Greenmail, Golden Parachutes and the Internal Revenue Code: A Tax Policy Critique of Sections 280G, 4999 and 5881

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I. INTRODUCTION

In an era when the adventures of corporate raiders and the misadventures of corporate managers have received widespread (frequently unflattering) attention, it was perhaps inevitable that Congress would pass legislation affecting two of the most widely-publicized phenomena associated with corporate takeover attempts: greenmail and golden parachute payments. In an era when major tax legislation has become an almost annual event, it was perhaps also inevitable that Congress would deal with greenmail and golden parachutes through the Internal Revenue Code (the Code). Nevertheless, it was unfortunate that Congress used the tax law to address the issues raised by greenmail and parachute arrangements. As a matter of tax policy, the Code provisions pertaining to greenmail and golden parachutes—sections 280G, 4999 and 5881—are not defensible additions to the tax code.
I reach this conclusion from an agnostic view of the merits and disadvantages of greenmail and golden parachutes. Whether one begins from a benign characterization of these arrangements or from a condemnatory perspective on greenmail and golden parachutes, sections 280G, 4999 and 5881 do not withstand scrutiny. The Internal Revenue Code was not the place for Congress to have voiced its sentiments on greenmail and golden parachute arrangements.

I will first explore the background against which Congress legislated, examining some of the definitional issues associated with greenmail and parachute payments. I will next discuss the scholarly and judicial responses which greenmail and golden parachutes have evoked. I will then outline Congress' reaction to these arrangements in the form of sections 280G, 4999 and 5881 of the Code in the fourth section of this article. The fifth section of this article presents the core of my analysis. I will canvass the various tax policy criteria which have developed for identifying appropriate uses of the tax law. These criteria include tests that enjoy widespread support among scholars and commentators, as well as tests with less general acceptance. Sections 280G, 4999 and 5881 fail all of these standards, regardless of

4. All references are to the provisions of the Internal Revenue Code of 1986 as amended through the Technical and Miscellaneous Revenue Act, Pub. L. No. 100-647, 102 Stat. 3343 (1988) (codified as amended I.R.C. §§ 1-9602 (West 1989)). Section 280G disallows a deduction for any excess parachute payment. A “parachute payment” is any payment in the nature of compensation to a “disqualified individual” if such payment is contingent on a change in the ownership or control of the corporation. I.R.C. § 280G (West 1989). Section 4999 imposes a 20% tax on such excess parachute payments. Id. § 4999. Section 5881 imposes a 50% tax on any person who receives greenmail. Id. § 5881. Section 162(k)(1) of the Code disallows most deductions “paid or incurred by a corporation in connection with the redemption of its stock.” Id. § 162(k)(1). This provision applies to all redemptions, not just those constituting greenmail payments. Accordingly, § 162(k)(1) has generally not been viewed as a companion provision of § 5881 and is not discussed in this article. I will also not discuss §§ 275(a)(6) and 3121(v)(2). Section 275(a)(6) makes the levies imposed on golden parachute payments (§ 4999) and greenmail (§ 5881) nondeductible for income tax purposes. Id. § 275(a)(6). Section 3121(v)(2) affects the treatment of excess parachute payments for social security payroll tax purposes. Id. § 3121(v)(2).

5. See infra notes 10-50 and accompanying text.

6. For a discussion of scholarly debate of these issues, see infra notes 51-125 and accompanying text.

7. See infra notes 126-58 and accompanying text.

8. See infra notes 159-212 and accompanying text.
one's substantive view as to the desirability or impropriety of greenmail and golden parachute arrangements.

In the sixth section, I argue that the Code provisions concerning greenmail and golden parachutes cannot be dismissed as harmless mistakes. Rather, they embody a serious misuse of the Code, imposing unnecessary costs on the administration of the federal tax system at a time when the system can ill-afford such costs. The misuse of the Code as exemplified by sections 280G, 4999 and 5881 also makes Congress' process less accountable and less expert. In the final section of this article, I suggest that opponents of greenmail and golden parachute payments, even if totally indifferent to the health of the tax law, nevertheless ought to be uncomfortable with sections 280G, 4999 and 5881. These provisions may come to be viewed as preempting the responses of courts and state legislatures to greenmail and parachute arrangements. If that proves to be the case, sections 280G, 4999 and 5881 will have exacerbated the perceived problems at which they are aimed.

II. GREENMAIL AND GOLDEN PARACHUTES: DEFINITIONAL ISSUES

Of the many phenomena associated with the corporate takeover activity of the 1980s, none has been more controversial than the arrangements which have come to be identified as greenmail and golden parachutes. Those opposing greenmail and parachute payments feel they represent the ultimate violation of shareholders' trust. Those holding a benign view of these arrangements feel they are appropriate tools of corporate governance with potentially beneficial results for the particular corporations involved and for the economy as a whole. Despite the attention greenmail and golden parachutes have received, no definition of either arrangement commands universal acceptance. For a clear understanding of the scholarly debate concerning the wisdom of greenmail and golden parachutes, an analysis of the definitional difficulties of each is in order.

9. See infra notes 213-18 and accompanying text.
10. See infra notes 13-16 and accompanying text.
11. See infra notes 51-61 and accompanying text.
A. Greenmail Definitional Issues

At its most basic level, the term "greenmail" has come to denote payments to corporate raiders to make such raiders cease their interests in ongoing or threatened takeover attempts. Typically, greenmail involves the repurchase of the raider's stock at a premium by the target corporation. However, greenmail may occur in other guises, such as by permitting raiders to acquire assets from the target corporation on favorable terms or by allowing payments to raiders by a third party (the "white knight") cooperating with the management of the target corporation.

Beyond these basics, the label "greenmail" raises several definitional issues: the good faith vel non of management making the payment, the prior involvement of the raider in the target corporation, the availability of the alleged greenmail payments to shareholders besides the raider and the identification of the premium paid to the raider.

For some opponents of greenmail, the essence of the perceived evil is corporate management's bad faith. Greenmail, in this view, is the use of corporate assets to entrench current management's incumbency. The raider is paid shareholders' assets, not for the shareholders' benefit, but to protect the jobs of those presently in control of the target corporation.

13. See Dennis, supra note 2, at 282 ("target management may buy out the ... [raider] at a significant premium over the current market price"); Gilson, Drafting an Effective Greenmail Prohibition, 88 COLUM. L. REV. 329, 329-30 (1988) (defining greenmail as "target management paying a potential acquirer to go away by repurchasing his shares at a premium"); Macey & McChesney, A Theoretical Analysis of Corporate Greenmail, 95 YALE L.J. 13, 13 n.1 (1985) ("[G]reenmail' . . . used most often to describe a firm's purchase of its own common stock at a premium above the current price."); Comment, Greenmail: Can the Abuses Be Stopped?, 80 NW. U.L. REV. 1271, 1274 n.21 (1986) ("Greenmail refers to the target's repurchase of shares held by a hostile bidder at an above-market price."); Note, Greenmail: Targeted Stock Repurchases and the Management Entrenchment Hypothesis, 98 HARV. L. REV. 1045, 1045 n.3 (1985) (defining greenmail as "targeted repurchase of securities at a premium price").


15. See Dennis, supra note 2, at 282 ("Arguably, [greenmail] serves to protect the interests of only the current managers of the target."); Gilson, supra note 13, at 330 ("[G]reenmail is just another ... technique by which target management entrenches itself at the expense of target shareholders.").

16. The most important proponent of this view is the Delaware Supreme
If greenmail is defined as a matter of management's bad faith, some payments to raiders can be justified by the sincerity of management's belief that it is acting for the benefit of the shareholders. In particular cases, management indeed might demonstrate that it reasonably believes it better for the shareholders to buy off a raider rather than to allow him to assume control of the corporation.

Alternatively, greenmail can be defined in more objective terms, ignoring the good faith or bad faith of management. In this view, shareholders are harmed by the payment of premiums to raiders regardless of the sincerity of management's belief that it is acting for the shareholders' benefit. Moreover, from an evidentiary perspective, it can be argued persuasively that bad faith ought not be identified as a specific element of greenmail. It is difficult, the argument suggests, to prove definitively that management is motivated by one concern, such as shareholder welfare, rather than another, such as self-interest. The possibility of management self-dealing is obvious and strong in situations where an unwanted suitor is paid off with corporate assets. Under this analysis, an irrebuttable presumption that payment is motivated by management's desire to protect itself from the raider's takeover should attach to any greenmail payment.

The approach to greenmail embodied in section 5881 of the Code embraces such an objective view. The tax established in section 5881 is triggered whether or not management acts in good faith for the benefit of the shareholders.

A second definitional issue which arises is the identification of those deserving to be denoted as "raiders." In one formulation, any shareholder is a raider whenever he threatens management and subsequently terminates his investment in the Court. That court's decisions proscribe greenmail payments made by management to entrench itself, but permit selective redemptions of stock made in good faith for the reasonably perceived benefit of the corporation and its shareholders. See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

Greenmail has been criticized as inequitable because the remaining non-threatening shareholders, unlike the raider, do not receive the benefit of the buyback offer. Id. Also, greenmail heads off the tender offer process, which prevents shareholders from benefiting from higher stock market prices during a tender offer. Id. Moreover, greenmail may cause stock values to drop. Id. at 72-73.

17. See Note, supra note 12, at 73. Greenmail has been criticized as inequitable because the remaining non-threatening shareholders, unlike the raider, do not receive the benefit of the buyback offer. Id. Also, greenmail heads off the tender offer process, which prevents shareholders from benefiting from higher stock market prices during a tender offer. Id. Moreover, greenmail may cause stock values to drop. Id. at 72-73.

18. Id. at 102-03 (citations omitted).

19. I.R.C. § 5881(a) (West 1989). This section states: "There is hereby imposed on any person who receives greenmail a tax equal to 50 percent of gain or other income of such person by reason of such receipt." Id.
corporation at a premium. From this perspective, the harm to the remaining shareholders stems from the fact of payment to the raider at a premium. That harm is not mitigated by any prior, long-term involvement in the corporation by the greenmail recipient.

Under an alternative view, the label “raider” should only attach to shareholders who acquire their stock for the purpose of challenging management or who hold their stock for an insufficient period to demonstrate concern for the long-term welfare of the corporation. From this perspective, the evil involved in greenmail emanates from the transient shareholder seeking a quick profit. A corollary of this view is that payments to dissatisfied, long-term investors fall outside the definition of greenmail. This latter perspective is reflected in section 5881, which defines a payment as greenmail only if the recipient has owned his stock for less than twenty-four months.

A third issue in defining greenmail is the matter of selectivity. Opponents of greenmail typically view it as an assault on fairness because the premium paid to the raider is not offered to the other shareholders of the corporation. In this view, the essence of greenmail is inequity: if all shareholders are given the same terms as the raider, there is no issue of fairness and no greenmail about which to complain.

An alternative perspective identifies the harm of greenmail, not as inequality among shareholders, but as the dismantling of corporate enterprise. To pay greenmail, corporations must grudgingly borrow funds or sell assets they otherwise would retain. From this vantage, there is no solace in the availability to all

20. See Gilson, supra note 13, at 340-41.
21. Id. at 335. “[A] need to hold an investment subject to market risk for a significant period of time reduces the likelihood that the investor has an exploitive motive in making the investment by increasing the costs of such a strategy.” Id. “Existing state statutes regulate repurchases involving shares held from two to three years.” Id. at 335 n.16 (citations omitted).
22. I.R.C. § 5881(b)(1) (West 1989). This section states in pertinent part: “‘greenmail’ means any consideration transferred by a corporation (or any person acting in concert with such corporation) to directly or indirectly acquire stock of such corporation from any shareholder if—(1) such shareholder held such stock . . . for less than 2 years before entering into the agreement to make the transfer . . . .” Id.
23. See Note, supra note 12, at 73.
24. See Comment, supra note 13, at 1306 (“greenmail has substantial transactions and opportunity costs to the market in general because significant resources are required to make greenmail payments.”); see also Note, The Hobbs Act and Rico, supra note 14, at 650 (“single greenmail payment often involves millions of dollars”) (footnote omitted).
shareholders of the opportunity to be redeemed at the same premium as the raider. While such an opportunity serves the claims of shareholder equity, it actually compounds the economic effects of paying the raider by forcing the corporation to acquire more debt or sell more assets to redeem the shares of other shareholders in addition to those of the raider. The net result, according to this view, is a weakening of the paying corporation.

The drafters of section 5881 identified the greenmail problem as one of selectivity rather than of corporate dislocation. No tax is imposed by section 5881 if the same opportunity to be redeemed at a premium is offered to all shareholders.25

A final definitional issue is the determination of the greenmail premium. As Professor Gilson has observed, the simplest measure of greenmail is the raider's total gain, that is, the difference between the raider's cost for his stock and the amount he is ultimately paid for it.26 However, this simple approach will frequently misstate the amount of the greenmail premium. Some of the gain accruing to the raider may reflect not a premium, but "normal" appreciation which happened to occur while the raider was holding his shares. Similarly, if the market price falls during the raid, the spread between the raider's cost and the payment he receives will understate the greenmail premium.27

An alternative is to define the greenmail premium as the difference between the amount paid to the raider for his stock and the market price which prevailed immediately prior to the raider's announcement of his interest in the target corporation.28 From this vantage, appreciation before the announcement of the takeover attempt reflects routine economic gain with respect to which the raider is as much entitled as would be any other ordinary investor. The market price at the time of the raider's announcement is therefore the "correct" one. Payments to the raider

25. I.R.C. § 5881(b)(3) (West 1989). This section states in pertinent part: "[G]reenmail' means any consideration transferred by a corporation to directly or indirectly acquire stock of such corporation from any shareholder if—...(3) such acquisition is pursuant to an offer which was not made on the same terms of all shareholders." Id.

26. Gilson, supra note 13, at 340-41 ("[I]f a potential acquirer buys a substantial amount of stock at ten dollars per share, and the company repurchases...for fifteen dollars...profit is...an illegal premium.").

27. Suppose, for example, that the raider buys stock at $5 per share, that his stock is subsequently redeemed at $7 per share and that the market price at the time of redemption has fallen to $4 per share. Under such circumstances, the spread between $7 per share and $5 per share apparently understates the greenmail premium.

28. Gilson, supra note 13, at 342.
above that amount, the theory suggests, reflect the raider's takeover effort and, therefore, a greenmail premium.

This definition also has its problems. The price prevailing at the time of the raider's formal announcement of interest may already reflect the takeover effort as word of the raider's activity informally develops. The price at the time of the raider's formal announcement, if already increased by word of the proposed takeover, will be too high a benchmark from which to measure the premium paid the raider.

Moreover, normal economic events continue during a takeover attempt. A payment to a raider may reflect, among other things, an increase in the value of the stock which occurred during the raid but which was unrelated to it. Hence, the difference between the price at the raider's announcement and the subsequent payment to him may be too large an indicator of greenmail because some of that spread may reflect appreciation unrelated to the takeover. Conversely, market trends might be downward. In that event, the spread between the announcement price and that prevailing at the time of the subsequent greenmail payment may underestimate the greenmail premium. At the time of the payment to the raider, the theoretical market price which would have prevailed in the absence of the raid might be lower than the price at announcement. 29

In addition, the price of the target corporation's stock at the time of the raider's announcement of interest may, in retrospect, have been an "incorrect" one. Frequently, after the payment of greenmail, the price of the target's stock stabilizes at a point above the level prevailing when the raider unveiled his takeover bid. Indeed, the theoretical defense of greenmail is buttressed by this phenomenon as it suggests that the raider may have brought the price of the target corporation to its proper, higher level.

