CONSULT YOUR OWN TAX ADVISOR: RETHINKING TAX-DISCLOSURE IN REGISTERED OFFERINGS

Abstract: Issuers in registered securities offerings are required to disclose, among other tax matters, the expected tax consequences to investors that result from investing in the offered securities (“nonfinancial tax disclosure”). I advance three arguments in this regard. First, current nonfinancial tax disclosure practice, as sanctioned by the SEC, performs little regulatory function. Nonfinancial tax disclosures provide irrelevant information, sometimes fail to provide material information, create unnecessary transactions costs, and divert valuable regulatory resources to the enforcement of largely-meaningless requirements. Second, I suggest the practical reason behind this regulatory failure is a failed attempt by tax practitioners and the SEC to address investors’ heterogeneous tax preferences. Nonfinancial tax disclosure practice assumes the existence of a “reasonable investor” that is also an “average taxpayer”, and tax disclosures are drafted for the benefit of such average taxpayer. I demonstrate, however, that the concept of the “average taxpayer” is not conceptually or empirically defensible. Third, the theoretical reason for the dysfunctionality of the regulatory regime is a misguided reliance on mandatory disclosure theory in the tax context. I argue that given the special nature of tax laws, mandatory disclosure theory—even if accepted at face value—does not support the current regulatory framework of nonfinancial tax disclosure. To remedy this failure, I describe the types of tax-related disclosures that would be supported by mandatory disclosure theory. Under my suggested regulatory reform, nonfinancial tax disclosure will only include issuer-level tax items, (namely, items at the company level not otherwise disclosed in the financial statements), that affect how “reasonable investors” calculate their own individual tax liabilities. Under such a regime, there is no need to rely on the “average taxpayer” construct.

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INTRODUCTION: APPLE’S BOND OFFERING AS AN ALLEGORY

On April 29, 2013, Apple Inc. (“Apple”) made a little piece of financial history with its $17 billion bond offering. At the time, it was the largest-ever debt issuance by a non-financial institution. Found on page S-15 of the offering document is a section titled “Certain U.S. Federal Income Tax Considerations”. This section provides information concerning the “U.S. federal income tax considerations of the ownership and disposition” of the bonds.

Issuers in registered securities offerings are required to disclose to investors all information that a reasonable investor would deem material for purposes of making an informed investment decision. Disclosure documents regulated by the SEC “disclose information about the companies' financial condition and business practices to help investors make informed investment decisions”. Securities and Exchange Commission (SEC), The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Information (Jun 10, 2013), online at http://www.sec.gov/about/whatwedo.shtml (visited Jan 2, 2014). See Zohar Goshen & Gideon Parchomovsky, The Essential Role of Securities Regulation, 55 Duke L J 711, 740-42 (2006)(SEC disclosure regulation allows for more “public disclosure “leads to fewer instances of asymmetric information between traders” and more informed traders); See Troy A. Paredes, Blinded by the Light: Information Overload and Its Consequences for Securities Regulation, 81 Wash U L Q 417, 418-19 (SEC disclosure seeks to “[f]orm [i]nformed investors with information, mandatory disclosure promotes informed investor decision making, capital market integrity, and capital market efficiency”); See also, Kenneth B. Firtel, Note, Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933, 72 S Cal L Rev 851, 851 (1999) (“SEC has responded to this argument with consistent efforts to make disclosure documents more readable and understandable in an attempt to show that disclosure can be geared toward the average investor”).

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3 See Apple’s Prospectus (cited in note 1).
4 Id.
5 Disclosure documents regulated by the SEC “disclose information about the companies' financial condition and business practices to help investors make informed investment decisions”. Securities and Exchange Commission (SEC), The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Information (Jun 10, 2013), online at http://www.sec.gov/about/whatwedo.shtml (visited Jan 2, 2014). See Zohar Goshen & Gideon Parchomovsky, The Essential Role of Securities Regulation, 55 Duke L J 711, 740-42 (2006)(SEC disclosure regulation allows for more “public disclosure “leads to fewer instances of asymmetric information between traders” and more informed traders); See Troy A. Paredes, Blinded by the Light: Information Overload and Its Consequences for Securities Regulation, 81 Wash U L Q 417, 418-19 (SEC disclosure seeks to “[f]orm [i]nformed investors with information, mandatory disclosure promotes informed investor decision making, capital market integrity, and capital market efficiency”); See also, Kenneth B. Firtel, Note, Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933, 72 S Cal L Rev 851, 851 (1999) (“SEC has responded to this argument with consistent efforts to make disclosure documents more readable and understandable in an attempt to show that disclosure can be geared toward the average investor”).
care about their after-tax returns, information about the tax cost associated with an investment could be considered material. Indeed, registrants are required to disclose to investors all material tax consequences associated with an investment in offered securities, and to qualify such disclosure by an opinion. Apple’s tax disclosure section is intended to respond to this regulatory framework by providing tax information to investors considering an investment in Apple bonds.

I suggest, however, that Apple’s tax disclosure in the offering document does not provide any information that a “reasonable investor” would deem material. In fact, I suggest that the disclosure provides little information at all, notwithstanding that the disclosure carries four densely-populated pages. Specifically, the third sentence in Apple’s tax disclosure makes it clear that any tax consequences discussed therein are only applicable to investors purchasing the bonds in the initial offering. The tax disclosure is not applicable to investors purchasing the bonds in the secondary market. Investors in the secondary market are left to decide for themselves the tax consequences associated with an investment in the Apple bonds.

In addition, the tax disclosure explicitly states its inapplicability to certain classes of investors, which include—among others—dealers in securities, financial institutions, insurance companies and other types of institutional investors. It is well documented, however, that securities in

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7 See, for example, SEC, Staff Legal Bulletin No. 19: Legality and Tax Opinions in Registered Offerings 11-12 (Oct 14, 2011) (discussing when tax consequences are “material” to investors), online at http://www.sec.gov/interps/legal/cfslb19.htm (visited Jan 2, 2014) (hereinafter referred to as “SEC Legal Bulletin”); William B. Barker, SEC Registration of Public Offerings Under the Securities Act of 1933, 52 Bus. Law 65, 105-106 (1996) (discussing the proper disclosure of federal income tax consequences in registered offering, as part of a general discussion on the system of mandatory disclosure, which is intended to deliver investors with “ accurate and current information” to support “fair and honest securities markets”); at the time of publication, Barker was a Senior Counsel to the SEC’s Division of Corporate Finance) (See Barker, note 7, at 82.).

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

9 See Apple’s Prospectus at S-15 (cited in note 1) (“Except where noted, this summary deals only with a note held as a capital asset by a beneficial owner who purchases the note on original issuance at the first price...”).

10 Id (“This summary does not address all aspects of U.S. federal income taxes and does not deal with all tax consequences that may be relevant to holders in light of their
initial offerings are mostly allocated to institutional investors\(^{11}\) of the classes that are excluded from the scope of Apple’s tax disclosure.

The result of the set of limitations described above is rather remarkable. Apple’s tax disclosure does not describe the tax consequences to investors that—as a practical matter—are expected to purchase the bonds in the initial offering. The tax disclosure also refrain{s} from describing the tax consequences to any investor that purchases the bonds in the secondary market. The logical outcome (or rather, the illogical outcome) is that Apple’s tax disclosure section describes tax consequences that are applicable to no one. As such, it is doubtful that Apple’s tax disclosure responds meaningfully to the rationale behind the regulatory framework. Nonetheless, Apple’s tax disclosure likely meets the formal regulatory requirements applicable to nonfinancial tax disclosure, as interpreted by the Securities and Exchange Commission (SEC).\(^{12}\)

Apple is hardly a unique case. It is probably the case that all initial securities offering documents filed with the SEC limit their nonfinancial tax disclosure to investors in the initial offering, and at the same time exclude most classes of investors that are expected to participate in the initial offering. Non-initial offering documents similarly contain language excluding most classes of investors from the scope of nonfinancial tax disclosure. This makes the systemic utility of nonfinancial tax disclosure tenuous.

I elaborate on the apparent meaninglessness of the regulatory framework in Part I. Securities regulations create a clear distinction between financial and nonfinancial tax disclosure. Financial tax disclosure generally refers to entity-level tax information; namely, taxes

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\(^{12}\) I discuss current practices as sanctioned by the SEC in section I.C. below.
imposed on the issuing entity in its own capacity. For example, a corporate issuer is subject to corporate income tax and other income tax expenses that must be disclosed in the financial statements.\textsuperscript{13} Conversely, nonfinancial tax disclosure refers to information concerning investor level taxes, meaning, taxes directly imposed on investors as a result of their investment in the security. For example, investors must report on their individual tax returns any income realized from dividends distributed by corporate issuers.

In this article I take issue with nonfinancial tax disclosure. Surveying nonfinancial tax disclosure practices under current SEC regulatory guidance, I conclude that such practices are largely pointless. Assuming the purpose of mandatory disclosure is to support rational investment decisions by disseminating necessary information to investors,\textsuperscript{14} such a purpose is not served.

Specifically, I suggest that current practices suffer from a misguided attempt to respond to investors’ heterogeneity in tax preferences.\textsuperscript{15} In the world of securities regulation, the solution to the practical problem of investors’ heterogeneity is to assume that there exists a rational, profit-seeking agent known as the “reasonable investor”\textsuperscript{16} Disclosure documents

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\textsuperscript{13} SEC Regulation S-X, 17 CFR § 210 (2013), Item 210.04-8(h) requiring issuers to account for income tax expenses.

\textsuperscript{14} Under the celebrated Efficient Capital Market Hypothesis (ECMH), “the prices of the stocks of actively traded companies … rapidly adjust to reflect the rational expectations generated by all available information as it becomes available.” See Donald C. Langevoort, \textit{Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation}, 97 Nw U L Rev 135, 136 (2002); for the central role the ECMH plays in the formulation of the disclosure requirement in registered offerings, see, for example Henry T.C. Hu, \textit{Too Complex to Depict? Innovation, “Pure Information”, and the SEC Disclosure Paradigm}, 90 Tex L Rev 1600, 1614-1621 (2012) (describing ECMH role in the development of current SEC disclosure paradigm); Donald C. Langevoort, \textit{Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited}, 140 U Pa L Rev 851, 851-852 (1992) (describing the central role that ECMH plays in supporting information disclosure); Ronald J. Gilson & Reinier H. Kraakman, \textit{The Mechanism of Market Efficiency}, 70 Va L Rev 549 (1984) (describing the process by which information supports efficient markets and arguing the mandatory disclosure is the most efficient way to achieve the necessary dissemination of such information).

\textsuperscript{15} See discussion in SubPart I.B.

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must accurately state all the information that a “reasonable investor” would deem “material” for purposes of making investment decisions.\(^1\) Even if all investors are “reasonable”, however, they each have different tax preferences.\(^2\) As a practical matter, issuers cannot draft nonfinancial tax disclosure addressing the tax consequences of all reasonable investors.\(^3\) In order to address such specific tax heterogeneity, market practice is to assume that all “reasonable investors” are also “average taxpayers”.\(^4\) The “average taxpayer” is a taxable individual who is not subject to unique tax rules and who possesses no unusual tax attributes. Nonfinancial tax disclosure is drafted for the benefit of these average taxpayers.

I show that drafting nonfinancial tax disclosure for the benefit of average taxpayers, however, amounts to a description of tax consequences that rarely (if at all) benefit anyone. I conclude Part I by arguing that current tax disclosure practice fails to provide the necessary information to investors, creates unnecessary transaction costs, and diverts the valuable resources of the thinly-staffed SEC towards the enforcement of a pointless regulatory regime.

In Part II, I suggest that the practical reason for the failures described in Part I, is that the concept of the “average taxpayer” is indefensible, for

\(^{17}\) See SEC Legal Bulletin at 11 (cited in note 7) (“[T]ax information is ‘material’ if there is a substantial likelihood that a reasonable investor would consider the information to be important in deciding how to vote or make an investment decision”).

\(^{18}\) New York State Bar Association Tax Section, Report on Tax Opinions in Registered Offerings 2-3 (Apr 4, 2012), online at http://apps.americanbar.org/buslaw/tribar/materials/20120813000000.pdf (visited Jan 2, 2014) (“The tax consequences are likely to vary significantly for investors subject to special tax rules (such as, for example, insurance companies, financial institutions, dealers in securities, certain traders in securities, tax exempt organizations, partnerships and equity owners of partnerships, and investors that hold the security as part of an integrated transaction, hedge or straddle).”) (hereinafter referred to as the “NYSBA Report”).

\(^{19}\) This would necessitate “to write a treatise, which in addition to being cumbersome, would be useless (from the perspective of disclosure) at best and misleading at worst.” See Robert P. Rothman, Tax Opinion Practice, 64 Tax Law 301, 383 (2010). See also notes 54-83 and accompanying text.

\(^{20}\) See NYSBA Report at 2 (cited in note 18) (“Although certain potential investors in a registered offering are subject to special tax rules, the primary target of most tax disclosure in registered offerings is the average investor expected to invest in the offered security or whose vote is being solicited in connection with the offering, necessitating a balance between detail and clarity such that the disclosure can be readily understood by that investor.”)
three important reasons. First, any nonfinancial tax disclosure item could theoretically be favorable to one taxpayer, but detrimental to another, even if both taxpayers are “reasonable investors”. This theoretical assertion is significant since the operation of efficient markets depends—among other things—on the assumption that the same piece of information is identically interpreted by all market participants (meaning, all participants agree whether the information is beneficial or detrimental to an asset’s value).\(^{21}\) This is not a reasonable assumption in context of nonfinancial tax disclosure.

Second, I show that court decisions have generally been consistent with the notion that no “class” of “average” taxpayers exists. Courts have failed to find liability with registrants who misstated facts in tax disclosures, to the extent the misstated facts related to investor-level tax consequences.

Third, drawing on financial literature, I show that the tax preferences that matter for the efficient operation of capital market are not the tax preferences of “average taxpayers” (as such term is defined by market practice).\(^{22}\) Rather, financial literature suggests that the relevant tax preferences in the operation of capital markets are those of institutional investors. Ironically, institutional investors are excluded from the scope of tax disclosure specifically because they are not considered to be “average taxpayers”. Current nonfinancial tax disclosure practice thus excludes investors that matter, and includes investors that do not (i.e., “average taxpayers”).

In Part III, I identify the theoretical source of the regulatory failure. The SEC’s regulatory paradigm is largely guided by mandatory disclosure theory.\(^{23}\) Mandatory disclosure theory is grounded in the idea that issuers

\(^{21}\) Eugene E. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J Fin 383, 387-388 (1970) (“all agree on the implications of current information for the current price and distributions of future prices of each security… And disagreement among investors about the implications of given information does not in itself imply market inefficiency unless there are investors who can consistently make better evaluations of available information than are implicit in market prices”). As I discuss below, in the case of tax consequences it is certainly the case that disagreement among investors may be consistent in the sense that investors will always have different evaluations. See notes 112-123 and accompanying text.

\(^{22}\) See discussion in in subsection II.C.

\(^{23}\) See Hu, 90 Tex L Rev at 1614-28 (cited in note 14) (describing the SEC disclosure paradigm); Allen Ferrel, *Mandatory Disclosure and Stock Returns: Evidence form Over-the-Counter Market*, 36 J Leg Stud 213, 213-214 (2007) (“The organizing principle of U.S. securities regulation has been the belief that mandatory disclosure of firm specific information enables capital market to function efficiently and in the interest of all investors”).
are best-positioned to disclose—in the least socially-wasteful manner—relevant facts about the entity that a reasonable investor would consider material. In the context of nonfinancial tax disclosure, however, a lot of the material information is either public or found with the investors, not with the issuing entity. In fact, the issuing entity is almost never in a position to obtain non-public investor-relevant tax information, or to accurately depict it. Thus, mandatory disclosure theory—even if accepted at face value—does not lend support to nonfinancial tax disclosure in its current form.

In Part IV, I propose a remedy to the regulatory failure. Assuming that mandatory disclosure theory will guide securities regulation in the foreseeable future, I question which types of nonfinancial tax disclosure would be justified under the theory. It is worth noting that the assumptions standing in the basis of the efficient capital markets hypothesis, and the disclosure paradigm supported by such assumptions, have been harshly criticized by many, primarily from the point of view of behavioral finance. While this body of critique definitely applies in the tax context,

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24 Zohar Goshen & Gideon Parchomovsky, 55 Duke L J at 755-766 (cited in note 5) (describing why mandatory disclosure is the best suited method to disseminate necessary information to the market); see Hu, 90 Tex L Rev at 1621-28 (cited in note 14) (describing such policy resulting in what he characterizes as the “intermediary depiction model”); Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va L Rev 549, 638-39 (1984) (describing the benefits of mandatory disclosure in creating “substantial savings for informed traders by collectivizing some of the costs of acquiring, processing, and verifying information traders had expended” prior to the securities regulation); John C. Coffee, Jr, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va L Rev 717, 732-34 (1984) (mandatory disclosure theory as the principal method to reduce social waste and duplication of investor research of investments). Indeed, Professors Easterbrook and Fischel also make the argument that mandatory disclosure provides not only a benefit to investors (i.e. the realization they are not receiving a “lemon”) but also to firms who have undertaken self-induced disclosure in order to keep their stock prices at a certain level and remain profitable (Easterbrook argues that firms making these voluminous disclosures give investors piece of mind and for the most part, prevent wild swings in firm price from investors looking towards new opportunities–firms want to receive the benefit from these disclosures, it not then most firms would delist or not have an initial public offering). Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va L Rev 669, 683-85 (1984).

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

26 The ECMH critique movement started with the seminal study by Robert J. Schiller, Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends, 71 American Econ Rev 421 (1981). Shiller concluded that the failure of the efficient capital
it is not the point of view I take in this article. Rather, I argue that the problem with tax disclosure is more fundamental: due to the special nature of tax law, current nonfinancial tax disclosure framework cannot be justified even under the best possible theoretical assumptions that otherwise support mandatory disclosure.

To address this theoretical failure, I differentiate between two categories of nonfinancial tax disclosure: investor-level nonfinancial tax disclosure and dual-level nonfinancial tax disclosure. Investor-level nonfinancial tax disclosure refers to items relating solely to tax consequences to investors in their individual capacity. Such investor-level disclosure is currently required by nonfinancial disclosure regulation. I suggest completely eliminating this requirement. I also demonstrate that the market and the SEC have already taken some implicit steps aimed at eliminating this type of disclosure.

