering strategies, especially multinational firms that can shift business activity to lower tax jurisdictions.¹⁰² In contrast, firms that have abnormally large deductions and credits today will have different effective tax rates tomorrow. This is especially true for firms that find ways of frontloading their deduction claims, which causes not only an unusually low tax liability today, but also an unusually high tax liability tomorrow.

The following examples demonstrate some of the ways that tax information could improve investor forecasts. An investor observes that Apple earned \$80 in 2016 and \$120 in 2017, as shown in the table below.

Apple limited information			
<i>Year</i>	<i>2016</i>	<i>2017</i>	<i>Forecast</i>
After-tax income	\$80	\$120	\$180

The investor is considering investing in Apple and decides to forecast Apple's 2018 income to see if Apple would be a profitable investment. Given that Apple's income grew by 50% from 2016 to 2017, it would be reasonable to assume that Apple's income will again grow 50% from 2017 to 2018.¹⁰³ In that case, the investor would forecast an income of \$180 for Apple in 2018.¹⁰⁴

Now assume that the investor has additional information about Apple. As in the table below, the investor also sees Apple's pre-tax income, its tax liability, and its 2017 retirement plan startup tax credit of \$5.¹⁰⁵ Apple's after-tax income is equal to its pre-tax income less its taxes, plus any credits: \$80 in 2016 and \$120 in 2017, just as in the limited information scenario.

¹⁰¹ These businesses include those engaged in qualified research and development (I.R.C. § 41) and oil exploration (I.R.C. § 45I).

¹⁰² The shifting of income to low-tax jurisdictions is often called "base erosion and profit shifting" or "BEPS" for short. See OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD PUBLISHING (Jul. 19, 2013), <http://dx.doi.org/10.1787/9789264202719-en>.

¹⁰³ $\frac{\$120 - \$80}{\$80} = 50\%$. These examples assume growth rates remain the same. Presumably a sophisticated investor's forecast would apply mean reversion and other principles to arrive at a superior forecast. The basic point made in these examples holds nonetheless.

¹⁰⁴ $\$120 + \$120 \times 50\% = \$180$.

¹⁰⁵ I.R.C. § 45E. Eligible employers may claim a credit of up to 50% of the qualified start-up costs of an employer provided pension using Form 8881. This credit is only available to small businesses, so Apple would probably not qualify.

Apple additional information			
<i>Year</i>	<i>2016</i>	<i>2017</i>	<i>Forecast</i>
Pre-tax income	\$100	\$160	\$256
25% Corporate tax liability	-25	-40	-64
Retirement plan startup credit	+5	+0	+0
After-tax income	\$80	\$120	\$192

Again, the investor would like to forecast Apple's 2018 income. Now, the investor observes that pre-tax income grew by 60% between 2016 and 2017.¹⁰⁶ Assuming that income before taxes continued to grow at a 60% percent rate, Apple's 2018 pre-tax income would be \$256,¹⁰⁷ Apple's tax would be \$64,¹⁰⁸ and Apple's after-tax income would be \$192.¹⁰⁹ The additional information changed the forecast, making it more accurate, because it allowed the investor to separate the recurring and non-recurring portions of taxes owed.¹¹⁰

In the Apple example, the investor observed something about the company from its tax information that would likely not be available on its Form 10-K: Apple is creating a retirement plan. With a more sophisticated financial model, the investor could also use this information to improve forecasts by considering Apple's ability to recruit good employees—presumably the retirement plan will be attractive to potential employees—and the increased costs associated with operating the retirement plan.¹¹¹

Tax information can also improve forecasts of non-tax items, such as sales, as demonstrated in the following example. An investor observes that Disney earned \$185 in 2016 and \$184 in 2017, as shown in the table below.

¹⁰⁶ $\frac{\$160 - \$100}{\$100} = 60\%$ is the rate of pre-tax income growth.

¹⁰⁷ $\$160 + \$160 \times 60\% = \$256$.

¹⁰⁸ $\$256 \times 25\% = \64 .

¹⁰⁹ $\$256 - \$64 = \$192$.

¹¹⁰ The two estimates differ by $\frac{\$180 - \$192}{\$192} = -6.25\%$.

¹¹¹ Some investors do take this information into account. For example, the Parnassus Endeavor Fund invests in companies with "outstanding workplaces." PARNASSUS INVESTMENTS 8 (2015), <https://cdn.parnassus.com/downloads/funds/ParnassusFundsBrochure.pdf>.

Disney limited information			
<i>Year</i>	<i>2016</i>	<i>2017</i>	<i>Forecast</i>
After-tax income	\$185	\$184	\$183

The investor is considering investing in Disney and decides to forecast Disney's 2018 income to determine whether Disney would be a profitable investment. Given that Disney's income decreased by approximately .5% from 2016 to 2017, it would be reasonable to assume that Disney's income will again decrease by approximately .5% from 2017 to 2018.¹¹² In that case, the investor would forecast an income of \$183 for Disney in 2018.¹¹³

Now assume the investor has additional information about Disney.¹¹⁴ As in the table below, the investor sees Disney's pre-tax income and the taxes Disney paid to California and Florida. Disney's after-tax income is equal to its pre-tax income less its taxes: \$185 in 2016 and \$184 in 2017, just as in the limited information scenario.

Disney additional information		
<i>Year</i>	<i>2016</i>	<i>2017</i>
Pre-tax income	\$200	\$200
10% California tax	-10	-12
5% Florida tax	-5	-4
After-tax income	\$185	\$184

The investor can use this additional information to deduce how much of Disney's income was in California and how much was in Florida.

As shown in the table below, because the California tax rate is 10% and Disney paid \$10 in California taxes in 2016 and \$12 in California taxes in 2017, the investor can deduce California income: \$100 in 2016 and \$120 in 2017.¹¹⁵ Similarly, the investor can deduce Florida income: \$100 in 2016

¹¹² $\frac{\$184 - \$185}{\$185} = -.5\%$.

¹¹³ $\$184 - \$184 \times .5\% = \$183$, rounded to the nearest integer.

¹¹⁴ For simplicity, assume also that the only costs Disney incurs are the state corporate taxes.

¹¹⁵ 10% of \$100 is \$10, so California income must be \$100 in 2016; 10% of \$120 is \$12, so California income must be \$120 in 2017.

and \$80 in 2017.¹¹⁶

Disney additional information			
<i>Year</i>	<i>2016</i>	<i>2017</i>	<i>Forecast</i>
California income	\$100	\$120	\$144.0
Florida income	100	80	64.0
Pre-tax income	\$200	\$200	\$208.0
10% California tax	-10	-12	-14.4
5% Florida tax	-5	-4	3.2
After-tax income	\$185	\$184	\$190.4

The investor can find separate growth rates for California and Florida income. From 2016 to 2017, California income grew by 20% and Florida income fell by 20%.¹¹⁷ Assuming that California income continues to grow at the same rate of 20%, it will be \$144 in 2018.¹¹⁸ Assuming that Florida income continues to decline at the same rate of 20%, it will be \$64 in 2018.¹¹⁹ At those income levels, 2018 California taxes will be \$14.4 and 2018 Florida taxes will be \$3.2.¹²⁰ Thus, the projected total income for 2018 will be \$190.4.¹²¹

The additional information improved the investor's 2018 forecast of tax liability and also allowed the investor to compute two separate income growth rates, which would likely be more accurate than computing one company-wide income growth rate.¹²² Perhaps even more importantly, the investor gained additional understanding of Disney's strategy regarding where it plans to expand its business.¹²³

The examples thus far have focused on the investor's forecast of future income, but tax information can also inform investors about the risks associated with investing in a corporation. As a final example, consider an

¹¹⁶ 5% of \$100 is \$5, so Florida income must be \$100 in 2016; 5% of \$80 is \$4, so Florida income must be \$80 in 2017.

¹¹⁷ $\frac{\$120 - \$100}{\$100} = 20\%$; $\frac{\$80 - \$100}{\$100} = -20\%$.

¹¹⁸ $\$120 + \$120 \times 20\% = \$144$.

¹¹⁹ $\$80 - \$80 \times 20\% = \$64$.

¹²⁰ $\$144 \times 10\% = \14.4 and $\$64 \times 5\% = \3.2 .

¹²¹ $\$144 - \$14.4 + \$64 - \$3.2 = \$190.4$.

¹²² The two estimates differ by $\frac{\$183 - \$190.4}{\$190.4} = -3.89\%$.

¹²³ Disney's competitors will also have access to this information. See *infra* Part IIIC2 for further analysis of this issue.

2019]

CASE AGAINST BUSINESS TAX PRIVACY

51

investor who observes, as shown in the table below, that Google had pre-tax income of \$100 in both 2016 and 2017; taxes of \$25 in 2016 and \$20 in 2017; and, thus, after-tax income of \$75 in 2016 and \$80 in 2017.