The difficulties with the first two definitional approaches suggest a third possible method, defining the greenmail premium as the difference between the amount paid to the raider and the prevailing price at some point after the raider's stock is redeemed. 30

29. Suppose, for example, that the price as of the raider's announcement of interest is $5 per share, that the raider is bought out at $8 per share and that, in the absence of the raid, bearish market conditions would have depressed the price to $3 per share. In this situation, the spread between the $5 price and the $8 price arguably understates the greenmail premium.

30. Gilson, supra note 13, at 345. "The most intriguing part of this approach is that the solution relies on the market to identify greenmail." Id. at 347.
This theory alleges that the post takeover price is the "true" one because it reflects the corporation's long-term value. The excess over this long-term value is the premium paid as greenmail. Professor Gilson identifies this approach as the most desirable way of determining the greenmail premium.\footnote{1}

The shortcoming of this approach is the inherent arbitrariness in deciding the date after the greenmail payment when the market price is "correct." The price immediately after the payment to the raider may still reflect the short-term tumult associated with the takeover effort. As time passes, the market price may be viewed as more reflective of long-term value. On the other hand, the longer one waits to fix the base price for determining the greenmail premium, the greater the danger becomes that price will reflect extraneous post-takeover events.

Finally, the greenmail premium can be defined simply as the difference between the amount paid to the raider and the prevailing market price at the time the raider's stock is redeemed.\footnote{2} This approach generally understates the premium associated with greenmail. When the raider and target management come to terms, some portion of the prevailing market price will reflect speculation related to the takeover. Consequently, the market price at the time of the raider's redemption already embodies part of the greenmail premium because that price reflects the raider's interest in the stock.\footnote{3}

Of these four possible approaches, the drafters of section 5881 embraced the first, defining the greenmail premium as the entire gain of the raider.\footnote{4}

\subsection*{B. Golden Parachute Definitional Issues}

Like greenmail, the concept of the golden parachute raises numerous definitional issues.\footnote{5} At its most basic level, the term

\footnote{1} See id. at 349.

\footnote{2} Id. at 338 ("[M]ost common formulation of a greenmail prohibition [is] the straightforward but, . . . naive view. . . .").

\footnote{3} Id. This approach is criticized as doing no more than setting a ceiling on the amount of greenmail that can be paid. Id.

\footnote{4} See I.R.C. § 5881 (West 1989).

\footnote{5} For background on the subject of golden parachutes, see Carney, supra note 14, at 421; Riger, On Golden Parachutes—Ripcords or Ripoffs? Some Comments on Special Termination Agreements, 5 PACE L. REV. 15 (1982); Subcommittee on Executive Compensation, Executive Compensation: A Road Map for the Corporate Advisor, 40 BUS. LAW. 219, 348 (1984); Comment, Golden Parachutes: A Perk That Boards Should Scrutinize Carefully, 67 MARQ. L. REV. 293 (1984); Comment, Testing the Flight of the Golden Parachute: Judicial Smooth Sailing or Turbulence Ahead?, 11 N. KY. L. REV. 519 (1984); Comment, supra note 2; Note, Platinum Parachutes: Who's Pro-
"golden parachute" has come to mean excessive severance payments to former employees. Some would refine the notion by labelling only those severance arrangements tainted unacceptably by corporate management's self-dealing as golden parachutes. In this view, the essence of the parachute problem is bad faith—management using its control of the corporation to reward itself excessively.

A corollary of this perspective is that severance payments established by management in good faith should not be denoted as golden parachutes. Severance outlays to managers should not be condemned as parachutes if management can demonstrate that the payments were undertaken with appropriate consideration for the shareholders' welfare.

Alternatively, good faith can be viewed as irrelevant to the characterization of a particular arrangement as a golden parachute. From this perspective, management's sincerity does not change the objectionable nature of the parachute arrangement—an excessive outlay made at the shareholders' expense. Or, as is the case vis-a-vis greenmail, large severance payments may be viewed as inherently permeated by self-dealing, making it unnecessary to state bad faith as a separate element of the definition of a golden parachute.

Under sections 280G and 4999 of the Code, excessive severance payments are denoted as parachute outlays whether or not management has acted in good faith.

36. See Comment, supra note 2, at 616.
37. See Note, Platinum Parachutes: Who's Protecting the Shareholder?, supra note 35, at 653 n.2 (giving two definitions which limit golden parachutes as applying only to "certain key executives" and "high level officials").
38. See Note, Golden Parachutes: Untangling the Ripcords, supra note 35, at 955 ("[C]ommentators expect most courts to determine the validity of golden parachute arrangements under . . . the 'business judgment rule'") (footnote omitted).
39. See Comment, supra note 2, at 620 ("[S]hareholders are subjected to unjustifiable costs in return for the promise of a team of 'super management.' It is virtually impossible for the hapless security holder to ever receive what he had paid for.").
40. Section 280G(b)(2)(A) defines parachute payment as "any payment," and gives no limitations with respect to good faith. I.R.C. § 280G(b)(2)(A) (West 1989). Section 4999 imposes a tax on "any person who receives an excess
A second definitional issue is what, if any, events must accompany the departure from employment. We might include all excessive severance payments in the definition of parachutes. In this view, a golden parachute exists whenever a manager departs with too much compensation.  

The definition of a golden parachute is commonly restricted to those severance payments associated with a change of corporate control. Such a change is typically defined by turnover on the board of directors, a threatened or successful tender offer or proxy fight, a sale of substantial corporate assets or some other comparable sign of a takeover attempt. Much of the practitioner-oriented literature on golden parachutes is devoted to the identification of the events constituting a change of control.

Sections 280G and 4999 define excessive severance outlays as parachute payments only if the severance payments are associated with a change of corporate control.

A third definitional issue is the role of shareholder approval. From one perspective, the opprobrium "golden parachute" should not attach to severance payments if those payments are condoned by the shareholders. This argument asserts that the shareholders' money is the object of concern, and if the shareholders choose to spend their funds for excessive severance outlays, that is their prerogative.

parachute payment," and gives no limitation with respect to good faith.  

41. In Demetracopoulos v. Strafford Guidance Center, 130 N.H. 209, 536 A.2d 189 (1987), the New Hampshire Supreme Court used the term "golden parachute" to refer to a provision in Demetracopoulos' employment contract which granted him the greater of a year's salary and fringe benefits, or 80% of the cash equivalent of the remainder of the contract, if he was dismissed, suspended, or demoted. Id. at 212, 536 A.2d at 191.

42. See Comment, supra note 2, at 616.


44. I.R.C. § 280G(b)(2)(A)(i) (West 1989). This section states in relevant part: "The term 'parachute payment' means any payment in the nature of compensation . . . if—(i) such payment is contingent on a change—(I) in the ownership or effective control of the corporation, or (II) in the ownership of a substantial portion of the assets of the corporation." Id.

45. Id. § 4999. Section 4999(b) expressly incorporates § 280G(b)'s definition of "excess parachute payment." Id. § 4999(b).


47. Id. at 725.
An alternative approach holds that shareholder approval cannot make a golden parachute acceptable. This attitude may reflect skepticism about the genuineness of shareholder self-governance. This view suggests that, because incumbent management controls the proxy system, shareholder approval of management's compensation should not be taken seriously. A stronger rationale for disregarding shareholder approval is the plight of the outvoted stockowner who opposes the golden parachute. While it may be acceptable for the majority to authorize management's self-dealing as to the majority's money, it is not appropriate for the majority to countenance self-dealing with the objecting minority's money. Because parachute payments come from all shareholders' funds, majority approval is not sufficient to overcome the minority's interest against management self-dealing.

On the subject of shareholder approval, sections 280G and 4999 distinguish between corporations with and without readily tradeable stock. In the context of a corporation with tradeable

48. See supra note 46 for a discussion of the criticism of mandatory stockholder approval.
49. Section 208G(b)(5) states:
(A) Notwithstanding paragraph (2), the term "parachute payment" does not include—
   (i) any payment to a disqualified individual with respect to a corporation which (immediately before the change described in paragraph (2)(A)(i)) was a small business corporation (as denied in section 1361(b), but without regard to paragraph (1)(C) thereof), and
   (ii) any payment to a disqualified individual with respect to a corporation (other than a corporation described in clause (i)) if—
      (I) immediately before the change described in paragraph (2)(A)(i), so stock in such corporation was readily tradeable on an established securities market or otherwise, and
      (II) the shareholder approval requirements of subparagraph (B) are met with respect to such payment.
   The Secretary may, by regulations, prescribe that the requirements of subclause (I) of clause (ii) are not met where a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and interests in such other entity are readily tradeable on an established securities market, or otherwise. Stock described in section 1504(a)(4) shall not be taken into account under clause (ii)(I) if the payment does not adversely affect the shareholder’s redemption and liquidation rights.
(B) The shareholder approval requirements of this subparagraph are met with respect to any payment if—
   (i) such payment was approved by a vote of the persons who owned, immediately before the change described in paragraph (2)(A)(i), more than 75 percent of the voting power of all outstanding stock of the corporation, and
   (ii) there was adequate disclosure to shareholders of all material
stock, section 280G disregards shareholder approval: an outlay otherwise constituting a parachute payment cannot be rescued by a shareholder vote. However, in the absence of such stock, section 280G provides that severance compensation is not a parachute payment if approved, after adequate disclosure, by a seventy-five percent shareholder vote.\textsuperscript{50}

III. GREENMAIL AND GOLDEN PARACHUTES: THEORETICAL ISSUES

A. Greenmail Theoretical Issues

Once we have defined greenmail and parachute arrangements, the question arises whether anything ought be done about them. For some commentators, greenmail can be a fairly benign phenomenon, potentially benefitting shareholders and the economy as a whole.\textsuperscript{51} Professors Macey and McChesney, for example, defend greenmail in certain cases relying on the widely-accepted premise that corporate raiders perform useful economic functions.\textsuperscript{52} Raiders make their profit by locating mismanaged and poorly-organized firms, and then acquiring such corporations' shares. Raiders' activity informs the market (including the shareholders and management of the target corporation) that a particular business will be more profitable if restructured or better managed. The prospect of being identified in this fashion, the argument continues, disciplines corporate managers to do better lest they be subject to raiders' attentions.

\textsuperscript{50} See id. \S 280G(b)(5)(B). For the text of this section, see \textit{supra} note 49.

\textsuperscript{51} See Macey \& McChesney, \textit{supra} note 13, at 17 ("Moreover, the model illustrates that payment of greenmail may improve the functioning of the market for corporate control and enhance economic efficiency."); see also Macey, \textit{Takeover Defense Tactics and Legal Scholarship: Market Forces Versus the Policymaker's Dilemma}, 96 YALE L.J. 342, 344 (1986) (discussing how shareholders might on average benefit from payment of greenmail); McChesney, \textit{Assumptions, Empirical Evidence and Social Science Method}, 96 YALE L.J. 339, 340 (1986) ("[M]any firms have in fact benefitted from raiders who buy into a firm only to be greenmailed off.").

\textsuperscript{52} For a discussion of useful economic functions of corporate raiders, see Macey \& McChesney, \textit{supra} note 13, at 16-28.
However, Professors Macey and McChesney advise that the raider who has identified an undervalued firm may not be the best ultimate owner of that business. There may be a third party who, once informed by the raider's activity, will manage the newly-discovered business better than the raider or who will restructure the newly-identified firm more profitably than could the raider. Shareholders of the target corporation would rather sell to this third party than to the original raider since the third party, expecting to make the firm more profitable than the raider, will pay more to the target's shareholders.

It thus may be appropriate in some settings to pay greenmail to make the original raider depart. The profit from greenmail rewards the raider for locating the undervalued firm and encourages him and others to canvass the market for other corporations similarly in need of better management or restructuring. The corporation located by the raider passes into the hands of a third party who can derive the greatest value from it. And the stockholders of the target corporation realize the greatest amount for their shares since they sell to the highest bidder, the third party alerted by the raider's activity.

In a similar vein, Professor Dennis believes that “the practice of greenmail should be allowed to continue.” A raider's acquisition of the stock of a target corporation, he maintains, “creates significant new information and facilitates control transactions.” Professor Dennis concludes that “[t]he ability of target management to enter into greenmail transactions makes” such acquisitions “more likely, and, thus, the community of shareholders gain.”

Professor Booth suggests that while greenmail “raises serious questions of fairness” among shareholders, it “may not be as great an abuse as is generally thought.” The raider's acquisition of stock, he observes, usually causes the market price to rise. This generates gain for the “shareholders most willing to sell,” those who profit from the raider's interest by disposing of

53. Macey & McChesney, supra note 13, at 18-19 (value of firm will be greater if control is placed in hands of current minority, new minority or third party).
54. Dennis, supra note 2, at 284.
55. Id.
56. Id.
58. Id. at 663.
their stock in a rising market. The raider's fellow shareholders may prefer to redeem the raider at a premium, rather than permitting him to gain control. In Professor Booth's words, "[g]reenmail may serve the interests of holdout shareholders if they stand to lose more by a transfer of control than the premium they must pay" to the raider. "As a counterbalance to management's discretion to propose a buyout," he observes, "greenmail can be viewed as beneficial rather than abusive." Other legal commentators have viewed greenmail less favorably, arguing that greenmail is unfair to the shareholders who do not receive it, and that greenmail is economically unjustified. Professors Gordon and Kornhauser, for example, argue that the Macey-McChesney scenario is "highly unlikely" and that, consequently, greenmail deserves condemnation as it "leads, in the aggregate, to shareholder welfare losses." Similarly, Professor Coffee criticizes greenmail as an entrenching tactic used by management of the target corporation to inappropriately perpetuate itself. Greenmail, he writes, "short-circuits the control contest" started by the raider, leaving existing management in place. In such cases, the "discipline of the takeover has been thwarted by the repurchase" of the raider's stock, a premature resolution of the takeover which leaves in place the target's managers. Professor Karjala concludes that "[g]reenmail can and should be prohibited." Among anti-greenmail commentators, however, there is significant disagreement as to the appropriate remedy. Professor Oesterle suggests that the courts are capable of handling green-

59. Id.
61. Booth, supra note 57, at 663.
62. See Gordon & Kornhauser, Takeover Defense Tactics, 96 Yale L.J. 295, 297 (1986) ('[T]arget stock buybacks are unlikely to increase shareholder wealth as a general matter and, on a shareholder wealth criterion, should not be permitted as a defensive tactic.').
63. Id. at 320.
65. Id. at 1290.
66. Id. at 1292. For other anti-greenmail commentary, see Greene & Junewicz, supra note 46, at 706-32; Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. Pa. L. Rev. 1, 31, 65 (1987); Note, Discrimination Against Shareholders in Opposing a Hostile Takeover, 59 S. Cal. L. Rev. 1319, 1336 (1986).
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mail cases under existing corporate law doctrines.\textsuperscript{68} Similarly, Professor Karjala believes that greenmail ought to be blocked by courts implementing “fiduciary duty considerations.”\textsuperscript{69} Others, skeptical of judicial decisionmaking in this area, would require the prior approval of the corporation’s shareholders before greenmail could be paid.\textsuperscript{70} For example, the Securities and Exchange Commission (SEC) Advisory Committee on Tender Offers would prohibit the payment of greenmail to any person owning stock less than two years unless the other shareholders approve.\textsuperscript{71} Yet a third approach is a statutory or regulatory prohibition on greenmail.\textsuperscript{72} Professor Weiss, embracing this alternative, would, in connection with a federal law on takeovers, forbid greenmail statutorily.\textsuperscript{73}

Not surprisingly, most of the litigation to date concerning greenmail has occurred in the Delaware courts or has applied Delaware law. In the leading decision, \textit{Unocal Corp. v. Mesa Petroleum Co.},\textsuperscript{74} the Delaware Supreme Court proscribed greenmail motivated by management’s desire to entrench itself while it condoned greenmail paid with the intent to protect corporate policy.\textsuperscript{75} In the court’s words:

\begin{quote}
[T]he principle of selective stock repurchases by a Delaware corporation is neither unknown nor unauthorized. . . .

