2020

Allocating Tax Transition Risk

Heather M. Field
UC Hastings College of the Law, fieldh@uchastings.edu

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HEATHER M. FIELD*

INTRODUCTION

In late 2017, Republicans enacted sweeping tax law changes with only a simple majority of votes in Congress and no bipartisan support. Democrats responded with promises to reverse those tax changes when political power swings back to the left.[1] Now, Democratic presidential candidates are advocating for a variety of significant tax law changes.[2] This political dynamic creates a tax landscape that appears increasingly unstable,[3] leaving taxpayers unsure about how to make economic decisions that are affected by tax laws and potential changes thereto.[4]

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* Professor of Law & Eucalyptus Foundation Chair, University of California, Hastings College of the Law. I am grateful for the opportunity to present this Article at the 2018 Association of Mid-Career Tax Professors Conference, the 2019 Northern California Tax Professor Roundtable, the 2019 Critical Tax Conference, the 2019 National Tax Association Meeting, and the Georgetown Tax Policy & Public Finance Workshop. Thanks to Victor Fleischer, Mark Gergen, David Hasen, Terri Lynn Helge, Jim Hines, Sarah Lawsky, Rich Moore, Susan C. Morse, Doron Narotzki, Darien Shanske, Manoj Viswanathan, Leonard Weiser-Varon, and Bret Wells, among others, for their comments and input. Thanks also to Mitchell Kane and the other editors at the *Tax Law Review* for their valuable contributions during the editing process.

[1] See, e.g., Toby Eckert, Senate Democrats Pitch Repeal of Tax Cuts to Fund Infrastructure, Politico (Mar. 7, 2018) (quoting Senator Schumer saying, "We want to roll back the Republican tax giveaways to big corporations and the wealthy[.]"), https://www.politico.com/story/2018/03/07/senate-democrats-tax-cuts-infrastructure-392523.

[2] See Amir El-Sibaie et al., Tax Foundation, Tracking the 2020 Presidential Tax Plans (Nov. 20, 2019), https://taxfoundation.org/2020-tax-tracker (updated regularly to reflect candidates' issuance of more detailed tax plans) (last visited Mar. 5, 2020).

[3] Republicans' use of the reconciliation process to pass the 2017 tax legislation avoided the possibility of filibuster, which is one of the "soft pivots" that impede changes in law. Jason S. Oh & Chris Tausanovitch, Quantifying Legislative Uncertainty: A Case Study in Tax Policy, 69 Tax L. Rev. 485, 509-10 (2016). If tax legislation continues to be considered without the possibility of filibuster, law changes are more likely. See id. at 485-88 (describing the filibuster's role in the law's stability).

[4] See, e.g., Transcript of Current Issues in M&A, PLI Tax Strategies (2018) (Peter Canellos, a Wachtell Lipton lawyer, commenting, "because of the nature of the enactment and the close vote in the enactment and the highly partisan vote on enactment, who's to say that when political realignments occur—if they occur—that these provisions won't be reversed and a new set of provisions more like the old ones or a third set of provisions less favorable than the ones that were enacted in a couple of years ago?"); Scott Greenberg, Tax Reform Isn't Done, Tax Foundation Fiscal Fact No. 578 (Mar. 8, 2018) (expressing similar concerns).

For example, when investing in a privately held corporation, should an investor determine the per-share price, assuming that the recently lowered corporate income tax rate[5] persists, or reduce the per-share price because the tax rate might go back up?[6] Should a U.S. multinational corporation onshore its intellectual property (IP) to take advantage of the new foreign derived intangible income (FDII) deduction, or is it better to leave the IP abroad because the FDII deduction might be eliminated or reduced?[7] When choosing which business opportunity to pursue, can a sole proprietor assume that the new qualified business income deduction will persist[8] and that a particular business will continue to be eligible for the deduction?[9] Similar questions abound, especially leading up to the 2020 election.

Tax law changes create winners and losers, and thus tax transition risk (i.e., the possibility that a future tax law change will affect taxpayers' entitlements)[10] impacts taxpayers' decisions. This is well under-

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5 IRC § 11 (imposing a 21% corporate income tax rate).

6 See also Transcript, note 4 (Canellos highlighting the impact of the same possible tax change on the question of whether a partnership should become a C corporation).

7 IRC § 250; see, e.g., Ryan W. H. Starr, Global Structuring and IP Planning in the Wake of US Tax Reform (Dec. 21, 2018), https://www.dlapiper.com/en/us/insights/publications/2018/12/ipt-news-q4-2018/copy-of-global-structuring-and-ip-planning-in-the-wake-of-us-tax-reform/.

8 IRC § 199A (scheduled to sunset in 2026); see Edward Kleinbard, Congress' Worst Tax Idea Ever, The Hill (Mar. 25, 2019, 9:00 AM) (arguing for repeal), https://thehill.com/opinion/finance/434998-congress-worst-tax-idea-ever.

9 Reg. § 1.199A-5 (defining "specified service trades or business" for which no § 199A deduction is available for certain taxpayers).

10 Uncertainty about a future tax law change is distinguished from uncertainty about whether a taxpayer's application of current tax law will be determined to be incorrect. See, e.g., Jonathan H. Choi, Tax Commitment Devices, 15 J. Bus. & Sec. L. 1, 6 (2014) (differentiating "uncertainty about the direction of future tax policy" from "uncertainty about the correct interpretation of the Code in the present or about the probability of its enforcement"); see also Sarah B. Lawsky, Probably? Understanding Tax Law's Uncertainty, 157 U. Pa. L. Rev. 1017 (2009) (discussing uncertainty in understanding the existing substantive tax law). Moreover, this Article generally discusses tax transition risk rather than uncertainty because this "risk" terminology is consistent with how other scholars discuss the uncertain prospect of transition gains and losses. See, e.g., Daniel Shaviro, When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity 27-32 (2000). That said, tax transition issues could involve both risk (i.e., possibility of change, where the probability is measurable) and uncertainty (i.e., unknown, unmeasurable possibility of change) in their more technical senses. See generally Frank H. Knight, Risk, Uncertainty, and Profit part 1 (1921). Moreover, parties grappling with possible tax transitions may differ not only as to their assessments about the likelihood of change (i.e., reflecting uncertainty in addition to risk), but also as to their risk preferences (i.e., one may be more risk averse or risk seeking than another). In addition, this Article assumes that tax transition risk is about more than just variance and contemplates asymmetrical expectations about the direction of the entitlement change. See id. Further, this Article's discussion of tax transitions assumes, unless otherwise stated, that any change to a legal entitlement begins as of the announcement of the entitlement change. Cf. David M. Hasen, Legal Transitions and the Problem of Reliance, 122 Colum. J. Tax L. 120, 136-137 (2010).

stood,[11] and many arguments about tax transition policy depend on assumptions and expectations about how taxpayers respond (or should respond) to uncertainty about future tax policy and its possible impact on legal entitlements.[12]

Yet the literature's account of *how* taxpayer behavior may change is incomplete. The literature says little about the role of private contracts through which taxpayers can explicitly allocate the economic benefits and burdens of a future tax law change among themselves. This gap in the literature is surprising given that (1) the leading view on tax transition policy argues that taxpayers should account for the risk of tax law changes the same way they take other market risks into account when making decisions,[13] and (2) private contracting is a well-accepted method for addressing market risks.[14] Where the literature does discuss taxpayer efforts to allocate tax transition risk by contract, such discussions are generally brief and theoretical,[15] raising empirical questions of whether such contracting actually occurs, and if so, when and how taxpayers use this strategy for managing tax transition risks.

This Article answers those empirical questions by examining four case studies—involving derivatives, credit agreements, municipal bonds, and public company merger agreements—each of which con-

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[11] See, e.g., U.S. Dep't of the Treas., Blueprints for Basic Tax Reform 181 (1977) [hereinafter Blueprints]; Shaviro, note 10, at 26; Thomas J. Brennan, What Happens After a Holiday?: Long-Term Effects of the Repatriation Provisions of the AJCA, 5 Nw. J. L. & Soc. Pol'y 1, 5 (2010) ("it is particularly well understood that temporary changes in law can affect future behavior, since rational actors will incorporate the likelihood of future legal change into their decision-making."); Michael Doran, Legislative Compromise and Tax Transition Policy, 74 U. Chi. L. Rev. 545, 548–49 (2007); Martin Feldstein, On the Theory of Tax Reform, 6 J. Pub. Econ. 77, 93 (1976); Michael J. Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. Pa. L. Rev. 47 (1977); David Kamin & Jason S. Oh, The Effects of Capital Gains Rate Uncertainty on Realization 29 (2019), https://www.law.nyu.edu/sites/default/files/upload_documents/The%20Effects%20of%20Capital%20Gains%20Rate%20Uncertainty%20on%20Realization%20-%20Kamin.pdf; Louis Kaplow, An Economic Analysis of Legal Transitions, 99 Harv. L. Rev. 509 (1986); Jason S. Oh, Will Tax Reform Be Stable?, 165 U. Pa. L. Rev. 1159, 1199 (2017); Kyle D. Logue, If Taxpayers Can't Be Fooled, Maybe Congress Can: A Public Choice Perspective on the Tax Transition Debate, 67 U. Chi. L. Rev. 1507, 1507 (2000).