Google limited information		
<i>Year</i>	<i>2016</i>	<i>2017</i>
Pre-tax income	\$100	\$100
Corporate income tax liability	-25	-20
After-tax income	\$75	\$80

The investor observes that Google's effective tax rate was 25% in 2016 but only 20% in 2017.¹²⁴ Given only this information, the investor will not know why the effective tax rate decreased from 2016 to 2017. If the investor cannot see why Google's effective tax rate changed, the investor will have a worse estimate of Google's future tax liability and a worse estimate of Google's future tax risk.

With more information, the investor could understand what the decrease in effective tax rate implies for Google's future. The decreased effective tax rate in 2017 would, for example, have different return and risk implications if it were caused by a one-time credit as opposed to Google adopting a risky tax avoidance strategy. If the 2017 effective tax rate were smaller because of a one-time credit, then 25% is probably a better approximation of Google's future tax rate. If the lower effective tax rate were caused by a risky tax avoidance strategy, which the IRS would likely contest, then the best approximation of Google's future tax rate would depend on the probability that Google prevails over the IRS and the penalties Google would face if it did not prevail. With a risky tax avoidance strategy, the best forecast of Google's tax rate might be lower than 25%, but investing in Google would also carry more risk because the outcome of the possible dispute with IRS would be uncertain.

The utility of tax return information to investors is not merely theoretical. In practice, the absence of tax information causes analysts to arrive at vastly different valuations for the same company—differences that can total tens of billions of dollars.¹²⁵ But because financial statements do

¹²⁴ $\frac{\$25}{\$100} = 25\%$; $\frac{\$20}{\$100} = 20\%$.

¹²⁵ Morris Pearl, *How Companies Like Apple Dodge Taxes and Their Own Investors*, N.Y. TIMES (Sep. 21, 2016), <https://www.nytimes.com/2016/09/21/opinion/how-companies-like-apple-dodge-taxes-and-their-own-investors.html> (describing how two analysts came up with valuations \$28 billion dollars apart for Dell, despite using similar methods, largely because

not contain much information about the riskiness of tax strategies, it is impossible to tell in most cases if a firm's effective tax rate is low because of a credit or a tax shelter.¹²⁶ Investors remain in the dark.

B. *Suboptimal Business Tax Planning and Compliance*

Investors are not the only ones that would eagerly scrutinize business tax returns. Businesses would also be keen to take a look. This Subpart considers the effect of eliminating business tax privacy on firms. It first shows how even similar firms will have different tax outcomes because (1) firms have different tax strategies, (2) firms make different judgments about how to record tax-relevant transactions, and (3) some firms are more inclined to err in their accounting than others. This Subpart then shows how public access to returns would allow firms to compare their returns to other firms, enabling each firm to find the best tax strategies, apply most appropriate tax-relevant judgments, and catch accounting errors. Ultimately, the flow of tax information between firms would make tax compliance and planning more uniform across firms. Without access to business tax returns, businesses will have disparate tax outcomes, which will cause economic distortions that are discussed in Part III.

1. Variation in Business Tax Outcomes

Under the Internal Revenue Code, business activities receive different tax treatment based on the location, timing, and character of those activities. For example, investment in opportunity zones, research and development expenses, and qualified oil and gas production all receive favorable tax treatment.¹²⁷

Even identical businesses, however, subject to the same laws, prepare substantially different returns. In an annual experiment, *Money Magazine* consistently found that different tax experts given the same information prepared substantially different tax returns.¹²⁸ This should come as no

they made different assumptions about the company's overseas taxes). There is also evidence that firms facing tax uncertainty delay large capital investments. Martin Jacob, Kelly Wentland & Scott Wentland, *Real Effects of Tax Uncertainty: Evidence from Firm Capital Investments* (Apr. 11, 2019) (working paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2518243. That information would certainly be valuable to investors.

¹²⁶ Hanlon, *supra* note 63, at 844.

¹²⁷ Businesses that invest in opportunity zones, I.R.C. § 1400Z-2 (2018), have qualified research and development costs, § 41, and produce oil or gas from marginal wells, § 45I, are entitled to favorable tax treatment.

¹²⁸ JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 229 (5th ed. 2017) (citing several studies from Money Magazine). See also Joel Slemrod, *The Costs of Tax Complexity: Presentation to the President's Advisory Panel on Federal Tax Return 5* (March 3, 2005). See, e.g., Lisa De Simone, John R. Robinson & Bridget Stomberg, *Distilling the Reserve for Uncertain Tax Positions: The Revealing Case of Black Liquor*, 19 REV. ACCOUNT STUD. 456

surprise. Tax compliance and planning are neither trivial nor perfunctory. Firms must record and categorize the multitudinous tax-relevant transactions they execute every day. Moreover, the size of the tax code combined with its opaque nature renders compliance hardly a simple matter of course.¹²⁹ When the incentive to minimize tax liability is added to the mix, actualized by tax practitioners of varying skill and moral fiber, we should be surprised whenever two businesses do manage to have the same effective tax rate,¹³⁰ let alone the same tax strategies.

If, however, business tax returns were public, every firm could compare its tax return to other firms' returns. Whenever a firm found discrepancies, it could take a close look, learn from the discrepancy, and if advantageous modify its tax planning and compliance strategy and execution.

2. Firm Learning

There are many ways to categorize the causes of disparate business tax outcomes.¹³¹ This section describes three (strategy, discretion, and error) and explains how eliminating business tax privacy and allowing firms to learn from one another would reduce disparate business tax outcomes.¹³²

Strategy. The Internal Revenue Code creates many opportunities for businesses to decrease their tax liability with careful tax planning. Common legal strategies to reduce tax liability include manipulating the timing of transactions, strategically structuring business transactions, preferring

(2014) (detailing how nineteen corporations accounted for a refundable excise tax credit in very different ways); Rice, *supra* note 10, at 125–62 (estimating the distribution of tax mistakes that small firms make).

¹²⁹ The US government itself seems unsure of how long the Code is: “The tax code has grown so long that it has become challenging even to figure out how long it is. A search of the Code conducted using the ‘word count’ feature in Microsoft Word turned up nearly four million words.” TAXPAYER ADVOCATE SERV., 1 ANNUAL REPORT TO CONGRESS 6 (2012), <https://taxpayeradvocate.irs.gov/2012-Annual-Report/downloads/Volume-1.pdf>.

¹³⁰ The simplest way to think about tax variation is as variation in effective tax rates. $ETR = \frac{\text{Measure of tax liability}}{\text{Measure of pretax income}}$. Using ETRs (which are average rates) simplifies the analysis and captures the essential intuition. The complete picture is much more complicated. In theory, the marginal rate should drive decision making in the primary market for capital, but the average rate should drive decision making in the secondary market for capital. Further complicating matters, because most investments yield returns over several periods, there are in fact several marginal tax and average tax rates that may be relevant.

¹³¹ One possible partition is error, avoidance, evasion, discretion, and chance. These are not always clearly defined and distinct, but the following demarcations offer a starting point: error and chance are unintentional, but error requires that available information is neglected or misused; avoidance and evasion are intentional; avoidance is at least plausibly legal; evasion requires concealing information from the tax authority and is illegal; and judgment implies that reasonable minds could differ on, for example, the correct application of law or the correct forecast of a financial item.

¹³² Part IIIB2 *infra* discusses why this is beneficial for the economy at large.

certain forms of financing, and shifting income to more tax-favorable jurisdictions.¹³³ Many of these strategies require complex transactions and an intricate network of affiliated business entities. Some of these strategies are legal, some are illegal, and some fall into a grey area, in which the IRS and a firm (or even different firms) might disagree about a particular application of tax law.¹³⁴

While many of these strategies are widely understood, the devil is in the details, and it would be a mistake to assume that business tax strategy is uniform across firms. Indeed, some corporations are well known to be more effective at tax planning than others. For many years, GE's tax department employed nearly 1,000 people and was called the world's best tax law firm.¹³⁵ Moreover, while many of the largest corporations have access to the same cadre of accounting and law firms, many smaller businesses do not.¹³⁶

¹³³ Stock repurchases and dividend payments both return capital to investors. These two transactions, however, are not identical from the perspective of the investors for tax purposes. Repurchases may trigger capital gains taxes and dividends may trigger dividend taxes—depending on the situation, one may be preferred to the other. Toward the end of a tax year, it may be advantageous to shift revenue recognition from the coming year to the current one if rates are expected to be higher in the following year. Interest from debt obligations may be deductible, but dividend payments are not. I.R.C. § 163 (2018). From a corporate tax standpoint, using debt instead of equity financing is thus an avoidance activity. Because equity has non-tax advantages, there are financial advisors that design instruments that resemble debt for tax purposes and equity for non-tax purposes.