. . . . If the board of directors is disinterested, has acted in good faith and with due care, its decision in the absence of an abuse of discretion will be upheld as a
\end{quote}

\textsuperscript{68} Oesterle, \textit{The Negotiation Model of Tender Offer Defenses and The Delaware Supreme Court}, 72 \textit{CORNELL L. REV.} 117, 134 n.69 (1986).

\textsuperscript{69} Karjala, \textit{supra} note 67, at 1502.

\textsuperscript{70} For a discussion of the effect of shareholder approval, see \textit{supra} notes 46-50 and accompanying text.


\textsuperscript{73} Id.

\textsuperscript{74} 493 A.2d 946 (Del. 1985).

\textsuperscript{75} Id. at 955.
It is also not surprising that the greenmail passing judicial muster has involved the payment of relatively small premiums. In *Polk v. Good*, for example, the Delaware Supreme Court, applying the *Unocal* standard, approved a settlement with reference to Texaco's purchase of Texaco stock owned by the Bass interests. The challenged redemption was characterized by the court as reflecting "a premium of approximately 3% over market." This, the court concluded, "seems reasonable in relation to the immediate disruptive effect and the potential long-term threat which the Bass group posed" to Texaco.

In contrast, greenmail involving larger premiums has met with unfavorable judicial response. Both *Heckmann v. Ahmanson*, which involved Walt Disney Production's redemption of Disney stock owned by the Steinberg interests, and *Fry v. Trump*, which involved payments by Bally Manufacturing Company to Donald Trump in redemption of Trump's Bally stock, illustrate judicial hostility towards greenmail involving large premiums. In *Heckmann*, the court affirmed a preliminary injunction granted to the complaining shareholders, holding that the shareholders had "established a reasonable probability of proving [that] breach of fiduciary duties" had occurred. Central to the court's conclusion was its observation that the Steinberg interests were bought out at "a price 50 percent above the market price following the [buy out] transaction." In *Fry*, the plaintiffs characterized the premium received by Trump as "over 20%." In response to Trump's motion to dismiss, the court concluded that the plaintiffs had stated various causes of action against Trump and the Bally directors.

B. *Golden Parachute Theoretical Issues*

Unlike greenmail, courts and commentators have generally

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76. *Id.* at 957 (citations omitted).
77. 507 A.2d 531 (Del. 1986).
78. *Id.* at 539.
79. *Id.* at 537.
80. *Id.*
84. *Id.* at 125, 214 Cal. Rptr. at 181.
86. *Id.*
recognized that particular golden parachutes may be justified.\textsuperscript{87} That recognition has been coupled with a sensitivity to the possibilities of management self-dealing. The most common defense of golden parachutes is that they minimize the conflict of interests between shareholders and managers when a corporation is the target of a takeover effort. This view suggests that corporate managers can more objectively evaluate takeover proposals if managers are assured that a takeover will not harm them individually. Freed by generous severance arrangements from anxiety about their own economic welfare, managers will be able to recommend their own displacement in favor of the raider if such displacement is in the shareholders’ best interests. More basically, defenders of parachute arrangements contend that in an environment distinguished by significant takeover activity, it is difficult or impossible to recruit and retain quality managers without extending to them the protections of golden parachutes.\textsuperscript{88}

In this vein, Professor Coffee suggests that golden parachutes make explicit corporations’ previously implicit promises to management of security and deferred compensation.\textsuperscript{89} In a quiescent corporate environment, he suggests, management enforced these implicit promises through its \textit{de facto} control of the board of directors. Given the prevalence of corporate takeovers, managers can no longer rely on their control of the board to enforce the corporation’s implied promises. Professor Coffee concludes that this creates the need for explicit contractual assurances to management of job security and deferred compensation, such as golden parachutes.\textsuperscript{90} Therefore, there is “legitimacy” to “some form of severance compensation” for corporate managers as well as “potential for abuse” in such arrangements.\textsuperscript{91}

Professor Williamson’s analysis of golden parachutes starts with the distinction between management skills that are firm-spe-
Without assurances of continuing employment, in his view, an executive will be reluctant to devote his career to the acquisition of skills useful only to a single employer. Golden parachutes permit managers to narrow the range of their employability by assuring them of generous severance compensation if anything happens to their relationship with the particular firm to which they have adapted their skills. Professor Williamson consequently views golden parachutes as appropriate for executives asked to develop firm-specific skills. He is, however, skeptical of such arrangements for managers with more generalized human capital because such managers can be more easily employed by a wide number of firms in the event of a takeover.

Professor Fischel also believes golden parachutes “may be beneficial in particular cases” to encourage managers to acquire “firm-specific skills.” Judge Posner has labelled golden parachutes one of the more “innocent” responses to a takeover threat. Such arrangements, he notes, may benefit shareholders “by reducing managers’ opposition to a takeover.” To Professor Macey, “[t]he value of golden parachutes is clear.” Such arrangements “reduce the conflict of interest between shareholders and managers during takeovers.” Parachutes also properly “compensate managers for the possibility that they will lose their jobs through corporate restructuring.”

To the detractors of golden parachutes, such arrangements are merely exercises in self-dealing by management. This perception is reinforced by instances of multimillion dollar severance payments hastily adopted in the middle of takeover fights. For some opposing golden parachutes, the management objectivity

93. Id.
94. Id. at 1218 n.63; see also O. Williamson, The Economic Institutions of Capitalism 314-16 (1985).
97. Id.
99. Id.
100. Id. at 187.
101. For a discussion of the issue of the good faith of directors, and whether good faith is relevant in defining “parachute payments,” see supra notes 15-19 and accompanying text.
allegedly assured by such arrangements is more properly viewed as the creation of perverse incentives for managers confronted with a takeover threat. How, they ask, can managers objectively assess a takeover proposal or defend shareholders' interests when managers will make an exorbitant amount of money if they arrange to have themselves fired? Others have suggested that golden parachutes are an improper defensive tactic used by target management to entrench itself by making a takeover more costly.

In this spirit, Professor Riger is highly critical of parachute arrangements, dismissing them as "parting gift[s] of corporate moneys without support in contract or corporate law." As to the various defenses of golden parachutes, he concludes, there is a "total lack of merit." Professor Gilson is among those troubled by the "perverse incentive[s]" created by golden parachutes. Professor Leebron similarly believes that such arrangements make target management less inclined to bargain over takeover terms. "Thus," he writes, "one could expect golden parachutes to lead not only to less frequent management opposition, but also to lower" prices for shareholders of the acquired corporation. Professor Rosenzweig agrees that golden parachutes reduce managers' incentives to conduct a vigorous auction of the target corporation so as to maximize the price received by the target's shareholders.

Just as commentators believe different remedies are appropriate in the greenmail context, opinion is divided as to the proper response to golden parachutes. Professor Oesterle believes existing doctrine adequate for the courts to police golden parachutes on a case-by-case basis, separating those permeated by self-dealing from those undertaken with appropriate concern for shareholders' welfare. Professor Coffee, in contrast, believes "a vague fiduciary standard" for golden parachutes "seems likely to produce much litigation and doubt, but little clear gui-

102. For the views of Professors Gilson, Leebron, and Rosenweig, see infra notes 105-08 and accompanying text.
104. Id.
107. Id.
dance or constraint." To create a bright line, he would subject all severance arrangements to shareholder approval "above some reasonable level (say, one year's compensation)." In a similar vein, Professor Siegel would require shareholder approval for any defensive tactic, including golden parachutes. The recommendations of the SEC Advisory Committee reflect a third approach, a legislative or regulatory response. The committee would prohibit the issuance of any golden parachutes once a tender offer has commenced. The SEC itself similarly favors a legislative ban on the creation or amendment of officers' and directors' compensation agreements during tender offers. Professor Weiss also favors prohibiting golden parachutes legislatively.

In the leading decision to date, Koenings v. Joseph Schlitz Brewing Co., the Wisconsin Supreme Court concluded that golden parachutes can be analyzed within existing contract doctrines. In the court's words: "[T]he term 'golden parachute' is not by itself legally significant, nor is it legally conclusive. It is merely descriptive of a certain type of employment contract given to top corporate executives and triggered by a change of corporate control."

The precise issue addressed in Koenings was the reasonability, and therefore enforceability, of the stipulated damages clause of the parachute agreement. In upholding the stipulated damages provision as reasonable, the court stressed the employer's need "to quell the fears of its employees that they may lose their jobs

110. See Coffee, supra note 64, at 1264.
111. Id.
113. See Hearings, supra note 71, at 86,682 (advisory committee recommendation 38 deals with golden parachute arrangements after commencement of tender offer).
114. Id. The committee would also require advisory shareholder votes as to golden parachutes adopted when no tender offer is pending. Id.
115. See Tender Offer Reform Act of 1984, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,630. The position of the SEC is not precisely the same as that of the advisory committee. The SEC does not favor advisory shareholder votes. Moreover, the SEC, for purposes of proposed legislation, would define all officers' and directors' compensation arrangements as golden parachutes whether or not dependent on a change of control. The committee defined parachute arrangements as those compensatory arrangements triggered by a change of control. Id.
116. Weiss, supra note 72, at 1730.
118. Koenings, 126 Wis. 2d at 360, 377 N.W.2d at 599.
should a takeover occur." Similarly, in *International Insurance Co. v. Johns*, the district court, applying Florida law, upheld parachute arrangements designed to retain "a talented management group" during a takeover. In response to the claim that the parachutes wasted corporate assets, the circuit court affirmed and held the arrangements, approved by "a disinterested board" and a majority of the corporation's shareholders, to be protected by the business judgment rule. Moreover, in *Buckhorn, Inc. v. Ropak Corp.*, the court, applying Delaware law, held that severance payments extended to management as golden parachutes passed muster under *Unocal*, but that stock options extended as parachutes did not.

Permeating all discussion of greenmail and golden parachutes is the overarching issue of federalism. The concern is the extent to which matters such as greenmail and golden parachutes ought be left to state regulation as part of the states' traditional primacy in matters of corporate law. The argument for state regulation is ultimately an appeal for decentralized decision making and for experimentation with alternative legal schemes. On the other hand, advocates of federal standards believe that, given the mobility of corporations among states, the weakest state rule will eventually become the national norm.

In adopting sections 280G, 4999 and 5881, Congress came down firmly on the side of federal regulation.

**IV. Sections 280G, 4999 and 5881: An Outline**

The Revenue Act of 1987 added section 5881 to the Internal Revenue Code, and the Technical and Miscellaneous Revenue Act of 1988 amended that section. Section 5881 imposes a

119. *Id.* at 369, 377 N.W.2d at 603.
121. *Id.* at 1239.
122. *International Insurance*, 874 F.2d at 1460-61.
124. *Id.* at 232-33.
126. See also Moore & Schuck, *Tax Aspects of Defensive Strategies to Corporate Takeovers*, 69 J. Tax'n 212, 214 (1988). For further background on § 5881, see Lustig, *The Emerging Role of the Federal Tax Law in Regulating Hostile Corporate Take-
separate, additional tax of fifty percent upon the "gain or other income" realized by the recipient of a greenmail payment. In light of current maximum effective income tax rates approaching forty percent, section 5881 can result in the cumulative taxation of greenmail at a rate of almost ninety percent. Even if greenmail takes a form which is tax-free under normal income tax rules, the fifty-percent levy of section 5881 applies. If, for example, greenmail is paid through a stock-for-stock exchange, tax-free under section 368, section 5881 nevertheless imposes its fifty-percent tax on the difference between the fair market value of the stock paid as greenmail and the basis of the greenmail recipient in the stock surrendered by him.

For purposes of section 5881, a payment to a shareholder constitutes greenmail if three criteria are satisfied. First, at the time of the agreement to make the payment, the greenmailer must have owned his stock for less than two years. This aspect of section 5881 reflects the perception of the greenmail problem as one of excess payments to transient investors. If a shareholder has held his stock for at least twenty-four months, section 5881 does not impose its fifty-percent levy.

Second, section 5881 applies only if the greenmailer, or a person related to or "acting in concert" with him, made or threatened a tender offer requiring registration with the SEC or with a state securities authority. This provision reenforces the


I.R.C. § 5881(a) (West 1989).

For corporations, the five-percent surcharge of § 11(b) can result in an effective tax rate of 39% on some income.

Adding regular income tax liability, as discussed in supra note 128, to the tax imposed by § 5881 would result in total tax of 89%.

I.R.C. § 5881(d) (West 1989). This section states: "The tax imposed by this section shall apply whether or not the gain or other income referred to in subsection (a) is recognized." Id.

§ 5881(b)(1). For the pertinent text of this section, see supra note 22.

Id. § 5881(b)(2), (c)(1). Section 5881(b)(2) states:

For purposes of this section, the term "greenmail" means any consideration transferred by a corporation (or any person acting in concert with such corporation) to directly or indirectly acquire stock of such corporation from any shareholder if—

at some time during the 2-year period ending on the date of such acquisition—

(A) such shareholder,
(B) any person acting in concert with such shareholder, or
(C) any person who is related to such shareholder or person de-
perception of the greenmail problem as the transient raider. Mere payment does not constitute greenmail. Rather, section 5881 defines a payment as greenmail only if it is extracted coercively through an actual or threatened tender offer. Interestingly, section 5881’s definition of a tender offer encompasses friendly, as well as hostile, offers.

Finally, a payment constitutes greenmail under section 5881 only if offered selectively. This aspect of section 5881 defines the greenmail problem as the unequal treatment of shareholders. If all shareholders are offered the same terms for the purchase of their stock, there is no problem of equity and therefore, under section 5881, no greenmail.

Section 5881 spawned at least three interpretive disputes after its adoption in 1987, two of which were addressed in the Technical and Miscellaneous Revenue Act of 1988. An issue arising under section 5881 in its original form was the status of payments by “white knights,” investors embraced by management as an alternative to the unwanted raider. Suppose, for example, that management of a target corporation locates a friendly investor to purchase the raider’s stock at a gain to the raider. In its initial form, section 5881 did not include the payment from the white knight to the raider within the definition of greenmail because the payment did not come from the corporation itself. The Technical and Miscellaneous Revenue Act of 1988 amended section in subparagraph (B), made or threatened to make a public tender offer for stock of such corporation . . . .

Id. § 5881(b)(2). Section 5881(c)(1) states: “The term ‘public tender offer’ means any offer to purchase or otherwise acquire stock or assets in a corporation if such offer was or would be required to be filed or registered with any Federal or State agency regulating securities.” Id. § 5881(c)(1).