The second category I suggest, dual-level nonfinancial tax disclosure, pertains to issuers’ tax items that could affect investors’ own tax consequences. For example, in certain cases, shareholders must report on their individual tax returns deemed dividend income attributable to issuers’ earnings, even if such earnings were not actually distributed to shareholders.\(^27\) I suggest that in such cases, issuers must disclose whether they have earned income that shareholders must report on their individual returns. Such disclosure is sometimes required under current regulatory regime, but it is unclear exactly when and to what extent.\(^28\) I suggest

\(^27\) See discussion in notes 200-202 and accompanying text.

\(^28\) It is worth noting that disclosure is occasionally required by tax law, not by securities regulations. The rationale driving such disclosures is to assure consistency of the tax treatment between the issuer of the holder. For example, issuers of instruments...
redesigning the regulatory framework to address this definitional issue.

Specifically, I suggest reforming the regulatory requirements so that an issuing entity will be required to disclose a nonfinancial tax item only if it is a “dual-level” tax item. A dual-level tax item is an item that meets the following two requirements: (i) the tax item is an entity-level tax item; and (ii) such items may affect the calculation of investor-level tax liabilities. There are specific instances in which both requirements are met, allowing for the development of a “standard form” or generic checklist of nonfinancial tax disclosure items. While the undertaking of identifying all such items may seem daunting, the result will be significantly simpler, accurate and more useful tax disclosures.

I conclude with a call to investors in registered securities to consult their own tax advisors. Such type of advice, regularly made by issuers in disclosure documents, is not always viewed favorably by the SEC. Such advice, however, is necessary if the purpose of mandatory tax disclosure is to enable investors to make informed investment decisions.

I. THE FAILURES OF NONFINANCIAL TAX DISCLOSURE

My purpose in this Part is to show the failures of nonfinancial tax disclosure practice in registered securities offerings. In Subpart I.A, I describe tax disclosure requirements and their intended purpose of supporting capital market efficiency. In Subpart I.B, I explain the main hurdle faced by practitioners drafting nonfinancial tax disclosures, namely investors’ heterogeneous tax preferences. In Subpart I.C, I survey the market practices responding to investors’ tax heterogeneity. I show that such practices, as sanctioned by SEC guidance, cannot be reasonably expected to support market efficiency. In Subpart I.D, I suggest that such practices may also be detrimental to market efficiency.

A. Tax Disclosure Requirements and Rationales

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29 Rothman, 64 Tax Law at 387 (cited in note 19) (“Recently, the author has encountered (and has heard anecdotal reports that others have encountered) resistance from SEC reviewers to telling people to consult their own tax advisors.”)
1. The Purposes of Tax Disclosure: Capital Market Efficiency

Ever since the enactment of the Securities Acts of the 1930s, the SEC’s regulatory paradigm relied on the notion that the disclosure of information is the cornerstone of an efficient market.\(^{30}\) The emergence and widespread acceptance of the Efficient Capital Market Hypothesis (“ECMH”) in the 1970s “bolstered the case for [a] robust informational foundation.”\(^{31}\) Under the ECMH, an efficient market is one in which securities prices “fully reflect” available information.\(^{32}\) Information thus supports accurate pricing of securities in the secondary market, and help prospective investors to assess the pricing of securities offered in the primary market.

While the ECMH has been subject to extensive criticism over the past three decades,\(^{33}\) it undisputedly played (and still plays) a vital role in the construction of United States securities regulations.\(^{34}\) I therefore question


\(^{31}\) Hu, 90 Tex L Rev at 1616 (cited in note 14) (“[ECMH] came to provide a social-science-based justification for the disclosure paradigm, and strongly influence the paradigm implementation”).

\(^{32}\) Fama, 25 J Fin at 384 (cited in note 21); see also, Merrit B. Fox, Civil Liability and Mandatory Disclosure, 109 Colum L Rev 237, 243, 252 (2009) (describing the primary benefit of the social value of disclosure as the “more efficient allocation of resources in the economy as a result of improved corporate governance, increased capital market liquidity, and the consequent reduction in the cost of capital, and the reduction in resources used by secondary market investors to gain advantages over each other in a race to discover information already known by issuers but unannounced.”). For the central role the EMCH plays in the formulation of the disclosure requirement in registered offerings, see also Langevoort, 97 Nw L Rev at 136 (cited at note 14) (the prices of the stocks of actively traded companies … rapidly adjust to reflect the rational expectations generated by all available information as it becomes available.”); see also Hu, 90 Tex L Rev at 1614-21 (cited in note 14) (describing ECMH role in the development of current SEC disclosure paradigm); see also Langevoort, 140 U Pa L Rev at 851-52 (cited in note 14) (discussed the central role that EMH plays in supporting information disclosure); see also Gilson & Kraakman, 70 Va L Rev 549 (cited in note 24) (describing the process by which information supports efficient markets and arguing the mandatory disclosure is the most efficient way to achieve the necessary dissemination of such information).

\(^{33}\) See note 26.

\(^{34}\) Lawrence A. Cunningham, From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis, 62 Geo Wash L Rev 546, 548
the internal logic of nonfinancial tax disclosure in the context of ECMH. I do not criticize ECMH, nor do I question nonfinancial tax disclosure in the context of such criticism.  

Molded with ECMH assumptions as its building blocks, our securities regulation regime requires issuers in registered securities offerings to disclose all information that a “reasonable investor” may deem “material” for the purposes of making informed investment decisions. The disclosure must be accurate and concise.

Tax information is no exception in this context. Taxes reduce the net return on an investment and as such may affect investment decisions. The tax cost associated with an investment could thus be considered a material piece of information by a reasonable investor. Indeed, the disclosure of tax-related information is an integral part of the regulatory scheme. Broadly speaking, mandated tax disclosure can be divided into two categories: financial and nonfinancial disclosures.

2. Financial Tax Disclosure: Entity-Level Taxes

Taxes borne by the issuer—for example, corporate taxes paid by corporate issuers—might be a significant expense item, affecting the issuers’ value or creditworthiness. Such considerations affect a reasonable investor’s investment decisions.

Financial disclosure regulation,
primarily mandated by Regulation S-X, requires that issuers account for their own income tax expenses in the financial statements.\footnote{26 CFR §210.4-08(h)}

Generally, Regulation S-X requires that financial statements disclose the income tax benefits and expenses of an issuer, and explain the timing of inclusion of such benefits and expenses.\footnote{26 CFR §210.4-08(h)(1).} Additionally, financial statements must contain disclosures regarding the total income at the end of the taxable year and the amount of tax incurred for such year, including the applicable tax rates and the method used by the corporation in computing the taxable amount.\footnote{26 CFR §210.4-08(h)(2).} Regulation S-X discusses little else, and instead references FASB Accounting Standards Codification Topic 740 (entitled “Income Taxes”), directing that tax disclosure statements be made in a manner consistent with the financial accounting standards therein.\footnote{26 CFR §210.4-08(h)(3). FASB Topic 740 represents the codification and replacement of the income tax accounting rules formerly contained in Financial Accounting Standards No. 109 (Accounting For Income Taxes, Fin. Accounting Standards Bd. 1992). FASB ASC 740 provide generally for recognition in the taxable year, consistent with Reg. S-X, but also details when future tax liabilities or deferrals should be taken into account. Most importantly, ASC 740 provides a two-step approach for businesses to decide when to include a tax benefit, expenditure, or other tax position in the financial statements. See Peter M. Fass, et al, \textit{Significant Accounting Developments--FASB ASC Topic No. 740, Income Taxes} Real Estate Investment Trusts Handbook §3.72 (Nov 2012). A “tax position” must be included in the financial statements when it is “more likely than not to be sustained upon examination” (i.e. the facts dictate its validity in case of an audit); then, the position will be valued at its highest possible realization, unless it fails the standard in such case the benefit recognized will be lower or the liability higher. Id. This approach falls in accordance with the principles underlying that current liabilities or assets be recognized as attributable to positions within the current year, and that deferred tax liabilities are recognized when future tax effects can be estimated (and revised when realization does not occur). Id; §21 “Income Taxes” Warren Gorham & Lamont GAAP Practice Manual (RIA, 2013). If such positions are not initially recognized, then ASC 740 sets forth standards for inclusion in the first period in which the deferred benefit or liability meets the “more likely than not standard” under the two-step approach. Fass, et al. Finally, ASC 740 also expanded the disclosure requirements of unrecognized tax benefits by addressing timing issues related to certain tax uncertainties in annual disclosures. Id.} In this article I do not propose any changes in respect of financial tax disclosure.\footnote{Other scholars have addressed such issues. See, for example, Linda M. Beale,}
3. Nonfinancial Disclosure: Investor-Level Taxes

The second category of tax disclosure refers to nonfinancial tax items. The main regulatory underpinning of nonfinancial tax disclosure is found in Item 601(b)(8) of Regulation S-K. Under Item 601(b)(8), issuers in registered securities offerings are required to disclose—and to qualify such disclosure by an opinion—all material tax consequences to the investor associated with purchasing, holding and disposing of the offered securities. Such disclosure provides information about taxes paid by the investors on their own account. Several additional provisions in U.S. securities regulation framework require the disclosure of nonfinancial tax information. In addition, several basket provisions require the disclosure of any non-enumerated “material” information, and as such may apply to nonfinancial tax items to the extent they are material.

While there is no explicit legal requirement to disclose nonfinancial tax consequences that are not “material”, it is apparently the SEC’s position that such tax consequences need to be disclosed (though it is not necessary
to support such disclosure with an opinion). Moreover, it is standard practice to disclose certain nonfinancial tax items that are not viewed material by tax practitioners or the SEC. For example, it has been suggested that the tax consequences associated with holding and selling common stock are not material. Nonetheless, disclosure documents for common stock offerings regularly contain a nonfinancial tax disclosure section.

Nonfinancial tax consequences are usually described in a dedicated section of the offering document, titled “Material Federal Income Tax Consequences”.

B. Nonfinancial Tax Disclosure and the Problem of Investors’ Tax Heterogeneity

The requirement to disclose nonfinancial tax consequences puts issuers in an impossible position. The reason is that even if investors are all “reasonable” and they all invest in the same security, different investors still face different tax consequences resulting from their investments. For example, investors face different tax rates depending on their tax bracket, tax status, or how long they have held the security. Some investors may

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

51 See NYSBA Report (cited in note 20) (noting that “the ‘plain vanilla’ tax consequences to investors of holding and selling the common stock” are not required to be disclose on account of not being considered “material”).

52 Id (“although a mere offering of common stock issued for cash does not involve any tax consequences that are ‘material’ to an investor”, the tax disclosure will typically describe the “plain vanilla” tax consequences for non-U.S. investors of owning and selling the common stock”). In Part IV.A, I take issue with the assertion that such tax consequences are not material and can be regarded as “plain vanilla”. For recent examples of such disclosure, see Burlington Stores, Inc., Common Stock Offering Prospectus: Certain U.S. Federal Income and Estate Tax Considerations For Non-U.S. Holders (2013), at online http://www.nasdaq.com/markets/ipos/filing.ashx?filingid=9114170#D552507D424B4_HT M_ROM552507_19 (visited Jan 2, 2014); see also Re/Max Holdings, Inc., Form S-1 Registration Statement: Material U.S. Federal Income Tax Consequences to Non-U.S. Holders (2013), at 161 (2013), online at http://www.nasdaq.com/markets/ipos/filing.ashx?filingid=9116267 (visited Jan 2, 2014).

53 Other titles used are “Material Federal Income Tax Considerations”, “Material Federal Tax Consequences”, among other similar titles.

54 For example, while most investors are only taxed upon realization (usually upon the disposition of securities), those who qualify as “dealers” in securities are taxed on a “mark-
have losses they can use to offset gains\textsuperscript{56}, while others do not have losses or otherwise are unable to take advantage of such losses.\textsuperscript{57} Some may face different tax regimes altogether as a result of being classified “foreign” or “domestic” taxpayers.\textsuperscript{58} Taxpayers’ classification as “corporations”, “individuals”, “partnerships”\textsuperscript{59} or any other classification under tax law, will inevitably change the investors’ tax consequences.

The difficulty of drafting concise and useful nonfinancial tax disclosure of broad application can be demonstrated by discussing the most obvious case of an income realization event associated with an investment in securities: the sale of common stock in the public market.

Under general rules applicable to gains from the sale of capital assets, a taxpayer must recognize income upon the disposition of the asset, in an amount equal to the difference between the amount realized and the tax basis in the asset.\textsuperscript{60} The tax basis of a publicly traded stock is, in most cases, the amount paid for the stock.\textsuperscript{61} While it is easy to describe such a rule in a disclosure, such description would be meaningless given that the

\begin{footnotesize}
\begin{itemize}
\item The gain on the disposition of capital asset (such as a publicly trade security) held for a period of more than a year is taxed at long-term capital gains rate (currently 15\% for most taxpayers; 20\% for taxpayers in the top marginal tax bracket), while the gain on the disposition of a capital asset held for a year or less, is taxed at short-term capital gains rate (which is the same on the ordinary tax-bracket of the taxpayer); IRC §1(h).
\item Taxpayers calculate their capital gains and losses on a netting basis. IRC §1222. For example, a taxpayer who realized a long-term capital loss on the disposition of one security will be able to use such loss to shield income from the disposition of another security, which is expected to generate long-term capital gains. A taxpayer with no such loss offset, is expected to carry a heavier tax burden on the disposition of the same security at a gain. In addition, individuals are allowed to offset up to $3,000 of capital losses against their ordinary income. IRC § 1211(b). Unused capital losses can be carried over to future years (indefinitely), and can be carried back (on a limited basis) to offset capital gains income. IRC § 1212.
\item IRC § 172.
\item While domestic taxpayers are taxed in the United States on all income from whatever source derived, foreign taxpayers are generally taxed only on income sourced within the United States. IRC §§ 871, 881. In most cases, income from the disposition of stock is sourced at the place of residence of the seller. IRC § 865(a). Thus, income from the disposition of security listed for public trading will be taxed to a U.S. resident, but exempt to a foreign resident. Source rules may also cause differential taxation to foreign and domestic taxpayers in the case of dividend and interest payments. IRC § 861.
\item Different types of entities may face different tax rules. Thus the entity classification of an investor can affect the tax results. See discussion in notes 112-125 and accompanying text.
\end{itemize}
\end{footnotesize}
rule’s application is heavily dependent on the particular tax situation of each investor.

As an initial matter, not all investors in securities are taxable upon disposition of a security. Certain categories of investors are tax-exempt, assuming they meet certain requirements. Different tax-exempt statuses require different sets of qualifications. Query if an issuer is able to describe in the tax disclosure section—clearly and concisely—the requirements one must meet in order to be granted tax-exempt status.

What if we assume, for purposes of drafting the tax disclosure, that all investors are taxable investors? This is, obviously, not a realistic assumption. Tax-exempt investors are major players in the U.S. securities markets. Yet, what if we can exclude such tax-exempt taxpayers from the scope of the disclosure, by adding some qualifying language? In such a case, a drafter would write the disclosure solely for the benefit of taxable investors. Carve-outs and qualifications are explicitly allowed under the regulations, as long as such carve-outs are clearly described in the tax opinion qualifying the disclosure.

However, even if we carve-out tax-exempt investors from the scope of the disclosure, the drafting task is not made easier. Gains from the sale of a capital asset (such as publicly-traded stocks) are subject to various tax rates. Capital gains are taxed at preferential rates, provided the security was held for a period longer than a year. If the security is held for a period of one year or less, then the investor’s gains are considered short-term capital gains, and are taxed at the investor’s marginal tax rate. An

62 Multiple types of entities who qualify for tax exempt statues actively participate in financial markets such as pension funds, university endowments, charitable organizations, governmental entities and so on.

63 For example, a recent Goldman Sachs survey suggests that nontaxable retirement funds own as much as 17% of the entire value of the U.S. equity market. See, David J. Kostin et al., 2013 U.S. Equity Outlook: Selectivity Seeking Growth 17 (Nov 28, 2012), online at http://www.mauldineconomics.com/images/uploads/overmyshoulder/Goldman_Sachs_-_US_Equity_Outlook.pdf (visited Jan 2, 2014). Pension fund also own 6% of the total U.S. bond market. Id at 19. On the whole, as recently as 2003, institutional investors controlled over 59.2% of the equity market ($7.97 trillion) versus 28.4% ($376 billion) in 1980. Thomas J. Chemmanur et al., The Role of Institutional Investors In Seasoned Equity Offerings, 94 J Fin Econ 384, 385 (2009). These institutions included multiple types of tax-exempt investors, such as university endowments, pension funds, and governmental entities.

64 SEC Regulation S-K, 17 CFR § 229.601(b)(8) (“Such tax opinions may be conditioned or may be qualified, so long as such conditions and qualifications are adequately described in the filing.”)

65 See discussion in note 56 and accompanying text.
issuer drafting a disclosure is not in a position to know how long an investor held (or will hold) the stock before selling it. A disclosure addressing such an issue must take an algorithmic approach of “if your holding period in the stock is “X”, then the tax consequence is “Y”; if your holding period is “N”, then the tax consequence is “M”…” and so on. This approach is sometimes used in practice, and complicates the disclosure drafting task substantially.\(^{66}\)

Even if we make another simplifying assumption according to which all investors purchase the security on the same day, and sell the security on the same day, not all investors face the same tax consequences. The drafting task remains difficult as different types of taxable investors face different tax regimes altogether. For example, dealers in securities have to mark-to-market their securities each year and pay tax to the extent the securities appreciated in value, regardless if the securities are disposed of.\(^{67}\) When the securities are actually sold, proper adjustment must be made in order to account for gain or losses previously recognized under the mark-to-market method.\(^{68}\) The taxable gain to a dealer is thus necessarily different than the taxable gain of non-dealers who have sold the securities at the same time, for the same price.

Dealers in securities are only one example of many types of investors that are subject to unique sets of tax rules.\(^{69}\) In order to make a tax disclosure accurate, issuers must theoretically disclose the different tax consequences faced by different types of investors. It is doubtful that such a disclosure could be made “concise”.