¹³⁴ A typical example is transfer pricing, especially when intellectual property is involved. Microsoft, for example, sold intellectual property to a subsidiary in a lower tax jurisdiction. The subsidiary then used the intellectual property to generate profit. The original sale was subject to US taxes and the subsequent profit was subject to foreign tax law (until the subsidiary pays a dividend to Microsoft). The price of the original sale effectively determined the allocation of taxable income between these two jurisdictions. Although there was uncertainty over the value of the intellectual property, Microsoft had a strong incentive to estimate the value to be as small as possible. Even though the profits belong to the subsidiary, they may be loaned to the parent company for periods less than 60 days. Rolling over these loans, HP, for example, was able to effectively repatriate billions. *Corporate Tax Avoidance: The Price Isn't Right*, THE ECONOMIST: THE SCHUMPETER BLOG (Sept. 21, 2012), <https://www.economist.com/schumpeter/2012/09/21/the-price-isnt-right>.

¹³⁵ David Kocieniewski, *G.E.'s Strategies Let It Avoid Taxes Altogether*, N.Y. TIMES (Mar. 24, 2011), <https://www.nytimes.com/2011/03/25/business/economy/25tax.html>. The claim that GE paid no taxes was sensationalized by the press and some politicians. Robert Farley, *Warren: GE Pays No Taxes*, FACT CHECK (Apr. 24, 2014), <http://www.factcheck.org/2012/04/warren-ge-pays-no-taxes/>. GE paid no taxes because it sustained an enormous loss from the collapse of GE Capital during the Great Recession. See, e.g., Allan Sloan, *The Truth About GE's Tax Bill*, FORTUNE (Apr. 4, 2011, 1:00 PM), <http://fortune.com/2011/04/04/the-truth-about-ges-tax-bill/>. GE has recently fallen on harder times and has slashed the number of tax professionals it employs. Neil Amato, *600 Tax Professionals Moving to PWC*, J. ACCOUNTANCY (Jan. 13, 2017), <https://www.journalofaccountancy.com/news/2017/jan/pwc-to-add-ge-tax-team-201715836.html>.

¹³⁶ The four largest accounting firms, PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young and KPMG, are collectively known as the "Big Four." Michael Rapoport, *Big Four Accounting Firms' Revenue Rise 10.4%, Strongest Growth in Years*,

Thus, although there is variation in tax strategy between similarly sized firms, the variation across all firms (from those with the most innovative tax planning to those with little or none at all) is far more substantial.

With public access to returns, firms could learn about the tax strategies of other firms. They could reverse engineer some of the compliance, sheltering, and preparation decisions of other firms.¹³⁷ In particular, they could learn about each other's inter-party transactions,¹³⁸ see which activities and jurisdictions other firms are using for tax sheltering purposes, and learn about transfer pricing arrangements.¹³⁹ By looking at the documents filed with the IRS subsequent to the original return, firms could also learn about what the IRS contests and what it does not and modify their tax strategies accordingly.¹⁴⁰ As each firm applied what it learned from other firms, tax strategies would become more uniform across firms.

Discretion. Complying with tax law requires firms to make many judgment calls. The Internal Revenue Code is filled with ambiguities, and tax cases often point taxpayers in different directions.¹⁴¹ Businesses may, for example, expense bad debts, but deciding what proportion of debts will be uncollectable is not an exact science and reasonable minds may differ.¹⁴² Business taxpayers also use discretion with non-substantive issues, such as what to disclose to the IRS.

In the long run, many judgments are overridden. Accountants must guess in the financial statements what fraction of debts that will not be collected, but that estimate will ultimately be replaced by the actual fraction of debts that the business is unable to collect. Similarly, accountants must guess how a dispute with the IRS will be resolved, but ultimately that forecast will be replaced by the actual outcome of the dispute.

Nonetheless, variation in discretion could make two otherwise similar firms appear very different in a given year. Consider, for example, two firms that were identical except for their accounting practices, with the more

WALL ST. J. (Dec. 10, 2018), <https://www.wsj.com/articles/big-four-accounting-firms-revenue-rises-10-4-strongest-growth-in-years-11544713625>.

¹³⁷ See *supra* Part IIB and Part IIC; Lenter, Slemrod & Shackelford, *supra* note 6, at 821; Blank, *supra* note 6, at 62–69.

¹³⁸ Blank, *supra* note 6, at 90.

¹³⁹ *Id.* at 91.

¹⁴⁰ *Id.* at 94–95.

¹⁴¹ For example, the IRS has the authority to reclassify debt as equity. I.R.C. § 385 (2018). The Internal Revenue Code and accompanying regulations contain several ambiguities, so Common Law standards have emerged from the various cases dealing with reclassification. These Common Law standards, however, are not uniformly applied, and in many plausible cases a taxpayer may not have much certainty about the likelihood of reclassification. STEPHEN SCHWARZ & DANIEL J. LATHROPE, *FUNDAMENTALS OF CORPORATE TAXATION* 122–37 (9th ed. 2016).

¹⁴² I.R.C. § 166 (2018).

aggressive one consistently estimating that a higher fraction of debts would be collected. The more aggressive firm would appear more profitable until, potentially years later, the actual collections would require the aggressive firm to adjust its accounting. Moreover, judgments about what to disclose to the IRS are likely to consistently favor those companies that disclose just enough to avoid additional scrutiny but no more.

With public access, a company would gain insight into the judgments other companies have made. This includes financial items like bad debts and what disclosures to make to the IRS.¹⁴³ As companies learned from one another, judgment calls would likely become more uniform across companies. No company would have an incentive to make aggressive judgment calls that might call attention to itself, nor would companies feel compelled to be diffident if they could observe typical behavior. As judgments become normalized, financial measures would better reflect firm business activities and not their discretion.

Error. Given that companies must record myriad transactions, it should come as no surprise that errors often appear in business tax accounting.¹⁴⁴ According to a Bloomberg survey, tax errors caused 16% of firms to suffer unfavorable adjustments, 11% to miss tax breaks, and 7% to grossly miscalculate tax provisions.¹⁴⁵ Some of these errors arose from information mismanagement, including incorrectly manually entering tax relevant data, accidentally deleting Microsoft Excel formulas designed to compute taxes, and overwriting tax relevant data.¹⁴⁶ Other errors arose from an accidental failure to comply with tax law, for example by prematurely closing books, adjusting asset values for past years without making all the necessary adjustments for subsequent years, writing off business units that still had value, and prematurely expensing deferred compensation.¹⁴⁷

¹⁴³ For example, under the financial accounting reporting requirements, corporations must create financial reserves for uncertain tax positions. These reserves account for the possibility that the corporation does not prevail in a tax dispute with the IRS. Tax law requires corporations that create a reserve to disclose it to the IRS on Schedule UTP. Since, however, the reserve is created at the discretion of the corporation, corporations may vary substantially in what they disclose. Blank, *supra* note 6, at 93. With public access to tax returns, corporations would develop a much better sense of what the disclosure norms are.

¹⁴⁴ See BLOOMBERG BNA, TOP TAX & ACCOUNTING MISTAKES THAT COST COMPANIES MILLIONS (2015) (conducting a survey of 200 in-house tax and accounting professionals at firms with revenues greater than one billion dollars). Errors vary across industries. Financial services firms are most likely to close books before collecting the necessary data; healthcare firms are most likely to struggle with city-specific regulations; and manufacturing firms have the greatest difficulty with depreciation and asset value issues. *Id.* In the individual income tax context, people also make errors, including not claiming credits. See Bhargava & Manoli, *supra* note 5, at 3489.

¹⁴⁵ See BLOOMBERG, *supra* note 144.

¹⁴⁶ *Id.*

¹⁴⁷ Additional common errors include incorrectly applying unitary state tax rules, failing

In some cases, these errors are detected quickly and corrected and ultimately do not affect the economic position of the company. Other times, however, the company is not so lucky. The detected errors can result in penalties or forgone benefits, affecting the economic circumstances of the firm. If errors are never detected, they will also have an effect on the firm by either permanently increasing or decreasing firm value.

With public access, if a business made a mistake in an Excel spreadsheet or neglected to claim a deduction, it would be far easier to detect. That company could compare its numbers to similar businesses, using their returns as a check. If certain isolated numbers or ratios were substantially different, the company could take a closer look for errors.

3. Towards Tax Uniformity

In the age of machine learning, firms would not be limited to side-by-side comparisons between tax returns. With public access, software developers could easily write algorithms that could process tax return information.¹⁴⁸ This software could highlight suboptimal tax strategies, overly aggressive or diffident judgment calls, and accounting errors. Activist investors might serve as a catalyst by investing in firms with relatively poor tax performance and increasing shareholder value by upgrading tax performance, further homogenizing business tax outcomes.¹⁴⁹ This would level the playing field between companies and limit the advantages any one could gain over others by being more tax savvy. Part III discusses why this is beneficial for the economy at large.