133. Id. § 5881(b)(2)(C). For the relevant text of this section, see supra note 132.

134. See I.R.C. § 5881(b)(2), (c) (West 1989).

135. Id. § 5881(b)(3). To avoid the tax imposed by § 5881, a purchase of stock must be, according to the statute, pursuant to an offer “made on the same terms to all shareholders.” Id. Presumably, this means all shareholders owning the same class of stock. If, for example, the common stock owned by a raider is being redeemed, the policies animating § 5881 are satisfied if the same offer is made to the other common shareholders. It should not be necessary for the offer to be made to preferred stockholders. However, the literal language of the statute is susceptible to the interpretation that the offer must be made to the owners of preferred stock as well.

136. Id.

137. See Dionne, Will the Greenmail Tax Apply to White Knights?, 39 TAX NOTES 1145 (1988); Levin, Greenmail Tax Traps for the Unwary, 41 TAX NOTES 229 (1988); Letter from Robert Willens to the Editor, 39 TAX NOTES 623 (1988) (arguing that greenmail should not apply to white knights).
tion 5881 to encompass payments by those "acting in concert" with the target corporation within the definition of greenmail. This formulation will require the Internal Revenue Service (IRS) and the courts to determine the level of cooperation necessary for third parties to be acting concertedly with the target corporation.

Second, concern had been raised as to the applicability of section 5881 in cases where greenmail is structured as a dividend for federal income tax purposes. Section 5881 originally defined greenmail only as "gain," a term which, in the arcana of federal tax lore, probably excluded payments when structured as dividends under the Internal Revenue Code. The Technical and Miscellaneous Revenue Act of 1988 amended section 5881 to clarify that its supplemental fifty-percent tax applies to any income received by the greenmailer including payments from the target corporation taking the form of dividends.

Finally, the notion of a "threatened" tender offer has been criticized as too vague to be workable. One prominent commentator asks of section 5881: "If Carl Icahn has dinner with the Chairman of Texaco and tells the latter that differences must either be worked out or he (Icahn) will make a tender offer to Texaco, is that a threat?" To make the quandary even more difficult, suppose the investor with a reputation for hostile takeover efforts does not feel it necessary to articulate his options. The renowned investor's mere purchase of stock may, without any explicit statement on his part, be perceived as a threat to management. Can a potential raider's reputation for takeover activity be enough of a threat to trigger section 5881? Or can it be said that the proponent of a friendly tender offer has "threatened" within the meaning of section 5881?

My own sense is that these interpretive problems are not so difficult or unusual as to make section 5881 unworkable. The federal income tax involves comparable concepts requiring interpretation and development. For example, the Code itself does not identify which expenses constitute medical care or what outlays qualify as charitable. While there is always skirmishing between taxpayers and the IRS at the borderlines of these concepts, the system on balance works tolerably well. Within a reasonable


139. See id.

140. See Dionne, supra note 137, at 1148.
time, regulations, rulings and cases can be expected to provide acceptable guidance as to the contours of section 5881.

Section 280G was originally added to the Code by the Tax Reform Act of 1984, and was subsequently revised by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. Section 280G restricts the deductibility of parachute payments made to certain "disqualified individuals": corporate officers, shareholders and highly-compensated personnel. This approach casts the golden parachute problem as self-dealing. Under section 280G, payments to rank-and-file employees generally do not constitute nondeductible parachutes, presumably because these employees do not control the corporation and therefore do not possess the power to self-deal.

To determine if a payment triggers its restrictions, section 280G requires the calculation of the disqualified individual's average annual income from the corporation for the prior five years. For purposes of determining this "base amount," taxable fringes are included but tax-free benefits are not. For example, the base amount includes employer-provided whole life insurance coverage but omits employer contributions to qualified pension and profit-sharing plans.

Payments to disqualified individuals trigger the deductibility restrictions of section 280G if such payments (a) are "in the na-


142. I.R.C. § 280G(c) (West 1989). "Disqualified persons" include both employees and independent contractors, such as outside directors who are officers, shareholders, or highly-compensated individuals. Id. Under § 280G(c), a person is deemed highly-compensated if he is among the highest paid one percent of the corporation's personnel or, if he is among the 250 highest paid personnel. Id.

143. See id. § 280G(b)(3), (d). If the disqualified person has worked for the corporation less than five years, his average annual income is determined for the time he has worked for the corporation. Id. § 280G(d)(2).

144. Id. § 280G(d)(1)(B).
ture of compensation," (b) are three or more times the recipient's base amount and (c) are "contingent" upon a change of control of the paying corporation.\footnote{145} This definition formulates the parachute problem as excessive payments triggered by changes of corporate control. If severance payments are made in installments, they are discounted to present value for the purpose of determining if they exceed three times the disqualified individual's base amount.\footnote{146} For purposes of section 280G, payments of property are treated at fair market value.\footnote{147} Payments pursuant to agreements reached within one year before actual changes of corporate control are presumptively treated as contingent upon the subsequent change of control.\footnote{148} Section 280G thus indicates that parachutes established in anticipation of or during takeover fights are likely to be permeated by management self-dealing.

Section 280G's definition of a parachute payment is subject to several qualifications. Related corporations are, for purposes of section 280G, treated as a single employer.\footnote{149} Qualified pension and profit-sharing plan distributions are excluded from the definition of a parachute payment.\footnote{150} Payments to disqualified individuals fall outside the ambit of section 280G if they can be

\footnote{145} Id. § 280G(b)(2)(A). The statute establishes three disjunctive tests for identifying a change of control. A change "in the ownership" of the corporation satisfies the statute as does a change of "effective control." \textit{Id.} As a third alternative, a payment is deemed contingent upon a change of control if such payment is triggered by a change "in the ownership of a substantial portion of the assets of the corporation." \textit{Id.} § 280G(b)(2)(A)(i)(II).

The proposed regulations under § 280G define a change in ownership as the acquisition by "any one person, or more than one person acting as a group" of more than 50% of the voting stock of the corporation or of more than 50% of the fair market value of all of the corporation's stock. 54 Fed. Reg. 19,390, 19,402 (1989) (proposed May 5, 1989).

The proposed regulations create a rebuttable presumption of a change of control if, within a 12-month period, "one person, or more than one person acting as a group" acquires at least 20% of a corporation's voting stock. The proposed regulations also create such a presumption if, within a 12-month period, a majority of the corporation's directors are replaced by persons not endorsed by incumbent management. \textit{Id.} at 19,402-03.

The proposed regulations define a change of substantial asset ownership as the acquisition, by a previously unrelated person or group, of one-third or more of the assets of a corporation. \textit{Id.} at 19,403.

For all of these tests, the regulations adopt the attribution rules of § 318(a). \textit{Id.} at 19,402.


\footnote{147} Id. § 280G(d)(3).

\footnote{148} Id. § 280G(b)(2)(C). In \textit{Sullivan v. Easco Corp.}, 662 F. Supp. 1396 (D. Md. 1987), the court held this presumption overcome when the payments were made prior to the actual change of control.

\footnote{149} I.R.C. § 280G(d)(5) (West 1989).

\footnote{150} Id. § 280G(b)(6).
proven reasonable compensation for services actually performed or to be performed in the future.\textsuperscript{151} All payments "made pursuant to an agreement which violates any generally enforced securities laws or regulations" are automatically parachute payments.\textsuperscript{152} Section 280G excludes outlays by certain small businesses from its coverage.\textsuperscript{153} Payments also fall outside the ambit of section 280G if the stock of the paying corporation is not readily tradeable and if the payments are approved by a three-quarters vote of adequately-informed shareholders.\textsuperscript{154}

If a payment triggers the restrictions of section 280G, the excess over the disqualified individual's base amount becomes nondeductible to the paying corporation.\textsuperscript{155} Under this scheme, relatively small differentials in severance compensation can produce quite discrepant tax results. Assume, for example, an employee-officer of a publicly-traded corporation earns a base amount of $100,000. Assume further that a change of corporate control triggers a severance payment of $299,999 to him. No amount of this $299,999 represents a distribution from a qualified plan. Absent a violation of securities laws or regulations, section 280G would not apply since the employee-officer's severance compensation falls one dollar short of three times his base amount.

Suppose now the same example with severance compensation of $300,000. Unless it can be demonstrated that $300,000 constitutes reasonable compensation for services, the extra dollar triggers section 280G.\textsuperscript{156} Consequently, of the total severance compensation, only $100,000, the employee-officer's base amount, is deductible to the corporation. An incremental dollar of severance payment results in the nondeductibility of $200,000, the excess over the base amount.

When section 280G applies, section 4999 also imposes a twenty-percent excise tax upon the disqualified individual, in addition to his regular income tax liability from the parachute pay-

\begin{flushleft}
\textsuperscript{151} Id. § 280G(b)(4).
\textsuperscript{152} Id. § 280G(b)(2)(B).
\textsuperscript{153} Id. § 280G(b)(5)(A)(i).
\textsuperscript{154} Id. § 280G(b)(5)(A)(ii), (b)(5)(B). For the text of these sections and a discussion of shareholder approval, see supra notes 46-50 and accompanying text.
\textsuperscript{155} I.R.C. § 280G(a), (b)(1) (West 1989).
\textsuperscript{156} See id. § 280G(b)(2)(A)(ii) ("parachute payment" if compensation which is contingent on change is three times the base amount).
\end{flushleft}
ment.\textsuperscript{157} To continue our example, the hypothetical employee-officer receiving $300,000 would, in addition to his normal income tax liability, pay an excise tax under section 4999 of $40,000 (twenty percent of $200,000).

Given an effective maximum personal income tax rate of thirty-three percent,\textsuperscript{158} the combination of regular tax liability and the section 4999 levy can result in tax of over fifty percent to the recipient on the excess parachute payment. Given a maximum effective corporate income tax rate of thirty-nine percent, the cumulative effect of nondeductibility to the corporation, regular income tax to the disqualified individual and section 4999 can be tax of over ninety percent of the excess parachute payment.

V. APPLYING TAX POLICY CRITERIA TO SECTIONS 280G, 4999 AND 5881

A. Overview

Over the years, tax policy analysts have developed numerous criteria for identifying appropriate tax provisions. Some of these tests primarily reflect economists' concerns about the impact of taxes on markets and economic efficiency. Other criteria principally embody the interests of academic lawyers. Some tax policy criteria are accepted by a broad spectrum of scholars, whereas other tests do not enjoy such wide acceptance.

I will now canvass these tax policy criteria and apply them to sections 280G, 4999 and 5881. I conclude that these sections of the Code satisfy none of the tests for identifying an appropriate tax provision.

B. Defining the Tax Base

The most compelling justification for a tax provision is that it helps define the base of the tax. Every tax allocates the burden of government in accordance with a particular base, such as retail sales, real property or net income. Identifying and clarifying that base is the most fundamental task of the tax law.\textsuperscript{159}

\footnotesize{157. Id. § 4999(a).}

\footnotesize{158. This effective rate is applied to income with respect to which the five-percent surcharge of § 1(g) applies.}

\footnotesize{159. In contemporary tax policy literature, the question of tax base definition most commonly arises in the context of tax expenditure analysis, a perspective premised upon the distinction between normative tax provisions defining the tax base and statutory measures using the tax system for other purposes. For an exhaustive treatment of tax expenditures, see S. Surrey & R. McDaniel, Tax Expenditures (1985); see also J. Dodge, The Logic of Tax 290 (1989). For}
Section 162(a) of the Code, authorizing the deduction of ordinary and necessary trade and business expenses, is a classic case of a base-defining tax provision. Income is the net increment in the taxpayer’s resources available for consumption and savings. To yield this net figure, gross receipts must be reduced by the costs of producing those receipts. Section 162(a) plays a fundamental role in determining the taxpayer’s income tax liability, converting gross receipts into taxable (i.e., net) income, the base of the tax.

Like most legal concepts, every tax base involves definitional problems at the margin. For example, is a temporary metal storage shed affixed to the ground real property, subject to tax under a real estate-based levy, or is it personal in nature, immune from a real property tax? Much of the Code addresses this type of base-defining problem. Consider an individual’s moving expenses when he changes jobs. Ought these costs be deductible as business-related? Or should such expenses be declared nondeductible as personal outlays? Section 217 addresses this issue by defining in a fairly objective manner when moving expenses are deductible in the calculation of taxable income.

It is not always easy to determine if a particular tax measure is base-defining in nature. Professor Andrews, for example, has argued that the Code’s medical and charitable deductions are largely base-defining, clarifying the net increase in the taxpayer’s personal resources available for taxation. However, most scholarly opinion is to the contrary, holding that sections 213 and 170 do not clarify the base of the income tax but erode it by subsidizing charitable gifts and medical outlays. Similarly, I believe the Code sections relative to qualified pension and profit-sharing plans can be viewed as implementing our normative understanding of an income tax. Most commentators disagree, characterizing the qualified plan provisions of current law, not as base-defining, but as a tax subsidy for particular types of retirement savings.

\[\text{a somewhat different perspective, see Zelinsky, }\]
\[\text{Efficiency and Income Taxes: The Rehabilitation of Tax Incentives, 64 Tex. L. Rev. 973 (1986) [hereinafter Efficiency];}\]
\[\text{and Zelinsky, }\]
\[\text{161. See id. at 310 nn.2-3.}\]
\[\text{163. See id. at 315, 322-26.}\]
Whatever disagreements exist as to the characterization of particular provisions, there is no doubt that a tax law must contain the measures appropriate to define the tax base. Can sections 280G, 4999 and 5881 be justified as base-defining provisions which assist in the proper determination of net income? The answer is no. Those who drafted and sponsored these sections intended not to define income more precisely, but to regulate corporate behavior. The accompanying committee reports indicate that sections 280G, 4999 and 5881 were intended to curtail perceived abuses of corporate management, not to clarify the concept of income.

The text and structure of section 5881 confirm that it was not added to the Code to refine the notion of income. Section 5881 operates completely independently of the income tax base. Greenmail payments excludable from gross income are nevertheless subject to the fifty-percent tax of section 5881. Section 5881 leaves unaffected, and operates apart from, the Code's definition of income.

Even if viewed as part of the income tax, section 5881 is too underinclusive to be considered a reasonable base-defining measure. Section 5881 operates in highly limited circumstances, selective payments to short-term investors associated with tender offers. There is no problem of income definition in this setting which would not also exist in the case of payments to long-term shareholders or to investors who threaten proxy fights, situations not covered by section 5881.

Section 4999 also fails muster as an exercise in tax base definition. Section 4999 does not purport to include parachute payments within income or to otherwise clarify the reach of the income tax. Parachute payments are already taxable under section 61 which includes compensatory receipts within income. Section 4999, therefore, operates independently of, and leaves unaffected, the rules for defining taxable income in the Code.


165. Id. ("The committee believes that corporate acquisitions that lack the consent of the acquired corporation are detrimental to the general economy. The committee therefore believes it is appropriate . . . to remove tax incentives for corporate acquisitions, . . . [and] create tax disincentives for such acquisitions.").

166. I.R.C. § 5881 (West 1989). For relevant text of this section, see supra note 132.


168. Id. § 61(a)(1).
Section 4999 is also too narrow in scope to be taken seriously as an exercise in tax base definition. Section 4999 applies in very limited circumstances, such as when disqualified individuals receive control-related severance payments equalling or exceeding three times their respective base amounts. This highly-focused formula is not responsive to any apparent problem regarding the definition of income.

Of the three Code sections, section 280G is most plausibly defended as base-defining because it is part of the structure of the income tax. Arguably, section 280G might be justified as an evidentiary measure, augmenting the Code's deduction for reasonable compensation through a rebuttal presumption that certain payments are nondeductible. From this perspective, payments triggering the mechanical definition of a parachute under section 280G(b)(2) are thereby classified as suspect. Section 280G(b)(4) then permits a taxpayer to rebut this presumption and prove the reasonability of such payments. Section 280G, under this theory, is an evidentiary adjunct to the normal income tax rules of section 162.