Assume now there are no dealers or other financial institutions investing in the stock (an unrealistic assumption, again). Also assume, for purpose of some further simplification, that all our investors are individuals (another unrealistic assumption). Even if all our investors are taxable individuals, who bought the stock at the same time, and sold it at the same time for the same price, the tax consequences to each investor would probably vary. Some investors may have capital losses from the

\(^{66}\) See, for example, Groupon Inc. SEC Form S-1 Registration Statement, Material United States Federal Tax Consequences 133 (Aug 10, 2011) (“Upon the sale or other disposition of our Class A common stock, you will generally recognize capital gain or loss equal to the difference between the amount realized and your adjusted tax basis in such stock. Such capital gain or loss will generally be long-term capital gain or loss if your holding period in respect of the stock is more than one year.”). Italics added.

\(^{67}\) See the discussion in note 54 and the accompanying text.

\(^{68}\) Id.

\(^{69}\) Other types of investors subject to specific taxation rules include, for example, Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), insurance companies, tax-exempt investors, and more.
disposition of other capital assets. In such a case, the losses could be used to shield the gains, reducing the taxable income.  

Even if all investors are taxable individuals who have no losses that can be used to offset gains, a disclosure could not be made uniform. For example, some investors in U.S. public markets are domestic, while others are foreign. Domestic investors are taxable in the U.S. on their income from whatever source derived. Foreign investors, on the other hand, are generally only taxed in the United States on income sourced within the United States. Income from the sale of a capital asset is sourced at the residence of the seller. It follows that income from the sale of a security is generally considered foreign-source income to a foreign seller. Thus, such income is not taxable in the United States to a foreign investor, but is taxable to a domestic investor. Under the Code, the result is different (again!) if the foreign seller’s income from the sale of the securities is “effectively connected” with a “U.S. trade or business” in which the seller is engaged. In such a case, the foreign seller is subject to taxation in the United States in the same manner as a U.S. resident. A disclosure contemplating all such nuances cannot be made concise.

The description above is only the tip of the iceberg. I have not delved into the specific rules of application of the examples discussed, and did not discuss income realization events associated with investment in securities other than the disposition of the security (such as dividends or interest payments), nor did I discuss disclosure in respect of securities other than common stock. I also did not touch upon many other subjects, too numerous to count, that contribute to investors’ heterogeneous tax preferences. The bottom line, however, is clear: the tax consequences resulting from investment in securities vary among investors, even if all investors are “reasonable investors”, and even if one makes numerous simplifying assumptions.

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70 See the discussion in note 56 and the accompanying text.
71 Foreign Investors own about 13% of the total value of U.S. equity markets. Kostin et al., 2013 U.S. Equity Outlook: Selectivity Seeking Growth (cited in note 63).
72 IRC § 865.
73 IRC § 871. United stated citizens and or residents for tax-purposes are taxed on their worldwide income from whatever source derived. Nonresidents are subject to separate taxation regime, general resulting in the foreign resident only being taxed on income derived in the United States. IRC §§1, 2(d).
74 IRC §§871(b), 882.
C. The Market-Created Construct of the “Average Taxpayer”

Practitioners, obviously, cannot draft tax disclosure that explains all conceivable tax consequences, taking into account each investor’s particular tax position. This would necessitate “writ[ing] a treatise, which in addition to being cumbersome, would be useless (from the perspective of disclosure) at best and misleading at worst.”

In the face of overwhelming tax heterogeneity, some practical drafting approach had to be developed. A recent New York State Bar Association (NYSBA) report articulated the Tax Bar position that “the primary target of most tax disclosure in registered offerings is the average investor expected to invest in the offered security.” Investor-level tax disclosure is thus being drafted for the benefit of some imaginary investor who faces “average tax consequences”. I shall refer to this market-created construct as the “average taxpayer”.

Having been developed by the market, the “average taxpayer” construct lacks an official definition. The market approach seems to define the “average taxpayer” or “average tax consequences” by way of elimination. In practical terms, the average taxpayer-investor represents what remains after taking into account all the limiting language and qualifications regularly used in disclosure statements.

There are three axes along which nonfinancial disclosure of tax consequences is limited: the scope of investors (limiting the personal scope of the disclosure to “average” taxpayers); the scope of taxes (limiting the substantive scope to “average tax consequences” faced by “average taxpayers”); and, the scope of reliance by investors (allowing taxpayers to rely on the disclosure only to the extent that the tax consequences described are indeed “average”). I discuss each in turn. I show that the functional outcome of the qualifications is to strip most of the significance out of nonfinancial tax disclosure.

1. Limiting the Personal Scope of Nonfinancial Tax Disclosure.

The most obvious way by which issuers limit the scope of nonfinancial tax-disclosure, is by excluding certain “non-average” taxpayers from the

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75 Rothman, 64 Tax Law at 383 (cited in note 19).
77 The NYSBA report does not use the terms “average taxpayer”. Rather, it refers to “average” tax consequences faced by “reasonable investor”. Using the term “average taxpayer” is for purposes of avoiding confusion with the term “reasonable investor” referring to the rationality of the investor (rather than to the investor’s tax profile). Distinguishing between the rationality of investors and their tax preferences is key to the analytical argument I advance in in this article.
disclosure’s application. Such exclusions present themselves in two ways. First, in the case of initial offerings, issuers almost always limit the applicable tax consequences described to consequences to investors who purchased the securities in that initial offering. Second, in the case of both initial and non-initial offerings, as well as in the case of periodic disclosure documents, disclosures are made expressly inapplicable to certain types of “sophisticated investors”, who are subject to unique tax rules (generally institutional investors). For example, insurance companies face specific tax rules applicable only the insurance industry. So do Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), dealers in securities, and other types of specially-defined entities under the Internal Revenue Code (IRC).

Indeed, according to the NYSBA Report, an “average” taxpayer is not a taxpayer subject to special tax regimes “such as, for example, insurance companies, financial institutions, dealers in securities, certain traders in securities, tax exempt organizations, partnerships and equity owners of partnerships, and investors that hold the security as part of an integrated transaction, hedge or straddle.” Thus, offering documents regularly contain language that explicitly states that tax consequences discussed are inapplicable to such classes of investors.

On its face, such an approach falls short of the basic requirement that disclosure address the material tax consequences of reasonable investors. While the identity of the reasonable investor remains elusive, it is clearly intended to function as a generic term, representing “the idealized, utility maximizing person from neoclassical economic theory.” By carving out

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

79 See, for example, Sophiris Bio Inc., SEC Form S-1: United States and Canadian Income Tax Considerations, 125 (Feb 15, 2013); see Third Point Reinsurance, Certain Tax Considerations at 171 (cited in note 78).

80 IRC §§ 801-848
81 IRC §§ 856-859
82 IRC §§ 851-855
83 IRC §475
84 NYSBA Report, at 4-5 (cited in note 18).
85 See, for example, the discussion in notes 78-79 and the accompanying text.
86 Lin, 34 Sea U L Rev at 694-695 (cited in note 26).
87 Id at 695; Hoffman, 90 Minn L Rev at 540-542 (cited in note 26) (discussing the traits of the “reasonable investor”).
specific types of investors from the scope of the tax disclosure, the
disclosure no longer addresses the material tax information all reasonable
investors need in order to make an informed investment decision. Any
taxpayer facing “non-average” tax consequences may nonetheless be a
“reasonable investor”, yet excluded from the scope of the tax disclosure.

For example, most investors purchase and trade securities in the
secondary market. A very limited number of investors are able to
participate in initial offerings. Thus, limiting the personal scope of the
disclosure to investors participating in the initial offering makes the initial
offering’s disclosure applicable to an extremely narrow set of market
participants, excluding most “reasonable investors” who happen to trade
in the secondary market.

This failure is exacerbated by excluding institutional investors from the
scope of initial public offering (IPO) disclosures. While institutional
investors are understandably not regarded as “average”, it is this class of
investors that usually participates in initial offerings. It follows that, as a
practical matter, nonfinancial tax disclosure does not describe the tax
consequences to investors that are expected to purchase the securities in
the initial offering; additionally, the disclosure fails to describe tax
consequences applicable to any investor who may purchase the securities
in the secondary market. In other words, under current practices, the tax
consequences described in the disclosure of initial offerings are applicable,
for the most part, to no one. It is questionable that such a disclosure can
perform any meaningful regulatory function.

Even in the case of non-initial offerings (such as in periodic
disclosures, or disclosure involving exchange offers, mergers and other
transactions), the exclusion of many types of investors is difficult to
rationalize, unless one takes the position that only the tax consequences of
certain reasonable investors should be addressed. The regulations do not
suggest such an approach.

As far as I can tell, the SEC has never objected to the practices
limiting the personal scope of nonfinancial tax disclosure.

2. Limiting the Substantive Scope of Nonfinancial Tax Disclosure.

It is also customary practice for issuers to limit the scope of

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88 See, for example, the discussion on institutional investors in note 11 and the
accompanying text.
89 Id.
90 The SEC even implicitly agreed to such practices by stating that tax disclosure can
be conditioned “provided the conditions or qualifications are adequately described in the
nonfinancial tax disclosure to the description of federal income tax consequences alone.\textsuperscript{91} Other taxes are explicitly carved out from the scope of the disclosure. There is practical sense to this approach, given that federal income taxes are probably of the broadest application in the case of securities traded in U.S. markets.\textsuperscript{92} Federal income taxes apply to most U.S. investors, and as such could be regarded as “average” tax consequences.

The problem with such an approach, however, is that it leaves outside the scope of the disclosure many other types of taxes that may nonetheless have “material” effects on the after-tax value of a security.\textsuperscript{93} To the extent disclosure is intended to provide investors with information necessary to make informed investment decisions, it is difficult to justify the inclusion of federal income tax consequences in the disclosure, yet the exclusion, for example, of state or other local tax consequences. State and local taxes may have a material effect on the return of an investment, and have already been interpreted to have such effect for purposes of financial tax disclosure.\textsuperscript{94}

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\footnote{91}{See, for example, Pattern Energy Group Inc., \textit{SEC Form S-1: Material U.S. Federal Income Tax Considerations for Holders of Our Class A Common Shares}, 190 (Aug 9, 2013), online at http://www.sec.gov/Archives/edgar/data/1561660/000119312513329269/d564947ds1.htm (visited Jan 2, 2014) (“The effects of other U.S. federal tax laws, such as estate and gift tax laws, and any applicable state, local or foreign tax laws are not discussed”); see also, for example, Ringcentral, Inc., \textit{SEC Form S-1: Material U.S. Federal Income Tax Consequences to Non-U.S. Holders of Our Class A Common Stock} 144 (Aug 26, 2013), online at http://www.sec.gov/Archives/edgar/data/1384905/000119312513346260/d1310247ds1.htm (visited Jan 2, 2014) (“This discussion is not a complete analysis of all potential U.S. federal income tax consequences relating thereto, nor does it address any estate and gift tax consequences or any tax consequences arising under any state, local or non-U.S. tax laws, or any other U.S. federal tax laws”).}

\footnote{92}{For example, U.S. residents own 87% of the value of the U.S. equity market. See, Kostin et al., 2013 \textit{U.S. Equity Market Economic Outlook} (cited in note 63). As such, federal income taxes are of broad applications to investors in these markets.}

\footnote{93}{See, for example, the discussion of various tax regimes found in note 84 and the accompanying text.}

\footnote{94}{See Pomp, 22 Cap U L Rev at 373 (cited at note 39). For example, Pomp postulates that by investors and analysts being able to take into consideration the state income tax rates and liabilities for different items on the financial statement, an investor can determine the efficiency and utility of a multinational company’s transfer pricing techniques in minimizing such liabilities (and thus determining how much consideration is given to state tax liabilities). Id at 428. Additionally, Pomp postulates a leveling-of-the-playing-field effect, in terms of disclosure, whereby large conglomerate corporations would have to disclose as much as more specialized and less diverse small and medium-sized corporations. Id at 435. The financial accounting standards prescribed under FASB ASC}\
\end{footnotes}
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It is also unclear whether language limiting the scope of the disclosure to federal income tax consequences meets the literal requirement of the regulations. Item 601(b)(8) of Regulation S-K, clearly prescribes that an opinion must accompany nonfinancial tax disclosure, “where the tax consequences are material to an investor.”

The requirement, on its face, is not limited to federal tax or to income tax matters, and applies to all tax matters.

The SEC apparently accepts the practice of such substantive limitations. In a recent Legal Staff Bulletin (the Bulletin), the SEC suggests that “only material federal tax consequences” must be covered by the tax opinion (and hence by the disclosure). Interestingly, however, the SEC takes issue with some practitioners’ attempt to limit the scope of the tax disclosure to certain federal income tax consequences. The SEC’s approach seems inconsistent. On the one hand, SEC guidance suggests that all material federal tax consequences must be disclosed; on the other

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740 and interpreted under FASB No. 48 (dealing with accounting for inclusion of uncertain income items) presents an interesting example of the materiality of state taxes, when discussing the disclosure of the effects of state taxes on uncertain income items. See Financial Accounting Standards Board, FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes, (Jun 2006). Due to the multitude of jurisdictions, “less authoritative guidance, greater volatility in state law changes, and less historic reliance on formal tax opinions”, the disclosure of state tax liabilities in financial statements related to uncertain liabilities disclosed under the “more likely than not” standard of FASB ASC 740 present a unique administrative and logistical challenge for company reporting. See Giles Sutton et al., State Tax Issues Regarding FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes, J. Multistate Tax & Incentives 26-27 (Jan 2007). Although each individual tax item may seem de minimis for reporting purposes, in the aggregate these state tax consequences of such items are large enough to be material for investors. Id. at 24. Under FIN 48, for example, companies must establish “uncertainty reserves” on their balance sheets that account for the “uncertainty that exists and the item [if] the item is material the company still must accrue a reserve based on a probability formula”; in most instances, these large reserve accounts (making them material to investors) represent the accrual of certain items with an “economic nexus” whereby states can levy a tax based on business presence. Charles F. Barnwell, Jr, State Income Tax Uncertainty Under FIN 48: The Reserve is Set Up, So Now What? J. Multistate Tax & Incentives (Aug 2008).


SEC Legal Bulletin at 12, (cited in note 7). Given that only “material” items must be disclosed, and given that any “material” tax item must be qualified by an opinion, it follows that any tax item that need not be qualified by an opinion, is also immaterial and as such need not be disclosed.

See SEC Legal Bulletin (cited in note 7) (Proscribing that opinions should broadly address federal income tax consequences or material federal income taxes consequences in its title and that the use of the term “certain” or “principal” in the section title is unacceptable since it “raise[s] a concern that the author of the opinion may be omitting a material tax consequences”).
hand, it is permissible under the same guidance not to disclose any of the material non-federal tax consequences. This distinction is inconsistent with the underlying purposes of the regulatory regime, namely to disseminate all material information.

The problem, however, is that there is no practical remedy that could enable issuers to meet the literal requirements of the regulations. For example, the disclosure of state income tax consequences could only be made accurate if the tax consequences to residents of all fifty states are described. This is not a practical course of action for issuers. Unfortunately, it seems that no standard exists, both in practice and in SEC guidance, to support an inclusion of certain types of tax consequences but the exclusion of others.

3. Limiting the Scope of Reliance on Tax Disclosure

“It is an article of faith among tax advisors that any opinion prepared for the benefit of a large number of third parties who may have different individual tax postures should include language urging each such third party to consult his own tax advisor.”

Practically every tax disclosure in securities offerings contains such language, urging investors to seek tax advice tailored to their own particular tax circumstances.

The SEC’s view of such language, however, is somewhat negative. The SEC acknowledges that such language is intended to address investors’ tax heterogeneity, but does not accept any such qualifying language to the extent it disclaims reliance on the tax matters described in the disclosure. The SEC’s approach in this regard is grounded in the assumption that investors should be able to rely on issuers’ disclosure in order to make investment decisions. As previously indicated, however, current disclosure practice effectively describes the tax consequences that are relevant to none (or only a few) of the investors. Therefore, there is little in nonfinancial tax disclosure that a reasonable investor can

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98 Rothman, 64 Tax Law at 386 (cited in note 19).
99 Id (“Typically, tax disclosure includes (often as part of the introductory boilerplate) a general statement to the effect that persons should consult their own tax advisors as to the application to them of the rules discussed therein.”).
100 Id at 387-88 (describing the SEC negative view of disclosure language urging investors to consult their own tax advisors).
101 SEC Legal Bulletin at 14 (cited in note 7) (“It is common practice, however, for an opinion to recommend that investors consult their own tax advisors or counsel, particularly with respect to the personal tax consequences of the investment, which may vary for investors in different tax situations.”).
102 Id (“The staff does not object to this practice so long as the recommendation does not disclaim reliance for tax matters on which counsel has opined.”).
legitimately rely upon, with or without a call to consult one’s own tax advisor.

If anything, urging investors to consult their tax advisors is necessary. One’s own tax advisor is arguably the only source where one can obtain relevant, reliable nonfinancial tax information regarding one’s own federal, state, and local, income and non-income tax consequences, and the effect that such taxes will have on the investment. Such information is not provided under current disclosure practices, nor can it be provided as a practical matter.

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

From the description above, it is clear that given investors’ heterogeneity in tax preferences, current regulatory regime controlling nonfinancial tax disclosure is impossible to comply with. In turn, market practice and SEC guidance—in seeking to make the drafting task manageable—uproot most of the relevance of the disclosure to any particular investor.

That is not to say, however, that the disclosure is completely meaningless. Arguably, a “reasonable investor” should be able to discern which parts of the disclosure are relevant and which are not given the investor’s particular position. In that sense, the disclosure may provide useful function by putting investors on notice in respect of certain tax information that is being disclosed, regardless of the fact the information may not apply to the investors who read it.

I contend, however, that there are good reasons for which we should care enough to warrant a reform of nonfinancial tax disclosure. Specifically, I argue that current nonfinancial tax disclosure practices fail to support, and may actually disrupt, the dissemination of information to the market.