While eliminating business tax privacy would move companies towards tax uniformity, it is unlikely that it would make tax compliance, planning, and execution perfectly uniform across firms for at least three reasons. First, managers vary in their moral fiber and risk preferences.¹⁵⁰ Some choose to evade taxes by filing false returns, some choose to push the envelope with

to keep up with or comply with city-specific tax rules, failing to comply with state tax law when deducting dividends, and not reconciling partnership earnings with past earnings estimates. The errors seem to stem from two sources: uninterested management and the limited input solicited from tax professionals in the design of the accounting systems. *Id.*

¹⁴⁸ Machine learning is “capable of identifying highly complex patterns in large datasets.” James Zou, Mikael Huss, Abubakar Abid, Pejman Mohammadi, & Ali Torkamani, *A Primer on Deep Learning in Genomics*, 51 NATURE GENETICS 12, 12 (2019), <https://www.nature.com/articles/s41588-018-0295-5#auth-6>. The universe of business tax returns may be complex but is far simpler than the human genome.

¹⁴⁹ Blank, *supra* note 6, at 38.

¹⁵⁰ Clearly not every CEO will go to the extreme of former Enron CEO, Jeffrey Skilling. Matt Stevens & Matthew Haag, *Jeffrey Skilling, Former Enron Chief, Released After 12 Years in Prison*, N.Y. TIMES (Feb. 22, 2019), <https://www.nytimes.com/2019/02/22/business/enron-ceo-skilling-scandal.html?searchResultPosition=1>.

aggressive tax strategies, and some choose to play it safe.¹⁵¹ Examining a false return will clearly not reveal that company's true tax strategies, and a risk-averse manager is unlikely to adopt the aggressive tax strategies that could be gleaned from other returns. Nonetheless, eliminating business tax privacy would get more eyes on tax returns, making tax evasion more difficult.¹⁵² And over the long-term, the range in tax risk-taking would decrease as aggressive tax planning would be publicly disciplined by the IRS and diffident tax planning would be publicly disciplined by investors pushing companies to more tax efficient strategies.

Second, some tax shelters are particularly well suited to multinational corporations. Businesses without affiliates in foreign countries will not be able to take advantage of transfer pricing to limit their tax liability.¹⁵³ There is anecdotal evidence, however, that with a little legal wizardry even small domestic firms have found ways of using international tax sheltering strategies.¹⁵⁴

Third, dumb luck can affect a firm's effective tax rate. Consider, for example, two identical firms. One makes a large capital expenditure on December 31, 2016, and the other makes the same large capital expenditure on January 1, 2017. If Congress enacts a new tax provision that offers a substantial credit for capital expenditures made in 2017, then the second firm would have a lower 2017 effective tax rate. Eliminating business tax privacy will do little to even the blows of fortune.

All in all, tax privacy is a substantial barrier preventing firms from having the same tax outcomes—it essentially allows different firms to play by different tax rules. Eliminating business tax privacy would decrease this tax variation across firms. With public access, if a company found substantial inconsistencies, it could take a closer look to see if it had missed a tax avoidance opportunity, come to a different judgment regarding a tax

¹⁵¹ Tax evasion is illegal and typically involves either deliberately underreporting income or over reporting deductible expenses. INTERNAL REVENUE SERVICE, EXAMPLES OF CORPORATE FRAUD INVESTIGATIONS – FISCAL YEAR 2015 (2015), <https://www.irs.gov/compliance/criminal-investigation/examples-of-general-tax-fraud-investigations-fiscal-year-2015>. The IRS estimates that in 2006 there was \$67 billion of underreporting corporate tax liability, most of which was evasion. INTERNAL REVENUE SERVICE, TAX GAP “MAP” TAX YEAR 2006 (2011), https://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf. It is worth noting that these numbers represent the position of the IRS and are not undisputed.

¹⁵² Rice, *supra* note 10, at 125–62.

¹⁵³ *Corporate Tax Avoidance: The Price Isn't Right*, THE ECONOMIST: THE SCHUMPETER BLOG (Sept. 21, 2012), <https://www.economist.com/schumpeter/2012/09/21/the-price-isnt-right>.

¹⁵⁴ See Adam Sherwin, *Crickhowell: Welsh Town Moves 'Offshore' to Avoid Tax on Local Business*, INDEPENDENT, (Nov. 10, 2015), <https://www.independent.co.uk/news/uk/crickhowell-welsh-town-moves-offshore-to-avoid-tax-on-local-business-a672897.html> (describing the local businesses in a Welsh town that used international tax sheltering strategies to minimize their tax liability).

issue, or made an error. Over time, this learning process would make tax planning and compliance strategies more homogenous across firms.

III. A WORLD WITHOUT BUSINESS TAX PRIVACY

The preceding Part explained how investors and businesses could use business tax return information. This Part argues that eliminating business tax privacy will improve the allocation of economic resources in three ways. First, the more information investors have, the better they can direct their investment towards productive businesses. Second, the more firms can learn from other firms, the more uniform tax planning and compliance will be across businesses, allowing businesses to compete for investment based on their productivity and not their tax-savviness. Third, the more firms can learn from other firms, the fewer resources they will expend on tax compliance and planning strategies, leaving more resources available for other activities that are more valuable to society.

A. *Economic Efficiency*

This Subpart shows how investing in the most profitable businesses generally leads to good productivity outcomes. It also argues that freely flowing information helps productivity, setting the stage for the discussion of how business tax privacy is bad for productivity.¹⁵⁵

1. Profitability and Productivity

Businesses need investment to, among many other things, fund purchases of new assets, expand into new markets, develop innovative products, and pay off large expiring debts.¹⁵⁶ In today's competitive global markets, few if any businesses could survive long without at least intermittent external financing. In the direst circumstance, a business with no appeal to investors would be dissolved and its assets would be distributed.

Investors ultimately decide which businesses get what resources, and investors prefer the businesses that are most profitable.¹⁵⁷ Fortunately for the economy, productivity and profitability are linked. When a company produces something valuable, it makes a profit. Thus, the profit motive often leads to the most productive companies receiving the most investment.¹⁵⁸

¹⁵⁵ For the purposes of this Article, efficiency is efficiency in allocation. See KRUGMAN & WELLS, *supra* note 18, at 29.

¹⁵⁶ RICHARD A. BREALEY, STEWART C. MYERS, & FRANKLIN ALLEN, PRINCIPLE OF CORPORATE FINANCE 2-4 (12th ed. 2017).

¹⁵⁷ BREALEY ET AL., *supra* note 156, at 7-9.

¹⁵⁸ Other factors may also play a role in investing decisions, such as the labor or environmental practices of a corporation. These factors, however, have a small effect compared to the profit motive, and many of these factors are entangled with the profit motive. For example, investors may prefer corporations that have high labor standards because they

The profit motive helps direct resources to the most productive use, but most unconstrained markets are flawed.¹⁵⁹ Private incentives alone will not put society's resources to their best use—or in economists' lingo, private incentives alone will not achieve economic efficiency.¹⁶⁰ If externalities from production and consumption are uncorrected or a monopoly sets prices above marginal cost, then the affected market is not efficient.¹⁶¹ How can society's resources be at their best use when production decisions do not account for pollution and monopolies extract surplus from consumers? This is where law has a role to play. Law can change the relative profitability of different business activities. Government can use regulations and taxes to steer businesses towards, for example, environmentally friendly products or production methods or limit the power of monopolies.

A less conspicuous way in which government has an enormous impact on economic efficiency is by exerting control over the exchange of private information. Obvious examples include patents,¹⁶² which are made publicly available, and mandated SEC reporting.¹⁶³ Government is also a store of an incredible amount of information, which it may or may not choose to publish, including business tax returns. Properly designed government intervention can help steer a market towards efficiency, but government policies can also have adverse impacts on the efficiency of markets. This may be by design. Most governments willingly trade some economic efficiency for a more equitable distribution of resources.¹⁶⁴ But some policies decrease efficiency with no apparent equity upside. Business tax privacy is one such policy.

believe that the law will eventually require corporations to meet those standards or because there is a reward from consumers or other stakeholders for exceptional labor or environmental practices.

¹⁵⁹ See VARIAN, *supra* note 78, at 233, 432 for a theoretical analysis of the economic harm of monopoly power and externalities.

¹⁶⁰ Economic efficiency is good for everyone on average. It means better returns for investors, more technological development, lower prices, and higher wages. But economic efficiency does not take into consideration equity issues. Income distribution is important, and most people would gladly give up some efficiency for a more equitable income distribution. The million-dollar question is how much efficiency should be traded for a more equitable income distribution. This is a matter of value judgments: people can come to equally coherent but differing conclusions about this tradeoff. I am not addressing equity concerns in this Article mainly because the available evidence on the equity consequences of business tax privacy is inconclusive.

¹⁶¹ See VARIAN, *supra* note 78, at 233, 432 for a theoretical analysis of the economic harm of externalities and monopoly power externalities.

¹⁶² 35 U.S.C. § 10(a) (2018).

¹⁶³ 17 C.F.R. §210 (2016).

¹⁶⁴ For example, the most economically efficient tax system would collect the same in taxes from every person regardless of their income. No country in the world has adopted this lump-sum tax to collect substantial revenue. Slemrod & Bakija, *supra* note 128, at 237.