Ultimately, this characterization of section 280G is unpersuasive. There are no unusual difficulties applying the Code's general rules in the Code about unreasonable compensation to parachute payments. In the case of the typical golden parachute, it is easy to find the normal indicia of nondeductible compensation under section 162. The parachute payee experiences a dramatic increase in compensation from his employer while ceasing to perform services for it. This is a classic situation in which the regular rules under section 162 adequately identify unreasonable compensation. It is not clear why these rules would require augmentation in the form of section 280G.

Moreover, as a provision addressing the issue of unreasonable compensation, section 280G is seriously underinclusive as to the circumstances in which it operates and to the persons with reference to whom it operates. Section 280G is triggered only if a severance payment "is contingent" upon a change of control of the paying corporation. Moreover, section 280G only operates with reference to the highest corporate elite. These contours are

169. Id. § 4999. Section 4999(b) refers to § 280G(b) for its definition of "excess parachute payment." Id.
170. Id. § 280G(b)(2)(A)(i). For the relevant text of this section, see supra note 44.
evidently responsive to a definition of the parachute problem as management self-dealing in takeover settings.

However, these provisions make no sense if section 280G is part of the normal unreasonable compensation rules. If it is difficult to apply section 162 to severance payments, that is the case whether or not the payments are triggered by a change of control and whether or not the payments are to disqualified individuals. Section 280G excludes from its ambit parachute payments by many, if not most, closely-held corporations. However, the reasonable compensation problem has traditionally been considered worst in that context.

The contours of section 280G correspond to a definition of the parachute problem as a matter of management self-dealing in the takeover of publicly-held companies. Those contours do not correspond to any apparent problem in implementing the normal prohibition on the deductibility of unreasonable compensation.

To summarize, sections 280G, 4999 and 5881 cannot be justified as provisions which define the income tax base. Rather than refining the notion of income, these measures evidently constitute penalties for engaging in corporate behavior Congress sought to restrict.

C. Taxes and Externalities

There is broad agreement that taxes may be used properly to correct the market failure resulting from externalities, benefits and costs affecting third parties. Economic decision makers typically ignore the effects of their transactions on bystanders. Therefore, they produce or consume more or less than is appropriate considering the welfare of those bystanders.

In some cases, third parties may bargain with decision makers to reduce or increase externalities. A homeowner, for example, may subsidize the cost of painting his neighbor's adjacent

171. I.R.C. § 280G(b)(5) (West 1989). For the text of this section, see supra note 49.


house if that painting will enhance the value of the homeowner's own property.

Frequently, however, there are too many persons creating and receiving externalities for bargaining to occur efficiently. In a crowded area with numerous houses, hundreds of bilateral bargains would be required if each homeowner were to compensate for the painting of all the properties whose conditions affect his own. Some homeowners would choose to freeload, neither painting their own homes nor compensating their neighbors, but still benefitting from the improvement in property values caused by others.

In such a setting, collective action becomes more efficient than bargaining over externalities. Instead of myriad bilateral transactions among homeowners, the city might pass an ordinance establishing minimum standards for the outside appearance of houses. Alternatively, the municipality might subsidize the expense of painting from public funds or impose a tax on buildings not properly painted. This last possibility suggests the propriety of externality-related taxes.174

The classic case of a tax-reducing externality is the effluent charge, a levy on pollution above prescribed levels. Suppose a river can naturally absorb 1,000 gallons of discharge a day while ten factories pour into the river a daily total of 1,500 gallons. One response might be a law mandating the adoption of particular technologies to reduce discharge to the level the river can absorb. An alternate approach is to require the reduction of pollution while permitting each factory to select the means most appropriate for it. To implement such an approach, a tax could be assessed on each factory for discharge in excess of 100 gallons per day. If the tax is set at the proper rate, each factory will reduce its discharge to 100 gallons daily, the amount corresponding to the river's natural capacity.

The notion of externality-mitigating taxes has not been with-

174. Much of the literature about law and economics is devoted to issues related to bargaining over externalities. See W. HIRSCH, LAW AND ECONOMICS: AN INTRODUCTORY ANALYSIS 14 (2d ed. 1988) ("[A]n externality exists whenever the decision of such economic actors . . . affects, through nonmarket transactions, the utility or production functions of other economic actors."); N. MERCURO & T. RYAN, LAW, ECONOMICS AND PUBLIC POLICY 43 (1984) ("In analyzing the manner in which law and economics interact, it is necessary to study the problem of externality."); R. POSNER, ECONOMIC ANALYSIS OF LAW 232 (3d ed. 1986) ("[T]he most dramatic function of the common law is to correct externalities . . . .").
out its critics. Some have suggested that the identification of third-party benefit and harm is too subjective a guide for public policy. Norman Ture, for example, has argued that, in the debate about liquor and cigarette taxes, the concept of externalities has been stretched unacceptably so as to label social, rather than private, virtually all costs associated with alcohol and tobacco. Others have argued that it is frequently impractical to identify the tax rate necessary to cause economic actors to abate the externalities they are causing.

Despite these criticisms, the notion of externalities is central to contemporary microeconomic theory while the concept of externality-abating taxes holds an important place in current tax policy analysis. The issue arises: Can sections 280G, 4999 and 5881 be justified on the grounds that they mitigate negative externalities? I think not. In the first instance, some believe that greenmail generates positive externalities, such as the disciplining of corporate managers chastened by the experience of their colleagues. From this perspective, the market does not produce too much greenmail but too little. Corporate raiders, when determining to invest their resources in the identification of undervalued firms, will not calculate these broader beneficial effects from their takeover activity. Section 5881 is thus perverse, penalizing raiders for the creation of third-party benefits in the form of en-

175. Ture, Social Policy and Excise Taxes, 40 TAX NOTES 737, 740 (1988) ("Any tax increase should have the broadest possible reach in the population, and its burden should be clearly identifiable by those paying the additional taxes. Taxes that are paid only by some of us or are hidden from us cannot effectively perform the basic function of taxes—to price out government services and activities.").

176. Id. at 738. The author noted:
[The] argument that excises on tobacco products and alcoholic beverages are consistent with the social goal of reducing the consumption of these items in order to reduce the health hazards and social costs they impose . . . depends, clearly, on whether public policy should be concerned with smoking and the consumption of alcoholic beverages, which, in turn, depends on showing that the production, sale, or consumption of these products imposes costs on others. It also depends on demonstrating that imposing excises on the production or sale of these products effectively addresses the alleged social cost problem.

177. Id. ("The lost time at work, the lost pay, the lost vacation time, the higher medical bills, if any, are costs the smoker bears; they are not costs for society.").

178. Id. at 739. On the subject of raising the gasoline excise tax, the author noted: "It challenges credulity that the tax-writing public policymakers have better information for producers and consumers to rely on in their respective decision making than is provided by the extremely efficient and sophisticated private petroleum market." Id.
hanced management performance throughout the economy. From this vantage, greenmail-producing activity is like house painting, to be encouraged, and not like pollution, to be abated. A positive view of golden parachutes also suggests that such arrangements should be promoted or at least left untouched by the tax law, not discouraged through extra taxation.

From a hostile view of greenmail and golden parachutes, there is also no persuasive externalities defense of sections 280G, 4999 and 5881. The asserted harm to shareholders from greenmail and parachute payments is the alleged waste of corporate assets. It is difficult to characterize these costs as externalities—harm imposed upon third-party bystanders. Shareholders ultimately control the corporation. If shareholders do not want greenmail or parachute payments made with their money, the shareholders can prevent it by removing management or forbidding greenmail and parachute arrangements via charter amendments. The asserted costs of greenmail and parachute payments are controllable by the shareholders, not imposed on them as helpless third parties.

One perspective on the modern business enterprise dismisses as naive the notion that shareholders in fact control the corporation they own and nominally govern.179 Asserting control of a widely-held corporation is expensive, for it requires uncoordinated stockowners to organize themselves and communicate with one another. For most shareholders the effort will not justify the expense. The net result, according to this argument, is management effectively unfettered from shareholder control.

From this vantage, greenmail and parachute payments are properly viewed as externalities: costs imposed by autonomous corporate management upon uncoordinated, essentially helpless third parties, the shareholders. Since it is not efficient for shareholders to organize to discipline management, collective action like a housing ordinance or a pollution tax becomes necessary. Sections 280G, 4999 and 5881 represent the result of such action.

This defense of sections 280G, 4999 and 5881, however, ultimately fails for two reasons. The first is the existence of large institutional shareholders who take their legal rights of control

179. See Coffee, supra note 89, at 75-76. Recent thought "has rejected the view of the firm as 'owned' by the shareholders in favor of a view that conceives of the firm as an equilibrium position achieved as the result of bargaining among the various participants, including managers, shareholders, and creditors." Id. at 76 (footnote omitted).
seriously. The benefits for most individual investors may be insufficient to justify a proxy fight against greenmail-paying management or for a charter change outlawing golden parachutes. The stakes for institutional shareholders, however, are much larger. Given the magnitude of their holdings, a few pension plans or foundations can readily invoke the proxy system in an effort to stop greenmail and parachute payments. Institutional shareholders do not need Congress to coordinate their efforts or to act on their behalf. The threat of institutional shareholders to sell their stock can also have a sobering effect on management.

Consider, for example, the furor arising from the redemption by General Motors of its stock owned by H. Ross Perot. Dissatisfied institutional shareholders did not need Congress to defend their interests. Within days, the president of General Motors was explaining the redemption to the institutions owning its stock. Whether or not the institutions were correct to accept his explanation, General Motors management took its large stockholders seriously indeed.

Second, if greenmail and parachute payments are viewed properly as costs imposed by uncontrolled management upon helpless shareholders, sections 280G, 4999 and 5881 are too underinclusive to remedy the problem. Section 5881 does not apply when the greenmail recipient has held his stock for more than twenty-four months. Why do shareholders need Congress' protection from management when stock is redeemed from short-term, but not long-term, shareholders? Section 5881 is only operative if the recipient of greenmail has, directly or indirectly, participated in a tender offer or threatened such an offer. If management can inflict costs upon shareholders with impunity, this restriction makes no sense. Should not Congress also protect shareholders when the greenmailer threatens a proxy fight, or if the greenmail recipient has made no threat at all, but is nonethe-

183. See supra note 132.
less redeemed for management’s self-interested sense of security? Section 280G applies only when excess severance compensation is paid in connection with a change of corporate control.184 Why do shareholders need protection from management in the case of such severance payments, but not when severance compensation is unrelated to a change of control?

In short, viewing shareholders as helpless victims of management proves too much. If excessive redemptions and severance payments are costs imposed by irresponsible management upon powerless stockowners, there is no reason for Congress to limit its concern to the highly-specific situations identified in sections 280G, 4999 and 5881.

A final externalities-based defense of section 5881 views greenmail as imposing third-party costs not on the shareholders of the paying corporation, but on other participants in the economy. Greenmail, the argument asserts, causes corporations to borrow excessively or to dispose of assets improvidently.185 While shareholders of the greenmail-paying corporation can protect themselves, the dislocation from greenmail injures third parties who are without control over the decision to pay greenmail.186 Such third parties potentially include customers, suppliers and employees of the greenmail-paying corporation and the communities in which the corporation is located. Therefore, section 5881 is needed to protect these helpless third parties from the disruptive effects of greenmail.187

One perspective views corporate “dislocation” as often bene-

184. For a discussion of § 280G, see supra notes 142-56 and accompanying text.

185. See Note, supra note 13, at 1049 & n.18; see also Easterbrook & Fischel, The Proper Role of a Target’s Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1175 (1981); Macey & McChesney, supra note 13, at 32-33 & n.75. Yet whenever management faces the threat of a takeover, it is likely to divest itself of the cash or assets desired by the bidder. See Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer’s Role in Corporate Governance, 84 COLUM. L. REV. 1145, 1242-43 & n.299 (1984).

186. McGee, Mergers and Acquisitions: An Economic and Legal Analysis, 22 CREIGHTON L. REV. 665, 675 (1989). “Consumers are . . . harmed because blocking a takeover (through the use of greenmail payments) prevents the new owners from using the acquired assets more efficiently, which would lead to higher quality products or services at lower prices.” Id. But see Easterbrook & Fischel, supra note 185, at 1190-91. The duty of the director of a target company is to operate efficiently and maximize the return to shareholders. See id. at 1191. In light of this duty, some scholars question whether the director has any duty to consider the interest of such non-investor groups as employees, customers, creditors and the community as a whole. See id. at 1190.

187. Externalities of this sort have recently become a topic of interest to legal scholars. See, e.g., Macey, supra note 51.
ficial for the economy. Some observers maintain that disposition of corporate assets can lead those assets into the hands of more productive owners and managers. 188 Debt can lead to more efficient operation of a corporation, pressuring management to achieve economies in order to pay interest. 189

From a less benign view of corporate dislocation, the terms of section 5881 are seriously underinclusive and may actually exacerbate the disruption associated with corporate takeovers. If Congress' concern is the impact of takeover activity on third parties, such as the communities in which corporate facilities are located, there is no reason for Congress to limit its attention to the dislocation caused by greenmail. On the contrary, greenmail may be viewed as among the least disruptive of the possible outcomes of a takeover struggle. Far more likely to affect third parties are takeovers which are consummated.

Greenmail leaves existing management in power and thereby protects to a degree the decisions and policies of incumbent management. On the other hand, the raider, if he assumes control of the target corporation, has no commitment to the target's status quo. Rather, the raider has mounted a raid premised on the need to alter the practices of current management. Greenmail probably carries less potential for disruptive effects upon third parties than does permitting the raider to take control and implement his pledge to reorient the target corporation.

Moreover, section 5881 condones, and perhaps encourages, the redemption potentially causing the greatest dislocation—a redemption available to all shareholders. Such a redemption carries the largest potential for dislocation because in such a setting, the corporation must borrow or expend, not just enough to satiate the raider, but additional funds to redeem other stockowners as well. Section 5881 might cause a corporation to broaden its redemption to all stockholders to avoid the greenmail tax. Section 5881 is thus an irrational response if the concern is the dislocating effects of greenmail upon third parties.

In sum, section 5881 is, at a minimum, a seriously underinclusive response to the dislocation caused by corporate takeovers,

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188. See Easterbrook & Fischel, supra note 185, at 1182-92. Some commentators argue that moving productive assets to higher-valued uses and to the hands of better managers benefits society. See id. at 1182. This dislocation of assets is socially desirable because it occurs in an active takeover market, which "simultaneously provides an incentive to all corporate managers to operate efficiently and a mechanism for displacing inefficient managers." Id. at 1184.
189. See id. at 1182-92.
a penalty tax on one of the least disruptive outcomes of a takeover fight—greenmail. Section 5881, by discouraging greenmail, may cause raids to be consummated which otherwise would not. Section 5881 may thus increase the extent of takeover-caused dislocation for third parties since a completed takeover generally carries greater disruptive potential than greenmail.

To summarize, the notions of externalities and of externality-mitigating taxes do not justify sections 280G, 4999 and 5881. For some analysts, the third-party effects from greenmail and parachute payments are beneficial, not harmful. This view would lead to the subsidization of greenmail and parachute payments, not to their abatement through taxation. One can take a dimmer view of greenmail and parachute arrangements but deny that their costs are externalities, beyond the control of the affected shareholders. Even if the costs of greenmail and parachutes are appropriately characterized as externalities, the terms of sections 280G, 4999 and 5881 are not responsive to any reasonably defined concern.