1. Material Information Is Not Being Disclosed and Disclosed Information May Be Misleading.

As explained above, the rationale behind U.S. disclosure regulation in general and nonfinancial tax disclosure in particular, is that the disclosure of material information is needed to support market efficiency. Under such a rationale, tax disclosure should provide the same level of information to all investors so that investors can adequately judge the tax costs associated with an investment. This should be the case regardless of type of the investor involved and of the types of taxes involved, since any taxes may affect investment returns.
Current nonfinancial tax disclosure describes tax consequences that matter very little (if at all), to anyone. Very few reasonable investors can find useful information in tax disclosure sections. Therefore, the current state of tax disclosure suggests at least a reasonable possibility that information that is material is not being disclosed, sacrificed for the sake of practical drafting. For example, once the disclosure is made inapplicable to certain institutional investors, there is no need for the drafter to describe tax consequences to such investors, even if such consequences are material.

The opposite alternative—to disclose all conceivable tax consequences—is also not desirable. This would result in enormous disclosures, extremely costly to issuers, and likely unhelpful (and probably confusing) to most investors. Indeed, judicial precedent has, to some extent, watered down the full disclosure philosophy and swung the pendulum back in tax disclosure cases, allowing issuers to somewhat sanitize their disclosures.103 Part of this change is attributable to the fact that an “excruciatingly lengthy and complex disclosure” may confuse investors and represent a practically unfeasible amount of disclosure for issuers to handle.104

Moreover, investors that do read current disclosures may erroneously assume that the tax consequences described therein apply to them. It is doubtful we can assume that “reasonable investors” are also tax experts. It is more likely that reasonable investors do not completely comprehend the intricacies of U.S. tax rules. For example, whether an investor is subject to Alternative Minimum Tax (AMT) may affect the tax consequences associated with investment in securities. Because of AMT’s unique consequences, disclosure documents regularly carve-out taxpayers who are subject to AMT from the disclosure’s scope. Thus, a reasonable investor, who is unaware of the fact she is subject to the AMT, may erroneously rely on disclosed nonfinancial tax information. In that sense, the SEC rule results in potentially misleading disclosure, not the fault of the issuer, but the fault of the so-called “average investor” who fails to realize the potential variances created by tax law.

103 In the seminal case, Luce v Edelstein, spawned a line of judicial precedents allowing issuers to avoid liability as long as the prospectuses or tax opinions involved “bespeak caution” to the investors of the risks associated with making the investment (sometimes consisting only of a generic statement of risk and advising to consult their own tax advisor). Luce v Edelstein, 802 F2d 49, 55-56 (2d Cir 1986).
2. The Practice is Wasteful For Both Issuers and Investors

Nonfinancial tax disclosure is associated with costs to both issuers and investors. Issuers must pay lawyers to draft nonfinancial tax disclosure, which consists of not only creating the “information bundle” of tax considerations that investors should be concerned with, but also entails the transaction costs undertaken by lawyers and tax consultants in producing and bringing the information out into the public.\(^\text{105}\)

The problem of drafting costs may not be of much importance when the disclosure consists of boilerplate language. This is possibly the case in the context of plain-vanilla issuances of corporate debt and stock. But it is definitely not the case in the context of tax disclosure applicable to corporate transactions, exchange offers, certain distributions, or issuances of preferred stock, convertible debt and other derivative instruments. The tax treatment of investors in such cases is highly complex, depending on the structure of a corporate transaction or the offered security. In such cases, the process itself is long and tedious—from the initial information-gathering stage, to collecting the required documents from the company in order to conform with the disclosure requirements, to analyzing the applicable tax provisions, and finally engaging in drafting a disclosure delivering relevant information to investors.\(^\text{106}\)

In many cases, disclosure costs represent justifiable expenses, as they are the least costly manner to disseminate necessary information to the market.\(^\text{107}\) However, in the tax context where opinions and disclosures are completely sanitized, such that little relevant information can be relied upon by investors, the transaction costs are expended for the purposes of drafting largely useless documents. This seems simply wasteful.

3. The Practice Depletes Valuable Administrative Resources

The SEC spends valuable resources enforcing securities regulations in

\(^\text{105}\) Manuel Utset separates out the shares, bonds, notes, etc. being made available to the public into two categories, in which lawyers spend a significant amount of time” the design and production of the product and the “information bundle” that goes alongside the product. Manuel A. Utset, Producing Information: Initial Public Offerings, Production Costs, and the Producing Lawyer, 74 Or L Rev 275, 299-300 (1995).

\(^\text{106}\) Although Professor Utset looks at the process primarily through the lens of the general corporate context of an initial public offering, the process remains much the same for tax disclosure which constitutes a small segment of the overall cycle. Id at 301-303. Additionally, Utset identified certain times in which companies will try and “pre-clear” disclosure issues with the SEC, these occurrences further explode the costs of the transaction. Id at 302-303.

\(^\text{107}\) See the discussion in Part I.D.1. illustrating the rationale behind disclosure as supporting market efficiency.
the United States. The magnitude of such task is enormous, and it is clear that the thinly staffed SEC must prioritize its tasks. For example, in the coming fiscal year, the SEC petitioned the Congress for a 27 percent increase in its budget, asking for an additional 676 full-time staff, or a 15 percent increase.\textsuperscript{108} 131 of the 676 new staff positions would be allocated to the enforcement area, as Chairman White has stressed the increased mandates under the Dodd-Frank Act and new rules promulgated by the agency are stretching the already thin staff and budget of the agency.\textsuperscript{109} Currently, much effort is spent by SEC staff on ensuring compliance with the regulatory requirements applicable to nonfinancial tax disclosure.\textsuperscript{110}

When such valuable administrative resources are expensed to enforce a regulatory regime that does not function to support its purported purposes, the practice is socially wasteful. Potentially, it diverts valuable administrative resources away from more necessary, and presumably more useful, enforcement functions.

II. THE “\textsc{Average Taxpayer}” IS NOT A DEFENSIBLE CONSTRUCT

To start remedying the regulatory failure identified, it is necessary to uncover its roots. I argue that there are both practical and theoretical reasons for the failure. In this Part I discuss the failure of the suggested practical solution to investors’ tax heterogeneity, namely, to draft nonfinancial tax disclosure for the benefit of a “reasonable investor” who is also an “average taxpayer”. I demonstrate that the concept of the “average taxpayer” is not defensible as conceptual matter, unsupported by court adjudication, and further discredited by financial models that explain the connection between asset prices and investor-level taxes. I conclude, therefore, that whatever regulatory reform we adopt, we should dispose of the idea of the average taxpayer.

A. \textit{The Conceptual Failure: There cannot be an “Average Taxpayer”}

One of the conditions required for the operation of efficient markets is that all participants in the market “agree on the implications of current

\textsuperscript{108} Peter Feltman, \textit{SEC hopes for big budget increase, Congress skeptical}, CQ Roll Call 2013 WL 72099192 (May 16, 2013).

\textsuperscript{109} John Olson & Gregg Wirth, \textit{SEC Chairman White Asks Congress to Pony Up Cash for the SEC}, 17 No. 6 Wallstreetlawyer.com: Sec. Elec. Age 3 (Jun 2013).

\textsuperscript{110} Searching EDGAR, I was able to find 63 comment letters—issued by the SEC to issuers in the first six months of 2013 alone—addressing possible issues with nonfinancial tax disclosure. In file with author.
information for the current price and distributions of future prices of each security.”

In the context of investor-level taxes, it is not obvious that such a condition could be met. As explained, different investors face different tax costs associated with investment in securities (even if all investors invest in the same securities).

How then, can heterogeneous tax tastes be factored into a single market price of a publicly-traded asset? How can heterogeneous investors assess whether an offering price of a newly issued security is fair? Everything else being equal, it is unreasonable to assume that two reasonable investors with different tax positions would assign the same value to a publicly-traded asset. This point is best illustrated by a couple of examples.

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

Ignoring taxes for the moment, once the distribution is made, the stock is expected to drop in value to $80 ($100 minus the $20 cash dividend distributed out of FCo.’s current assets). Any shareholder who had held a $100 stock at distribution, will hold – after the distribution – a stock valued at $80 and cash proceeds of $20 for a total net value of $100. Thus, prior to the dividend distribution, the value of the stock is not expected to change as long as we ignore tax consequences (at least not because of the expected distribution).

Assume that TE is a U.S. taxpayer who is tax-exempt, and is also a “reasonable investor”. TE holds the stock of FCo. on day 1. Immediately after FCo.’s dividend announcement, TE is approached by NE, another reasonable U.S. taxpayer, who is not tax-exempt. NE offers to buy TE’s stock for $95, i.e., $5 less than market price. TE agrees, which results in immediate economic gain of $5 to NE. How is this result possible if both NE and TE are reasonable investors? The answer is that it is possible because in real life we cannot ignore taxes, and because TE and NE are heterogeneous in their tax preferences.

Let’s start with TE’s point of view. Most tax systems in the world impose withholding taxes on dividends paid to foreign residents. Assume that the jurisdiction in which FCo. is domiciled imposes withholding taxes at a rate of 25%. The withholding tax on a $20 dividend distribution is thus $5. Post distribution, TE will have at hand a stock valued at $80, but only $15 net after-tax cash proceeds. To summarize, from TE’s point of

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111 See Fama, 25 J Fin at 387 (cited in note 21).
112 See, for example, the discussion in notes 67-74 and the accompanying text.
view, the net value of stock is expected to decrease to $95 as a result of the expected dividend.

The picture is very different from NE’s point of view. Under the IRC, certain U.S. taxpayers are entitled to receive credit against foreign taxes paid, and use such credit against their U.S. income tax liability.° NE—being a taxable investor—has U.S. income tax liability. It therefore expects to be able to use any tax credit offered by the U.S. government to reduce its U.S. tax liability dollar-to-dollar. TE, on the other hand, as a tax-exempt taxpayer, does not have any U.S. taxable income against which foreign tax credit could be applied. For TE the foreign tax credit is meaningless.

From NE’s point of view the value of the stock should remain unchanged, i.e., $100 (notwithstanding that NE was able to buy the stock for only $95). After the distribution NE expects to hold a stock valued at $80, and gross proceeds of $20. Like TE, NE is burdened by $5 withholding taxes in the foreign jurisdiction, so the net cash proceed for NE is also $15. Unlike TE, however, NE is granted $5 foreign tax credit on account of the foreign withholding taxes, which can be used to shield NE’s U.S. taxes. The credit offset the withholding taxes. The total value of the stock to NE is thus $100.

Now, if immediately after the dividend is distributed NE would turn and sell the FCo stock back to TE for $80, then TE remains indifferent. As you recall, TE values the stock at $95. This value includes an expected $15 net distribution. Buying for $80 a stock it previously sold for $95, compensates TE for the $15 loss of the distribution (which was received by NE who held the stock at the time of the distribution).

NE, on the other hand, bought the stock for $95, sold it for $80 (for a loss of $15), but had received dividend distribution valued at $20 thanks to the foreign tax credit. NE made a $5 economic gain, essentially financed by the U.S. Treasury in the form of foreign tax credit.°

These facts are not made up. They are a simplified version of the transaction described in Compaq v Commissioner,\textsuperscript{14} where Compaq and a

\textsuperscript{113} IRC §901.

\textsuperscript{114} Note that any possible U.S. taxable income on the distribution received by NE, is offset by the loss from the sale of the stock.

\textsuperscript{115} Compaq Computer Corp. and Subsidiaries v C.I.R.,\textsuperscript{115} 277 F3d 778, 780-83 (5th Cir 2001). Responding to such perceived abuse, Congress enacted IRC §901(k)(1). This code section disallows the use of a foreign tax credit on withholding taxes paid by a foreign corporation the stock of which is held by the recipient of the dividend for certain minimum periods. For a thorough discussion on how taxes created price variations in the Compaq case, see Michael Knoll, Compaq Redux: Implicit Taxes and the Question of
tax exempt investor engaged in a transaction of the sort described above. This transaction was made possible because the two investors valued the stock differently because of their different tax preferences. The example is illustrated in Table 1.

Table 1 – stock values for TE and NE after dividend announcement, as affected by their individual tax positions

<table>
<thead>
<tr>
<th></th>
<th>TE (tax exempt)</th>
<th>NE (taxable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading value (before dividend)</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Excepted effect of the distribution on stock value</td>
<td>-$20</td>
<td>-$20</td>
</tr>
<tr>
<td>Gross dividend expected to be received by the shareholder</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>Foreign withholding taxes expected to be imposed on the dividend (25%)</td>
<td>-$5</td>
<td>-$5</td>
</tr>
<tr>
<td>Foreign tax credit (on account of withholding taxes)</td>
<td>n/a(^{116})</td>
<td>5</td>
</tr>
<tr>
<td>Economic value</td>
<td>$95</td>
<td>$100</td>
</tr>
</tbody>
</table>

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

On Day 0, FC, a foreign corporate-investor (who is assumed to be a “reasonable investor” that resides in a jurisdiction other than Divicorp’s jurisdiction), considers buying a substantial portion of Divicorp’s stock. If it buys the stock before Day 1, it will be a shareholder on Day 1, entitled to receive the dividend to be distributed on Day 2. Assume that the dividend is subject 20% withholding tax in Divicorp’s jurisdiction. FC knows that upon the distribution of the dividends, the value of the DiviCorp stock is expected to decrease by the amount of the distribution.

Upon distribution, FC will have at hand a stock valued at $90, and a gross dividend distribution of $10. However, FC will bear the burden of

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\(^{116}\) The foreign tax credit is only useful to taxpayers with taxable income. As such, the foreign tax credit is irrelevant to TE who is tax exempt.
withholding taxes imposed on the dividend. At a rate of 20% tax imposed on the $10 distribution, FC will be left with $8 of the distribution on hand. FC thus values the stock at $98 ($90 share value post distribution plus $8 net distribution). In other words, FC—as a reasonable investor—interpreted the information about the forthcoming dividend distribution to be detrimental to the value of the stock ($2 net decrease to share value). 117

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

DC is another corporate investor that is assumed to be a “reasonable investor”. It also considers purchasing a sizable stake in Divicorp on Day 0. Unlike FC, however, it is a domestic U.S. corporation. Like FC, DC will bear the burden of 20% withholding tax. However, as explained above, DC will also be entitled to a corresponding foreign tax credit from the U.S. government which means that DC is indifferent as far as withholding taxes are concerned. Foreign residents like FC are generally not entitled to receive foreign tax credits from the U.S. government.

Here is where it gets tricky. Unlike many other jurisdictions in the world, the U.S. does impose tax in respect of distributions made from foreign corporations. Let’s assume that DC is subject to a 20% tax rate on dividend income. However, DC expects the dividend distribution to carry with it an additional favorable tax attribute: a foreign deemed-paid tax credit.

This calls for some explanation. Under the Internal Revenue Code, upon the distribution of dividends by foreign corporations, certain domestic corporate shareholders may receive credit, not only for withholding taxes imposed by the foreign jurisdiction, but also for foreign income taxes paid by the distributing corporation. 118 Under section 902 of the Internal Revenue Code, the amount of the net distribution is grossed-up to take into account the foreign income taxes paid by the distributing corporation, and credit is then given in respect of such taxes. Such credit is not available to foreign taxpayers such as FC.

Assume that Divicorp was previously subject to a 33.3% corporate income tax rate in its home jurisdiction. Therefore, the distribution of $10

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117 For simplicity, it is assumed that no income tax treaty applies. In reality, income tax treaties will reduce withholding rates on dividends. For U.S. treaties withholding rate on dividends is generally between 5% and 15%. See United States Model Income Tax Convention, Article 10: Dividends at 16, (Nov 15, 2006), online at http://www.irs.gov/pub/irs-trty/model006.pdf.
118 IRC § 902.
is grossed-up for the amount of taxes previously paid by Divicorp in respect of the income underlying the distribution. The gross amount is calculated as follows: \([(\text{net distribution}) / (1-t)]\), or $10 / 1 - 0.33 = $15.

In other words, Divicorp had $15 gross corporate income. That income was subject to foreign corporate income tax at a rate 33.3%, generating $5 foreign tax liability, leaving $10 net income available for distribution. After grossing up such amount, DC is deemed to receive $15 of dividends for U.S. federal income tax purposes.\(^{119}\)

At 20% U.S. income tax on deemed distribution of $15, DC is subject to $3 tax in the U.S. However, the distribution carries with a deemed paid tax credit in the amount of $5 (the corporate income taxes actually paid by Divicorp in the foreign jurisdiction), which DC can use to offset its taxable income from other sources.

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

Table 2 – stock values after dividend announcement, as affected by FC and DC’s particular tax positions

<table>
<thead>
<tr>
<th></th>
<th>FC (foreign)</th>
<th>DC (domestic)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading value (before dividend)</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Exected effect of the distribution on stock value</td>
<td>-$10</td>
<td>-$10</td>
</tr>
<tr>
<td>Gross dividend expected to be received by the shareholder</td>
<td>$10</td>
<td>$10</td>
</tr>
<tr>
<td>Witholding taxes expected to be imposed on the dividend (20%)</td>
<td>-$2</td>
<td>-$2</td>
</tr>
<tr>
<td>Foreign tax credit (for withholding)</td>
<td>n/a(^{120})</td>
<td>$2</td>
</tr>
</tbody>
</table>

\(^{119}\) The net distribution is grossed up by adding back the $5 tax paid in the foreign jurisdiction.

\(^{120}\) The foreign tax credit is generally only granted to U.S. taxpayers. As such, the foreign tax credit is irrelevant to FC who is a foreign taxpayer.
<table>
<thead>
<tr>
<th>tax)</th>
<th>U.S. income tax on grossed-up distribution (20%)</th>
<th>n/a</th>
<th>-$3^{121}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deemed paid foreign tax credit (for corporate taxes paid by Divicorp)</td>
<td>n/a</td>
<td>$5^{122}</td>
<td></td>
</tr>
<tr>
<td>Economic value</td>
<td>$98</td>
<td>$102</td>
<td></td>
</tr>
</tbody>
</table>

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

The examples discussed above show that ECMH’s assumption—that all investors interpret all information similarly—is questionable in the tax context. There is no “class” of average taxpayers who interpret tax-related information similarly. Importantly, the ECMH acknowledges that there may be inconsistencies in the interpretation of market information. However, the ECMH suggests that markets will remain efficient nonetheless, as long as such gaps in the interpretation of information are not consistent and there is no one class of investors that consistently is better informed and better positioned to interpret market information. This remedial mechanism is inapplicable in the case of investor-level taxes. As long as FC is a foreign taxpayer and DC is a domestic corporate taxpayer, they will remain inconsistent in their interpretation of tax-related information. Given that DC is willing to pay more than FC, DC will probably set the market price (sellers of Divicorp stock will sell it to the highest bidder).