[12] See Part I.

[13] See Part I.B.

[14] See, e.g., Howell E. Jackson et al., Analytical Methods for Lawyers 64 (2nd ed. 2011); Kenneth J. Arrow, Insurance, Risk and Resource Allocation, in Essays in the Theory of Risk-Bearing 134, 138-39 (1971); see also Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87 (1989).

[15] See Shaviro, note 10, at 35; Louis Kaplow, Transition Policy: A Conceptual Framework, 13 J. Contemp. Legal Issues 161, 176-84 (2003); see also Avishai Shachar, From Income to Consumption Tax: Criteria for Rules of Transition, 97 Harv. L. Rev. 1581, 1596 (1984) (hypothetical). But see Franklin L. Green, The Folly of Long-Term Tax Planning: Comments on the Instability of the Tax Law, 74 Tax Notes 481, 491-92 (Jan. 27, 1997) (a practitioner-oriented article with a footnote mentioning credit agreement gross-ups upon withholding tax changes).

tains contractual provisions that explicitly shift tax transition risk among the parties to the contract. Thus, it is clear that taxpayers use contracts in a variety of contexts to shift the economic incidence of future tax law changes. A recent high-profile example involved the merger agreement between Pfizer and Allergan that allowed either party to terminate the deal before closing (for a fee) if a tax law change adversely affected the tax treatment of the planned inversion of Pfizer.[16] After the Treasury Department issued additional anti-inversion regulations, Pfizer exercised its termination right and, per the merger agreement, paid Allergan $150 million.[17]

The case studies also illustrate how the contracting strategies vary. The tax transition risk-shifting agreements differ as to the protection provided (e.g., compensation and/or an exit right), how frequently the provision is used in the context (from very rarely to virtually always), the degree of standardization (from boilerplate to bespoke), and how explicitly the parties factor the risk-shifting agreement into the overall economics of the underlying transaction.

The implications of this study of tax transition risk-shifting agreements are threefold—one predictive and two normative. First, tax transition risk-shifting agreements could be useful anytime an economic decision is a function of tax law, meaning that use of such agreements will likely grow when the political dynamic creates uncertainty about the stability of the tax laws.[18] This growth could even include the development of tax transition insurance and tax change derivatives or prediction markets, notwithstanding the views of some who largely dismiss such developments as unrealistic because of the

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[16] Agreement and Plan of Merger by and among Pfizer, Inc., Allergan PLC and Watson Merger Sub Inc. (Nov. 22, 2015), https://www.sec.gov/Archives/edgar/data/78003/000119312515385453/d70588dex21.htm. Another high-profile example that readers practicing in the 1980s might remember involved the Eurobonds issued through Netherlands Antilles corporations. The bonds were callable upon certain tax changes, including the termination of the U.S.-Netherlands Antilles tax treaty. When the United States announced termination of the treaty, the market for these bonds dropped precipitously because the termination of the treaty allowed corporations to redeem bonds at par, at a time when they were trading at a premium. With the threat of massive bond redemptions at below market value, the United States modified its plans regarding the Netherlands Antilles treaty, thereby preventing the call options from being triggered. See generally Mark F. Johnson, Antilles Treaty Termination Favored, But Period of Uncertainty in Bond Market Lies Ahead, 36 Tax Notes 127 (July 13, 1987); Mark B. Schoeller, The Termination of the United States-Netherlands Antilles Income Tax Convention: A Failure of U.S. Tax Policy, 10 U. Pa. J. Int'l Bus. L. 493, 508-10 (1988). Thanks very much to Jim Hines for this example.

[17] Pfizer Announces Termination of Proposed Combination with Allergan (Apr. 6, 2016), https://www.pfizer.com/news/press-release/press-release-detail/pfizer_announces_termination_of_proposed_combination_with_allergan.

[18] The use of tax transition risk-shifting agreements is also likely to increase when parties have different appetites for bearing tax transition risk, even if there is 100% certainty about the likelihood and magnitude of a possible tax law change. See Part IV.A.

challenge of pricing the instruments.[19] Second, given current tax transition policy, tax transition risk-shifting agreements are most likely to be normatively desirable when sophisticated parties contract with each other to manage large tax transition risks well enough to proceed with social welfare enhancing transactions, other market mechanisms for managing tax transition risk fail to satisfy the taxpayers' risk preferences, and this Article's recommendations are followed to minimize the problems these risk-shifting agreements could otherwise pose. In most other situations, these agreements likely should not be used. Third, tax transition risk-shifting agreements should inform tax transition policy. Taking these agreements into account does not resolve the tax transition debate, but does, among other things, support a larger role for government-provided transition relief for changes affecting less sophisticated taxpayers, and perhaps a smaller role for government-provided transition relief for changes affecting sophisticated taxpayers who can use risk-shifting agreements and other strategies to manage tax transition risk effectively.

The discussion herein focuses on how taxpayers manage the risk of *tax* law changes, not of legal transitions in general.[20] This is for three reasons. First, the dramatic tax changes made by the 2017 Act coupled with the potentially dramatic additional tax changes proposed by candidates running in the 2020 presidential election merit a reexamination of transition policy and a return to the transition literature in the tax-specific context. Second, tax law changes create winners and losers more tangibly and quantifiably than changes in some other fields. Third, several examples of transition risk-shifting agreements are available in the tax context to ably illustrate how private contracting is used in response to possible legal transitions. Given the foregoing, tax provides a good starting place for the examination of the role of private contracting in legal transitions. Subsequent work may consider how this Article's analysis resonates beyond tax.

This Article proceeds as follows. Part I provides background about tax transition policy, highlighting the scholars' analogy between tax transition risk and market risk. Part II discusses common actions that taxpayers take in response to possible tax law changes, focusing on market-based responses. Part III explains private contracting as an additional market-based tool for managing tax transition risk and discusses the case studies to illustrate the use of such contractual provisions. Part IV identifies where tax transition risk-shifting agree-

[19] Jonathan Masur & Jonathan Remy Nash, The Institutional Dynamics of Transition Relief, 85 N.Y.U. L. Rev. 391, 428, 433-35 (2010).

[20] In contrast, some scholars such as Louis Kaplow discuss legal transitions more generally, considering both tax and nontax changes. See Kaplow, note 11.

ments could be used. Part V discusses policy implications and the normative desirability of the use of these agreements. Part VI examines the implications of the foregoing for tax transition policy. Part VII is a brief conclusion.

I. The Tax Transition Policy Debate

Many scholars have summarized the debate about transition policy,[21] but doing so here explains the importance of this Article's study of private contracting as a response to tax transition risk. Readers familiar with the tax transition literature may wish to skip ahead.

The transition policy literature proceeds from the well-accepted understanding that tax law changes create winners and losers.[22] To illustrate, consider the most commonly discussed example, which involves the possible repeal of the exclusion for interest on municipal bonds[23] and a taxpayer who recently purchased a thirty-year fixed-rate municipal bond, assuming that the exclusion for muni bond interest would continue.[24] Immediately effective repeal of the exclusion would adversely affect the bondholder because future interest would be taxable rather than tax-free, and the value of the bond would decrease accordingly. Issuers of muni bonds would also be adversely affected because their future borrowing costs increase. Holders and issuers of taxable bonds, on the other hand, would receive a windfall because demand for those bonds would increase, thereby increasing the value of previously issued taxable bonds and decreasing future borrowing costs for those issuers.

Using this example and others, scholars argue for and against providing transition relief to taxpayers who are affected by a change in law.[25] Should the government mitigate the losers' adverse consequences arising from the law change (e.g., through grandfather provi-

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[21] See, e.g., Doran, note 11, at 545-59; Hasen, note 10, at 124-35.

[22] See, e.g., Blueprints, note 11, at 181.

[23] IRC § 103. Graetz uses this example throughout his article on transitions. Graetz, note 11. Others followed his lead. See Saul Levmore, The Case for Retroactive Taxation, 22 J. Legal Stud. 265, 266 n.3 (1993) (calling the muni bond example "a favorite of the legal transition literature").

[24] See Graetz, note 11, at 54-63 (discussing this example in more detail).

[25] Although the transition policy question is relevant to both those who win and those who lose as a result of the law change, the literature typically focuses on those who are harmed. See Kaplow, note 15, at 167–68 (arguing that scholars should address transition gains in addition to transition losses). Scholars differ not only on whether they favor or oppose transition relief, but also on whether Congress should adopt a generally applicable transition policy or whether transition rules should be determined on a case-by-case basis. Compare Kaplow, note 11, at 557-60 (favoring "the implementation of a consistent, predictable transition policy") with Saul Levmore, Changes, Anticipations, and Reparations, 99 Colum. L. Rev. 1657, 1684 (1999) (suggesting retention of some flexibility about whether, how, and when transition losses are compensated).

sions) or should the losers bear the full brunt of the economic loss created by the law change? And should the government tax the winners to reduce their unanticipated windfalls or should the winners reap the full benefits created by the law change?[26] Ultimately, this debate seeks to determine when (and why) transition risk should be borne by the private sector (i.e., where no transition relief is provided to the specific taxpayers affected by the tax law change) or by the public sector (i.e., where government provides transition relief, the cost of which is ultimately borne by diffuse taxpayers across the country).