2. An Illustration of Economic Efficiency

Before describing how business tax privacy impairs economic efficiency, it will be helpful to provide an illustration of how the profit motive moves resources to their best use. For now, assume the flow of information between businesses and between investors and businesses is unconstrained. The next Subpart relaxes this assumption and explores how impeding information flows with business tax privacy has an adverse effect on the allocation of society's resources.

Consider an investor who can invest in two corporations, Ford and GM. The investor may allocate investment between the two corporations however the investor likes.¹⁶⁵ Ford and GM use the investment to produce environmentally friendly cars.¹⁶⁶ The following table shows how investment in Ford increases both the number of cars Ford produces and Ford's income. For ease of analysis, assume that each car generates \$1 of income.

Ford investment schedule		
<i>Investment</i>	<i>Cars manufactured</i>	<i>Income</i>
\$0	0	\$0
1	6	6
2	11	11
3	15	15
4	18	18
5	20	20

Notice that cars manufactured and pre-tax income increase with investment.¹⁶⁷ Assume GM has the following investment, cars manufactured, and income schedule.

¹⁶⁵ Assume that the investor rounds to the nearest dollar.

¹⁶⁶ The cars are environmentally friendly so that the example is not complicated by negative externalities. Assume that marginal car production is decreasing in investment for both firms. In other words, the first dollar of investment will produce more cars than the second dollar, which will produce more cars than the third dollar, so on and so forth. This is a standard assumption in economics. It tends to be correct because the resources best suited for a given production activity are the ones first used for that production activity. As the best resources are used up, less suitable ones are used which decreases marginal productivity. In the absence of this assumption, it might be optimal for the investor to only choose one business to invest in.

¹⁶⁷ Notice also that each additional dollar of investment generates fewer cars—the first dollar of investment generates \$6 of pre-tax income, but the second dollar only generates an additional \$5.

GM investment schedule		
<i>Investment</i>	<i>Cars manufactured</i>	<i>Income</i>
\$0	0	\$0
1	7	7
2	13	13
3	18	18
4	22	22
5	25	25

The investor receives the entire income of the corporation and must decide how to allocate investment between the two corporations.¹⁶⁸ The investor will set investment allocation to maximize the combined income of Ford and GM.¹⁶⁹ If the investor had \$5 to invest, the investor could allocate \$5 to Ford and \$0 to GM, \$4 to Ford and \$1 to GM, so on and so forth. Each investment allocation would produce cars and generate income from Ford and GM, as per their investment schedules above.

The table below shows the six whole dollar possible investment allocations and the resulting total car production and income generated.

¹⁶⁸ Eventually, the investor will receive the income of the corporation either from dividends or share repurchases. Abstracting away the tax consequences of transferring income from the firm to the investor greatly simplifies the model and only causes analytical wrinkles if the taxes paid on these transfers are correlated with the income function or effective tax rates of the firms. If either of these correlations exists, the model could be modified to account for them. In any case, the basic point the model illustrates holds true.

¹⁶⁹ If the investor has optimized, an additional dollar of investment in either firm yields the same increase in income. This allocation is optimal because at any other allocation the investor could shift \$1 from the firm with lower marginal return to the firm with higher marginal return and increase her income. In this example the marginal pre-tax incomes are close but not be equal because the investor is investing in whole dollars, not in fractions of dollars.

Investment options			
<i>Investment in Ford</i>	<i>Investment in GM</i>	<i>Total Cars</i>	<i>Total Income</i>
\$5	\$0	20	\$20
4	1	25	25
3	2	28	28
2	3	29	29
1	4	28	28
0	5	25	25

The investor's most profitable investment allocation is \$2 in Ford and \$3 in GM. Every other investment allocation generates less income. Note that this is also the allocation that leads to the most cars produced. Because it maximizes the number of cars produced given the fixed investment of \$5, this is the best investment allocation in terms of economic efficiency.

In this example, everything works out for the best. The investor maximizes profit and society maximizes cars produced. But the outcome in this example rests on the assumptions that the investor had perfect knowledge about the profitability of Ford and GM, that neither Ford nor GM received additional investment for its tax-savviness, and that neither Ford nor GM expended resources developing tax compliance and planning strategies. The next Subpart relaxes these assumptions to demonstrate how business tax privacy changes the picture.

B. *The Benefits of Eliminating Business Tax Privacy*

The previous Section offered an illustration of economic efficiency. This Subpart explores the benefits of eliminating business tax privacy using that same GM and Ford example but restricting information flows. First, it asks what would happen if investors had less information and thus made worse investing decisions. Second, it asks what would happen if businesses could not learn from each other and thus some businesses gained a tax-savviness advantage over others. And third, it asks what would happen if, again, businesses could not learn from each other and thus had to redundantly develop the same tax strategies.

1. Improving Investor Forecasts

Part IIA demonstrated that investors could use business tax return information to better estimate the risks and returns of the businesses they are

considering investing in. Among other things, additional information helped investors distinguish between fixed and variable costs and one-time and recurring costs.

In general, the more information investors have, the better their forecasts are. Better forecasts positively affect not only investor profits but also the economy more generally by shifting investment to more productive companies. Letting investors see tax return information improves forecasts and thus directs resources to the most profitable and therefore most productive activities.

In the previous Section, an investor allocated investment between Ford and GM. Now we add nuance to this example by considering two alternative scenarios—one in which the investor has access to business tax returns and a second in which the investor does not. In each scenario, the investor forecasts car production. The forecast with business tax return data is correct, and the forecast without tax return data is simply the best the investor can do with the information available.¹⁷⁰ As the table below shows, the two forecasts do not agree about which investment allocation is best. There are many reasons why a forecast may be incorrect, including those discussed in Part IIA.¹⁷¹ If the investor cannot observe business tax return information, the investor will choose the allocation based on the incorrect forecast.

Investment options		<i>Total Car</i>	<i>Total Car</i>
<i>Investment</i>	<i>Investment</i>	<i>Forecast with</i>	<i>Forecast without</i>
<i>in Ford</i>	<i>in GM</i>	<i>Tax Return Data</i>	<i>Tax Return Data</i>
\$5	\$0	20	25
4	1	25	28
3	2	28	29
2	3	29	28
1	4	28	25
0	5	25	20

Without tax return data, the investor forecasts profit incorrectly and allocates \$3 to Ford and \$2 to GM, instead of \$2 to Ford and \$3 to GM, the

¹⁷⁰ For simplicity, the incorrect forecast simply switches Ford and GM's production schedules. Any forecasting error, however, that changes the investor's desired investment allocation will result in a similar decrease in production.

¹⁷¹ The examples in Part IIA included being unable to distinguish between one-time and recurring items, being unable to distinguish between fixed and variable costs, and forecasting less accurate aggregate growth rates as opposed to division or product specific growth rates.

correct allocation. This misallocation decreases car production by 3.4%.¹⁷² Letting investors see tax return information improves these forecasts and thus directs resources to the most profitable and therefore most productive activities.

In this example, the investor either made the correct or the incorrect forecast, depending on what information was available. In practice, the same basic concepts apply, but instead of correct and incorrect forecasts the investor ends up with a more accurate or less accurate forecast. Across many investments and over many years, more accurate forecasts divert investment to more productive businesses.

An additional benefit to eliminating business tax privacy comes from making tax policy more transparent to investors. Benevolent tax policy should be designed to induce a behavioral response from investors. Ideally, tax policy should place higher tax burdens on firms that generate negative externalities to discourage investment in those firms and lower tax burdens on firms that generate positive externalities to encourage investment in those firms. The more difficult it is for investors to know what current tax liability is and what future tax liability will be, the more muffled the intended behavioral response will be.

Consider, for example, a tax policy that encourages R&D and thus benefits parties unrelated to the business undertaking the R&D. This is an economically efficient policy, but if investors cannot observe the tax benefits of R&D, they may not reward a firm for its R&D activity. As demonstrated in Part IIA, investors might assume the R&D tax incentive is nonrecurring or they might assume it is a risky tax shelter. In either case, investors would underinvest in a firm providing positive externalities.

2. Homogenizing Business Tax Outcomes

Even if investors have all the information they need, they would still invest in less productive businesses if those businesses were tax-savvy. Investors make their investing decisions based on forecasts of after-tax income. If two firms are equally productive but one has a lower tax rate, the one with the lower tax rate will be a more attractive investment. The same principle applies more generally: firms with lower tax rates will receive more investment relative to firms with higher tax rates. If the differences in effective tax rates are large enough, then a less productive, low-tax firm would look more attractive to investors than a more productive, high-tax firm.¹⁷³

¹⁷² A 3.4% difference in production matters: 3.4% of US GDP is hundreds of billions of dollars. That is, however, not to say that this Article makes any estimate about how large the productivity gains from eliminating business tax privacy would be.