Thus, FC is excluded from buying the stock. Under

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^{121} The 20% U.S. tax rate is applied against deemed dividend income of $15 (and not $10). The net distribution is grossed up by adding the tax paid in the foreign jurisdiction on the earnings from which the distribution is made. If Divicorp had $15 gross corporate income that was subject to 33.3% foreign corporate tax, the tax paid by Divicorp in the foreign jurisdiction is $5. The gross amount is calculated by (net distribution) / (1-t). In this case $10/(1-0.33) = $15.

^{122} The $5 corporate income tax paid by Divicorp in the foreign jurisdiction is deemed paid by DC, which entitles DC to credit.

^{123} See Fama, 25 J Fin at 383 (cited in note 21).

^{124} Id.

^{125} DC would be a “marginal investor” under such circumstances. The concept of the marginal investor is further discuss below. See the discussion in notes 163-167 and accompanying text. In the alternative, taxpayers in the same position as DC’s are expected
ECMH assumptions, FC cannot be assumed to buy the stock for the higher price, and accept below-market return. Any investor willing to accept a below-market risk adjusted return for its investment cannot be assumed to be a “reasonable investor”. Our disclosure regime is built upon the assumption that investors are “reasonable”.

B. Courts Adjudication and the “Average Taxpayer”

The discussion above suggests that the logic behind the concept of the “average taxpayer” is tenuous. Such conclusion is also reflected in courts adjudication dealing with nonfinancial tax disclosure. It is questionable whether “average taxpayers” can act upon misstated or omitted facts in nonfinancial tax disclosure, and courts decisions imply that no class of “average taxpayers” exists. Investors who brought actions against issuers, alleging misstatement or omission of material facts in nonfinancial tax disclosure, rarely secured remedies where the alleged misstatement or omission related to personal tax consequences.

Before describing courts decisions in this context, it is important to make a distinction between two categories of cases addressing nonfinancial tax disclosure. The first category relates to investors’ claims in respect of “tax shelter offerings”. In such offerings, the securities are offered primarily for their tax benefits associated with them. Aggressive promoters sometimes structure entities with the sole purpose of generating favorable tax attributes to the stakeholders in those entities, and then offer security interests in these entities to the public. Investors buy the securities solely for the expected personal tax benefits, not because the issuing entity is expected to be a successful business entity (in fact, more often than not the deal involves an entity generating paper losses that can be used to shield income from other sources). The IRS and Congress often respond to these abusive schemes, and such responses occasionally result in the denial of the tax benefits promised in the offering. Unsurprisingly, tax shelter offerings generated a voluminous body of litigation, as investors who were denied the expected tax benefits sought remedy from the promoters. I do not address this type of offerings in this article. The

126 For a discussion on the tax shelter industry as well Congress and IRS’s responses see, for example, Martin A. Chirelstein &Lawrence A. Zelenak, Tax Shelters and the Search for a Silver Bullet 105 Colum L Rev (2005);

127 See, for example, Affco Investments, 2001 LLC, et al, v Proskauer Rose LLP, 625 F3d 185 (5th Cir 2010) (plaintiffs unsuccessful against law firm that upheld the
assumption is that securities that are tailored to create a specific tax benefit will only attract investors that, considering their personal tax position, would be able to take advantage of the benefits suggested. Such investors could not be regarded as “average taxpayers”.

The brief survey herein pertains solely to a second category of cases, in which tax consequences are presumed to be marginal to investment decisions. The assumption underlying the ECMH is that investors purchase securities (and make any other investment decision in respect thereof) for sound business reasons. Investment in securities is made for the expected value increase and favorable credit worthiness of the issuer, and not for the tax benefits associated with the security. In most cases, taxes are simply another cost of investment that one must account for. Court decisions in this category are few and far between. This is not surprising. With all the carve-outs included in nonfinancial tax disclosures, very few investors have something to act upon, even if they feel they have been misled.

In the few relevant cases that do exist, courts have generally taken the approach that investor’s individual tax outcomes from transacting in securities are not actionable, concluding that “discussions of the personal tax ramifications of proposed corporate transactions are beyond the scope of the securities laws.”

When drawing the line between nonfinancial tax disclosure that is or is not part of the securities regulatory framework, courts distinguish between tax consequences that depend solely on the stakeholder’s tax consequences, and tax consequences that “flow through directly from the corporate transaction itself”, making only the latter actionable.

The most common context in which such distinction arises is in

validity of a tax shelter scheme); see also Kottler v Deutsche Bank AG, 607 FSupp2d 447 (SDNY 2009) (taxpayers failed to state a claim under the PSLRA a fraudulent tax shelter scheme against the banks and investment advisory firms who created them); see also Arnold v KPMG LLP et al, 543 FSupp2d 230 (SDNY 2008) (plaintiff unable to recover damages for professional malpractice against accounting firm where he bought the tax shelter or law firm that endorsed it).

128 Minzer v Keegan, 1999 WL 33972459, 11 (EDNY 1999) affd, 218 F3d 144 (2d Cir 2000); see also Lewis v Oppenheimer & Co., 481 F Supp 1199, 1206 (SDNY 1979) (“The income tax situation of each stockholder is personal business, and absent injury to the corporation, is irrelevant to damage claims under the federal securities laws.”).

129 See also Mendell v Greenberg, 927 F2d 667, 676; ammd 938 F2d 1528 (2d Cir 1990) (“Expanding the requirements of SEC Rule 14a–9 to insist upon disclosure of incidental tax benefits—benefits that do not flow directly from the corporate transaction itself but rather from the individual shareholder’s personal tax situation—goes beyond the purposes of the Rule”); See also Shaev v Hampel, 2002 WL 31413805, 6 (SDNY 2002).
connection with insiders’ benefits resulting from proposed transactions, in litigation brought under SEC Rule 14a-9. Rule 14a-9 prohibits proxy solicitations to be “false or misleading with respect to any material fact, or which omits to state any material fact.” Management and other insiders’ interests in the transaction or plan in respect of which shareholder votes are solicited, could be material to an investor weighing its vote. For example, stock interests held by management other corporate insiders should be disclosed in a proxy solicitation where shareholders will vote on a plan or transaction. Insider interests may also include tax benefits that may result to them from the transaction, and in certain circumstances those benefits must be explicitly disclosed to shareholders. These disclosure requirements have generated litigations in instances where shareholders argued that proxy statements have failed to accurately describe the expected tax consequences to insiders, which would have arguably exposed a conflict of interest between insiders and other shareholders. In such cases courts must distinguish between incidental tax benefits to insiders, and tax benefits that directly flow from the transaction at issue.

For example, in *Mendell v. Greenberg,* a shareholder brought an action against several corporate insiders in connection with a proxy statement soliciting votes to approve a proposed merger. The plaintiff argued the proxy statement failed to disclose certain incidental tax benefits to controlling shareholders expected from the transaction. In denying such a claim, the 2nd Circuit reasoned that since personal tax benefits are speculative in nature, a requirement to disclose them is more likely to confuse than to inform. The court noted that “the practical difficulties

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130 17 CFR §240.14a-9.
131 Id.
132 Schedule 14A, outlining the information to be disclosed in connection with proxy solicitations. 17 CFR §240.14a-101 Schedule 14A. For example, Item 7 outlines the information required in the proxy relating to any action for the election of directors or executive officers while Item 8 directs disclosure of information relating to the compensation of directors and executive officers. Id.
133 In the case of compensation plan involving options in the registrant, Schedule 14A requires the disclosure of “the federal income tax consequences of the issuance and exercise of such options to the recipient and the registrant”. Id at Item 10.
134 See *Mendell v Greenberg,* 927 F.2d 667.
135 “Here [the Insider’s] failure to disclose the personal tax consequences resulting to her from the merger were speculative in nature and may not be deemed a material omission. To hold otherwise would require that major shareholders include speculative predictions of their personal finances in a proxy statement that is more likely to confuse than enlighten other stockholders.” Id at 677.
involved in computing speculative personal tax consequences—especially since those consequences depend upon indeterminate, often difficult to predict variables—precludes any requirement that potential incidental tax benefits need be disclosed.” In a concurring opinion, Judge Ellsworth Van Graafeiland added that even if the expected tax benefits to insiders were significant, it could not be acted upon unless the other shareholders or the corporation were harmed, which did not seem to be the case.

In *Lewis v. Dansker*, the plaintiff argued that that a proxy statement failed to accurately account for the value of a proposed transaction to insiders. Specifically, the value to insiders that had been disclosed did not account for deductible losses expected to be generated to insiders as a result of the transaction. Such deductible losses increased the net value of the transactions to insiders, beyond the par value disclosed in the proxy solicitation. The court rejected the argument, reasoning that “the usability of such losses will vary—not exclusively according to the source of the deduction—but also according to the individual’s other income, offsets to income, and tax bracket.” As such, any disclosure would have been speculative in nature. Moreover, in questioning whether such information would have been “material” to shareholders for purposes of making their voting decisions, the court suggested that incidental tax benefits to insiders resulting from a proposed transaction is an irrelevant piece of information to shareholders, as long as the interest of the corporation is not harmed.

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136 Id at 676.
137 Id at 681-82 (“There is no proof in this record that the price paid for the stock was in any way inadequate or inappropriate or below the value of the stock. The only inference we are trying to draw about some lack of value here is the fact that the majority shareholder might have been involved in some kind of a fire-sale mentality which influenced the other shareholders. I have very serious questions whether a shareholder can reasonably rely upon what a majority shareholder does anyway, because it seems to me he as a matter of policy should make his own decision based upon what he thinks he ought to do, and the law should not reward him for relying upon what a majority shareholder does.”).
139 Id at 643. *Italics* added.
140 “We fail to see, nor has the plaintiff advanced any reason, why an investor, in deciding whether to approve the three proposals, would have been influenced one way or the other by the amount of incidental tax benefits the [insiders] received from transactions between the partnerships and the corporation which benefits were not derived from nor had any relation to the proposals themselves... We believe that the interest of a shareholder asked to approve these transactions would be limited to two questions: Would the benefits to be conferred on the [insiders] (1) adversely affect the corporation or (2) adversely affect the investor’s individual interest in the corporation? Clearly, the amount of tax savings the [insiders] would receive could not be said to have any bearing on these
In *Freedman v. Barrow*, a shareholder brought a derivative action against a corporation in respect of proxy statements soliciting votes in connection with a compensation plan to employees of the corporation. The plan included, among others, incentive compensation in the form of stock appreciation rights (SAR). The plaintiff argued the proxy statement had failed to accurately disclose the set of incentives and disincentives to employees in exercising their rights under the plan. Specifically, the plaintiff suggested the proxy statement failed to adequately describe the tax consequences to employees in exercising the SARs. Rejecting the argument, the court reasoned that the decision whether to exercise a stock option “necessarily depends on individual factors such as the employee’s own financial situation, his ability and willingness to borrow, and his tax consequences.” Therefore, any disclosure in this respect was not required as it would have amounted to a “speculative assertion”.

Another case worth mentioning is *Zemel*. There, a plaintiff alleged that a proxy statement failed to disclose that a liquidation plan was structured so as to achieve favorable tax outcomes to insiders. In concluding that such information is not “material”, the court reasoned that “[the] plaintiff has provided no evidence that the interests of the shareholders were compromised by the tax-efficient outcome for [insiders], and so has failed to show that the alleged non-disclosure was material.”

This body of adjudication weighs against the existence of an average group of taxpayers. If tax outcomes are a result of personal tax positions, as courts have suggested, they cannot be viewed as “average”.

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142 Id at 1144.
144 Id at 4.
145 For additional cases making the distinction between personal tax consequences and tax consequences that flow directly from the transaction in the context of proxy solicitation, see *Lewis v. Oppenheimer*, 481 FSupp 1199 (SDNY 1979); *Shaev v. Hampel*, 2002 WL 31413805 (shareholders brought action against a corporation and its officers suggesting that in soliciting a vote for the approval of a stock incentive plan failed to “disclose all the federal tax consequences” of granting an option, particularly the fact that “under the U.S. federal estate tax, gift tax, and generation-skipping transfer tax, these stock options and SARs are treated as taxable.” The court rejected the argument since the described benefits are personal and do not “flow directly” from the transaction.); *Seinfeld v Bartz*, 2002 WL 243597 (ND Cal 2002), affd 322 F3d 693 (9th Cir 2003) (no material omission in failure to disclose “all federal tax consequences” of an option plan).
benefits to insiders cannot even be regarded as “average” to a group of insiders, because not all insiders share the same tax preferences. Even if all insiders benefits from the transaction tax-wise, disclosure is not necessarily required since tax benefits to insiders do not necessarily result in detriment to the corporation.

These cases, however, do not address the issue of “tax averageness” in the context of a direct tax detriment to stakeholders resulting from inaccurate disclosure. Very few cases did address such direct tax-related injury to investors, but these cases too suggest the non-existence of a class of average taxpayers.

For example, in Minzer v. Keegan, shareholders of a target corporation brought action to recover damages resulting from a merger of the target corporation with an acquirer. The plaintiffs alleged that the proxy solicitation failed to adequately disclose that the tax consequences from the merger were detrimental to shareholders, when compared to the tax consequences that would have resulted had another bid been accepted. Specifically, shareholders of the merged corporation were paid 75% in stock of the acquiring corporation, and 25% in cash, with the cash portion of the consideration being immediately taxable to the selling shareholders. Another bidder, whose bid was rejected by the board, proposed a full stock-for-stock merger (namely, that shareholders of the target corporation would have received only stock in the acquirer in return for their stock in the target). A stock-for-stock exchange would have been tax-free for the shareholders. Failing to disclose the favorable tax consequences of the other bid had allegedly resulted in a direct tax injury to the shareholders.

The court rejected the argument, first, on a factual ground, stating that the disclosure did include the requisite description of the structural difference between the two offers. However, the court also added that because the “true value of each bid depends on the tax situation of individual shareholders”, it cannot be said that the other offer can be considered “materially higher”. In doing so, the court implicitly rejected that idea that personal tax consequences resulting from corporate

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147 “In suggesting that the shareholders needed to be told that different transaction structures would result in different tax treatments, plaintiffs ignore the Supreme Court’s admonishment that the purpose of the securities laws is to disclose, not to treat the shareholders like ‘nitwits’ or to ‘attribute to investors a child-like simplicity.” Basic Inc. v Levinson, 108 US 224, 234 (1988).

148 Minzer v Keegan, 1999 WL 33972459 at 11.

149 Id.
transactions are “average” to all shareholders.

In cases where courts did grant a remedy to shareholders as a result of tax-related injury, it was not because of the tax injury itself, but rather that the injury was a result of misstatement relating to a corporate-level item. Such misstatement denied shareholders the information required to calculate their own tax liabilities. For example, in Herbst v. ITT, a merger was structured so as to achieve tax-free treatment. In seeking a ruling from the IRS that the merger was indeed tax-free, however, the corporation failed to disclose certain relevant information to the IRS.

A class plaintiff claimed that this failure created a risk that the tax-free treatment of the merger would not be respected, and that such risk must have been disclosed in the proxy statement. In response, the defendants argued, among others, that the plaintiff cannot stand as a class representative. The rationale of the argument was that if the merger is deemed taxable, different investors may face different tax consequences, and such consequences depend on personal tax positions.

In approving the claim as a class action, the court reasoned that had the merger been taxable, all shareholders, regardless of their tax position would have been affected. Since certain shareholders would have rejected the merger (because of the tax detriment), the bidder would have been compelled to offer a better price for the shares, and such offer would have been made available to all shareholders. While the court seemed to agree that the tax consequences to shareholders vary, it was not the tax consequences that created the “class”. Rather it was the benefit to all shareholders in the form of a higher bid. The failure of the defendants in Herbst was that they did not disclose that the transaction might have been taxable, not that they failed to disclose what the results of a taxable transaction to shareholders are. Such results are personal to each shareholder.

Similarly, in Swanson v. Wabash, the court found a corporation liable for shareholders’ personal tax consequences resulting from a stock purchase transaction. The plaintiff alleged that the structure of stock purchase transaction denied him of the benefits of long-term capital gains (LTCG) taxes, as he was forced to dispose of his stock before he reached the requisite holding period required to enjoy LTCG treatment.

150 Herbst v. Int’l Tel. & Tel. Corp., 495 F2d 1308 (2d Cir 1974).

151 “ITT also contends that Herbst cannot represent the large, tax-exempt, institutional shareholders. As noted above, all those who exchanged their shares would have benefited from a higher price. Under Herbst’s claims all shareholders, large and small, tax-exempt or not, would benefit equally and so her claim is typical.” Id at 1314.

Specifically, if one holds capital assets for a long enough period, then upon disposition of the asset tax is imposed at preferred rates. Obviously, the holding period of shareholders in their stock is a completely personal attribute. Nonetheless, the plaintiff was able to prove that certain shareholders were allowed, under a special arrangement, to hold on to the stock longer than other shareholders, specifically so they can enjoy LTCG treatment upon disposition. The court found the corporation liable not because of the plaintiffs’ specific tax loss (in fact, the plaintiff failed to prove he suffered any tax-related injury),¹⁵³ but because the opportunity to hold on to the stock was not made available to all shareholders. Had it been, each shareholder would have made his or her own calculations—considering personal tax positions—as to whether to hold on to the stock or sell it immediately.

Finally, it is worth mentioning that another group of cases—dealing with approval of settlements in securities fraud class actions—also supports the argument that reasonable investors cannot be categorized into a single class of average taxpayers. For example, in *Ikon Office Solutions*,¹⁵⁴ parties to a class action and a related derivative suit sought approval of a settlement. Several class members objected to the proposed settlements, arguing that “the Settlement Notice impermissibly failed to inform claimants of the tax consequences of any disbursement”.¹⁵⁵ The court rejected the argument, noting that different claimants may face different tax consequences, and concluding that it is preferable that claimants consult their own tax advisor, rather than seek disclosure as to their tax consequences in the settlement notice.¹⁵⁶

¹⁵³ When discussing class certification the court noted as follows: “Indeed, only some of the Wabash shareholders were eligible for the long-term capital gain tax treatment which [Plaintiff] alleges certain shareholders were illegally permitted to receive, and [Plaintiff] apparently was not one of those eligible persons… [Plaintiff]’s inability to prove that she individually suffered harm from the violations alleged … does not make her claims inimical to those of the proposed class…Rather than denying [Plaintiff]’s motion for class certification on this basis (as the defendants propose), we feel that the proper solution is to condition class certification on the addition of at least one Wabash shareholder who can assert [such] claims”). *Swanson v Wabash, Inc.*, 577 F Supp 1308, 1324 (ND Ill 1983).