A. The Old View

Historically, policymakers and scholars argued that taxpayers had a reliance interest in the tax law that should be protected if the law changes.[27] The idea was that taxpayers, when making economic decisions, often reasonably relied on the tax law as it existed at the time of the decision.[28] To protect taxpayers' reliance interest and prevent them from suffering unfairly from unexpected increases in taxes or decreases in asset values, changes in tax law should be nominally prospective[29] and should be accompanied by transition relief, such as a grandfather provision, phased-in effective date, or delayed effective date.[30] In the example involving the repeal of the tax exclusion for interest on muni bonds, the old view supports providing transition relief to protect the muni bondholders through, for example, a grandfather provision that continues the exclusion for interest on any muni bond issued before the change in law.[31] Ultimately, the old view endorsed transition relief (i.e., the allocation of tax transition risk to the public sector rather than to the private sector) as "both fair, because it protected investors' reliance interest based on expecting legal con-

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[26] Hasen, note 10, at 124 (explaining the debate using similar questions).

[27] Blueprints, note 11, at 181; Feldstein, note 11, at 95-97; Note, Setting Effective Dates for Tax Legislation: A Rule of Prospectivity, 84 Harv. L. Rev. 436, 436-46 (1970).

[28] Blueprints, note 11, at 181; Note, Setting Effective Dates for Tax Policy, note 27, at 439; Alan S. Novick & Ralph I. Petersberger, Retroactivity in Federal Taxation: Part II, 37 Taxes 499, 499-502 (1959) (discussing the role of reliance).

[29] Comm. on Tax Policy, Tax Section, N.Y. State Bar Ass'n, Retroactivity of Tax Legislation, 29 Tax Law. 21, 28 (1975).

[30] Blueprints, note 11, at 189-91 (discussing transition relief methods). Grandfather provisions generally provide that the new rule will not apply to transactions entered into or assets held before the new law's enactment date. Graetz, note 11, at 53. Phased-in effective dates generally provide that a new rule "is made effective gradually, for example, one-third in the year after enactment and one-third in each of the two subsequent years." Id. at 52. Delayed effective dates generally provide that a new rule "is made effective only after the passage of some time, for example, five years from the date of enactment." Id.

[31] Graetz, note 11, at 60-63 (elaborating on grandfathering in the muni bond context).

tinuity, and efficient, because it reduced the need for costly precautions against the risk of tax law change."[32]

B. The New View

Articles by Michael Graetz (in 1977) and Louis Kaplow (in 1986) transformed the transition policy discourse. Both rejected the premise of the old view, arguing that it is unreasonable for taxpayers to ignore the possibility of law change when making decisions[33] and arguing for a non-mitigation norm,[34] often called the "new view" of tax transition policy.[35] In particular, they argued that "[p]eople should make investments with the expectation that political policies may change"[36] and that taxpayers should take into account "probability estimates of possible changes in the legal regime."[37] Kaplow and Graetz argued that transition relief generally blunts taxpayers' incentives to anticipate socially valuable policy changes and "insulates investors from the real effects of their decisions, [thereby] distort[ing] behavior" by, for example, leading to overinvestment in investments that are tax-favored under the then-applicable law.[38] In contrast, declining to provide transition relief (i.e., allocating tax transition risk to the private sector via a transition policy of non-mitigation) incentivizes taxpayers "to take into account the prospects for government reform,"[39] leading to a more "efficient level of investment . . . induced [because] investors bear all real costs and benefits of their decisions."[40]

Core to Kaplow's and Graetz's arguments for a non-mitigation norm is an analogy between the risk of tax law change and other market risks that taxpayers face, such as "a change in market demand or technology."[41] Graetz questions, "What . . . is the difference between market and political processes that justifies protection only from political change?"[42] And Kaplow argues that "[f]or purposes of analyzing

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[32] Shaviro, note 10, at 2-3 (summarizing the rationale for the old view).

[33] Graetz, note 11, at 75-76; Kaplow, note 11, at 522-26.

[34] Kaplow, note 11, at 551 (favoring "a transition policy of nominally prospective implementation of changes in government policy with no transition relief" and retroactive application of policy changes curtailing previously permitted "undesirable" activity); Graetz, note 11, at 87 (arguing against the use of grandfather provisions).

[35] Hasen, note 10, at 124.

[36] Graetz, note 11, at 87.

[37] Kaplow, note 11, at 525-26.

[38] Id. at 513; see Graetz, note 11, at 63-73.

[39] Kaplow, note 11, at 531.

[40] Id. at 528-29; see also Levmore, note 25, at 1658 (calling this an "anticipation-oriented" approach).

[41] Graetz, note 11, at 65; see Kaplow, note 11, at 533. But see Hasen, note 10, at 142-45 (arguing that legal changes and factual/market changes are not equivalent).

[42] Graetz, note 11, at 65.

risk and incentive issues, the source of uncertainty is largely irrelevant. A private actor should be indifferent as to whether a given probability of loss will result from the action of competitors, an act of government, or an act of God."[43] Thus, they argue that, just as the government generally allocates market risk to the private sector and does not compensate for losses arising from market changes, the government generally should allocate tax transition risk to the private sector and should not compensate for losses arising from tax law changes.[44] Said differently, "because the optimally efficient rule for managing market risks is private ordering, or self-help, private ordering [rather than government relief] should apply to managing legal transition risk as well."[45] Kaplow discusses the analogy to market risk in detail, and he contends that taxpayers who are concerned about the risk of law changes should respond using market mechanisms similar to those used to respond to other risks: through diversification or insurance, adjusting how they price an investment, and/or changing how much they invest, among other responses.[46]

For example, the new view supports making the repeal of the muni bond interest exclusion effective as of the date of enactment of the new law (i.e., a nominally prospective effective date)[47] and providing no transition relief. If bondholders are adversely affected because, when deciding to invest in muni bonds, they failed to consider the possible repeal of the exclusion, they suffer due to their lack of anticipation. Had they anticipated the possibility of repeal, they would have made their investment decision not based on the bond's value under steady-state conditions, but rather based on the bond's *expected* value (i.e., weighing the value from each alternative—continuation or repeal[48]—by its probability of occurrence).[49] That could have caused them, for example, to pay less for the bond. If the purchase price of

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[43] Kaplow, note 11, at 534.

[44] Id.

[45] Hasen, note 10, at 135 (explaining the new view).

[46] Kaplow, note 11, at 525-28, 535.

[47] A "nominally prospective" change is one with an effective date no earlier than the date of enactment of the change. In contrast, a "nominally retroactive" change has an effective date prior to the date of enactment of the change. Although nominally prospective changes do not, by their terms, apply to events occurring before enactment, such changes can still have *retrospective impact* because they can still affect the value and economic consequences of actions taken before the date of enactment. See Graetz, note 11, at 49–52; see also Daniel E. Troy, Toward a Definition and Critique of Retroactivity, 51 Ala. L. Rev. 1329, 1332–39 (2000) (distinguishing retroactivity from retrospectivity).

[48] There could be other alternatives. "There are [actually] three primary types of proposals that include changes to state and local government bonds—capping the preference, eliminating the preference, and changing the preference to a direct issuer subsidy." Grant A. Driessen, Cong. Res. Serv. RL30638, Tax-Exempt Bonds: A Description of State and Local Government Debt (2018). However, for simplicity, the text assumes a binary policy choice.

the bond already took account of the cost of potential repeal, no additional compensation would be warranted upon repeal if it occurs. Proponents of the new view seek to incentivize this type of anticipation by taxpayers because it leads to a more efficient allocation of resources.[50]

C. Subsequent Work

Although the new view became dominant,[51] the tax transition policy debate continues. Most notably, Daniel Shaviro has also generally endorsed a non-mitigation norm for tax policy transitions.[52] Although he rejected Kaplow's and Graetz's assumption that all changes improve the law,[53] Shaviro shared Kaplow's and Graetz's concern about the economic incentives that transition policies create for taxpayers[54] and drew on the analogy between risks relating to tax law changes and risks related to market changes.[55] Among other contributions, Shaviro discussed taxpayers' often heterogeneous risk preferences and argued that, "to the extent that people determine and achieve their preferred risk positions without regard to transition policy, offering transition relief against the risk of legal change is both unnecessary when they want to avoid a given risk and ineffectual when they want to bear it."[56] Shaviro's "risk preference" framing of taxpayer responses to transition risk helps explain why taxpayers, even those who rationally anticipate a possible tax law change, might take different approaches

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[49] Graetz, note 11, at 65-66 n.57 (citing A. K. Sen, Collective Choice and Social Welfare 95 & n.9 (1970) for the proposition that "The expected utility hypothesis which typically forms the basis for economic analysis of 'rational behavior in risky situations' treats individual behavior as 'an attempt at the maximization of . . . utility numbers' where '[t]he utility from each alternative is weighted by its probability.'").

[50] Kaplow, note 11, at 513.

[51] Hasen, note 10, at 124.