D. Taxes as Economically Neutral Revenue Raisers

Microeconomic theory suggests that governments should be financed by taxing activities with respect to which demand or supply (or both) is relatively insensitive to price. Financing government in this fashion does minimal damage to the pre-tax choices of consumers and producers, and minimizes the economic disruption of taxation.¹⁹⁰

Suppose a government is considering the taxation of two activities. In one activity, as illustrated in figure one, consumer demand is relatively insensitive to price. As to the other, illustrated in figure two, demand is quite elastic, that is, it is responsive to changes in price. Before the imposition of the tax, the market yields quantity $Q_{1A}$ of the first service or good at price $P_{1A}$ while, in the second market, prevailing pre-tax price and quantity are $P_{2A}$ and $Q_{2A}$, respectively.

Consider a possible tax on the activity with inelastic demand. Suppose that, for each unit sold, producers must pay a tax of T. Supply conditions in the industry will adjust, reflecting this additional cost on producers. After the tax has been levied, the price

¹⁹⁰ See D. Hyman, supra note 173, at 336; R. Musgrave & P. Musgrave, Public Finance in Theory and Practice 289-312 (4th ed. 1984); H. Rosen, supra note 173, at 291; Rudnick, Corporate Tax Integration: Liquidity of Investment, 42 Tax Notes 1107, 1122 (1989) (discussing optimal tax principle “which suggests that there will not be a social welfare loss to the extent that a tax is applied on an inelastic quantity”).
PRE-TAX SUPPLY AND DEMAND SCHEDULES

![Figure One: Demand Inelastic](image)

![Figure Two: Demand Elastic](image)

POST-TAX SUPPLY AND DEMAND SCHEDULES

![Figure Three](image)

![Figure Four](image)
in the market will rise substantially, from $P_{1A}$ to $P_{1B}$, while the quantity purchased and produced will decrease minimally, from $Q_{1A}$ to $Q_{1B}$. This phenomenon is illustrated in figure three.

This result is not surprising. With respect to this first activity, demand is relatively insensitive to price. Producers can mark-up their prices by most of the tax with little loss of sales. Government revenues would be represented by the area $N_1-O_1-P_{1A}-P_{1B}$.

The story's ending, however, is not perfect. Some (relatively few) consumers will be deterred from purchasing this first activity as a result of the tax-based increase in price. They will move the resources measured by the area $O_1-M_1-Q_{1A}-Q_{1B}$ to other sectors of the economy. By definition, those alternatives are less attractive to the consumers than the activity out of which the consumers have been taxed. Had those alternatives been preferable to the now-taxed activity, the resources denoted by the area $O_1-M_1-Q_{1A}-Q_{1B}$ would have been devoted to those alternatives in the first place.

The tax will have induced a few consumers to move resources suboptimally, to goods and services which (but for the tax) the consumers did not want. The resulting decrease in welfare, denoted deadweight loss, is reflected by the relatively small area $N_1-O_1-M_1$. The area $N_1-O_1-M_1$ is fairly compact because, under the assumption of demand inelasticity, few resources have been shifted as a result of the tax.

This outcome contrasts with the result from a tax imposed on the elastically-demanded activity. Here, tax of $T$ results in major disruption, because demand is highly responsive to price. This result is depicted in figure four. The post-tax price, $P_{2B}$, will embody only a small portion of the tax. Given the sensitivity of consumers to price, producers cannot pass on the tax without substantial loss of sales. With producers absorbing most of the tax, output will contract considerably, from $Q_{2A}$ to $Q_{2B}$. The relatively small tax-induced increase in price will nevertheless deter price-sensitive consumers. Tax revenues, represented by the area $P_{2B}-P_{2A}-O_2-N_2$, will be disappointing because of the self-defeating nature of the tax. The tax will significantly reduce the economic activity from which the government is trying to raise revenue. Substantial resources, denoted by the area $O_2-M_2-Q_{2A}-Q_{2B}$, will be diverted from the now-taxed activity to the previously less-desired sectors of the economy as price-sensitive con-
sumers respond to the tax-based price increase. The resulting deadweight loss will be measured by the area N2-O2-M2.

The area N1-O1-M1 in figure three is much smaller than the area N2-O2-M2 in figure four. Therein lies the economic argument for taxing the first activity and not the second: taxing an inelastically demanded activity causes less economic disruption because fewer resources are moved to less attractive sectors of the economy. Indeed, the welfare loss represented by the area N2-O2-M2 may be only the first stage in the disruption of the economy. Because revenues P2B-P2A-O2-N2 are disappointing, the government might either tax a third activity, causing further dislocation, or increase the tax rate from T to T1. That increase, however, will exacerbate the decline of the second activity and will force even more resources into less desired goods and services.

Microeconomic theory thus suggests that, with all factors being equal, governments seeking revenue should tax those activities with demand or supply (or both) insensitive to price. The so-called "sin" taxes on tobacco and alcohol, as well as gasoline levies, can be justified on these grounds. Because people will smoke, drink or drive anyway, such taxes can produce significant revenue with little disruption to the economy.

This perspective provides no support for sections 280G, 4999 and 5881. It is implausible to characterize these provisions as designed to produce revenue or as producing significant revenue in practice. It is equally implausible to view the activities to which sections 280G, 4999 and 5881 apply—greenmail and golden parachutes—as inelastically demanded or supplied.

The drafters of sections 280G, 4999 and 5881 did not intend them as economically nondisruptive revenue raisers. The drafters' intent was to stop greenmail and golden parachutes. The optimal outcome for the sponsors of sections 280G, 4999 and 5881 would be for these provisions to generate no revenue at all and for them to deter completely all greenmail and parachute


192. See H.R. Rep. No. 100-391 (II), 100th Cong., 1st Sess. 1086, reprinted in 1987 U.S. Code Cong. & Admin. News 2313-701 ("The committee ... believes it is appropriate not only to remove tax incentives for corporate acquisitions [which lack the consent of the acquired corporation], but to create tax disincentives for such acquisitions.").
payments. In a fundamental sense, sections 280G, 4999 and 5881 were intended to be not economically neutral, but economically disruptive, diverting resources from greenmail and parachute payments which otherwise will occur.

It is, in any event, implausible to defend sections 280G, 4999 and 5881 as economically nondisruptive revenue measures. Such a defense must rest on the unlikely assumption that greenmail and parachute payments are inelastically supplied or demanded. However, greenmail and parachute payments are not plausibly viewed like smoking, drinking or driving, activities which will occur at a fairly steady rate regardless of the burdens placed on them. A more compelling argument is that the levels of greenmail and parachute payments are greatly influenced by the associated costs, risks and rewards.

Ultimately, the defense of sections 280G, 4999 and 5881 as revenue raisers assumes that these provisions are ineffectual as regulatory measures. If (as is more likely) sections 280G, 4999 and 5881 significantly inhibit greenmail and parachute payments, they do not pass muster as revenue provisions.

Corporations do not supply greenmail automatically but rather begrudgingly, only when there is no feasible alternative. There is no relatively fixed quantum of greenmail in the economy which will inevitably be forthcoming. Greenmail is paid sporadically and only in response to the greatest provocation: the actual or perceived threat of a takeover. Greenmail, in short, is not logically viewed as an inelastically-supplied good.

Moreover, demand for greenmail appears highly responsive to the costs, risks and potential rewards of the raider demanding it. Identifying undervalued companies takes time, effort and high-paid manpower. The raider must devote substantial sums to the acquisition of the target corporation's stock. If these sums are borrowed, the raider must pay interest. If the money used for the purchase of the target stock belongs to the raider, he must reckon with the opportunity costs of tying up his own capital. Takeover efforts can be protracted. Expensive litigation is virtually inevitable. Investment bankers must be paid. If he communicates directly with shareholders of the target, the raider incurs advertising expenses.

Furthermore, success for the raider is not assured. Even the best known takeover investors have their failures. Target management may find a white knight, leaving the raider with neither the prospect of being redeemed nor the opportunity to take over
the corporation. Management may successfully restructure the target or engage in other defensive maneuvers, leaving the raider without a profit. Shareholders may side with management rather than the raider. The raider’s financial backers may lose interest in a protracted fight with management of the target company.

The defenders and opponents of greenmail agree that raiders undertake their activity not because raiders believe they are benefiting the economy, but to make a profit. In light of the costs and risks involved, that profit must be substantial to justify the enterprise. It is therefore unlikely that raiders are price insensitive, that is, indifferent to the potential return from their efforts. More plausibly, raiders are shrewd investors who appreciate their risks and costs and demand commensurate rewards.

This perspective suggests that section 5881 is not an economically neutral revenue raiser focused upon an inelastically-demanded activity. More convincingly, section 5881 represents a substantial reduction of the raider’s potential reward and reduces demand for takeover activity. By halving the raider’s potential after-tax profits, section 5881 will inhibit the raider from undertaking the efforts necessary to demand greenmail.

Alternatively, section 5881 will cause the raider to operate in a manner skirting the tax. The raider, because of section 5881, may wage a proxy fight rather than a tender offer. Alternatively, he may accept greenmail only if available to all shareholders. In either event, section 5881 does not serve as a plausible revenue measure.

It is also reasonable to believe that the level of parachute payments is influenced by the associated costs, risks and rewards and that, therefore, golden parachutes are neither supplied nor demanded inelastically. Managers demanding parachutes do not do so without risk. Managers can be sued by disgruntled shareholders contending such arrangements violate the legal duties owed to the shareholders. Even if managers prevail in such litigation, they may be burdened by legal fees and bad publicity. Paradoxically, the institution of a golden parachute may, by demoralizing shareholders, precipitate the takeover against which the parachute is intended to protect.

It thus makes most sense to view corporate managers as balancing the risks and rewards in deciding to demand parachutes. Section 280G increases the expense of a parachute to the corporation and thus heightens the manager’s risk as a fiduciary. Section 4999 decreases the benefits of a parachute to the recipient by
imposing a penalty tax. It is more plausible to assume managers are sensitive to these tax provisions than to believe they are not. Under that assumption, sections 280G and 4999 are not economically-neutral revenue measures imposed upon an inelastically-demanded activity, but rather are impediments to the taxed activity, parachute payments.

Similarly, it is not reasonable to view golden parachutes as inelastically supplied by the paying corporations. Shareholders seem in no apparent rush to initiate such arrangements on their own. Outside directors voting to supply parachutes to management incur potential legal liability for their acts without deriving any personal benefit. Golden parachutes do not possess the same aura of inevitability as drinking, driving and smoking.

When they do demand and supply parachutes, many managers and employers will design such parachutes to avoid the penalties of sections 280G and 4999. In such cases, sections 280G and 4999 will not act as revenue raisers because they will not generate revenue.

In sum, sections 280G, 4999 and 5881 cannot plausibly be defended by microeconomists’ preference for raising revenue through taxes on economic activities insensitive to the effects of taxation. Those who drafted these provisions did not intend them as economically-neutral revenue measures. It is more plausible to view sections 280G, 4999 and 5881 as discouraging greenmail and parachute payments rather than as deriving revenues from them.

E. Excise Taxes and the Protection of Exempt Organizations

Sections 4999 and 5881 take the form of excise taxes—supplemental levies imposed upon greenmail and parachute payments in addition to the regular income taxes generated by those payments. During the last twenty years, Congress has, with general approval, developed a network of excise levies to protect tax-exempt institutions and their assets. While superficially appearing to be like these excise provisions, sections 4999 and 5881 cannot be justified as part of this regulatory network.

Prior to 1969, the Code’s only punishment for the abuse of

193. See supra note 191 and accompanying text.
tax-exempt institutions was the revocation of exempt status. If, for example, the trustee of a qualified pension trust borrowed trust assets interest-free, the IRS could seek only one sanction—loss of the trust’s exempt status and consequent disqualification of the pension plan. Similarly, if the manager of a charity diverted charitable assets to build his home, the only punishment under the Code was the revocation of the charity’s tax-exempt status.

For two reasons, this scheme proved inadequate. First, the impact of revocation was typically (sometimes exclusively) felt by innocent third parties. When a pension trust and plan lose qualified status under the Code, plan participants become immediately taxable on their vested benefits even though the participants do not yet receive these benefits. In addition, employers may lose part or all of their deductions for contributions to the plan. Yet, the participants and employers may be innocent of any involvement in the incident causing forfeiture of exempt status.

Similarly, loss of a charity’s tax exemption leads to disallowance of donors’ deductions and to taxation of the charity’s income. The consequent diminution of the charity’s resources would probably impact upon the recipients of the charity’s services. Yet the service recipients typically have no involvement in the abuse leading to revocation of exempt status. The same is frequently true of donors who find their contributions nondeductible because of abuses in which the donors did not participate and of which they were unaware.

The second problem with revocation of exempt status as the sole sanction was its draconian nature. There was no such thing as partial forfeiture of tax-exempt status. A relatively slight transgression had to receive the same punishment as more serious abuses. There was no way for the IRS or the courts to calibrate the punishment proportionately to the misfeasance.

In 1969, Congress adopted a set of excise taxes protecting private foundations, the charities deemed most subject to

195. Id. at 7-13 (discussing origins of excise system protecting exempt entities); see also Interview with Milton Cerny, Retiring Technical Advisor to the Assistant Commissioner for Employee Plans and Exempt Organizations, 40 Tax Notes 1125, 1126-27 (1988) (discussing current and former structure of Exempt Organizations Technical Division of Internal Revenue Service).
196. I.R.C. § 402(b) (West 1989).
197. Id. § 83(h).
198. Id. §§ 170(c), 501(c)(3).
abuse. Under these provisions, if certain misfeasances occur, an excise tax is imposed upon the foundation and the specific person causing the abuse. Loss of exempt status remains the ultimate penalty for the most serious problems.

The excise taxes established in sections 4941, 4944 and 4945 serve three functions. First, they deter the persons who might abuse private foundations by imposing sanctions directly upon such persons, as well as on the foundations. Second, the excise taxes reimburse the Treasury for the Treasury's "loss" when exempt status is misused. The Treasury extended exemption to the abused foundation on the theory certain standards of conduct would be satisfied. When those standards are violated, the Treasury is in a contractual sense entitled to a return of its money since the subsidy of tax exemption was conditioned upon those standards. Third, the excise taxes serve as intermediate penalties so that the IRS and the courts have usable sanctions for violations deserving punishment but not the revocation of exempt status. The excise levies, in short, represent a carefully-tailored solution to a problem internal to the tax system, the abuse of the favored status of exempt organizations.

In 1974, Congress adopted a parallel set of excises relative to qualified plans. While loss of exempt status remains the ultimate sanction, less serious "prohibited transactions" trigger a penalty tax paid by the plans and the persons causing those transactions. Comparable rules have also been adopted for trusts paying benefits to victims of black lung disease.

The various excise taxes have been fine-tuned since their original adoption. On balance, they are working well and enjoy widespread acceptance.

Sections 4999 and 5881, while superficially appearing like these levies, cannot be defended as part of the effort to protect tax-exempt organizations through excise taxes. Most obviously, greenmail and golden parachutes, as defined in sections 4999 and 5881, do not occur in the context of exempt institutions. The

199. See id. §§ 4941, 4944, 4945. In addition, other excises tax private foundations engaging in proscribed behavior without imposing penalties on foundation managers. See, e.g., id. § 4942.