¹⁵⁴ *In re Ikon Office Solutions, Inc.*, *Sec Litig*, 194 FRD 166 (ED Pa 2000).

¹⁵⁵ Id at 188.

¹⁵⁶ Id (“All things considered, singling out one of many potential tax consequences seems more likely to create than alleviate confusion. Generic language stating that it is advisable to consult a tax specialist is preferable.”); see also *In re Cendant Corp. Sec Litig*, 109 F Supp 2d 235, 255 (DNJ 2000) aff’d sub nom 264 F.3d 201 (3d Cir. 2001) (concluding that personal tax consequences to claimants need not be disclosed because such disclosure related to individual information.).
To summarize, current adjudication is consistent with the idea that no “average taxpayer” exists. Misstated tax information is actionable by reasonable investors, only to the extent the failure is to disclose that there are tax consequences associated with the offering. Omitted or misstated tax information is not actionable to the extent that it fails to describe what the tax consequences are for each investor. The personal tax consequences of the reasonable, prudent investor are not actionable because they do not represent an “average” tax result.

C. The Preferences of “Average Taxpayers” Do not Affect Market Efficiency

If market efficiency is the stated purpose of securities regulation, we are left confused. Taxpayers interpret nonfinancial tax information differently, and current adjudication is consistent with such reality. Market prices, however, are eventually set somehow. Investment decisions are being made. If market participants are “reasonable”, tax costs must be taken into account. Whose tax preferences actually matter, then? Financial literature suggests that the preferences that matter are not the tax preferences of “average taxpayers”.

The effect of investor-level taxes on asset prices is a heavily studied area by economic, finance and accounting scholars. Multiple studies have attempted to model the effect of heterogeneous tax preferences on market prices, and to support such models by empirical research. Such literature has had little impact on the regulation of non-financial tax disclosure. In this Subpart, I seek to fill this gap, questioning what implications such studies may have on the structure of nonfinancial tax disclosure.

1. The Irrelevance View

One view expressed in financial literature, known as the irrelevance view, is that market prices are set by nontaxable actors, such as pension funds and educational institutions’ investment funds. Such investors are

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158 See, for example, Fischer Black & Myron Scholes, The Effects of Dividend Yield and Dividend Policy on Common Stock Prices and Returns, 1 J Financial Econ 1 (1974) (finding no evidence that expected returns on high yield common stocks differ from the expected returns on low yield common stocks either before or after taxes); Merton H. Miller & Myron S. Scholes, Dividends and Taxes: Some Empirical Evidence, 90 J of Poli Econ 1118 (1982) (criticizing empirical studies that show evidence of the effects of
frequent traders, who are always at a better arbitrage position vis-à-vis taxable investors, and therefore always set market price. Tax-exempt investors are willing to pay more as compared to other investors for the same risk-adjusted (but not tax-adjusted) returns, because they do not expect to incur any investor-level tax burden.

Obviously, if tax-exempt investors set market prices, there can be little reason to justify nonfinancial tax disclosure in the first place (assuming the purpose of such disclosure is to support accurate market pricing). In such a case, tax consequences are simply an irrelevant piece of information.

More importantly, however, tax-exempt investors are not “average taxpayers”. The “average taxpayer” is assumed to be a taxable investor.159 Indeed, tax-exempt institutions are specifically carved out from the scope of nonfinancial tax disclosure.160

2. The Marginal Investors and Clientele Effects

In recent years, the irrelevance view lost traction.161 Multiple studies did find that asset prices are affected by investor-level taxes, and have suggested various models to explain the mechanism of tax capitalization and its effects on asset pricing.162


159 See NYSBA Report at 10 (cited in note 18).

160 See the discussion of examples cited in note 62 and the accompanying text.

161 Hanlon & Heitzman, 50 J Acct & Econ at 164 (cited in note 157) (“There is growing evidence that the irrelevance view does not hold and that taxes matter in pricing stocks”).

162 Different mechanisms potentially explain how taxes are impounded into equity prices. In the case of dividends, there are three competing views. One is the irrelevance view, discussed above. Under the traditional view non-tax benefits of dividend distributions offset the tax cost associated with dividends. Under the new view all future taxes associated with dividends are capitalized into share prices, under the assumption that all earnings eventually bear the burden of dividend taxation. Dividend policies thus have no effect on share prices. For a recent summary of mechanisms of dividend tax capitalization summary, see Hanlon & Shane at 160-61. In the case of capital gains taxes, there are two pricing-relevant mechanisms, supposedly with opposite effects. On the demands-side, buyers will be willing to pay lower prices for securities in order to compensate for the future tax liability associated with the disposition of such securities (the capitalization effect). The capitalization effect is expected to reduce stock prices as a result of decreased demand. On the supply side, however, sellers will be inclined to defer sales, for example, until they have held the stock for a period that allows preferable tax treatment, or if CGT is higher than it was when the stock was originally purchased (the lock-in effect). The lock-in effect is expected to increase market prices as a result of decreased
One body of studies suggests that the equilibrium price is set by a single, identifiable marginal investor, whose tax preferences determine the rate at which taxes are capitalized. Marginal investors are frequent traders (such as dealers in securities and other financial institutions) who are indifferent between purchasing two securities with similar risk profiles that are taxed differently. In such a case, the tax profile of an asset is the marginal consideration in the investment decision.

Under such a view, investor-level tax disclosure could be rewritten to target such marginal investors, if we knew who the marginal investors were. Financial literature has yet to provide conclusive evidence with respect to the identity of marginal investors as a “class.” Moreover, the identity of a marginal investor can theoretically be different in different trades. Such an approach implies that investor-level taxes are detrimental to market equilibrium, as they facilitate arbitrage opportunities (namely, the arbitrage gain created by trading one asset for a comparable asset, solely because of the comparable asset’s more favorable tax profile).

Returning to the example 2 of FC and DC discussed above, DC may be indifferent between purchasing the stock of Divicorp, and the stock of another corporation, Eurocorp, which operates in the same industry segment as Divicorp. Assume that Eurocorp’s stock is also valued at $100 per share as of Day 0, and that Eurocorp also intends to distribute a $10 dividend. If Eurocorp however, did not previously pay corporate tax in a supply. While both effects are well documented in empirical studies, the total effect on market equilibrium remains elusive, and seems to be different among different types of assets. For a recent summary, see Zhonglan Dai et al., *Capital Gains Taxes and Asset Prices: Capitalization or Lock-in?,* 63 J Fin 709 (2008).


Scholes, et al, *Taxes and Business Strategy* at 130. For example, an investor who is subject to a 30% tax rate, is indifferent between purchasing a taxable security which is expected to generate 10% pre-tax risk-adjusted return, or a tax-exempt security expected to generate 7% non-taxable risk-adjusted return.


See Hanlon & Heitzman, 50 J Acct & Econ at 165 (cited in note 157).
foreign jurisdiction, no deemed-paid foreign tax credit is expected to flow to DC with the distribution. If both shares are offered on the market for their current price of $100, DC would prefer the stock of Divicorp over Eurocorp solely because of the stocks’ different tax profiles. As explained, DC would be willing to pay as much as $102 for the stock. Any price below that would be a bargain. As such, DC will be the marginal investor setting the price of Divicorp’s stock, because it is willing to pay more than other investors.

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

Even if we were to overcome the practical difficulties, however, financial literature makes it clear that “marginal investors” are not “average taxpayers”. They are financial institutions, who are usually subject to various specific tax regimes.¹⁶⁷ Dealers in securities, for example, are usually subject to mark-to-market taxation under section 475 of the IRC, and are explicitly carved out from current non-financial tax disclosure. The market of tax disclosure does not regard such investors as “average taxpayers”.¹⁶⁸

While the marginal investor approach explains how market prices are determined by individual investors, it is unlikely that many investors could find “a pair of securities with identical risk that vary only on the tax treatment of the returns.”¹⁶⁹ Investors who are not the marginal investors would nonetheless favor investments that are expected to maximize their after-tax return.¹⁷⁰ The resulting tax-induced capital allocation is known as

¹⁶⁷ See Hanlon & Heitzman, 50 J Acct & Econ at 129-30 (cited in note 157) (Discussing the illusive identity of the marginal investor); see also Lynn A. Stout, The Mechanisms of Market Inefficiency: An Introduction to the New Finance, 28 J Corp L 635, 649-53 (2003) (proposing that the market price set by the marginal investor will often contain a value opinion different from that of the average taxpayer’s value of the security); see also Benjamin C. Ayers et al, “Read My Lips”: Does the Tax Rhetoric of Presidential Candidates Affect Security Prices?, 48 J L & Econ 125, 127-28 (2005) (discussing how changes in tax rates may or may not affect security prices depending on whether the unknown marginal investor setting the price is tax-exempt, tax-neutral, or tax-induced).

¹⁶⁸ See NYSBA Letter at 3 n 4 (cited in note 18).

¹⁶⁹ Hanlon & Heitzman, 50 J Acct & Econ at 165 (cited in note 157).

¹⁷⁰ Scholes et al, Taxes and Business Strategy at 130 (cited in note 170).

For example, under the clientele approach, tax-exempt investors are expected to invest in dividend-paying firms, where they enjoy a current and steady stream of untaxed cash. On the other hand, taxable investors who prefer to defer taxation as long as possible will tend to invest in growth companies, which seldom distribute taxable dividends. Such investors expect to eventually pay taxes at preferential long-term capital gain rates upon disposition of the security. Different companies are thus expected to have different tax clienteles based on the nature of the company’s distribution policies.\footnote{Edwin J. Elton & Martin J. Gruber, \textit{Marginal Stockholder Tax Rates and the Clientele Effect}, 52 Rev Econ Stat 68, 72-74 (1970) (finding clientele effects based on a company’s dividend policy, particularly for corporations because of the deduction rather than tax-exempt institutions); Franklin Allen et al, \textit{A Theory of Dividends Based on Tax Clientele}, 55 J Fin 2499, 2501 (2000) (asserting that high dividend policy will attract more institutional investor clienteles and send a signal of a “quality” firm and management); see also Robert H. Litzenberger & Krishna Ramaswamy, \textit{The Effect of Personal Taxes and Dividends on Capital Asset Prices}, 7 J Fin Econ 163, 192 (1979) (finding evidence of a clientele effect for stockholders in higher tax brackets choosing stocks with lower dividend yields).}

Looking back at our own example of FC, DC, Divicorp and Eurocorp, domestic investors who have use of foreign tax credits—like DC—will be attracted to the stock of Divicorp. After the initial arbitrage opportunities resulting from the dividend announcement are exploited, Divicorp share price is expected to stabilize at $102 per share, and it is expected that all new buyers of Divicorp shares will be domestic corporate taxpayers. Foreign corporate investors like FC will be attracted to Eurocorp’s stock, the price of which is expected to stabilize at $98.

Investor-level tax disclosure could make theoretical sense if we force issuing entities to “know” who their tax clienteles are, and apply different tax-disclosure requirements to each entity, based on the profile of the entity’s tax clientele. Again, it is not clear that this is a practical approach.

More importantly however, tax clientele literature strongly suggests against the use of the “average taxpayer” concept as a linchpin for nonfinancial tax disclosure. If the Clientele Effect is real, then it cannot be
said that a class of “average taxpayers” exists. The Clientele Effect supports an argument according to which different classes of different taxpayers affect the prices of different securities. Market environment is therefore dotted with multiple classes of “average” taxpayers.

3. Portfolio Basis Approach

Finally, another group of studies suggests that market equilibrium is achieved because investors price assets on a portfolio basis (rather than on single asset basis).\(^{173}\) This approach assumes that each investor aggregates various tax consequences—resulting from investment in securities with different tax profiles—into the pricing of all securities in the portfolio. If this position is accepted, then nonfinancial tax disclosure must theoretically describe all relevant tax information to all investors. Thus, different investors will be able to aggregate the tax information from different issuers, in order to construct their desired “tax portfolio”. It seems that this is what the regulations are asking issuers to currently do. I have already discussed the impossibility of meaningfully complying with such a requirement.\(^{174}\)

More importantly, under such an approach, the tax preferences that are expected to affect market prices are the preferences of “[i]nvestors with the greatest wealth and least risk aversion...”.\(^{175}\) Such investors are not “average investors”. Investors that hold the largest portfolios and are not risk-averse are usually institutional investors,\(^{176}\) or otherwise extremely wealthy investors that are specifically excluded from the scope of nonfinancial tax disclosures.\(^{177}\)


\(^{174}\) See the discussion in SubPart I.B.

\(^{175}\) Hanlon & Heitzman, 50 J Acct & Fin at 165 (cited in note 157).

\(^{176}\) Due to their diversification and increased risk-aversion, some studies have shown institutional investor ownership to be synonymous with volatility in the stock price of a firm (since institutional investors can benefit from such volatility). Richard W. Sias, *Volatility and the Institutional Investor*, 52 Fin Analysts J 13, 13-14 (1996); see also Ryan T. Ball, *Does Anticipated Information Impose a Cost on Risk-Averse Investors? A Test of the Hirschleifer Effect*, 51 J Acct Rsrch 31, 55 (2013) (using institutional investor ownership as a proxy to explain volatility in a firm’s stock price).

\(^{177}\) While nonfinancial tax disclosure sections do not explicitly exclude high net-worth individuals from the scope of the disclosure, all such disclosure sections exclude taxpayers that are subject to Alternative Minimum Tax (“AMT”). Recent data suggests that AMT
In summary, financial models and empirical studies have yet to produce conclusive results as to the identity of investors whose tax preferences actually affect market prices. The studies, however, are very telling in the sense that we can reasonably conclude that there is one type of investor whose preferences likely matter very little (if at all). That is, the tax preferences of “average taxpayers”—as depicted in current tax disclosure practice—are largely irrelevant in the operation of capital markets. It thus makes little sense to draft tax disclosure solely for the benefit of such taxpayers.

The only relatively “safe bet” stemming from financial literature is that the tax preferences of institutional investors, or other wealthy investors, are the ones that affect market behavior. This only reinforces the critique against current tax disclosure practices: institutional investors are regularly carved-out from the scope of nonfinancial tax disclosures.

III. MANDATORY DISCLOSURE THEORY AND NONFINANCIAL TAX INFORMATION

As I have shown thus far, the regulatory requirements applicable to nonfinancial tax disclosure cannot be assumed to advance market efficiency. Drafters of nonfinancial tax disclosure are faced with the problem of investors’ heterogeneous tax preferences. The practical response to such difficulty is to draft disclosure to the benefit of an “average taxpayer”—a market-created construct. I have shown that this construct is indefensible. In this Section, I identify the theoretical source of the regulatory failure.

I suggest that the guiding principle of U.S. securities regulations—mandatory disclosure theory—does not support nonfinancial tax disclosure regulation in its current form. I start by briefly describing fundamentals of mandatory disclosure theory. I then question nonfinancial tax information in the context of such fundamentals.

A. Mandatory Disclosure and the Intermediary Depiction Model

Whether issuers in registered securities offerings should be subjected to mandatory disclosure requirements is a long-lasting, voluminous debate applies to the top 4.2 percent of taxpayers in 2013. Aggregate AMT Projections, 2012-2023, Table T13-0209, Urban-Brookings Tax Policy Center Microsimulation Model (Aug 26, 2013), online at http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0209.pdf (visited Jan 2, 2014). Thus, most (if not all) high net worth individuals are subject to AMT, and as such excluded from the scope of the disclosure.
in the securities regulation literature.\textsuperscript{178} It is not my intention to add to this discussion. It is clear, however, that the structure of our securities regulation regime is largely guided by mandatory disclosure theory.\textsuperscript{179} My departure point is to assume that the theory of mandatory disclosure is persuasive, and likely to guide our securities regulatory framework for the foreseeable future. I examine the scope of mandatory nonfinancial tax disclosure under such assumptions.

Under mandatory disclosure theory, mandatory disclosure is necessary in order to deliver the information needed to support efficient markets (as required by ECMH). The acceptance of mandatory disclosure theory culminates in a securities regulation regime that has been described as the “intermediary depiction model”.\textsuperscript{180} Under this regulatory model, “[a]n intermediary—for instance, a corporation issuing shares—stands between the investor and an objective reality.”\textsuperscript{181} The intermediary, i.e. the issuer, is required to describe reality to investors, and regulatory efforts are aimed at making sure that such depiction is complete and accurate.\textsuperscript{182} Obviously, the completeness of accuracy of the information depicted could not possibly “entail consideration of the entire variety of economic, political, social, and other aspects of the real world that could affect the fortunes of a company's investors: the mandate has long centered on firm-

\textsuperscript{178} Sharon Hannes, Comparisons Among Firms: (When) Do They Justify Mandatory Disclosure?, 29 J Corp L 699, 700 (2004) ("The justification for the mandatory nature of federal securities disclosure regulation have been thoroughly examined in the literature, during a long lasting debate..."); Lawrence A. Cunningham, Capital Market Theory, Mandatory Disclosure, and Price Discovery, 51 Wash & Lee L Rev 843, 845 (1994) ("the proper scope of the mandatory disclosure rules has been debated almost continually since the enactment of the 1934 Act"); James D. Cox, Coping in a Global Marketplace: Survival Strategies for a 75-Year-Old SEC, 95 Va L Rev 941, 962-64 (2009) ("...the longer-lasting debate regarding the social benefits of mandatory disclosure rules. Opponents have argued that mandatory disclosure rules are superfluous or at least impose costs in excess of their benefits"); Brett H. McDonnell, Sticky Defaults and Altering Rules in Corporate Law, 60 SMU L Rev 383, 384-386 (2007) (describing the long-standing debate over default versus mandatory rules, and examining the possibility of opting out of these rules).


\textsuperscript{180} Hue, 90 Tex L Rev at 1614-28 (cited in note 14) (describing the history of securities regulation and the rise of the intermediary depiction model).