[52] Shaviro, note 10, at 98-101, 229. More specifically, for policy (as opposed to accounting) changes, Shaviro would allow the imposition of *retroactive* taxes and would deny transitional relief. Id. at 101. In his book, Shaviro also endorsed a norm against the imposition of nominally retroactive taxes, but he has since argued that this norm lacks the "intellectual coherence to be put on a par with [the other two norms he endorsed in his book]." Daniel J. Shaviro, When Rules Change Revisited, 13 J. Contemp. Legal Issues 279, 291 (2003).

[53] Shaviro, note 10, at 64-91 (discussing how public choice issues affect the direction of the law and the analysis of transition policy).

[54] Id. at 286-89.

[55] Id. at 287.

[56] Id. at 286; see also id. at 33-42. Shaviro explains that some taxpayers are unable to achieve their preferred risk preferences for various reasons including cognitive biases, the nature of the risk (i.e., whether the risk is systematic or particularly hard to diversify), and market failures. Id. at 40-42. In these situations, he argues that transition relief may be warranted. Id.

to possible change.[57] Moreover, this helps explain why a market for responding to tax transition risk exists at all—namely, taxpayers seek distinct risk positions, and thus may, for example, serve as counterparties in risk-shifting transactions. In addition, Shaviro provided the literature's most comprehensive discussion (only a few pages) explaining how taxpayers could achieve their preferred risk positions through private contracting.[58]

Some commentators, on the other hand, reject a key premise of the anticipation-based new view by challenging the analogy between tax law changes and market changes. They argue that possible tax law changes are unlike possible market changes because, among other reasons, the government controls the timing of the former but not the latter.[59] Indeed, there is only a transition policy question for law changes *because* there is a choice about when the law change becomes effective; the same question is not present with market changes, which just occur when they occur.[60] Thus, although private market transactions may often be the most efficient way for taxpayers to manage market risk, the government's control over (and information about) the occurrence and timing of the tax law change suggests that it may be "cheaper or more effective"[61] for the government to provide protection from tax transition risk than it would be to demand that taxpayers anticipate and use market mechanisms to respond to the possibility of law changes.[62] That is, the government, rather than taxpayers, may be the least-cost avoider. If so, the government is more likely to be able to both reduce and spread transition costs, and thus may be the superior bearer of the transition risk.[63]

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[57] In addition to having different risk preferences, taxpayers may have different beliefs about the likelihood of particular tax changes. See id. at 33.

[58] Id. at 35-36.

[59] See, e.g., Hasen, note 10, at 142-45.

[60] Id.

[61] Shaviro, note 10, at 41 (explaining that government-provided transition relief may be appropriate where it provides "cheaper and more effective protection" than private risk-allocating transactions).

[62] Kyle Logue also argued, in particular, that "the anticipation-based story [should have] little to say . . . [particularly] when legal change occurs merely because there is a change in the political power structure—say, the Republicans boot the Democrats out of office, or vice versa." Where "legal change is best understood as the product of a game of political tug-of-war," legal change is not akin to market progress, and transition policy should not incentivize taxpayers to use market mechanisms to manage the risk of change. Rather, transition policy should seek to "minimiz[e] risks of expropriation." Kyle D. Logue, Legal Transitions, Rational Expectations, and Legal Progress, 13 J. Contemp. Legal Issues 211, 214 (2003).

[63] See Eric Chason, The Economic Ambiguity (and Possible Irrelevance) of Tax Transition Rules, 22 Va. Tax Rev. 615, 638-42 (2003); Kyle D. Logue, Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment, 94 Mich. L. Rev.

Moreover, some question taxpayers' abilities to anticipate legal change in the ways that the new view expects and argue that, even if taxpayers can rationally anticipate law change, transition policy should only expect them to do so if legal change improves the law.[64] Thus, they argue that, while there may be a narrow set of circumstances in which it is appropriate to allocate transition risk to the affected taxpayers, doing so on "incentive or anticipation grounds just does not make sense for most legislative tax law change."[65]

In addition, some commentators renewed calls for transition relief on other grounds, including that (1) Congressional precommitment to providing transition relief reduces the costs arising from lobbying by interest groups seeking to protect their tax preferences;[66] (2) transition relief may facilitate legislative compromise, thereby making reform more politically feasible;[67] and (3) transition relief can reduce the government's cost of tax incentives that try to influence behavior.[68] Although these commentators advocate for transition relief, their arguments generally reflect an anticipation-based understanding of legal transitions. They contemplate that taxpayers who anticipate the possibility of a tax change might alter their behavior in response. Specifically, taxpayers might lobby more for their preferred substantive rule and preferred transition policy[69] or pressure their representatives to entrench a current tax preference, thereby hoping to impede changes in the law.[70] Further, if taxpayers know a tax incentive might be repealed, they might demand a larger tax benefit before they will take the desired action.[71] Thus, these arguments for transition relief

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1129, 1154-58 (1996); see also Howard E. Abrams, Rethinking Tax Transitions: A Reply to Dr. Shachar, 98 Harv. L. Rev. 1809, 1819 (1985).

64 Logue, note 11, at 222-29, 242-44.

65 Id. at 256-57.

66 J. Mark Ramseyer & Minoru Nakazato, Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow, 75 Va. L. Rev. 1155 (1989) (arguing that transition relief lessens legislators' abilities to extract "protection" money, thereby improving overall societal welfare); see also, e.g., Rebecca M. Kysar, The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code, 40 Ga. L. Rev. 337, 362-67 (2006) (similar argument against sunset provisions).

67 See, e.g., Doran, note 11, at 545, 547, 581-89; Levmore, note 25, at 1684.

68 Logue, note 63, at 1138-43 (arguing that failing to provide transition relief for incentive subsidies ("provisions whose primary purpose is to alter taxpayers' decisions regarding how they will invest their resources") might increase the overall cost to the government because taxpayers might demand a larger tax benefit given the risk of repeal). Steven Shavell makes a related argument in favor of grandfathering policies that resulted in investment in "durable precautions" (e.g., investment in expensive technology to comply with prior rules). Steven Shavell, On Optimal Legal Change, Past Behavior, and Grandfathering, 37 J. Legal Stud. 37, 38-39, 46-47 (2008); see also Masur & Nash, note 19, at 398 (summarizing additional arguments).

69 Ramseyer & Nakazato, note 66.

70 See Masur & Nash, note 19, at 400-01.

71 Logue, note 11, at 1138-43.

start largely from the same descriptive baseline as the new view (i.e., transition policy should consider how taxpayers act in anticipation of law changes). However, rather than concluding that such anticipation increases efficiency, these arguments conclude that costs of the anticipatory actions exceed the costs of providing transition relief, supporting the allocation of tax transition risk to the government. Thus, anticipation-induced taxpayer behavior may make transition relief preferable.

II. Understanding Taxpayer Behavior When Tax Rules May Change

Many of the foregoing arguments about whether transition risk should be allocated to the public or private sector depend on how taxpayers act and should act, given the possibility that tax law could change. As a result, the reality of taxpayer behavior affects how compelling different tax transition policy arguments are and in what circumstances. For example, the new view expects taxpayers to manage tax transition risk using market solutions, and thus even new view proponents acknowledge that, where taxpayers cannot use market mechanisms efficiently to mitigate transition risk effectively (e.g., because of a taxpayer's attributes, details of the possible law change, or market imperfections), government relief (i.e., an exception to the new view) might be warranted.[72]

Of course, different possible tax law changes can produce different taxpayer responses. Responses depend on the magnitude, likelihood, directionality, and potential volatility of the change; the time horizon for the change; the reasons for the potential change; the options available to the taxpayer in light of the change (e.g., whether the taxpayer can defer the decision, and whether the options are discrete or continuous); and the cost of potential responses, among other things.[73]

Despite the many variables relevant to taxpayers' responses to possible tax law changes, several responses are relatively common. Tax-

[72] See Michael J. Graetz, Retroactivity Revisited, 98 Harv. L. Rev. 1820, 1835-37 (1985) (arguing that taxpayers' abilities to bear and spread risk are relevant to the choice of transition rule); Kaplow, note 11 (1986), at 536-51; Shaviro, When Rules Change Revisited, note 52, at 286.

[73] See, e.g., Diana Falsetta et al., Decision Making under Tax Provision Uncertainty: The Case of Sunsets (May 9, 2018) (studying taxpayer responses based on the nature or reason for a sunset provision) (unpublished manuscript) (on file with the *Tax Law Review*); Gilbert E. Metcalf & Kevin A. Hassett, Investment with Uncertain Tax Policy: Does Random Tax Policy Discourage Investment, 109 Econ. J. 372 (1999) (directionality); Ernesto Zangari et al., Tax Uncertainty: Economic Evidence and Policy Responses 11, 14-16 (Eur. Comm'n Taxation Papers, Working Paper No. 67-2017, 2017). https://www.researchgate.net/publication/316284939_Tax_Uncertainty_Economic_Evidence_and_Policy_Responses.

payers could ignore the possibility of the law change and merely assume perpetuation of current law. Alternatively, taxpayers might lobby their representatives to support or oppose the substantive law changes or to advocate for or against transition relief if the substantive law changes.[74] In addition, taxpayers might respond to tax transition risk using various market-based strategies, including timing changes, price changes, changes in the decision to act at all, and diversification/hedging. This Part discusses each of these well-understood market-based responses. Later, Part III will turn to an additional, less commonly discussed, market-based mechanism through which taxpayers achieve their tax transition risk preferences—private contracting.