200. Id. § 4975 (tax imposed on persons engaged in prohibited activities). In addition, Congress has used the excise tax system to deter certain financial undertakings and failures of qualified plans; see, e.g., id. § 4971 (employer taxed upon failure to meet minimum funding standards).

201. Id. §§ 4951 (taxes on self dealing), 4952 (taxes imposed upon taxable expenditures).
greenmail and parachute problems which these provisions address occur vis-a-vis the quintessential profit-making organization of modern capitalism, the publicly-traded corporation.

More fundamentally, the greenmail and golden parachute problems are not similar to the concerns giving rise to the excise levies regulating exempt organizations. These excises address a specific problem internal to the tax system—the failure of tax-favored entities to satisfy the standards upon which their exemptions are premised. When the assets of a private foundation, a black lung trust or a qualified plan are misused, the Treasury is perceived as one of the victims since its tax subsidy has been abused. Since the Treasury is viewed as a party harmed and the harm is a tax law violation, it is logical for the remedy to compensate and be administered by the Treasury via the tax system. The excise levies effect a repayment to the federal fisc of the tax subsidy erroneously extended on the assumption the subsidized organization would meet its obligations. In the case of abuse of exempt status, the Code is the most appropriate instrument for fashioning a remedy since the problem is itself a violation of the Code.

As to greenmail and parachute arrangements, none of these considerations apply. Assuming greenmail and parachute payments do pose a problem, it is not a tax problem logically calling forth a Code-based remedy or the involvement of the Treasury. The putative victim of greenmail and parachute payments is not the Treasury, but the shareholder. If anyone deserves compensation, it is the shareholder, not the federal fisc. Section 4999’s companion provision, section 280G, actually compounds the harm to shareholders, denying a deduction for parachute payments and thereby increasing the corporation’s taxes. There is no reason, in the greenmail and parachute settings, the Treasury should benefit in this fashion from the shareholder’s misfortune. If a federal approach to greenmail and parachute payments is appropriate, the federal securities statutes provide an obvious instrument for effectuating that response, making resort to the Internal Revenue Code unnecessary.

In short, the excise system protecting tax-exempt institutions is a carefully-tailored response to a problem internal to the tax system. Such an approach is not compelling when the Treasury is not the victim and when there are more appropriate instruments available, such as the federal securities laws, for addressing greenmail and parachute arrangements.
F. The Tax System as Efficient Means of Communication

The tax system is an inexpensive means by which the federal government can communicate its domestic policies. Most businesses and households incur the ongoing costs of complying with the tax law, such as filing returns and consulting professionals. Once these inevitable annual expenses are incurred, there are relatively small marginal costs to acquiring additional information through the tax system. This contrasts with the higher, duplicative expense associated with separate, nontax networks for communicating federal policies. 202

Consider, for example, the targeted jobs credit embodied in sections 38 and 51 of the Code. 203 The credit reimburses employers through the tax system for a portion of the wages paid to newly-hired, economically-disadvantaged employees. 204 An employer typically learns about sections 38 and 51 from his accountant or tax lawyer or will discover these provisions himself when the employer prepares his own return. The employer is, in any event, incurring the cost of complying with the tax system in the form of professional fees and the employer's own time and energy. As part of this process and with relatively little additional cost, the employer can discover the targeted jobs credit through the employer's tax professionals or through the process of filing a return.

From the perspective of the federal government, the tax system is an ongoing communications link with taxpayers. Because


203. I.R.C. § 51(a) (West 1989) (rule for computing amount of targeted jobs credit); id. § 38(b)(2) (allows for inclusion of targeted jobs credit of § 51(a) in year's business credit).

204. See id. § 51(a) which provides: "The amount of the credit allowable by section 44B [credit for employment of certain new employees] for the taxable year shall be the sum of—

(1) 50 percent of the qualified first-year wages for such year, and (2) 25 percent of the qualified second-year wages for such year." The amount generated by this calculation is used in § 38(b) as part of the general business credit. See id. § 38(b)(2).
of this pre-existing link, the jobs credit need not include a substantial component reimbursing the employer for his costs in discovering the credit since these costs are minimal for the employer. Consequently, the credit can be set lower than if it were necessary to reimburse the employer for significant expense in discovering the credit.

Consider the likely alternative to sections 38 and 51—a direct expenditure program administered by the Department of Labor. An employer hiring disadvantaged individuals would submit a report to the Labor Department and receive a reimbursement check for a portion of the wages paid to these targeted individuals. How would employers learn of this program? A network of professionals might emerge to inform employers and assist them in obtaining reimbursement from the Labor Department. This could result in substantial duplication of cost as the employer, already engaging professionals to comply with the tax system, would pay a second group of advisors relative to the Department of Labor.

Perhaps employers would canvass governmental departments on their own and discover programs in which they could participate. Again, this search process is wasteful of the employer's time and energy since the employer is already communicating with the federal government through the employer's tax return.

Either way, the nontax alternative must be larger than the tax-based equivalent. The targeted jobs credit can be set at a level reflecting the employer's low transactions cost in discovering the credit through the pre-existing tax system. For the same net impact on the employer's decision to hire disadvantaged persons, the Labor Department's version would have to reimburse more to offset the employer's larger expense in finding the program.

The cost advantages of communicating through the pre-existing tax system are clearest as to small businesses and middle income households. For such persons, the tax system is likely to be their only continuing legal relationship with the federal government. For small businesses and middle income individuals, tax advisors are frequently the only professionals with whom there is ongoing contact. Communication outside the tax system will require the establishment of duplicate channels.

In contrast, upper income households and large corporations typically have a greater range of relationships with the govern-
ment and with legal advisors. Publicly-held corporations have counsel to monitor compliance with corporate, securities, environmental and other laws. Frequently, large businesses maintain lobbying offices in Washington to apprise them of new governmental policies and programs. Upper income individuals are more likely to be engaged in activities requiring the continuous advice of a wide range of counsel. The cost advantage of communicating through the tax system disappears when there are such alternative channels of communication through which information can also be obtained at low marginal cost.

Given the intended audience, sections 280G, 4999 and 5881 cannot be justified as the cheapest means of communicating federal policies about greenmail and parachute arrangements. These sections are aimed at publicly-traded corporations with a wide array of professional advisers and with numerous links with the federal government other than the tax system. Section 5881 only applies when the raider has undertaken or threatened a “public tender offer” requiring filing with appropriate securities authorities.205 Section 5881 thus applies only to corporations likely to have securities counsel. Similarly, sections 280G and 4999 apply to larger corporations typically enmeshed in securities and corporate law issues and thus employing lawyers for an array of nontax matters. Had Congress’ response to greenmail or golden parachutes utilized the securities statutes, that response would have been communicated through the securities law network to the intended audience of publicly-held corporations as quickly and as cheaply as were sections 280G, 4999 and 5881.

In short, there may be efficiencies communicating federal policies to small businesses through the only consistent link between such businesses and the national government—the pre-existing tax system. There is, however, no such justification for the use of sections 280G, 4999 and 5881 to regulate publicly-traded corporations with whom the federal government has existing, alternate forms of relatively inexpensive communications such as the securities laws.

G. Merit and Demerit Goods

The notion of merit and demerit goods plays a marginal role in microeconomic theory. A merit good206 is one thought desira-

205. I.R.C. § 5881(b)(2)(c) (West 1989). For the relevant text of this section, see supra note 132.

206. Merit goods are “[g]oods that the government compels individuals to
ble for the consumer which the consumer, although properly in-
formed, does not fully appreciate.207 Conversely, a demerit good
is a good harmful to the consumer which he uses anyway.208
Merit goods are said to be underutilized by consumers who ig-
nore or discount their benefits while demerit goods are said to be
overconsumed because their harm is minimized or ignored.

It is not surprising that the concept of merit and demerit
goods occupies only a fringe position in formal economic theory.
It suggests that consumers, even with adequate information, do
not know what is good for them. Such a notion does not fit com-
fortably into the body of economic theory premised on rational,
utility-maximizing consumers capable of enhancing their own
welfare. Indeed, the paternalism inherent in the notion of merit
and demerit goods does not fit well into our broader intellectual
traditions with their emphasis on individual autonomy and
choice.209

While the concept of merit and demerit goods plays a margi-

While the concept of merit and demerit goods plays a marginal
role in formal microeconomic theory, it has in practice had
great influence in particular cases, such as the “sin” taxes on alco-
hol and tobacco.210 While some support these levies as nondis-
ruptive revenue raisers (people will drink and smoke anyway),
others defend the sin taxes as discouraging people from consum-
ing things bad for them (people will drink and smoke less if the
price increases through taxation).211 The notion of demerit
goods is most plausible with respect to items like alcohol and to-
bacco which are highly addictive and therefore potentially distort
consumers’ normally rational judgment.
Even if some economic activities are properly declared demerit goods and consequently subject to taxation to discourage their consumption, it is difficult to justify sections 280G, 4999 and 5881 in this fashion. Those defending greenmail and golden parachutes would deny that they are harmful and therefore deserving of discouragement through taxation.

Even assuming the impropriety of greenmail and parachute payments, the theory of demerit goods does not convincingly explain sections 280G, 4999 and 5881. To be characterized as a demerit good, it is not enough that an activity be harmful. Rather, the harmful nature of the good must also be unappreciated by the informed consumer.

While it may be plausible to so characterize physically-addictive goods, it is unpersuasive to cast greenmail and parachute payments along these lines. If greenmail and parachute arrangements are disadvantageous to shareholders, that harm should be clear to shareholders and remediable by them. Greenmail and parachute payments do not generate the judgment-distorting equivalent of a nicotine rush. There are no recorded cases in which shareholders, their judgment clouded by the thrill of paying greenmail, have become addicted to the redemption at a premium of a corporate raider's shares.

In short, the demerit good label does not fit comfortably upon greenmail and parachute payments. Whatever the validity of characterizing physically addictive items as demerit goods and taxing them accordingly, shareholders are capable of exercising unclouded, utility-maximizing judgment as to greenmail and golden parachutes. Sections 280G, 4999 and 5881 consequently cannot be rationalized as abating demerit good consumption.

H. User Fees

Public finance economists adore user fees. In theory and in practice, a major problem with publicly-provided services is the regulation and revelation of demand. If the consumer of a governmentally-provided service receives the benefits but pays none of the costs directly, he has the incentive to demand an almost infinite level of the service. The consumer of a free service need not disclose his “true” preference for it—the amount he would demand were he required to pay for it himself. The result is excess demand for publicly-provided activities.

212. See D. Hyman, supra note 173, at 327; H. Rosen, supra note 173, at 322.
The response of most public finance economists to this problem is the user fee, a price assessed by government for the services it offers. With user fees, consumers purchase publicly-provided activities just as they buy privately-supplied goods and services. Those desiring less of a public service demand less and purchase less, while those who want more pay for it.

Obviously, user fees cannot be instituted for most governmentally-supplied activities. It would be impractical to charge each person for the amount of national defense he desires. On the other hand, utility and utility-like services are quite conducive to user fees. As a matter of resource allocation, a public water company can charge for each gallon just like its privately-owned counterpart. In the same vein, tolls can be levied on highway users proportionate to the distance travelled by them.

Sections 280G, 4999 and 5881 cannot be justified as user fees. Most apparently, these sections are not triggered by the consumption of a publicly-supplied service but rather by the receipt of payment from a private source, the corporate payment of greenmail and parachute outlays.

Consequently, a user fee defense of sections 280G, 4999 and 5881 must focus upon the social overhead associated with greenmail and parachute payments. The payers and recipients of such payments rely on the governmental infrastructure to protect their transactions. Police and prosecutors defend property. Courts and legislatures provide legal rules. Sections 280G, 4999 and 5881 might be viewed as reimbursing the federal fisc for these overhead costs.

There is, however, nothing unusual about the social overhead associated with greenmail and parachute payments which justifies a unique surcharge for such overhead in addition to regular income tax liability. As means of allocating the costs of governmental services, sections 280G, 4999 and 5881 are under-inclusive, charging narrowly-defined categories of transactions while ignoring similar occurrences which place comparable burdens on government-provided activities. Every corporate redemption of stock and every compensatory payment to a corporate manager takes place against the backdrop of socially-provided police, prosecutors and courts. Redemptions triggered by proxy fights, as well as redemptions of long-term shareholders, use the same social overhead as the redemptions covered by section 5881. Severance payments to managers are implicitly protected by government-provided activities whether or not such
payments are related to a change of corporate control and whether or not such payments exceed three times the recipient's base amount.

There is thus no reason to believe that greenmail and parachute payments, as defined in sections 280G, 4999 and 5881, place greater strain on publicly-provided services than similar transactions for which the Code does not impose a special surcharge. Because of their underinclusiveness, there is no convincing defense of sections 280G, 4999 and 5881 as user fees compensating the federal government for services extended.

VI. THE COSTS OF SECTIONS 280G, 4999 AND 5881

My review of the criteria developed by tax policy analysts suggests that sections 280G, 4999 and 5881 cannot plausibly be defended as appropriate additions to the Internal Revenue Code. As a matter of tax policy, sections 280G, 4999 and 5881 do not fit comfortably within any recognized doctrine for identifying proper use of the tax law.

Were matters to end there, sections 280G, 4999 and 5881 might simply be dismissed as inconsequential lapses of Congress' better judgment. Regrettably, sections 280G, 4999 and 5881 cannot be regarded as harmless mistakes because they generate two significant costs. First, inappropriate tax statutes, like sections 280G, 4999 and 5881, impose burdens on the administration of the tax law, and divert enforcement resources from other, potentially more pressing areas. Second, the misuse of the Code as exemplified by sections 280G, 4999 and 5881 makes the legislative process less accountable and less expert. It permits policy to be fashioned without the substantive congressional committees charged with responsibility for that policy. Such misuse of the Code allows Congress to make decisions without open acknowledgment of the nature of those decisions. Such misuse of the Code also overburdens the tax-writing process making less likely quality decisions by tax policymakers.

Even if sections 280G, 4999 and 5881 do not as a theoretical matter belong in the tax law, they must be enforced once placed in the Code. The Treasury must administer the entire Code, not just the portions justified as a matter of tax policy.

Enforcement is not costless. Revenue agents must be trained to understand new provisions of the Code. Audit time must be devoted to determining if transactions fall within the ambit of sections 280G, 4999 and 5881. Treasury officials must develop reg-
ulations explicating these new provisions. Factual and interpretive disputes will arise between taxpayers and the IRS. Sometimes litigation will result. Resources will thus be diverted from the administration of other tax laws to the enforcement of sections 280G, 4999 and 5881.

This diversion of resources might be tolerable were the condition of federal tax administration currently acceptable. However, no one believes that to be the case.\textsuperscript{213} There is widespread recognition of serious failure in national tax administration as reflected in uncollected and unreported revenues, unnecessary hostility between taxpayers and the IRS, and difficulties retaining quality IRS personnel. Much of the impetus behind the Tax Reform Act of 1986 stemmed from a perception of crisis in the federal tax system. In such circumstances, any unnecessary burden on the Treasury is a serious matter.

Even if Congress recognized the burdens created by sections 280G, 4999 and 5881 and in response appropriated additional funds for the Treasury, sections 280G, 4999 and 5881 would generate unacceptable costs for federal tax administration. Some resources cannot be increased by appropriation. There is, for example, only one Commissioner of Internal Revenue. The time and energy he must divert to the enforcement of sections 280G, 4999 and 5881 is, by definition, irreplaceable.