¹⁷³ Uniform taxes may distort decision making too if a uniform tax causes investors to

Rewarding a tax-savvy business with additional investment may make sense from an investor's perspective but is not good for productivity.¹⁷⁴ Maximizing productivity requires that investment be allocated based solely on how productive businesses are. Rewarding businesses that are tax-savvy at the expense of businesses that are less tax-savvy but more productive results in less economic output.

In our example, if both Ford and GM faced the same effective tax rate, then taxes would not change investment allocation. The tax would reduce the income derived from both firms by the same proportion. Assuming overall investment did not decrease, the investor's rate of return would fall, but the number of cars produced would remain the same.

If, however, Ford and GM had different effective tax rates because one was more tax-savvy, the investor would shift her investment around to reduce total tax liability.¹⁷⁵ Doing so would lower the pre-tax income of the investor, but the decreased tax burden would more than make up for the lost pre-tax income. The larger the variance in tax outcomes across firms, the more investment would shift to tax-savvy firms, regardless of the productivity consequences.

More concretely, assume that Ford has an effective tax rate of 10% and GM has an effective tax rate of 30%. The following table computes after-tax income for Ford and GM.

reallocate their resources. In the absence of an optimal tax purpose, however, non-uniform taxes have a much larger distortionary effect because they change the relative attractiveness of different firms, irrespective of their productivity.

¹⁷⁴ That is not to say that all tax variation is bad. Returning to our example, if GM uses a more toxic production process (which might explain why GM can produce cars at a lower cost) and the government determines that the optimal policy is to discourage investment in toxic production processes through the tax system, then GM should have a higher tax rate. While this results in fewer cars, it also results in greener production, which may be a beneficial tradeoff. In general, tax rate variation may be beneficial if it corrects externalities, generates revenue with the smallest possible deadweight loss, or stimulates the economy in a recession. In each of those cases, the optimal tax policy might place a differentiated burden on different corporations. But there is no economic efficiency rationale to divert scarce resources to a corporation because it has a lower effective tax rate stemming from its tax strategy. In theory, it is possible that firms with better tax planning have more elastic responses to taxes, in which case it would decrease productivity to eliminate differentiated tax burdens.

¹⁷⁵ The investor would maximize return by allocating investment such that both investments had equal after-tax marginal returns. If at a certain allocation both firms had the same pre-tax marginal return, the investor could shift investment from the high tax firm to the low tax firm and increase income.

Investment options				
<i>Investment in Ford</i>	<i>Investment in GM</i>	<i>Pre-tax Income</i>	<i>Tax Liability</i>	<i>After-tax Income</i>
\$5.00	\$0.00	\$20.00	\$2.00	\$18.00
4.00	1.00	25.00	3.90	21.10
3.00	2.00	28.00	5.40	22.60
2.00	3.00	29.00	6.50	22.50
1.00	4.00	28.00	7.20	20.80
0.00	5.00	25.00	7.50	17.50

The more investment GM receives, the higher the combined effective tax rate of GM and Ford because GM has a higher effective tax rate. Just as before, the highest pre-tax income is generated if the investor allocates \$2 to Ford and \$3 to GM. If, however, the investor moves \$1 from GM to Ford, then pre-tax income will fall by \$1 to \$28, but tax liability will fall by even more, by \$1.10, from \$6.50 to \$5.40. The investor loses \$1 of after-tax income but gains \$1.10 of after-tax income. Thus, from the investor's perspective, the optimal investment allocation is \$3 in Ford and \$2 in GM. But this is not optimal from an economic efficiency perspective. This investment allocation reduces the number of cars manufactured from 29 to 28, as compared to the pre-tax or no-tax case. The tax variation led to a worse investment allocation. The total number of cars produced decreased by 3.4%, even though the total investment, \$5, did not change.

It does not matter which firm has the lower effective tax rate. Even though in this example GM produces more cars at each level of investment, the total number of cars produced declines when GM has the lower effective tax rate. To illustrate this point, the following table shows investment allocation when Ford is taxed at a rate of 30% and GM is taxed at a rate of 10%.

Investment options				
<i>Investment in Ford</i>	<i>Investment in GM</i>	<i>Pre-tax Income</i>	<i>Tax Liability</i>	<i>After-tax Income</i>
\$5.00	\$0.00	\$20.00	\$6.00	\$14.00
4.00	1.00	25.00	6.10	18.90
3.00	2.00	28.00	5.80	22.20
2.00	3.00	29.00	5.10	23.90
1.00	4.00	28.00	4.00	24.00
0.00	5.00	25.00	2.50	22.50

From the investor's perspective, the optimal investment allocation is \$1 in Ford and \$4 in GM. But this is not optimal from an economic efficiency perspective. This investment allocation reduces the number of cars manufactured from 29 to 28, compared to the pre-tax or no-tax case. Once more, tax variation led to a worse investment allocation. The total number of cars produced decreased by 3.4%, even though the total investment, \$5, did not change. In the global economy, a decrease in the production of goods and services by even a fraction of a percent would result in hundreds of billions of dollars of lost production.

There are many ways to add nuance to this model, but the fundamental point remains: tax variation changes investment allocation.¹⁷⁶ Firms with lower effective tax rates will receive more investment than they would have if all firms faced the same effective tax rate.

How does all this relate to business tax privacy? Recall from Part IIB that corporations are very unlikely to have identical effective tax rates because of differences in strategy, discretion, and error—among other things. But eliminating business tax privacy would allow every firm to learn from the returns of other businesses. With public access to business tax returns, businesses would adopt each other's tax strategies, make the same judgment calls, and find errors in their own tax accounting. Tax preparers (who would be partially freed from confidentiality agreements), activist investors, and consulting firms could catalyze tax outcome homogenization.¹⁷⁷ This would lead to business tax standards for successful tax avoidance (i.e. benchmarking), and firms could be evaluated along

¹⁷⁶ The above logic applies equally well when there is an arbitrary number of firms, when there is a secondary market for investment securities, when the model is dynamic, and when investment supply is responsive to return. These modifications would not alter the fundamental result of the model.

¹⁷⁷ Lenter, Slemrod & Shackelford, *supra* note 6, at 821.

avoidance metrics just as they could for customer satisfaction and workplace safety.¹⁷⁸

Eliminating business tax privacy would make tax planning and compliance strategies more homogenous across firms, making the relative marginal profits of firms depend less on their tax strategies. In essence, tax privacy is a barrier preventing firms from having the same tax compliance and planning, which allows different firms to play by different tax rules. Firms should receive more investment if they are more productive, but there is no social benefit to rewarding firms that have lower tax rates because of their tax compliance and planning strategies. Making business tax compliance and planning strategies more homogenous across businesses reduces the variation in effective business tax burdens and ultimately leads to businesses receiving investment commensurate to their productivity and not how tax savvy they are.¹⁷⁹

3. Reducing Tax Compliance Costs

Beyond generating undesirable tax variation that distorts investment, business tax privacy inflates already substantial business tax planning and compliance costs. To comply with tax law, businesses must record their transactions, submit documents to the IRS, and remit payment. This is not a simple exercise: GE's annual corporate tax returns fill approximately 57,000 pages.¹⁸⁰ Businesses also exert considerable effort structuring transactions to minimize tax liability.¹⁸¹ Recall that GE's tax department, at one time the best tax law firm in the world, employed nearly 1,000 people.¹⁸² More generally, the IRS estimates that taxpayers spend nearly six billion hours per year complying with tax law, 359 million hours of which are spent by

¹⁷⁸ *Id.*; Blank, *supra* note 6, at 62–8.

¹⁷⁹ Another benefit of uniform tax compliance and planning is that it would make the cost of valuing firms lower because investors could correctly assume a smaller range of possible business tax strategies.

¹⁸⁰ John McCormack, *GE Filed 57,000-Page Tax Return, Paid No Taxes on \$14 Billion in Profits*, WKLY STANDARD (Nov. 17, 2011, 1:11 PM), http://www.weeklystandard.com/blogs/ge-filed-57000-page-tax-return-paid-no-taxes-14-billion-profits_609137.html. Although a considerable portion of GE's tax efforts are directed at compliance, GE also directs substantial resources towards sheltering its income.

¹⁸¹ Lillian Mills, Merle M. Erickson & Edward L. Maydew, *Investments in Tax Planning*, 20 J. AM. TAX'N ASS'N 1, 1 (1998). Accounting firms provide tax services for businesses looking to minimize tax liability. See generally Tim Anson et al., *Integrated Global Structuring: Aligning Global Business Models and Tax Planning*, INT'L TAX SERVS., PRICEWATERHOUSECOOPERS (2008).