A. Change the Timing to Complete the Transaction During the Period Likely to Have More Favorable Tax Rules

The most commonly discussed market-based response to tax transition risk is for the taxpayer to adjust the timing of a transaction to complete it during the period likely to have more favorable tax rules.[75] Just as an *announced* change in rules can lead to "taxpayers either rushing to engage in "under-the-wire" activity before tax rules become less favorable or sitting on their hands until it becomes more favorable,"[76] a *possible* change can lead to a similar result. "Behavior in response to tax rates [or other tax changes] can be affected not only by the tax [rules] now in place but [also by] expectations as to what those tax [rules] might be in the future."[77]

For example, a recent study by David Kamin and Jason Oh demonstrated that "capital gain rate uncertainty can create significant financial incentives to change the timing of realization."[78] Kamin and Oh concluded that "[t]he relative magnitude of these [behavioral] effects

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[74] See text accompanying note 66.

[75] See Shaviro, note 10, at 105; Rebecca M. Kysar, Lasting Legislation, 159 U. Pa. L. Rev. 1007, 1064 (2011).

[76] Shaviro, note 10, at 105; see also, e.g., James M. Poterba et al., Deferred Tax Positions and Incentives for Corporate Behavior Around Corporate Tax Changes, 64 Nat'l Tax J. 27, 29 (Mar. 2011) (a scheduled tax rate decrease can lead a firm with "large deferred tax assets" to accelerate income recognition and can lead other firms to defer income recognition); Ben Steverman, Want a Divorce? Then Do It Right Now or Pay Much Bigger Tax Bill (Nov. 2, 2018) (discussing the possibility of accelerating a planned divorce into 2018, before the effective date of the 2017 Act's changes to the treatment of alimony).

[77] Kamin & Oh, note 11, at 2; Metcalf & Hassett, note 73, at 373 ("firms will delay or speed up investment depending on their perceptions of the probability and magnitude of [potential] tax changes").

[78] Kamin & Oh, note 11. This response was well accepted. See, e.g., Alan J. Auerbach, Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric, Brookings Papers on Econ. Activity (2) 595 (1988); Oh, note 11, at 1199; Oh & Tausanovitch, note 3, at 521-22. However, "the magnitude of the effect and its possible implications [had] never been extensively analyzed" before Kamin & Oh's study. Kamin & Oh, note 11, at 3.

[of capital gains rate uncertainty] depends on a number of factors, including the investment time horizon, the degree of risk aversion, and the likelihood of future rate changes."[79]

Studies by other scholars identified similar timing responses to uncertainty about future changes in the tax rate applicable when U.S. multinational corporations repatriate foreign profits held abroad. An empirical study by Thomas Brennan showed that the 2004 repatriation tax holiday, which was purportedly a onetime event, conditioned firms to expect future tax holidays, leading them to build up foreign earnings abroad and defer repatriation in anticipation of a possible future repatriation rate reduction.[80] Another study by other scholars found a similar effect in response to a credible 2008 proposal (not ultimately enacted) for a reduction of the tax rate on repatriated funds.[81] They documented that "firms proactively respond to *deliberated* tax incentives, and engage in (presumably) unconditionally negative NPV behavior in the short term (i.e., [deferring repatriation, leading to] excess cash holdings [abroad]) in exchange for future, risky tax gains."[82]

Additional examples abound where taxpayers change the timing of their actions in response to anticipated, but uncertain, tax law changes. In the lead-up to the passage of the Tax Reform Act of 1986, taxable firms delayed income in anticipation of the possibility that corporate tax rates would be reduced.[83] In light of uncertainty in 2010 about possible future increases to the estate and gift taxes, estate planning advisers suggested that taxpayers consider accelerating gifts into 2010 to take advantage of 2010's gift tax rates,[84] and some people even discussed whether to time a loved one's death given anticipated future changes to the estate tax.[85] More generally, sunset clauses have similar

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[79] Kamin & Oh, note 11, at 3-4 (also identifying that the incentive effect of small potential changes was stronger among some taxpayers than others).

[80] Brennan, note 11, at ¶¶ 3-4, 41-42.

[81] Lisa De Simone et al., Repatriation Taxes and Foreign Cash Holdings: The Impact of Anticipated Tax Reform (Stan. U. Graduate Sch. of Bus., Working Paper No. 3507, 2017) ("provid[ing] evidence on how evolving beliefs about the enactment of future tax policy shape corporate behavior"), https://www.law.nyu.edu/sites/default/files/upload_documents/Repatriation%20Taxes%20and%20Foreign%20Cash%20Holdings%20-%20De%20Simone.pdf.

[82] Id. at 8 (emphasis added).

[83] Scholes, Wilson & Wolfson, Firms' Responses to Anticipated Reductions in Tax Rates: The Tax Reform Act of 1986, 30 J. Acct Res. 161 (1992).

[84] WTAS, Pulling the Plug on Estate and GST Tax Savings (Dec. 2010), https://www.andersentax.com/newsletter/2010/december/pullingtheplug.php.

[85] Merrell Bailey, Death Arbitrage: Should I Pull the Plug Today? There's No Estate Tax (Jan. 10, 2010) (questioning whether "to allow someone you love to die today, or keep the person alive, betting that Congress will change the estate tax laws in a manner more favorable to a delayed death"), https://www.yourcaringlawfirm.com/blog-6-death-arbitrage-should-i-pull-the-plug-today-there-s-no-estate-tax/; see also Barry A. Nelson, Throw

implications—potentially encouraging taxpayers to accelerate an action into the period before the sunset (if that period's tax rules are more favorable) because of uncertainty about whether the favorable tax provision will be extended.[86]

With the timing adjustments discussed above, taxpayers are, in effect, betting that the law will change in a particular way,[87] but taxpayers can also use timing changes to hedge their bets about possible tax law changes. If a taxpayer spreads out its actions—taking some action now and deferring some for later (i.e., a time-cost averaging-like approach), the taxpayer's potential benefits from a taxpayer-favorable change in law are reduced, but so are the taxpayer's potential detriments from a taxpayer-unfavorable change. Thus, taxpayers can also use timing adjustments to reduce their exposure to tax transition risk.

B. Change the Price or Return to Account for the Risk

Tax transition risk can lead not only to changes in timing, but also to changes in the price and required return for an investment.[88]

The possibility that an asset's favorable tax treatment might be reduced or eliminated likely reduces the price that the taxpayer is willing to pay for the asset. For example, if repeal of the exclusion for interest on muni bonds (without grandfathering) looks increasingly likely, the muni bonds' tax preference will decline in value, approaching zero if repeal is imminent.[89] As repeal becomes more and more certain, an investor will be willing to pay less and less for the bond, and the bonds will trade at a discount to the price at which they would trade in the absence of any tax transition risk.

Similarly, if the favorable tax treatment for an investment might be reduced or eliminated, the taxpayer will likely demand a higher return to induce the taxpayer to make the (currently) tax-favored investment. For example, if the government creates a tax preference to incentivize taxpayers to take a particular action but the tax preference is

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Me From the Train (Oct. 2008), http://www.estatetaxlawyers.com/articles/2008-10%20T&E%20Throw%20Me%20From%20the%20Train.html.

[86] Kysar, note 75, at 1064.

[87] Acceleration of action bets that the law will change in a taxpayer-unfavorable way, while delay bets that the law will change in a taxpayer-favorable way. Cf. Auerbach, note 78, at 605 ("holding a[n asset, that if sold, would produce] capital gain is like buying an option based on future tax rates").

[88] An investment's purchase price and return are related, which is why they are grouped together here. For example, for a muni bond with fixed-rate interest, the greater the purchase price is discounted from par, the greater the return inherent in the bond.

[89] Chason, note 63, at 619 ("The keen insight of Graetz and Kaplow is that a transition policy of no-grandfathering can result in an automatic repricing of the tax preference. If taxpayers know that repeal without grandfathering is inevitable in the short term, they will also know that the tax preference is nearly worthless.").

at risk of disappearing, taxpayers will likely demand a larger tax preference than they would if the continuation of the tax preference was certain.[90]

These price changes and demands for higher returns likely arise for at least two reasons. First, risk-averse taxpayers often demand risk premiums.[91] Second, even for risk-neutral rational taxpayers, the return to the investment with an at-risk tax preference must be higher for the investment to have the same probabilistically weighted expected value as the investment would have absent the risk.[92] If the price/return can be adjusted to account for the tax transition risk, a deal can be struck, albeit at a different price than had the tax law been stable.

C. Factor in the Risk and Choose One Option

Sometimes, taxpayers just factor in the risk of tax law changes and make a decision. This is often required with "all-or-nothing" choices, where a taxpayer cannot change the price or timing and must choose among two or more discrete options. For example, should a business owner who owns one business operate that business as a corporation or a partnership? Should an entrepreneur choosing between two possible business opportunities pursue the one where the profitability depends on continued availability of, and eligibility for, the § 199A deduction? Should a founder of a new business incorporate that business in the United States or abroad? Should a multinational business with one major IP asset onshore that asset or leave it overseas? These decisions and many more[93] depend, at least in part, on whether the tax changes made by the 2017 Act are likely to persist.