\textsuperscript{181} Id at 1608

\textsuperscript{182} Id at 1608, 1623.
To question whether mandatory disclosure theory, and its primary instrument—the intermediary depiction model—actually advance market efficiency in the tax context, it is necessary to deconstruct the concept of market efficiency into its main components. Generally, market efficiency is understood to have two main determinants: accurate pricing mechanisms and financial liquidity. I discuss nonfinancial tax disclosure within the context of each such determinant.

1. Mandatory Disclosure and Accurate Pricing in the Tax Context

While disclosure could theoretically be made on a voluntary basis, mandatory disclosure is justified as an economic matter, because it is the least costly way to disseminate the optimal level of information to the market.

Several arguments support this assertion. First, mandatory disclosure reduces the cost of generating information because it is cheaper for the issuer to disclose information it holds anyways, rather than for the outside investor to unearth such information. In the context of tax consequences to investors, however, the issuer does not have all the relevant tax information. Much of the relevant tax information pertains to tax-attributes of the investors. In fact, it is unlikely that the issuer could reasonably acquire investor-level tax information both practically and legally. From a practical point of view, it will be extremely costly for issuers to approach all of their investors in order to attain all the relevant tax information about such investors. This is especially true considering the frequent trading that occurs in the public market. From a legal point of view, most

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183 Id at 1623 (italics added); see also Ferrel, 36 J Leg Stud 213 (cited in note 23).
184 Goshen & Parchomovsky, 55 Duke LJ at 714 (cited in note 5).
186 Goshen & Parchomovsky, 55 Duke LJ at 738 (cited in note 5).
187 Id at 738.
such information is subject to various privacy safeguards, making it impossible to acquire such information without some waiver of liability from investors.188 Returning to our example of FC and DC, Divicorp could not be reasonably expected to know that DC can utilize foreign tax credit to offset income it has from sources unrelated to DC’s investment in Divicorp’s stock.

The second economic argument in support of mandatory disclosure is that in the absence of mandatory disclosure, it is not clear that all relevant information can be discovered by outside investors with no inside access, even if such outsiders are willing to endure high costs in search of such information.189 In the tax context, such an argument may or may not be relevant. A lot of the important tax information is already found with the investors. For example, DC already knows it can use foreign tax credits to its benefit. In fact, DC is the only one in a position to know whether the use of foreign tax credit is available to it.

The third economic argument in support of mandatory disclosure is that unless disclosure is made standardized and mandatory, different investors might engage in duplicative efforts to unearth the same piece of undisclosed information. In essence, the standardized form of mandatory disclosure makes it easier and cheaper for investors to compare among investment alternatives.190 In the context of nonfinancial tax information, this justification is weak. Each investor is uniquely situated for tax purposes, and therefore does not necessarily have use of information that pertains to the tax preferences of other investors. For example, DC may wish to uncover whether Divicorp’s dividend distribution carries with it a foreign tax credit. FC, on the other hand, does not care; as a foreign taxpayer, FC has no use of the foreign tax credit.

The fourth economic justification for mandatory disclosure is that mandatory disclosure serves as a collective subsidy for all investors who

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189 Goshen & Parchomovsky, 55 Duke LJ at 738 (cited in note 5); see also Hannes, 29 J Corp L at 705 (cited in note 178). The argument is that management might be incentivized to suppress unfavorable information. Mandatory disclosure is thus required to assure that an optimal level of information is disseminated by issuers.

190 See, Hannes, 29 J Corp L at 706-707 (cited in note 178).
trade based on information.\textsuperscript{191} This is unlikely to be the case, however, with respect to nonfinancial tax disclosure that is extremely costly for the issuer to obtain, but costless to investors to the extent they already hold that information (which, as explained, is many times the case). The subsidy argument could theoretically apply to information that relates to issuer-level nonfinancial tax attributes (such as whether the issuer paid foreign taxes on account of which foreign tax credit may be granted). On the other hand, investor-level tax information comes to the investor at zero (or very low) cost. It cannot be expected to be subsidized by the issuer for whom it is extremely costly to obtain such information.


Mandatory disclosure supports liquidity in the market by ensuring symmetrical access to information.\textsuperscript{192} In the absence of mandatory disclosure, less-informed investors might lose confidence in the market, since they are always positioned to lose to more-informed investors.\textsuperscript{193} Asymmetrical information might make less-informed investors reluctant to trade, or suggest lower bidding prices or higher asking prices for their securities. Mandatory disclosure thus enables less-informed investors to free-ride market prices set by informed investors.\textsuperscript{194}

However, to the extent the tax consequences disclosed relate to investor-level tax consequences, it will be irrational for a “reasonable investor” to rely on market interpretation of nonfinancial tax information. The pricing of assets in the market reflects the tax preferences of specific classes of investors, not all investors.\textsuperscript{195} To the extent an investor wishes to invest in a specific security, she cannot reasonably assume that her tax preferences are currently reflected in the market price of the security. Thus, a reasonable investor must consider her own tax status, and must not “free ride” market interpretation of tax consequences. Any reasonable investor must spend time and resources in order evaluate how taxes may

\textsuperscript{191} See Goshen & Parchomovsky, 55 Duke L J at 740 (cited in note 5).

\textsuperscript{192} Christian Leuz & Peter Wysocki, Capital-Market Effects of Corporate Disclosures and Disclosure Regulation, 2 Task Force to Modernize Securities Legislation in Canada: Research Studies 183, 196 (Jun 26, 2006), online at http://faculty.chicagobooth.edu/christian.leuz/research/papers/Capital-Market-Effects-of-Corporate-Disclosures-and-Disclosure-Regulation.pdf (mandatory disclosure as a “commitment” tool for companies to reveal the same amount of information and mitigate informational asymmetries); Goshen and Parchomovsky, 55 Duke L J at 740 (cited in note 5)

\textsuperscript{193} Id.

\textsuperscript{194} Id.

\textsuperscript{195} See the discussion in notes 158-177 and the accompanying text.
affect her own particular situation. The best way to do so is probably to consult one’s own tax advisor.196

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

The discussion of nonfinancial tax disclosure in the context of mandatory disclosure theory suggests that the intermediary depiction model is not always the best instrument to disseminate nonfinancial tax information. The intermediary depiction model requires that an issuer disclose information about the issuer. In the context of nonfinancial tax disclosure, much of the information that is viewed “material” is information about the investor.

Consider the example discussed above,197 where DC interpreted the tax consequences of the dividend distribution to be favorable to the stock price, while FC considered the same information to be detrimental. The material facts that caused such differences in interpretation were that DC was a domestic resident for tax purposes, and therefore able to enjoy the benefits of the foreign tax credit. FC, on the other hand, was a foreign resident that could not claim the foreign tax credit in the United States.

Whether an investor is “domestic” or “foreign” for federal income tax purposes, and whether such investor is able to make use of foreign tax credits,198 are facts about the investors. Therefore, the result is that to the extent relevant “material” tax information relates solely to investor level tax attributes, the issuer is not at all an “intermediary” standing between objective reality and the investor.

At best, an issuing entity is in a position to assess the relevant tax provisions that may apply to a particular offering, but cannot possibly assess the applicability of such provisions to any particular investor. Nonfinancial tax disclosure could potentially describe the relevant legal authorities in the abstract, but in such a case the disclosure would be nothing more than a restatement of the tax laws applicable to the

196 See the discussion in notes 98-102 and the accompanying text.
197 See the example discussed in Part III.A.
198 Not all investors can utilize foreign tax credits. The ability to do so depend on multiple issues pertains to each investor’s unique position. For example, the ability to utilize foreign tax credit is subject to limitations prescribed in section 904 of the IRC. The limitation depends, among others, on the amount of income a taxpayers has from foreign sources and U.S. sources, and on the tax rate that would have been imposed on the foreign source income had such income been subject to tax in the United States. These issues are highly individualized.
transaction. This would be, in most cases, disclosure of public knowledge which is generally not required.199

Conversely, in the case of financial tax disclosure, it is clear that the issuer is indeed an intermediary standing between relevant tax information and the investor. As discussed, whether Divicorp paid foreign taxes that would trigger foreign tax credits to domestic investors is information in respect of which Divicorp is indeed an intermediary. Such disclosure would be part of the financial tax disclosure, anyway required under current regulatory regime.

It is also possible, however, to identify instances in which the issuer is an intermediary in respect of nonfinancial tax disclosure as well. For example, certain foreign corporations owned by U.S. shareholders may be classified under the IRC as “controlled foreign corporations” (“CFC”).200 If a CFC earns income that is classified as “subpart F income”,201 such income is deemed distributed to the CFC’s “U.S. shareholders”.202 This means, in turn, that the “U.S. shareholders” are subject to tax in their own capacity, on the dividend deemed distributed to them from the CFC, notwithstanding the fact that no actual distribution was made.

Whether income is “subpart F income” is a matter of law, and depends largely on the nature of the activities of the corporation earning the income. Therefore, issuers that are CFCs probably do stand between the relevant fact—namely whether they have earned “subpart F income”—and the investor, who would want to know whether he or she is burdened by tax on his or her own account, as a result of the corporation’s activities.203

To summarize, the intermediary depiction model is not always suited for purposes of nonfinancial tax disclosure. It is not helpful to the extent that the tax information at issue relates to purely investor-level taxes, which depend on the investors’ individual tax attributes. It might be

199 See In re Progress Energy, Inc., 371 FSupp2d 548, 552-53 (SDNY 2005), and cases cited therein (“It is well-established law that the securities laws do not require disclosure of information that is publicly known”).
200 A CFC is a foreign corporation, more than 50% of its voting stock is held by “U.S. shareholders. IRC § 957.
201 SubPart F income is generally income from passive sources. IRC § 954.
202 A “U.S. shareholder” is a United States person holding 10% or more of the total combined voting power of the corporation. IRC § 957.
203 Practice in this regard is mixed. However, some issuers disclose the fact that they may qualify as CFCs. See, for example. SEC Form S-1 Registration Statement, Arizona Chemical Ltd., (Apr 12, 2010), at 163 (discussing the application of CFC rules to the offering). online at http://www.sec.gov/Archives/edgar/data/1489057/000095012310034000/y82079sv1.htm.
relevant, however, to the extent the information relates to issuers’ tax attributes, which investors need to know about in order to calculate their own tax liabilities. With this in mind, I turn to suggest a reform to the regulatory framework controlling nonfinancial tax disclosure.

IV. REFORMING NONFINANCIAL TAX DISCLOSURE REGULATION

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

My purpose here is to suggest a reform to nonfinancial tax disclosure regulation, under the assumption that mandatory disclosure theory remains the guiding principle of securities regulation. The reform is aimed at making sure that issuers disclose all (and only!) nonfinancial tax disclosure items that could theoretically be required by mandatory disclosure theory. I show that if such an approach is taken, we can dispose of the market-created construct of the average taxpayer, and hence nonfinancial tax disclosure becomes broadly applicable. For these purposes, I suggest to draw a clear line between nonfinancial investor-level tax disclosure and nonfinancial dual-level tax disclosure.

A. Nonfinancial Investor-Level Tax Disclosure Should be Eliminated

Investor-level tax information is any information that is (i) found with the investor rather than the issuer, and (ii) pertains to tax consequences the effect of which on the value of a security depends on each investor’s individual tax attributes. The disclosure of nonfinancial investor-level tax information cannot be justified under mandatory disclosure theory.

Unfortunately, the current regulatory regime seems to require the disclosure of such information. Item 601(b)(8) of Regulation S-K mandates a disclosure qualified by an opinion “supporting the tax matters and consequences … as described in the filing when such tax matters are material”. Such “material” consequences may include (or may depend

\[204\] SEC Regulation S-K, 17 CFR § 229.601(b)(8).
As discussed, nonfinancial tax disclosure that meets the literary breadth of Item 601(b)(8) is impossible to draft as a practical matter. And as a practical matter, such literal requirement is not practiced or enforced. As I have shown, courts have failed to find liability with registrants who failed to accurately state such investor-level tax outcomes. In addition, it seems that some practitioners implicitly adopt the view that investor-level tax items should not be disclosed. For example, the Tax Bar takes the position that “tax consequences of owning and selling common stock … are not ‘material to an investor’” because the tax consequences associated with such transactions are regarded as “plain vanilla” consequences. Therefore such information is not required to be disclosed according to the New York State Bar Association.

Information about tax consequences associated with the holding and the disposition of common stock is a perfect example of an investor-level tax item. The effects of taxable gain or capital loss associated with stock disposition strictly relate to each investor’s particular position, and in most cases do not relate to actions taken by the issuing entity. By not disclosing such information, some practitioners seem to refrain from disclosing information that strictly relates to investor-level tax items.

This rationalization that the tax consequences of owning and selling common stock need not be disclosed because they are not material, however, is wrong. It cannot be said that the cost of capital gains taxes associated with the disposition of the stock (as high as twenty percent tax imposed on the net gain), is not material to “reasonable investors”. In fact, the tax cost associated with stock disposition has been empirically proven to affect investment behavior. The reference to “plain vanilla”

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205 See NYSBA Report at 7 (cited in note 18).
206 Id.
207 See the discussion in notes 55-56 and the accompanying text.
209 See the discussion of the capital gains tax rates found in note 55.
210 See Đai et al, 2 J Fin at 710,738 (cited in note 162) (finding a “lock-in effect” and investors holding onto capital gains due to decreased supply after a reduction in the capital
tax consequences is also misplaced, because the consequences depend on each investor’s particular situation. The application of capital gains taxes to stock dispositions is not generic.

The best confirmation for how confusing the definition of “materiality” is in the context of disposition of common stock, is in the diversity of the practice with respect thereto. For example, three recent major initial offerings of common stock completely diverged in their scope of the nonfinancial tax disclosure and the qualifying opinion associated with such disclosure. Groupon Inc.’s pre-IPO registration statement included a rather expansive disclosure addressing the tax consequences associated with holding and disposing of the offered stock. Facebook Inc.’s IPO disclosure, however, contained a significantly narrower disclosure, which only addressed the tax consequences to non-U.S. shareholders. Finally, Google’s registration statement did not include any nonfinancial tax disclosure addressing tax consequences associated with the ownership and disposition of common stock.

I would argue that the tax consequences associated with stock dispositions are material. There is a good reason, however, not to disclose such consequences. The information pertaining to tax consequences associated with stock dispositions is information that is found with the investor, and not with the issuer. Mandatory disclosure theory does not require issuers to disclose any conceivable material information available, but only information that pertain to facts about the issuers. The same should apply in the context of nonfinancial tax disclosure. To summarize, the rationale not to disclose tax consequences associated with common stock disposition is that such consequences are investor-level tax items, not (as suggested by NYSBA) because the consequences are immaterial.

Under the same logic, it is justifiable not to disclose, for example,

gains rate); see Janet A. Meade, The Impact of Different Capital Gains Tax Regimes on the Lock-In Effect and New Risky Investment Decisions, 65 Acct Rev 406 (2013); see also Peter Klein, The Capital Gain Lock-In Effect and Long-Horizon Return Reversal, 59 J Fin Econ 33, 57 (2001) (testing an asset pricing model where long-horizon investors will realize gains they have “locked-in” due to accrued capital gains in high tax periods during low periods at the end of a long horizon).


214 See the discussion in notes 179-183 and the accompanying text.
state-level tax consequences. The SEC currently approves nondisclosure of state-level tax items, though it seems clear that nothing in Item 601(b)(8) exempts such information from being disclosed. The reason not to disclose it is that the issuer simply does not have such information at hand. Only investors themselves are in a position to appreciate which states’ taxes may be of relevance.

It is thus recommended that Item 601(b)(8) (and any other nonfinancial tax disclosure item, for that matter), will be amended to explicitly state that issuers are not required to disclose information that relates solely to investor-level tax items.

B. Nonfinancial Dual-Level Tax Disclosure Should be Expanded

1. Dual-Level Nonfinancial Tax Disclosure Explained

By dual-level tax disclosure, I refer to issuer-level tax information that directly affects how investors calculate the investors’ own tax liabilities (and as a consequence, the tax cost associated with the investment).

I have already mentioned one example of such dual-level information, in the context of subpart F income earned by an issuer that is a CFC. In order to calculate their own tax liabilities, certain investors must know if the issuer has earned any subpart F income. Under mandatory disclosure theory, it is justified that a CFC issuer discloses the amount of subpart F income, because the issuer is best positioned to know how much of the income it earned is “subpart F income”. However, investors should figure out for themselves the consequences of such subpart F income to their stock value.

It is not clear to what extent Item 601(b)(8) currently requires issuers to disclose dual-level tax consequences. The SEC, for example, has taken the position that tax information with respect to “mergers or exchange transactions where the registrant represents that the transaction is tax-free (e.g., spin-offs, stock for stock mergers)”, is “material” and therefore required to be disclosed and qualified by an opinion. This makes much sense, because whether a merger qualifies for tax-free treatment is a question the issuer is best positioned to answer.

In some cases, however, it seems that the SEC approach falls short from requiring the requisite disclosure in the context of dual-level

215 See the discussion in notes 94-97 and the accompanying text.
216 See the discussion in notes 94-97 and the accompanying text.
217 See the discussion in notes 200-202 and the accompanying text.
nonfinancial tax items. For example, the SEC takes the position that “when a registrant represents that an exchange offer or merger is a taxable transaction,” such representation is not “material.” It follows that such an item does not need to be disclosed under the plain language of the regulations. This approach is inconsistent with mandatory disclosure theory. The fact that a transaction may be taxable is a material fact for reasonable investors across the board, regardless of the fact that the tax consequences for each investor may be different.

My bottom-line recommendation is to rewrite Item 601(b)(8) so as to require a disclosure of any nonfinancial tax item that is (i) an issuing entity-level tax item (to the extent not already disclosed in the financial statements), and that (ii) affects how investors may have to calculate their own tax liabilities (regardless of the fact that the tax liabilities to each investor may be different).

If such a rule is adopted, then nonfinancial tax disclosure can be made applicable to all investors, regardless of their “averageness”, and the concept of the “average taxpayer” can be disposed of. There will be no need to exclude any investor from the scope of tax disclosure, regardless if an investor is subject to a unique taxation regime, or if an investor purchased the security in the initial offering or in the secondary market. All investors, average and non-average, will find in dual-level disclosure the information that—together with their personal tax information they

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219 Id.