¹⁸² David Kocieniewski, *G.E.'s Strategies Let It Avoid Taxes Altogether*, N.Y. TIMES (Mar. 24, 2011), <https://www.nytimes.com/2011/03/25/business/economy/25tax.html>. Businesses more generally also spend substantial amounts on tax compliance and planning. Lillian Mills, Merle M. Erickson & Edward L. Maydew, *Investments in Tax Planning*, 10 J. AM. TAX'N ASS'N 1 (1998).

corporations on their returns.¹⁸³

Businesses and practitioners cannot learn from each other's work because business tax returns are private.¹⁸⁴ This means that (1) each firm must pay its own in-house or external tax practitioners and (2) no single tax practitioner can look at all the business tax returns together and derive the most efficient tax strategies. As a result, several tax consultants redundantly develop the same tax strategies and write similar tax opinions.¹⁸⁵ Consequently, business tax privacy generates substantial economic waste.¹⁸⁶

Making returns public would disseminate tax-sheltering knowledge. With access to the universe of returns, consultancies would be able to use machine learning and sophisticated statistical techniques that would find the best tax strategies.¹⁸⁷ Whatever one thinks of tax-efficient strategizing, this approach would eliminate the economic waste inherent in redundant tax planning.¹⁸⁸ The tax reform passed in late 2017, for example, has already

¹⁸³ TAXPAYER ADVOCATE SERV., 1 ANNUAL REPORT TO CONGRESS 13 (2008), https://www.irs.gov/pub/tas/08_tas_arc_intro_toc_msp.pdf.

¹⁸⁴ There is substantial variation to the extent that businesses outsource tax compliance and planning. Some businesses perform tax compliance functions internally, some outsource them, but most fall between these extremes. GE, for example, once had a tax department that employed 1,000 people, but many of those employees now work for PWC. Amato, *supra* note 135. For businesses that perform tax compliance internally, business tax privacy clearly increases compliance costs because businesses cannot see how other corporations handle similar tax issues. Instead each business must independently and redundantly research myriad tax issues. For businesses that outsource tax compliance, business tax privacy increases compliance costs but these costs are mitigated, albeit only slightly, by the fact that the law and accounting firms that provide tax compliance services can develop in-house knowledge that multiple clients will receive. Nevertheless, two factors limit the extent to which compliance costs are held down by large accounting and law firms. First, business tax privacy may still limit the extent to which accountants and lawyers can use tax knowledge developed for one client to service another. Second, the markets that accounting and law firms operate in are not competitive, increasing the ability of these large firms to profitably engage in redundant work.

¹⁸⁵ See James R. Hines Jr., *On the Timeliness of Tax Reform*, 88 J. PUB. ECON. 1043 (2004) (showcasing a model in which eliminating tax shelters quickly increases the total expenditure on socially wasteful activities as firms seek to develop new tax shelters).

¹⁸⁶ Society is devoting scarce resources to redundantly researching tax shelters when those resources could instead be used to produce goods and services, advance science, teach the young, or perform any number of other valuable functions. Of course, there is another possibility: ending corporate privacy could demonstrate the efficacy of tax consultants and increase their use. Given the prevalence of aggressive tax planning and sheltering, this is unlikely.

¹⁸⁷ Some software already exists—for example, GoSystem and Fast Tax. These programs are designed to reduce compliance costs (much like TurboTax for individual taxpayers), which will lower tax variation. A sophisticated program using big data and machine learning, however, would be able to do much more.

¹⁸⁸ Some scholars believe that corporations are near the maximum possible sheltering. Lee Sheppard, *Should Corporate Tax Returns Be Disclosed?*, 142 TAX NOTES 1381, 1382 (2014) (quoting Reuven Avi-Yonah, who suggests that we are near the maximum possible corporate aggressiveness). If that is the case, it would be better for society to let corporations

increased the revenues of the largest accounting firms by billions of dollars.¹⁸⁹ Each of these firms is researching the same topics, and some of these topics may be researched independently for many different clients because business tax privacy prevents businesses from learning from one another.

Society can realize substantial benefits from innovation. There are numerous examples of recent technologies that have improved and saved lives, including safer automobiles, new medicines, and advances in communications technology. But the reasoning that suggests we should encourage or protect these innovations does not apply to tax shelters. Most tax shelters do not make the world better off because they do not create anything of value. They simply change the distribution of tax burdens and drain resources that could have been used more beneficially. Moreover, tax shelters encourage a race to the bottom because no business wants to be at a disadvantage.¹⁹⁰ Businesses devote resources to developing tax shelters because if they do not, another business will, and that business will become more attractive to investors.

C. *The Potential Costs of Eliminating Business Tax Privacy*

Eliminating business tax privacy will improve investor decision-making, reduce capital misallocation, and decrease waste from redundant business tax compliance and planning costs. But the same spreading of information that has these benefits may also have some downsides. This Subpart considers the most costly of these downsides and suggests reasons why eliminating business tax privacy may nonetheless be the better policy.

1. Lower Business Tax Revenue

Some scholars have suggested that eliminating business tax privacy would lower government revenue.¹⁹¹ With access to the universe of business

maintain those shelters without redundant shelter-development expenditures.

¹⁸⁹ Michael Cohn, *Tax Reform Boosts Consulting Revenue for Accounting Firms*, ACCT. TODAY (June 6, 2018), <https://www.accountingtoday.com/news/tax-reform-law-boosts-consulting-revenue-for-big-four-accounting-firms>.

¹⁹⁰ Firms expending resources to lower their tax liability is rent-seeking. Rent-seeking entails using scarce resources in a manner that produces no social value to secure some private benefit. See generally Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 63 AM. ECON. REV. 291 (1974). It's possible that all businesses would agree to substantially limit tax sheltering if they could be sure that all other businesses would do the same. This would allow them to direct resources to other more productive endeavors.

¹⁹¹ There are unlikely scenarios in which a better understanding of IRS enforcement would lead firms to adopt less aggressive tax strategies. In that case (examining this argument alone), government revenue would increase if business tax privacy were eliminated. Businesses learning from one another would lead to additional government revenue if, for example, firms learned to keep away from aggressive strategies that the IRS might combat.

tax returns, businesses would learn more about different tax sheltering strategies.¹⁹² Moreover, firms could estimate a tax aggressiveness frontier, essentially determining which combinations of tax strategies are safe from IRS action and which are not.¹⁹³ Firms would have an incentive to opt for the maximum tax aggressiveness that would not invite additional IRS scrutiny. Combined, this tax shelter proliferation and lost IRS strategic advantage would allow firms to have a lower effective tax rate.

There are, however, two reasons to doubt that this revenue reduction will be substantial. First, eliminating business tax privacy increases the tax base by increasing productivity. Thus, while effective tax rates may fall, those rates will be applied to more business income, and a smaller rate times a larger base has an ambiguous effect on revenue. Second, more eyes on business tax returns are likely to increase compliance by reducing tax evasion and extremely aggressive tax avoidance.¹⁹⁴ Thus, while some tax sheltering strategies are likely to become commonplace, others are likely to become less used.

Even if there were a substantial reduction in revenue, Congress could easily change fiscal policy along another dimension to recuperate that revenue.¹⁹⁵ Optimal tax policy requires collecting tax revenues sufficient to fund the government, taking equity, efficiency, and administration considerations into account.¹⁹⁶ And if, as this Article argues, business tax privacy is a very economically inefficient means by which to maintain government revenue, then we are better off eliminating business tax privacy and recuperating the lost revenue with another policy.¹⁹⁷

2. Proprietary Business Information Made Public

Some have asserted that business tax returns contain information that,

Investors learning from business tax returns would also lead to additional government revenue if, for example, investors flocked to firms with conservative tax approaches.

¹⁹² Blank, *supra* note 6, at 62–69.

¹⁹³ Assuming the IRS did not change its enforcement strategy.

¹⁹⁴ Rice, *supra* note 10, at 125–62.

¹⁹⁵ Since 1985, Congress has made several changes to the income tax, including changing corporate statutory rates. *See, e.g.*, Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2249; Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 2264 Stat. 166.

¹⁹⁶ Slemrod & Bakija, *supra* note 128, at 14. Indeed, because government revenue is not an end in itself, it is possible but highly unlikely given the federal government current budget, that the revenue need not be recuperated.

¹⁹⁷ I take no position here on what the better alternatives are but will note two possibilities. One, Congress could simply increase corporate tax rates—this could generate revenues equivalent to the status quo much more efficiently. Two, the US could adopt a value-added tax as suggested by many in tax policy circles. In the unlikely case that the costs of raising revenue using other policy dimensions are exceedingly high, a welfare maximization and a government revenue maximization paradigm would yield the same result: business tax privacy is the better policy.

if released, could harm businesses.¹⁹⁸ Although there are many pieces of information that a business might not want public, this argument seems specifically to refer to information that competitors could use to that business's disadvantage.¹⁹⁹

While this raises a plausible issue, there are two reasons why it is unlikely that publicizing proprietary information on tax returns will cause severe economic disruptions—it may even have economic benefits. First, access to proprietary information is a two-way street. Firm A certainly does not want Firm B to see its information. But Firm A does want to see Firm B's information. If business tax privacy is eliminated, Firm A will benefit at Firm B's expense because A can see B's tax return, but B will also benefit at A's expense because B can see A's return. The proprietary information argument ignores this symmetry: competitors should both benefit from and be hurt by additional access to information. Of course, this is not to say that all firms would be equally benefited or hurt by the policy, but in aggregate this is not so dire a concern as some have claimed. Ultimately, the efficiency gains described above make eliminating business tax privacy a net positive for businesses.