When faced with such choices, a rational taxpayer would determine the expected value of each option, taking into account the probability of the potential tax change and the tax consequences in each scenario (including the possibility that transition relief might be provided). A risk-neutral taxpayer would choose the option with the highest expected value. A risk-averse taxpayer might select the option with greater certainty, even if it has a lower expected value. Either way, the taxpayer makes a choice between discrete risk/reward combinations. And sometimes, factoring in the tax transition risk may cause a tax-

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[90] Logue, note 68, at 1138-39.

[91] Id.

[92] This assumes a tax preference might be reduced. Potential *increases* to tax preferences could also impact price and required return, but in different directions.

[93] See, e.g., Greenberg, note 4, at 12 (discussing how uncertainty about the deductibility of interest may impact a decision to borrow).

payer not to proceed at all,[94] thereby killing a transaction or investment that would have occurred had the tax law been expected to be stable.[95]

D. Diversify or Hedge Against the Risk

Taxpayers can also diversify or hedge. Diversification is one of the primary market methods for managing any type of financial risk, whether due to a risk of law change or otherwise.[96] A few commentators have explicitly suggested that diversification can help taxpayers protect themselves from adverse consequences of future tax law changes, particularly changes implemented without transition relief.[97] One way to use this strategy to manage tax transition risk involves broad market diversification, where a taxpayer's portfolio "is spread so widely amongst different assets that a single rule change (such as repealing the municipal bond preference) is unlikely to have much effect."[98] A more tailored approach involves making multiple investments on opposite sides of a specific risk. For example, a taxpayer concerned about the possible repeal of the exclusion for muni bond interest could invest in taxable bonds in addition to municipal bonds. This hedges the tax transition risk because, if the exclusion is repealed without transition relief, the muni bonds' values decline, but the taxable bonds' values increase.[99]

It is not always possible to manage transition risk through this type of diversification or hedging. Diversification cannot eliminate tax transition risk that is common across most all assets (i.e., systematic

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[94] Kaplow, note 11, at 529-30; Kaplow, note 15, at 180 ("prospect of such reform [e.g., a tax on a product later determined to be harmful] will, in the absence of relief, discourage investment in producing the product").

[95] Tax transition risk can prevent a deal from occurring even if there is an array of continuous pricing options. For example, the price that a taxpayer is willing to pay (given the risk of law change) may just be below the price any seller is willing to accept.

[96] Kaplow, note 11, at 527 ("diversification through the financial markets is the other primary market mechanism for spreading risks").

[97] Id. at 537; Shaviro, note 10, at 35; Linda A. Schwartzstein, Smoke and Mirrors: Tax Legislation, Uncertainty and Entrepreneurship, 6 Cornell J.L. & Pub. Pol'y 61, 74 (1996).

[98] Shaviro, note 10, at 35.

[99] Id. This strategy can be flipped if the taxpayer wants to increase, rather than reduce, exposure to the particular tax transition risk. That is, instead of hedging or diversifying to reduce exposure to tax transition risk, a taxpayer may intentionally choose to concentrate investments, thereby increasing the taxpayer's exposure to the risk that the law might change. To illustrate, if the exclusion for muni bond interest may be repealed without grandfathering, a taxpayer could concentrate her investments in muni bonds, thereby betting that the exclusion will not be repealed. On the other hand, a taxpayer avoiding munis and concentrating investment in taxable bonds makes the opposite bet. Thus, taxpayers might respond to transition risk by diversifying or concentrating their investments depending on whether they want to reduce or increase, respectively, their exposure to the risk of change.

transition risk).[100] In addition, for some tax change risks, it may be difficult to find pairs of investments where the change in law would harm one investment but help the other. Moreover, taxpayers cannot always adjust the magnitude of their investments on sliding scales.[101] As noted above, some choices, like choice of entity questions, involve discrete, rather than continuous, options. But there may be opportunities to spread even that risk. For example, although any individual enterprise must choose whether to be taxed under one regime or the other, a private equity firm concerned that corporate rates might increase dramatically (and by more than individual rates) could invest in some businesses organized as corporations and others organized as partnerships. If corporate tax rates go up, the firm will be better off for having some of its portfolio invested in flow-through vehicles, and if corporate tax rates stay low, the firm will be glad that at least some of its portfolio is invested in corporations.

III. Private Contracting to Allocate Tax Transition Risk

The literature considers, at least to some extent, all of the market-based strategies discussed in Part II. However, all of those strategies fail, in some way, to offer a full response to tax transition risk. This is for at least two reasons. First, some market-based approaches are aggregate responses rather than responses tailored to the specific taxpayer. For example, market-based pricing changes (e.g., changes to the trading prices of muni bonds to reflect the possibility of tax law changes) enable marginal buyers and sellers to respond effectively to tax transition risk but are unlikely to meet the transition risk preferences of other taxpayers. Second, even when strategies are tailored to the specific taxpayer, the strategies are subject to inherent limitations. For example, timing adjustments can be useful responses to tax transition risk, but only so much work can be done in the finite amount of time before a tax law change is enacted. Similarly, a taxpayer's ability to change the price of an asset to account for the possibility that the tax law might change depends on whether there is a counterparty willing to transact at the taxpayer's desired price. Further, once transition risk is factored into a decision and a choice is made, it may not be possible to undo the choice without material additional costs. And, as explained above, it is not always possible to manage tax transition risk fully through diversification and hedging.

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[100] Id. at 41.

[101] For example, it is difficult to diversify the risks associated with human capital because "people typically need to specialize in specific occupations that may be sensitive to rule changes." Id.

There is another market-based strategy that taxpayers can use—private contracting—which offers promise for managing tax transition risk that remains unaddressed by the strategies described in Part II. However, this strategy has received little attention in the literature. Private contracting, as a strategy for managing tax transition risk, contemplates that two or more parties will enter into a contract that states how parties' economic relationship will change (e.g., one party will pay another party more money or one party can exit the deal at a predetermined price) if a specified tax law change occurs. This type of private contracting has two crucial features that distinguish it from the market-based responses to tax transition risk described in Part II, which may involve contracts (e.g., a contract to sell an asset sooner rather than later). First, private contracting involves a contract that explicitly references particular possible changes in the tax law, while the other market-based strategies do not.[102] Second, because the contract enumerates specific consequences that arise if the particular tax law change occurs, private contracting allows for responses to tax transition risk that are much more tailored to the individual taxpayers and their preferences than are possible under other market-based responses to transition risk.

This type of private contracting allows parties to allocate the economic benefits and burdens of a possible tax law change among multiple parties within the private sector.[103] By doing so, parties can change the incidence of the economic consequences that arise from future tax law changes.

Returning to the muni bond example illustrates the point. If a taxpayer owns a muni bond bearing 4% interest and the interest exclusion is later repealed without transition relief, the taxpayer's after-tax return will decline from 4% to 3% (assuming, for ease, a 25% tax rate and setting aside any price effects that might result from the tax

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[102] Any contracting involved in the strategies described in Part II generally references the *asset* that could be affected by the potential tax law change (e.g., the asset being purchased at a different time or different price) but does not reference the *particular tax law change* itself.

[103] In limited circumstances, it may also be possible for a private party to contract directly with the government entity that has the power to change the tax law. In these "tax stabilization agreements," the government typically guarantees that certain taxes of a private party will be fixed as of a certain time, for a specified period of time, thereby protecting the party from adverse changes in tax law. See, e.g., James M. Otto, Creating a Positive International Mining Investment Climate, Rocky Mountain Mineral L. Found. Annual & Special Inst. 1-1 §7 (2003) (use of tax stabilization agreements in connection with international mining investments). Although a tax stabilization agreement is a *contracting* response to tax transition risk, it is different from the private contracting discussed in this Article because a tax stabilization agreement confers *government-provided* transition relief (albeit for a single taxpayer rather than for all taxpayers) and is not a *market* mechanism for responding to tax transition risk.

change). But if the muni bond indenture provides that the issuer will gross-up the interest payments if a change in law repeals the exclusion, the issuer would pay 5.33% interest. After a 25% tax, the taxpayer would still be left with a 4% after-tax return, equal to the taxpayer's 4% net return before the law change. Thus, although the tax law change nominally affects the investor and not the issuer, the issuer suffers the economic harm resulting from the tax law change because the parties shifted the tax transition risk via contract.

This is not a theoretical example. Some muni bond indentures provide for a tax gross-up if the exclusion is repealed.[104] There are several other real-world examples of this type of arrangement where a party concerned about the adverse impact of a possible tax law change explicitly shifts the risk to a counterparty through a contingent contractual agreement. Those counterparties are typically parties to the underlying transaction (as in the muni bond example) but could, at least theoretically, also be third parties who are otherwise uninvolved in the matter (as with insurance).[105]

It is well understood that contracts can be used to shift risk,[106] but the literature pays little attention to taxpayers' use of contracts to shift tax transition risk. A few scholars raise the possibility of managing tax transition risk through third-party insurance (i.e., contractual protection provided by a counterparty not otherwise involved in the underlying matter).[107] In addition, one article by nontax scholars meaningfully explores why a market in legal change insurance does not exist and is unlikely to develop.[108]

There is even less attention paid to contractual agreements that explicitly allocate tax transition risk between parties to an underlying transaction (e.g., as in the muni bond example). Shaviro says the most when he briefly raises the possibility of such arrangements; he identifies the use not only of "explicit private insurance" but also the use of "some sort of contract right that functions like an insurance agreement without bearing the name" as devices through which a taxpayer can select "the level and type of risk exposure that one prefers."[109] He also posits a theoretical muni bond example involving a "case where the bonds' issuer . . . commits to make specified extra payments in the

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104 See Part III.B.3.