220 The SEC position is that in such cases “the registrant must provide accurate and complete disclosure concerning the tax consequences,” but a registrant need not qualify such disclosure by an opinion. Id. This is, in fact, wrong. Regulation S-K requires registrants to disclose all various items of nonfinancial information specifically enumerated in the regulation. In addition, various basket provisions in securities laws and regulations require registrants to disclose all “material” information. 17 CFR §229.601(b)(8) (disclosure of any material tax issues); see also 1933 Act Rule 408(a), 17 CFR §230.408(a) (including in the registration statements any further information to make the statements not misleading); see 1934 Act Rule 12b-20, 17 CFR §240.12b-20 (includes any further material information required to make any necessary information, not misleading); see also 17 CFR §240.10b-5(b); see also 17 CFR §240.14a-9(a). Under Item 601(b)(8), all material nonfinancial tax information must also be accompanied by an opinion. Thus, to the extent nonfinancial tax information is “material” it must be disclosed and qualified by an opinion. To the extent nonfinancial information is not considered material, it need not be disclosed under the basket provisions, nor need it be disclosed under Regulation S-K that only enumerates material tax consequences. The result is that to the extent the SEC takes the position that the fact that a merger is taxable is immaterial—there is nothing in the regulation that requires a registrant to disclose such fact.

221 "Herbst, 495 F2d at 316-17 (cited in note 150)

222 This is to prevent duplicative disclosure of information that is required to be disclosed anyways under Regulation S-X.
hold anyways—will enable them to calculate the tax cost associated with the investment.

2. Some Examples for Dual-Level Nonfinancial Tax Disclosure

I have noted above at least one example of dual-level tax items (whether income earned by a CFC issuer is “subpart F income”). Some additional examples should illustrate the types of nonfinancial disclosure required under my suggested dual-level disclosure regime. Market practice is to disclose some of the examples suggested, but not to disclose others. The suggested regulatory regime will put an end to the confusion by clearly defining dual-level tax disclosure.

a. Whether an issuer is a corporation or partnership for tax purposes

Under the U.S. “classical system” of corporate taxation, corporate entities are opaque for tax purposes. Tax is imposed at the corporate level (and then again, upon distribution of dividends or the disposition of stock). Corporate tax is not borne directly by the shareholders.\(^{223}\) Therefore, corporate tax expenses are part of financial statements, not part of nonfinancial disclosure.

Partnerships, on the other hand, are generally transparent for tax purposes. Any income earned by the partnership is not taxed at the partnership level, but rather “flows through” to the investor (as most other partnership tax attributes). Thus, investors must know whether the issuing entity will be treated as a corporation or as a partnership for tax purposes. To the extent the entity is a partnership, investors should expect to report partnership earnings on their own returns, regardless if the partnership distribute anything to the investors.\(^{224}\) Such disclosure is part of current practice.

b. Whether an issuer qualifies for a special tax status

In many cases under the IRC, if an issuing entity meets certain

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\(^{224}\) Under section 7701 of the Code, a publically traded partnership must meet certain requirements in order not to be treated as a corporation for tax purposes. Whether the issuing entity qualifies for partnership treatment would be material for any reasonable investor.
requirements, its shareholders become subject to a unique taxation regime. For example, if a domestic corporation’s value is attributable mostly to real estate located in the United States, such entity becomes a United States Real Property Holding Corporation (“USRPHC”). Upon the disposition of stock in a USRPHC, certain foreign shareholders are subject to tax on any gain from the disposition, in the same way that U.S. residents are. This is unlike the normal course of taxation for capital gains, which are usually non-taxable to foreign residents. Since an issuing entity is best positioned to know whether it owns enough U.S. real estate to become a USRPHC, all issuers should be required to disclose whether they are USRPHCs or not. Disclosure practice in this regard is mixed.

Another example with a similar rationale is the Passive Foreign Investment Company (“PFIC”). A PFIC is a foreign corporation that meets certain thresholds of passive earnings or passive-assets holdings. If a corporation is a PFIC, shareholders may elect to mark-to-market their holdings each year and report their taxes as if they have sold their PFIC stock; shareholders may also elect to include deemed earnings of the PFIC on an ongoing basis regardless if distributions were made (provided investors have enough information about the corporate earnings); or, shareholders can do nothing, but pay heavy interest on back taxes when an actual distribution is made. An issuing entity is best positioned to know whether it is a PFIC or not, because it is best positioned to assess the value of its passive-income-generating assets, or the amount of its passive income. Practice in that regard is mixed, and issuers many times resort to noncommittal language such that “to the best of the issuer’s knowledge” it is or is not a PFIC.

225 IRC § 897(c).
226 Disposition of publicly traded stock is exempted from the scope of the rule to the extent the owner owns less than five percent of such publicly traded stock.
227 IRC § 897(c).
228 In the experience of the author, some issuers may offer disclosure in that respect, suggesting that they may or may not be USRPHCs for tax purposes. Other issuers simply ignore this issue.
229 IRC § 1297 (the basic threshold requirements provide the classification of a foreign corporation as a PFIC if 75 percent or more of the gross income is passive income and the average percentage of assets that produce passive income is at least 50 percent).
230 IRC § 1296.
231 IRC § 1293.
232 IRC § 1291.
233 See Harmony Gold Mining Company, Ltd., SEC Form F-20, Additional Information, at 140 (Oct. 25, 2013), online at http://www.sec.gov/Archives/edgar/data/1023514/000119312513411617/d612311d20f.htm (“We believe that we will not be a passive foreign investment company, or PFIC, for US
Under my suggested regulatory regime, issuers will be required to clearly state whether they are PFICs, and whether they will provide information to allow investors to report deemed distributed income on an ongoing basis.

Multiple other examples exist for entity classification that affects investor-level tax liabilities. Such examples include CFCs discussed above, Real Estate Investment Trusts ("REITs"), Regulated Investment Companies ("RICs"), and more.

c. Whether a distribution qualifies as a “dividend” for tax purposes

Whether a distribution qualifies as a dividend for tax purposes affects the tax treatment to an investor. A distribution that is a dividend will subject investors to tax on dividends (the effect of which depend on each investor’s consequences).\(^{234}\) A distribution that is not a dividend for tax purposes will be regarded as a return of capital not taxable to the extent of the investor’s basis in the security, and thereafter subject to capital gains taxes.\(^{235}\) The investor’s basis in the security as well as the effects of capital gains on an investor is clearly an investor-level tax item, which arguably should not be disclosed.

However, whether a distribution qualifies as a “dividend” for tax purposes or not, is clearly a dual-level disclosure item. Only distributions made out of earnings and profits ("E&P")—a defined term under the IRC—are “dividends” for tax purposes.

Significantly, whether a corporation has enough E&P to support a dividend for tax purposes is a determination made at the end of the tax year. Distributions to shareholders, however, are made throughout the year, before an E&P determination can be made. In certain circumstances, tax law requires a corporation making a distribution before year-end to make a “reasonable estimate” in order to determine whether the distribution constitutes a dividend.\(^{236}\) This estimate is based on the federal income tax purposes for the current taxable year. However, we cannot assure you that we will not be considered a PFIC in the current or future years’); see also LiveReel Media Corporation, SEC Form F-20, Additional Information, at 42 (Oct 28, 2013), online at http://www.sec.gov/Archives/edgar/data/1168981/000107997413000671/lievrel20f63013.htm (‘‘We do not believe that LiveReel has previously been, or currently are a PFIC. However, there can be no assurance that the IRS will not challenge our determination concerning our PFIC status or that we will not be a PFIC for the current or any future taxable year’’).

\(^{234}\) IRC §316, 301(c)(1).

\(^{235}\) IRC §301(a), 301(c)(2), (c)(3).

\(^{236}\) Treas Reg §1.1441-3(c).
“anticipated amount” of E&P, which in turn must depend on forward looking expectations of the corporation regarding its business performance between the time of distribution and the end of the year. Thus, whether there will be enough E&P to support a dividend treatment, is squarely within the knowledge of the distributing entity, not the investors. Investors, however, must to know if a distribution is a “dividend” in order to calculate their own tax liabilities.

d. The expected tax treatment of a structured financial instrument

Different types of securities are subject to different tax treatments, both with regards to issuers and holders of such securities. Debt is treated differently than equity and equity derivatives. Different types of debt tax classifications may carry different tax results. It is no wonder that issuers discuss at length in their disclosure documents whether offered debt instruments should be treated as Variable Rate Debt Instruments (“VRDIs”) or as Contingent Payment Debts Instruments (“CPDIs”). Equity derivatives are notorious for expensing many tax associate hours, trying to ascertain whether the instrument is a Forward Contract, Variable Prepaid Forward Contract, a “1256 Contract” or a multitude of other variations, all subject to various tax treatments.

While the classification of an instrument is not a per se issuer-level item, there are two main justifications to support the disclosure of such classification. First, the classification of an instrument is many times dependent on the likely occurrence of a future event, a materialization of a specific risk, or other events unrelated to the investors. The issuer who has tailored the specific instrument is much better informed than any prospective investor to analyze the likelihood that such events may occur, and as a consequence to opine on the most likely tax classification of the instrument.

Second, while issuers and investors are not required to agree upfront on an instrument classification for tax purposes, inconsistent treatment

237 Id.
238 Treas Reg §1.1275-5.
239 Treas Reg §1.1275-4.
241 IRC § 1256.
243 As noted above, tax law occasionally requires issuers of financial instruments to disclose certain tax items in respect of the instruments to investors, in order to assure consistent treatment by both issuers and holders. See discussion in note 28.
may create problems for investors. For example, if an issuer classifies an instrument as debt for tax purpose, payments on the instrument are likely to be regarded as interest, creating a deductible expense to the issuer. The IRS expects to see a corresponding inclusion of income by the investor (the recipient of the interest). If the investor believes, however, that the instrument is an equity derivative, he or she may regard any payments as a nontaxable return of capital. The IRS is sure to dislike such a result and may try to recharacterize the payments. It may prove problematic for an investor to argue for a specific classification of an instrument if the issuer takes a different position regarding the classification of the same instrument.\textsuperscript{244} It is therefore justified that issuers disclose their intended classification such securities. Such disclosure is part of current practice, and should be made mandatory under my suggested reform.

3. The Prospects of “Check-listing” Dual-Level Nonfinancial Tax Disclosure

It is possible to reform the regulatory requirements by way of a generic definition of the items that need to be disclosed. As explained above, such a generic approach will require the disclosure of any nonfinancial tax item that meets two requirements: (i) it is an issuer-level tax item, and (ii) such item may affect how investors calculate their own tax liabilities. It is not inconceivable, however, to generate a checklist covering all tax items that meet such qualifications. A taskforce could be formed to survey the tax code and create a list of all dual-level items in

\textsuperscript{244} Under the “Danielson Rule”, a taxpayer cannot argue against explicit tax treatment provided in an agreement the taxpayer is a party to, but instead must apply the same tax treatment consistently when reporting any income from the sale or disposition of property. \textit{C.I.R. v Danielson}, 378 F2d 771, 777-78 (3d Cir 1967) (Absent proof that negates the agreement (i.e. fraud, duress, etc.), the court held the sellers of the property had to consistently report the allocation of consideration from the sales price for the execution of certain covenants not to compete, and in this case recognize ordinary income from the consideration received). Consequently issuers regularly insert language in nonfinancial disclosure sections binding investor to report the security in a particular way for federal income tax purposes. For example, see \textit{SEC Form 424B1 Barclays Phoenix Autocallable Notes Due January 14, 2015} (July 19, 2013), at pps-6. (“The U.S. federal income tax consequences of your investment in the Notes are uncertain and the Internal Revenue Service could assert that the Notes should be taxed in a manner that is different than described below. Pursuant to the terms of the Notes, Barclays Bank PLC and you agree, in the absence of a change in law or an administrative or judicial ruling to the contrary, to characterize your Notes as a contingent income-bearing derivative contract with respect to the Reference Asset”). Online at \url{http://www.sec.gov/Archives/edgar/data/312070/000110465914001599/a14-1048_15424b2.htm}
order to standardize nonfinancial tax disclosure, and create a “check-the-box” type SEC form. It is possible the different checklists will be produced for different disclosure events. For example, a different checklist will be applicable to a proxy solicitation in the context of a merger, as opposed to checklists applicable for IPOs or periodic disclosures.

An example may illustrate how such checklist might work. For example, in its annual report to shareholders, an issuer will have to answer “yes” or “no” to the question whether it is a CFC at the time of the report. If the answer is “yes”, then the issuer will have to report the amount of Subpart F income for the period:

**Item [x]:** Is the registrant a controlled foreign corporation (CFC) within the meaning of Section 957 of the Internal Revenue Code? □ Yes; □ No.

**Item [x](i):** If the registrant is a CFC, enter the amount of Subpart F income as defined in Section 952 of the Internal Revenue Code, for the reported period: $_______

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

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

Finally, I suggest that the proposed regime is far better than our current state of affairs. This is important as SEC rulemaking practice requires an extensive cost-benefit analysis before adopting a regulatory change. It is beyond the scope of this article to execute a full-blown analysis questioning the costs and benefits of the proposed dual-level tax disclosure regime. However, I expect that such an analysis will support the adoption of my suggested rule.

Generally speaking, SEC analysis in the context of rulemaking addresses four components. First, is necessary to identify “the need for the rulemaking and [explain] how the proposed rule will meet that need.” In this article, I have identified the need to revise current

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246 Id.
nonfinancial tax disclosure. I have explained how such disclosure fails to achieve the purported purposes of our securities regulation regime. I have also explained how dual-level tax disclosure is expected to support the regulatory rationale.

Second, a cost-benefit analysis requires an articulation of the “economic baseline against which to measure the proposed rule’s likely economic impact (in terms of potential benefits and costs, including effects on efficiency, competition, and capital formation in the market(s) the rule would affect).” My assumption is that the economic baseline in such an analysis would be the current regime, which – as I have argued – does not provide the necessary information to support market efficiency.247

The third requirement is to clearly identify and evaluate “reasonable alternatives to the proposed regulatory approach.”248 I have identified two such alternatives: a generic rule requiring dual-level nonfinancial tax disclosure, and “check-listing” of dual-level tax disclosure. The development of the checklist alternative is beyond the scope of this article, as it will require putting a taskforce in place, to survey tax rules for items appropriate for the checklist. The costs associated with the development of such a checklist must be taken into account when considering the development of the new rule.

Finally, at the heart of the rulemaking process is the comparison of the costs and benefits of the proposed alternatives against the baseline.249 I have outlined the apparent costs of the current regime above.250 I expect both the generic alternative and the “checklist” alternative of dual-level tax disclosure to fare better than current regime both in terms of costs and benefits.

In terms of the benefits, dual-level tax disclosure is expected to enhance disclosure of tax information that is relevant for market efficiency, and eliminate the disclosure of irrelevant information. All investors (as opposed to very few investors under current regime) should find dual-level nonfinancial tax information relevant.

In terms of costs, dual-level tax disclosure should reduce costs to investors, issuers and the SEC. Investors will have access to information not previously disclosed, and therefore information-gathering costs are expected to decrease. Issuers will not be required to generate any new information. All dual-level tax information is information the issuers hold

247 See the discussion in Subpart I.D.
248 See Rulemaking Memorandum (cited in note 245).
249 Id.
250 See the discussion in Subpart I.D. and notes 103-110 and the accompanying text.
anyways. On the other hand, issuers will not be required to disclose information that they do not have (namely, investor-level tax information). Under the checklist method, disclosure will be particularly cheap to issuers, as the lengthy tax narratives in current disclosure will be replaced with a “check-the-box” type form. This is expected to significantly reduce the cost of drafting. The SEC should also find its costs in reviewing nonfinancial tax disclosure shrink, as the framework of what needs and need not be disclosed is ostensibly clearer in the context of dual-level tax disclosure. The only significant added cost would be a onetime outlay required to generate the proposed checklist of dual-level tax items, a cost that I expect to be outweighed by the benefits extended by a better disclosure regime.

CONCLUSION: CONSULT YOUR OWN TAX ADVISOR

Nonfinancial tax disclosure regulation is aimed at making sure that “reasonable investors” receive all the “material” information related to the investors’ tax consequences associated with an investment in registered securities. This regulatory regime is a reflection of the widespread acceptance of the efficient capital markets hypothesis and the mandatory disclosure theory it supports.

In this article, I have argued that even if we accept the regulatory rationale with no reservations, the current regulatory framework does not support the rationale. Specifically, investors in publically-traded securities have various tax preferences, even if they are all “reasonable investors”. As such, the task for drafting nonfinancial tax disclosure to address all the tax consequences that a reasonable investor may deem material becomes impractical.

The market and the SEC have responded to the practical difficulty by having nonfinancial tax disclosure drafted for the benefit of a “reasonable investor” who is also an “average taxpayer”. I have shown that the concept of average taxpayer is indefensible, both theoretically and empirically. As a theoretical matter, no “average” taxpayer can be envisioned, because tax laws, by definition, create rules of particular applicability to each taxpayer. Moreover, financial literature teaches us that the tax preferences that actually make a difference in the operations of capital markets are the preferences of taxpayers who are not perceived to be “average”. The result is that the current practice is to draft nonfinancial tax disclosure in a manner that describes tax consequences that are largely irrelevant to the regulatory rationale.

I have also shown that the regulatory framework fails to take into
account the special nature of tax information required to determine investors’ tax consequences. Mandatory disclosure theory calls for the disclosure, by issuers, of information about the issuers (or other information that issuers are more likely to easily gather, compared to investors). However, much of the information that determines the tax outcomes of investment in securities is information about the investors, and such information is already found with the investors. I therefore suggest reforming the regulatory framework so as to require issuers to only disclose nonfinancial tax information about the issuers that investors may need in order to calculate the investors’ own tax liabilities. I suggest that such disclosure could be formed as a checklist.

In all likelihood—even assuming the best intentions of market participants—issuers cannot be expected to deliver to investors with heterogeneous tax preferences all material nonfinancial tax information. To the extent relevant information relates to investor-level tax consequences, seeking personal tax advice is the only prudent course of action. I will therefore end this article with a generic advice to all investors in publically-traded securities: consult your own tax advisor. It is the best piece of advice regularly included by issuers in their tax disclosures. Follow it.