Second, and more importantly, access to proprietary information would increase competitiveness, which would have widespread economic benefits.²⁰⁰ Business tax privacy makes it easier for businesses to hide what their best products and best markets are, which increases their market power—their ability to sell at higher prices with less innovation. If competitors could access proprietary information, businesses would become more competitive, which would drive down prices and increase innovation.²⁰¹

The proprietary information argument becomes somewhat more compelling when considered from a global perspective. Eliminating business tax privacy might disadvantage US businesses because they would have to disclose information that their foreign competitors would not—

¹⁹⁸ This information includes “revenue and expense information by legal entity, jurisdiction, and functional category.” Tax Executives Institute, *supra* note 7, at 242.

¹⁹⁹ *Id.*

²⁰⁰ A student at the University of Richmond School of Law raised the possibility that business tax information could be used to conduct espionage on firms that provide goods and services to the US military. If this is the case, then clearly those firms should be exempted from public disclosure.

²⁰¹ The benefits from increased competition would have to be weighed against any chilling effect on investment. It is possible that a business might not choose to invest in a new product line or market because it did not believe it could realize a sufficient return on the initial investment if other competitors became aware of this business move. This is only possible in the somewhat unusual circumstance where the first mover must pay substantial investment costs that subsequent movers will not have to pay. Intellectual property law may prevent this from being a substantial cost.

although some countries do require some business tax disclosures.²⁰² It is, however, not clear to what extent business tax information would be a boon to foreign competitors. The US subsidiaries of foreign businesses would still have to disclose their US returns, so to the extent that a foreign advantage would materialize, it would have to stem from non-US business operating outside the US. Moreover, investor preferences for transparency may lead to US firms becoming substantially more attractive for global investment.²⁰³ Finally, because the US has substantial clout, other countries may follow suit and also limit business tax privacy.

3. Elimination of Tax-related Jobs

The one group that benefits unequivocally from the current rules are those that develop the tax shelters—mostly accountants and lawyers that may work for a business or a consultancy that advises many businesses. If business tax privacy were eliminated, the value of developing new tax shelters would diminish and the demand for tax accountants and lawyers might shrink.

There are two reasons, however, why this potential cost should not be a major factor when evaluating business tax privacy. First, even with business tax privacy eliminated, the tax code will still be very long and very complex. Tax compliance and planning will still require many lawyers and accountants. Second, in the long run, the world is better off with fewer people developing tax shelters because they would instead be doing something more valuable. In the United States, there are few remaining telephone operators, typewriter repair-people, and stable attendants. Despite the fact that these were commonplace jobs within the not so distant past, current employment rates are unaffected by the disappearance of these jobs. Policymakers should be cognizant of the hardships experienced when the economic forces that feed an industry dry up, but the solution should be to help with the transition, not prop up unproductive industries.

4. Reduced Tax Compliance

Businesses do not want to share their tax information. To that end, if business tax privacy were eliminated, businesses might reduce their compliance with tax law to keep some information private.²⁰⁴ This is

²⁰² Lenter, Slemrod & Shackelford, *supra* note 6, at 811–12.

²⁰³ See generally Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 664 (2016) (discussing the value of transparency in investment).

²⁰⁴ Letter from Robert L. Ashby, International President, Tax Executives Inst., to Paul H. O’Neil, Secretary, Dep’t of the Treasury, and Harvey L. Pitt, Chairman, Sec. and Exch. Comm’n (July 25, 2002) (“Confidentiality of tax return information is a key privacy right that should be vindicated not just for its own sake, but because it is the cornerstone of voluntary

certainly a possibility, though it remains an open question how large this effect would be. If returns were made public, investors might reward firms for revealing more information, in which case the IRS might experience increased compliance with tax law. Moreover, evidence suggests that additional scrutiny tends to lead to increased compliance, and eliminating business tax privacy would result in substantially more scrutiny.²⁰⁵ Variants of the algorithms that would help businesses optimize their tax compliance and planning could be used to detect non-compliance. And if Congress and the IRS suspect reduced compliance, they could alter audit procedures and non-compliance penalties to minimize the negative effects of reduced compliance.

5. Antitrust Concerns

There are two antitrust concerns associated with eliminating business tax privacy. First, businesses attempting to collude with one another could use tax returns to help verify that their partners are not deviating from the collusion agreement. Second, one business might be able to reverse-engineer cost data for a competitor and undercut that competitor. Both of these are legitimate concerns, but the obvious policy remedy for these anticompetitive behaviors is antitrust law. Using tax privacy to achieve better antitrust outcomes has all the undesirable economic efficiency consequences discussed in this Article—consequences that would be avoided if antitrust law were used to address these antitrust concerns.

D. Alternatives to Eliminating Business Tax Privacy

Several policy prescriptions might alleviate the economic distortions caused by business tax privacy without eliminating business tax privacy. A simpler tax code could limit the potential for tax sheltering, decrease compliance costs, and make forecasting future tax liability easier.²⁰⁶ Lower

compliance”). See also Lenter, Slemrod & Shackelford, *supra* note 6, at 826; Hoopes, Robinson & Slemrod *supra* note 46 (finding evidence that large private firms in Australia acted to avoid disclosure in anticipation of new public disclosure requirements).

²⁰⁵ Rice, *supra* note 10, at 125–62.

²⁰⁶ If the taxes were as simple as possible (i.e. a lump sum tax), then (1) businesses could not meaningfully have differentiated tax preparation and tax sheltering technologies, (2) businesses would not spend socially valuable resources to develop new tax strategies, and (3) investors would have no difficulty forecasting future tax liability. A lump sum tax would incentivize firms to merge, so investors would have to anticipate mergers to correctly forecast tax liability. Another possibility is using formulary apportionment to allocate taxable income. See generally Reuven S. Avi-Yonah & Kimberly A. Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, in *PATH TO PROSPERITY: HAMILTON PROJECT IDEAS ON INCOME SECURITY, EDUCATION, AND TAXES* 319, 327 (Jason Furman & Jason E. Bordoff eds., 2008); Susan Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593 (2010).

business tax rates would reduce the incentive to tax-shelter, which would decrease tax variation and the extent to which tax decisions determine firm value.²⁰⁷ Eliminating business taxes would render the entire debate moot.

Tweaking the Internal Revenue Code to make business tax returns public has two advantages over these other policy prescriptions. First, it does not require any major legislation—it only requires a few modifications to the Internal Revenue Code’s section on tax privacy.²⁰⁸ To the extent that more complicated legislation is less likely to be enacted or more likely to have unintended consequences, eliminating business tax privacy will be preferable. Second, businesses already file tax returns. Thus, businesses will bear no additional compliance costs if business tax privacy is eliminated. Solutions that involve other changes to the tax code would create additional compliance burdens, as would any solution that required firms to prepare additional documents.

Others have suggested that some businesses, particularly corporations, should be compelled to publish very limited information from their tax returns—for example, their tax liability or, for public companies, a reconciliation between their financial statements and taxes paid.²⁰⁹ While these additional disclosures may have some benefits, they will not substantially mitigate the economic distortions addressed here because the real value of business tax returns comes from the detailed information, not bottom line numbers. From the perspective of investors, the more information they have, the better. Knowing the exact business tax liability for one year will not be particularly useful for investors because, without understanding the components of tax liability, investors will still be handicapped when attempting to forecast future tax liability. Similarly, if businesses are unable to learn exactly what other businesses are up to, then the extent to which tax compliance and planning strategies will flow between businesses will be limited. Without this exchange of information, investment will not be redirected to more productive firms and redundant, socially wasteful expenditures on tax compliance and planning will not decrease.

²⁰⁷ This would necessitate raising revenue from other sources to be a revenue neutral policy. See generally Harry Grubert & Rosanne Altshuler, *Shifting the Burden of Taxation from the Corporate to the Personal Level and Getting the Corporate Tax Rate Down to 15 Percent*, 69 NAT’L TAX J. 643 (2016).

²⁰⁸ I.R.C. § 6103.

²⁰⁹ See, e.g., Lenter, Slemrod & Shackelford, *supra* note 6, at 803, 821; Blank, *supra* note 6, at 62–69.

2019]

CASE AGAINST BUSINESS TAX PRIVACY

77

CONCLUSION

Economic efficiency is paramount to tax policy, but on one important issue—whether businesses should be entitled to tax privacy—the efficiency criterion has received short shrift. This Article evaluates business tax privacy using the same efficiency criteria applied to other tax issues and argues that eliminating business tax privacy would be beneficial. Public access to business tax returns was a feature of the country’s first corporate tax legislation. Economic efficiency considerations commend a return to our original approach.