105 See Part IV.B.

106 See Arrow, note 14, at 138-39 (explaining that all contracts that involve events that happen in the future involve risk and allocation thereof); Ayres & Gertner, note 14 , at 87-88 (discussing contracts as opportunities to opt out of default rules, thereby shifting rights, obligations, and risks).

107 Shaviro, note 10, at 35; Graetz, note 11, at 75 (wondering why no insurance market exists); Kaplow, note 11, at 527-28; Kaplow, note 15, at 176-84.

108 Masur & Nash, note 19, at 433-35.

109 Shaviro, note 10, at 35; see also Green, note 15, at 491-92.

event of repeal [of the exclusion], thus protecting the investor against transition risk" or a "put option, entitling the investor to sell the affected municipal bond for a specified price (reflecting expected value but for repeal)."[110] However, even Shaviro's discussion is presented as merely theoretical.

This Part provides empirical evidence about whether such contracting actually occurs, and if so, when and how. To do so, Part III.B examines four real-world case studies where private contracting is explicitly and intentionally[111] used to allocate the risk of tax law change among parties to a transaction. Later, Parts IV, V, and VI will examine the implications of these case studies.

Before turning to the case studies, however, Part III.A first explains the economics of these tax transition risk-shifting contracts.

A. The Risk-Shifting Function of Contracts Contingent on Tax Law Changes

Consider again the muni bond example where the issuer agrees to gross-up the interest payments if the exclusion is repealed. When investors buy the bond, they are paying for multiple things: (1) the stream of future interest payments (plus ultimate repayment of principal), and (2) the right to receive gross-up payments in the event of repeal of the exclusion. Because the investor bought more than a regular muni bond (i.e., which lacks the contingent gross-up), the investor likely paid more for (or accepted a lower return on) the bond with the gross-up than the investor would have for a similar bond without it. In effect, the investor pays a slightly higher up-front price to obtain guaranteed transition relief, albeit from the transaction counterparty rather than from the government, and the issuer gets paid a little more up front as compensation for agreeing to bear the economic cost of a possible future change in the muni bond exclusion. Said differently, the investor not only buys the bond but also buys tax transition insurance from the issuer.

Thus, like the market-based responses to tax transition risk discussed in Part II, private contracting also allows different parties to achieve their risk preferences. An issuer can include a gross-up provi-

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[110] Shaviro, note 10, at 35.

[111] This Article focuses on intentional and explicit contracting to shift tax transition risk, but there may be some instances where a contract *implicitly* allocates the benefits and burdens of a future law change. This could arise anywhere a party's contractual right is determined based on whatever the law is at the relevant time. For example, if terms in a partnership agreement are defined with reference to a section of the Code or regulations, any change to that section of the Code or regulations could be interpreted as integrated into the contract. Which party benefits or is burdened depends on what the law is, but such a provision implicitly allocates the tax transition risk.

sion to bet that the exclusion will persist and omit the gross-up if it is concerned about the possible change and uninterested in downside exposure. Similarly, an investor seeking to minimize exposure to the risk should purchase bonds with the gross-up, but an investor comfortable with bearing the risk should purchase bonds without the gross-up.

Fundamentally, these types of tax transition risk-shifting arrangements are what Lee Anne Fennell calls "risk/expected value exchange[s] (REVE[s])."[112] Fennell explains that, "[i]n the simplest REVE, one party receives or pays the expected value of a set of possible future states of the world, while the other party accepts the loss or gain, if any, associated with the state of the world that actually obtains."[113] That is, a simple REVE shifts risk through a swap: the payment of a sum certain in exchange for future cash flow contingent upon the occurrence of an uncertain future event. This is what the contingent gross-up in the above muni bond example achieves. The investor makes an additional payment to the issuer in exchange for the issuer's agreement to make gross-up payments on the interest if the exclusion is repealed. The investor's additional payment for this protection should (theoretically) be calculated based on the expected value of the gross-up.[114]

A numerical example can illustrate how tax transition REVEs work. Consider *Buyer* and *Seller*, both of whom price an asset at $100 in a world where there is absolute certainty that the applicable tax law will not change. The asset will change hands between *Buyer* and *Seller* at a price of $100. Now assume that there is a chance that the tax law could change, imposing a $30 tax on *Buyer*. If *Buyer* believes[115] that the chance of change is 30% and *Seller* believes that the chance of change is 20%, the parties would reach an impasse. *Buyer* would be willing to pay no more than $91 ($100 minus its $9 expected value of the tax), but *Seller* would be willing to accept no less than $94 ($100 minus its $6 expected value of the tax). Thus, no deal for the asset could be reached, even if the parties try to use the market-based responses to transition risk described in Part II. However, the parties can enter into a tax transition risk-shifting contract that shifts the potential economic cost of the tax to *Seller*. If they do so, *Buyer* reverts

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[112] Lee Anne Fennell, Unbundling Risk, 60 Duke L.J. 1285, 1298 (2011).

[113] Id. at 1298-99.

[114] Risk-averse investors may be willing to pay a risk premium for the protection provided by the gross-up. The pricing also depends on whether the investors have access to the details of the contract terms and whether the market can differentiate between bonds with and without a gross-up.

[115] Assume, for purposes of the examples, that each party held an honest belief about the likelihood of change and was not merely posturing to get a better price in the negotiation.

to pricing the asset at $100,[116] and the asset sale should proceed, at some price between $94 and $100 (e.g., at $96 if *Buyer* has a bargaining power advantage). This deal involves a REVE. Today, *Buyer* pays *Seller* $5 more than *Buyer* would have otherwise been willing to pay for the asset, and in exchange, *Seller* agrees to bear the risk of the law change (i.e., make *Buyer* whole for the tax if it ultimately arises). And the amount of *Buyer*'s additional payment is determined with reference to the parties' expected value of the tax.[117]

This example helps illustrate that a contract contingent on a tax law change is merely a specific type of REVE. Understanding how this works facilitates extrapolation from the tax transition REVEs in the case studies to a wide variety of tax transition REVEs that could exist in the future. This extrapolation will be discussed in Part IV.A, after the case studies.

B. Case Studies of Tax Transition Risk-Shifting Contracts

Four real-world case studies—involving derivatives, credit agreements, municipal bonds, and public company merger and acquisition (M&A) agreements—provide evidence that taxpayers use private contracting to allocate tax transition risk and illustrate how such contracts vary. Differences include the protection provided (e.g., compensation and/or an exit right); how frequently the provision is used in the context (from very rarely to virtually always); the degree of standardization (from boilerplate language to bespoke); and how explicitly the parties factor the risk-shifting agreement into the overall economics of the underlying transaction, among other things.[118]

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[116] *Buyer* might price the asset with the tax transition REVE at slightly below $100 if *Buyer* anticipates counterparty risk (i.e., the possibility that *Seller* would not perform its obligations under the tax transition risk-shifting contract).

[117] The additional $5 payment is less than *Buyer*'s $9 expected benefit of being protected from the risk and is enough to ensure that *Seller* receives, in the aggregate, a premium over *Seller*'s $94 risk-adjusted price of the asset. In this example, *Buyer*'s additional payment, above the $91 *Buyer* is willing to pay for the asset subject to transition risk, should be between $3 and $9, with the final price determined in negotiation.

[118] Tax transition risk-shifting agreements also vary as to which types of tax law changes trigger the contractual provision (e.g., proposed changes or changes not yet effective). In addition, there is variation in the dispute resolution procedures applicable to determine how the tax transition risk-shifting agreement operates in a particular situation. It is hard to know precisely how such disputes are resolved because any such disputes are likely resolved privately. Some tax transition REVEs do, however, specify procedures for resolving disputes about the application of the provisions. See, e.g., Heather M. Field, Tax MACs: A Study of M&A Termination Rights Triggered by Materially Adverse Changes in Tax Law, 73 Tax Law. 823 (2020) (discussing a range of approaches taken in merger agreements for resolving disputes about whether a tax transition risk-shifting agreement is triggered).

The case studies begin with the most standardized tax transition risk-shifting agreements and progress to the most bespoke.

1. Derivatives

The Change-in-Tax-Law Provisions. Over-the-counter (OTC) derivatives contracts generally provide two consequences if a tax law change imposes additional, but unavoidable,[119] withholding tax.[120] First, the payor is generally obligated to gross up the payee for the additional tax, so the net amount ultimately received by the payee equals the amount the payee would have received absent the additional tax.[121] Second, the payor has a right to terminate a transaction where there is a substantial likelihood that a tax law change will trigger the gross-up obligation.[122]

These provisions are included in most all OTC derivative contracts, and the terms are largely boilerplate. Pervasiveness and standardization of these provisions are products of the International Swaps and

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[119] The imposition of additional withholding tax can sometimes be avoided by, for example, the payee's furnishing of specified information to the payor, or the payor's transfer of its rights and obligations under the agreement to a different office or affiliate of the payor. See Int'l Swap Dealers Ass'n, Master Agreement §§ 2(d)(4)(A), 4(a), 6(b)(ii) (1992) [hereinafter ISDA 1992 Master Agreement].