The misuse of the tax law as exemplified by sections 280G, 4999 and 5881 also makes the legislative process less accountable and less expert, bypassing the substantive committees of Congress and potentially obscuring the nature of the decisions made in the guise of revenue statutes. Congress’ procedures give its substantive, nontax committees significant authority within their respective jurisdictions. This reflects numerous considerations: the interest in a particular subject congressmen demonstrate by sitting on committees overseeing that subject; the expertise developed by committee members and their staffs from continued exposure to matters within their committee assignments; the need

\textsuperscript{213} See Erekson & Sullivan, A Cross-Section Analysis of IRS Auditing, 41 Nat’l Tax J. 175, 175 (1988) (“The Internal Revenue Service estimates the ‘tax gap’—the total revenue lost to the U.S. Treasury due to noncompliance with tax laws—to be about $100 billion in 1986 . . . .”) (footnote omitted); Gibbs, Tax Reform: An Opportunity for a Fresh Start in Tax Administration, 6 Am. J. Tax Pol’y 1, 2-6 (1987) (remarks to American College of Tax Counsel on changes in professional goals and standards at IRS); News, Gibbs, Outlines Challenges for Tax Administration in 1989, 41 Tax Notes 1258, 1258 (1988) (“this is a particularly critical time in tax administration”).
for a 535-member parliament to delegate the initiation of policy to smaller, more specialized, more accountable groups.

The tax law has become an irresistible vehicle for avoiding the substantive committees of Congress, the designated legislative channels for initiating policy. Omnibus tax legislation has virtually become a yearly affair. In the tumult to produce the annual revenue bill, it is possible to attach to tax legislation provisions which could not gain the approval of the appropriate substantive committees. Once part of a catch-all tax package, these provisions are not easily dislodged although, by themselves, they would not pass congressional muster.214

Sections 280G, 4999 and 5881 typify this problem. Congress has had before it many nontax proposals addressing greenmail and parachute arrangements.215 None has progressed far in the legislative process. The strong suspicion arises that, as to greenmail and golden parachutes, omnibus tax legislation has been used to achieve results unobtainable through more appropriate legislative channels.

Commentators like Professors Surrey, McDaniel and Yorio observe that bypassing the substantive committees of Congress through the tax-writing process results in policy formulated by tax specialists without the expertise of the members of the substantive committees and their staffs. Policies affecting farmers, in this view, should be initiated by those knowledgeable about agriculture, not by those whose expertise lies in taxation. Moreover, using the tax law to avoid the substantive committees of Congress diminishes accountability in the legislative process and obscures the nature of the policies formulated through the Internal Revenue Code. In such a setting, responsibility for the initiation of policy becomes diffused among the tax and substantive committees. Consequently, Congress' processes become less focused. It becomes necessary to ask: Who is responsible for agricultural policy—the committees on agriculture or the tax committees? The answer is not clear.

214. Verdier, Special Report, A Framework for Predicting Congressional Action, 41 Tax Notes 435, 438 (1988) (“Congress' increasing penchant for omnibus bills that must be passed by some deadline provides vehicles for proposals that by themselves would never make it onto the agenda.”).

215. For a discussion of some of the proposed federal legislation, see Hook, What Is Wrong with Takeover Legislation, 8 N. Ill. U.L. Rev. 293, 297-99 (1988) (proposals include: lowering report level from current 5%, providing for civil penalties when false statements are made in 13D schedules, and extending period that tender offer must remain open).
When the tax-writing process is used to avoid the substantive committees of Congress, issues that should be addressed openly can easily become obscured because the underlying matter is formulated as a tax question. The federal regulation of greenmail and golden parachutes raises many issues, such as the merits of national rather than state standards, the ability \textit{vel non} of shareholders to protect themselves through their legal control of the corporation and the desirability of expanding federal regulation to areas historically covered by state corporate law. Were greenmail and golden parachutes addressed through the appropriate substantive committees of Congress, these issues would likely be confronted. However, sections 280G, 4999 and 5881 pretend to be revenue measures and make it easier for Congress to avoid the securities and corporate law considerations raised by the federal regulation of greenmail and parachute arrangements.

Unfortunately, sections 280G, 4999 and 5881 cannot be dismissed as mistakes unlikely to be repeated. For example, some concerned about leveraged corporate acquisitions suggest that the federal tax laws be used to police such acquisitions.\textsuperscript{216} Regrettably, sections 280G, 4999 and 5881 provide precedents for addressing such matters through the Code although such matters are better approached through the securities statutes, the antitrust laws, banking regulations or other nontax vehicles.\textsuperscript{217}


\textsuperscript{217} I should emphasize that my opposition is to narrowly-targeted, tax-based responses to LBOs along the lines of §§ 280G, 4999 and 5881. Some commentators suggest that current concern about LBOs should address more fundamental issues of tax policy, such as the need to more precisely distinguish debt from equity, and the discrepant treatment under current law between interest and dividend payments. Insofar as concern with LBOs leads to better resolution of some of these basic questions, the tax law would be improved. However, such fundamental reform is quite different from narrowly-focused provisions along the lines of §§ 280G, 4999 and 5881. For a discussion of such fundamental reform, see Warren, \textit{Special Report, Recent Corporate Restructuring and the Corpo-
Some might defend the circumvention of the substantive committees of Congress on the grounds that these committees become captured by special interests (e.g., as to the agriculture committees, farming interests). In this view, it becomes necessary to use the tax-writing process to achieve sound policy, free of the influence of those who have captured the substantive committees.

Sections 280G, 4999 and 5881 might be viewed as providing plausible support for this perspective. The Senate and House committees with jurisdiction over greenmail and golden parachutes have taken no effective action as to these phenomena. It became necessary, according to this view, to seek redress through an alternate channel, the tax-writing process.

I find this notion unpersuasive. If there is a problem as to the capture of the substantive committees of Congress by special interests, resort to the tax law is at best a temporary solution. Once interests learn that the tax-writing committees must be controlled to protect their welfare, nothing prevents such interests from focusing their resources upon that task. The tax-writing members of Congress are not immune to the blandishments and threats of special interests. Indeed, some analysts maintain that Congress' tax writers are the prime targets of such attention.218

Moreover, one man's evidence of capture is another's proof of sound public policy. If the substantive committees of Congress decline to take effective action as to greenmail and parachute payments, that may reflect superior wisdom rather than capture by those making and receiving such payments. There are respectable arguments against federal action in these areas. Greenmail and golden parachutes are viewed by some as benign phenomena. For others, greenmail and parachute arrangements are properly left to the attention of the state courts and legislatures.

In short, the inaction of the substantive committees may not reflect the capture of those committees, but the considered opinion of the members of Congress who have thought about green-

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mail and golden parachutes the most. This characterization makes resort to the tax-writing process indeed ill-advised.

Misuse of the tax law in the fashion of sections 280G, 4999 and 5881 also overburdens the tax-writing process, diminishing the likely quality of the decisions by tax policymakers. Those required to be expert in everything are likely to become expert in nothing. In an environment in which the Internal Revenue Code is stretched to cover too many concerns, overburdened tax decisionmakers will be able to approach expertly neither the issues intrinsic to the tax system nor the substantive, nontax matters addressed through the Code.

VII. THE ISSUE OF PREEMPTION

Let us consider a final defense of sections 280G, 4999 and 5881 potentially advanced by those who are indifferent to the health of the tax law or who believe such health less important than confronting greenmail and parachute arrangements. For these purposes, let us accept that sections 280G, 4999 and 5881 fail all criteria of sound tax policy, that placing inappropriate provisions into the Code improperly diverts administrative resources from other areas of enforcement and that using the tax-writing process to bypass Congress’ substantive committees makes Congress less accountable and less expert in its actions. Granting all that, an argument might develop that it still was appropriate to adopt sections 280G, 4999 and 5881 given the malignant nature of greenmail and parachute arrangements. The evils associated with greenmail and parachute payments made necessary whatever remedy could be adopted, regardless of the costs to the administration of the tax law and to the legislative process.

Those who would so defend sections 280G, 4999 and 5881 should consider the possibility that these provisions will prove, explicitly or implicitly, preemptive of state law and, in the long run, inhibit more stringent responses to greenmail and parachute arrangements at the state level. The boundaries embodied in sections 280G, 4999 and 5881 may come to establish federally-created safe harbors within which greenmail and parachute payments may be made with impunity. As to payments triggering the penalties of section 280G, 4999 and 5881, those penalties may come to be viewed as preemptive of state law remedies which would have compensated shareholders.

Consider, for example, a control-related severance package equalling 2.95 times an executive’s base amount, just short of sec-
tion 280G's definition of a parachute payment. Suppose further that disgruntled shareholders challenge this severance arrangement in court alleging self-dealing, waste of corporate assets and violation of management's fiduciary obligations. The corporation may plausibly contend that Congress has foreclosed this attack. If the courts agree that sections 280G and 4999 preempt state law responses to allegedly golden parachutes, these provisions will have created a nationwide safe harbor for severance arrangements which the courts, left unimpeded, might have proscribed.

Consider also the possibility of a legislature amending a state's corporation statute to preclude selective redemptions of stock unless the redeemed shareholders have owned their shares for at least thirty months, six months longer than the period described in section 5881. Does section 5881 preempt this amendment of state law?

Preemption issues similarly arise as to transactions covered by sections 280G, 4999 and 5881. Does, for example, the applicability of section 280G prevent a shareholder's suit as to a golden parachute? If so, section 280G will hurt shareholders doubly, increasing the federal taxes of their corporations because of the nondeductibility of parachute payments while foreclosing shareholders' state law remedies for redress.

A related preemption concern for greenmail and parachute opponents should be the differing enforcement priorities of the IRS and the victimized shareholders. As an institutional litigator, the IRS may, for tactical reasons, eschew some cases while pursuing others. The IRS may rationally compromise cases involving sections 280G, 4999 and 5881 when the shareholders (absent preemption) would utilize their state law remedies. Similarly, the IRS might reasonably decline to assert liability in situations where the shareholders will proceed if they are able.

A final preemption concern stems from the inefficacy of denying deductions to corporations which do not have taxable income. It is widely recognized that tax expenditures cannot readily affect the behavior of persons without taxable income. If, for example, a corporation has a net operating loss, it obtains no significant benefit from any extra deductions bestowed by Congress. As Professor Zolt has observed, the converse is true for some tax penalties: denying a deduction has no serious impact upon a taxpayer with no taxable income. To a corporation already losing money, it is not a serious sanction to deny deductibility for parachute payments. This raises the ironic possibility that

Even if sections 280G, 4999 and 5881 do not explicitly preempt state law responses to greenmail and golden parachutes, courts might find it persuasive evidence of reasonableness that a particular arrangement does not trigger a federal penalty tax. The result could be an implicit, but effective, preemption of more stringent state responses to greenmail and golden parachutes.

There is evidence this is already happening. In \textit{Buckhorn Inc. v. Ropak Corp.},\footnote{220. 656 F. Supp. 209 (S.D. Ohio 1987).} the court found certain parachutes acceptable as a matter of state law because the parachutes did not trigger section 280G.\footnote{221. \textit{Id.} at 232. The court noted that in the present case the directors had “reasonable grounds” to believe that a tender offer would pose a threat to the company’s key employees. \textit{Id.} In addition, the protective measures were in proportion to the posed threat. \textit{Id.} Moreover, the payment would only be made to the managers if they were fired or constructively discharged within 12 months of the change of control. \textit{Id.}} The failure of parachutes to activate the limitations of section 280G, the court said, “provides some assurance that the severance payments would be reasonable in the event that they are exercised.”\footnote{222. \textit{Id.} at 233.} In \textit{Worth v. Huntington Bancshares},\footnote{223. No. 52861 (Ohio Ct. App. Nov. 25, 1987) (LEXIS, States library, Ohio file), aff’d in part, rev’d in part on other grounds, 43 Ohio St. 3d 192, 540 N.E.2d 249 (1989).} the court also buttressed its approval of particular golden parachutes with the observation that the parachutes in question were not deemed abusive under section 280G.\footnote{224. \textit{Id.} (“a judicial framework for evaluating the reasonableness of a compensation clause is also provided by the Deficit Reduction Act of 1984”); \textit{see also} Comment, \textit{Golden Parachutes: Safe Landings in Ohio and Elsewhere}, 57 U. CIN. L. Rev. 699 (1988).} In \textit{International Insurance Co. v. Johns},\footnote{225. 874 F.2d 1447 (11th Cir. 1989). Golden parachute cases are not the only situations in which a federal tax statute has influenced courts’ perceptions of state corporate law. In Theodora Holding Corp. v. Henderson, 257 A.2d 398, 400 (Del. Ch. 1969), minority shareholders challenged the propriety under Delaware law of a corporate charitable contribution. In upholding the gift, the chancery court found it “a helpful guide” that the gift was fully deductible for federal income tax purposes. \textit{Id.} at 405.} the court found section 280G to “be a guiding factor” in determining, as a matter of state law, whether specific parachute arrangements constituted corporate waste.\footnote{226. \textit{International Insurance}, 874 F.2d at 1462 n.30.}
My own judgment is that sections 280G, 4999 and 5881 should not be viewed as preemptive of shareholders' state law remedies, and that compliance with the boundaries of these provisions should not be taken as evidence of reasonability. Having been crafted as tax legislation, these provisions should not be treated as an exhaustive congressional pronouncement as to greenmail and parachute payments. If Congress wants to make a comprehensive statement on greenmail and golden parachutes, it should discipline itself to proceed in a proper fashion, such as initiating a statute by the appropriate substantive committees of Congress, or explicitly labelling a tax provision preemptive of state law.

Professor Macey has argued for a plain meaning approach to statutes benefitting special interests so as to require legislative explicitness about the arrangement being enacted.227 Analogously, the courts should constrain Congress by treating tax statutes as nothing more than revenue measures unless Congress openly indicates that it is using the tax system to promulgate substantive policy.

However, my judgment on this score is not beyond cavil. The courts may plausibly conclude that sections 280G, 4999 and 5881 should be treated as federal corporate law and not be given credence as mere revenue measures. From this premise, it is a short step to conclude that sections 280G, 4999 and 5881 preempt more stringent action by the states or, at a minimum, are relevant to a determination under state law.

It might take years, perhaps decades, for the judicial system to determine definitively whether sections 280G, 4999 and 5881 have preemptive effect. Prior to a decision of the United States Supreme Court, various lower courts may rule differently, leaving some shareholders with state law remedies as to parachute and greenmail payments, and others without such remedies. This possibility should give pause to the defenders of sections 280G, 4999 and 5881.

227. Macey, Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model, 86 COLUM. L. REV. 223, 227 (1986) ("The traditional approach . . . encourages more public-regarding legislation by frequently transforming statutes designed to benefit narrow interest groups into statutes that in fact further the public's interest.").
VIII. Conclusion

As a matter of tax policy, sections 280G, 4999 and 5881 do not belong in the Internal Revenue Code. These sections satisfy none of the criteria for identifying appropriate tax provisions. The misuse of the tax law as exemplified by sections 280G, 4999 and 5881 imposes unnecessary costs upon the administration of the tax system. It also makes the legislative process less accountable and less expert.

It is likely that in the years ahead Congress will devote considerable attention to the governance of publicly-held corporations. If it is to legislate in this area, Congress should avoid use of the Internal Revenue Code in the fashion of sections 280G, 4999 and 5881. Congress could demonstrate respect for the tax system and for Congress’ own processes by repealing these ill-advised provisions.