[120] The United States generally imposes a 30% tax on certain amounts (e.g., interest and dividends) from U.S. sources received by a foreign individual or corporation, subject to elimination or reduction by treaty or by certain exceptions in the Code. IRC §§ 871, 881. This tax is collected by withholding and is thus often referred to as a "withholding tax." IRC §§ 1441, 1442. Payments on derivative contracts can be subject to this withholding tax. IRC § 871(m); see generally Sam Chen & Paul J. Kunkel, Taxation of Equity Derivatives (Portfolio 188), Bloomberg Tax & Acct., https://pro.bloombergtax.com/portfolio/taxation-of-equity-derivatives-portfolio-188/ (last visited Apr. 14, 2020); Jessica L. Katz et al., U.S. Taxation of Foreign Corporations (Portfolio 908), Bloomberg Tax & Acct. https://pro.bloombergtax.com/portfolio/us-income-taxation-of-foreign-corporations-portfolio-908/ (last visited Apr. 14, 2020).

[121] ISDA 1992 Master Agreement, note 119, at § 2(d)(i)(4). There are some exceptions to this obligation, including if the additional tax is imposed due to misrepresentation by the payee or the payee's connection with the relevant jurisdiction. Id. at § 2(d)(i)(4), § 14 (definition of "indemnifiable tax"). The ISDA 1992 Master Agreement actually provides that the payor is obligated to gross-up the payee for all withholding taxes (subject to exceptions), even those that exist as of the date of the agreement. It would be extremely unusual for parties to enter into such an agreement if they expect withholding tax (and thus a gross-up obligation) to apply. Nevertheless, the gross-up for additional withholding taxes imposed as a result of a change in law merely extends this baseline treatment, so that all such withholding taxes are treated the same—they are grossed-up.

[122] Id. at § 5(b)(ii). Typically, there is only one ISDA agreement between any two parties, covering all of the derivative transactions between them. The termination right applies only to those specific transactions for which the gross-up is triggered; the rest of the agreement and the rest of the transactions are unaffected. Also, if a change in law results in an additional withholding tax that is *not* required to be grossed up, the *payee* has a termination right. Id. However, this is likely to occur infrequently because most increased withholding taxes resulting from law changes are required to be grossed-up.

Dealers Association Inc. (ISDA), which created master agreements (one in 1992 and one in 2002, both of which have the same tax transition risk-shifting provisions)[123] to standardize the market terms used in OTC derivative transactions.[124] Standardization is believed to provide benefits including certainty about the terms and their interpretation, and consistency, which reduces transaction costs.[125] The parties typically just sign their chosen ISDA master agreement, and they complete an attached schedule to provide transaction-specific details and make any desired adjustments to the master agreement's provisions.[126] Only in limited circumstances do parties adjust the tax provisions in the schedule.[127]

Risk-Shifting Achieved. The ISDA master agreement's tax transition provisions shift the risk of adverse withholding tax law changes.[128] The gross-up provision shifts the economic burden of a possible withholding tax increase from the payee to the payor.[129] However, receipt of ongoing gross-up payments is not guaranteed because the triggering of a gross-up obligation also generally provides the payor with an exit right.[130] This exit right reduces the magnitude of downside tax transition risk that the payor bears. If the payor concludes that the transaction is no longer worthwhile if a law change triggers a gross-up obligation, the payor can terminate. However, termination is optional, not mandatory, and the payor might not exercise the option, in which case the transaction will continue with gross-up payments. Thus, the ISDA master agreement does, on net, shift some risk of future withholding tax changes from the payee to the payor.

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123 Linda Z. Swartz, ABCs of Cross-Border Derivatives, in PLI Corporate Tax Practice Series: Strategies for Acquisitions, Dispositions, Spin-offs, Joint Ventures, Financings, Reorganizations & Restructurings 408-1, 408-66 (2018).

124 The ISDA 1992 Master Agreement became the industry standard and continues to be widely used despite the 2002 update. Sherri Venokur et al., Do End-Users Benefit from Entering ISDA Master Agreements?, GlobalCapital (Jul. 4, 2004), https://www.globalcapital.com/article/k65fsdm72yff/do-end-users-benefit-from-entering-isda-master-agreements; Ray Shirazi, Basics of the ISDA Master Agreements, in PLI Corporate Law & Practice: Fundamentals of Swaps & Other Derivatives 121 (2018).

125 See Venokur et al., note 124.

126 Shirazi, note 124, at 122.

127 For example, "when significant tax legislation is being proposed," "parties will frequently include it in the definition of change in tax law," thereby ensuring that the agreement's tax law change provisions apply if such change comes to pass. Sylvie A. Durham, Derivatives Deskbook § 2:3.2 (2d ed. 2015). This is largely precautionary because most proposals of concern would already be covered by the broad contractual provisions.

128 Of course, derivatives are, themselves, often used to shift risk among market participants for prudential or speculative purposes. Michael Chui, Derivatives Markets, Products and Participants: An Overview, in 35 BIS IFC Bulletin 3, 4 (2012).

129 The protection provided to the payee is still subject to counterparty risk.

130 The triggers for the gross-up and the termination right vary slightly and are not entirely coextensive. Compare ISDA 1992 Master Agreement, note 119, at § 2(d)(i)(4) and § 5(b)(ii).

The value of the net risk-shifting is likely to be priced into the deal (i.e., payee would pay slightly more) at least to some degree because these deals typically involve highly sophisticated parties[131] and "[b]ecause the ISDA Master Agreement represents accepted market practice, [so] there is widespread familiarity with its terminology and provisions among market participants in every major financial market."[132] Nevertheless, the change in tax law provisions may have a relatively small value in comparison to the rest of the parties' agreement, especially if parties think the risk of tax law change is low, and the small size of the price impact could affect its accuracy.

2. *Credit Agreements*

The Change-in-Tax-Law Provisions. Credit agreements[133] also typically include gross-ups for increased withholding taxes imposed on loan payments because of a change in law.[134] However, the change-in-tax-law provisions are different in several respects from those in the OTC derivatives context.

First, although an industry group (the Loan Syndications and Trading Association (LSTA)) creates model agreements for syndicated loans that include tax transition risk-shifting provisions and although these provisions are included widely throughout the syndicated loan industry, these provisions are subject to more negotiation and are thus less standardized than those in OTC derivative transactions.[135] Many U.S. financial institutions have adopted the LSTA model credit agreement, but "each financial institution in the United States generally has its own 'form' credit agreement which provides a slightly different for-

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[131] See generally Chui, note 128 (describing market participants). There have been concerns, particularly as a result of the financial crisis, that there are less sophisticated participants in the OTC derivatives market that need regulatory protection. See, e.g., Mary Schapiro, Bringing Transparency and Oversight to the OTC Derivatives Market, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Oct. 9, 2009), https://corpgov.law.harvard.edu/2009/10/02/bringing-transparency-and-oversight-to-the-otc-derivatives-market/.

[132] Venokur et al., note 124.

[133] A credit agreement articulates the rights and obligations of a lender and a borrower in connection with a loan made from the former to the latter. In large credit facilities, loans are typically made from institutional lenders to large businesses, often organized as corporations.

[134] See generally Michael Bellucci & Jerome McCluskey, The LSTA's Complete Credit Agreement Guide 122-28 (2d ed. 2017). With credit agreements, as with the ISDA master agreement, the gross-up obligations generally do not cover taxes imposed for reasons within the lender's control. The discussion of gross-ups herein should be understood to take this limitation into account.

[135] Bilateral credit agreements (i.e., between a single borrower and a single lender) may be even more varied than syndicated credit agreements (i.e., between the borrower and multiple lenders, often where parts of the loan are sold off to other lenders after origination). Larger credit facilities tend to be syndicated to secure sufficient funding, and the existence of a market in syndicated loans increases the value of standardization.

mulation of these provisions."[136] LSTA's model agreements, which are "consistently updated and augmented each year,"[137] help establish industry norms for these agreements.[138] However, there is some variability in the real-world credit agreements both in general and in the tax transition risk-shifting provisions specifically. Although the model provides boilerplate language from which parties often start their negotiations, there are many ways to revise these provisions to maximize (for lenders) or minimize (for borrowers) potential gross-up obligations.[139] Ultimately, while these gross-up agreements can vary from the model, they typically do "not vary too far from other bank loan deals currently in the market."[140]

Second, the tax gross-up obligation included in syndicated credit agreements may cover much more than increased withholding taxes. Borrowers in syndicated credit agreements must gross-up for increased withholding taxes and may also have to gross up for certain other (non-withholding) tax increases due to a law change.[141] This obligation arises under the broadly applicable (not tax-specific) "yield protection" provision (aka "increased cost" provision), which requires borrowers to indemnify lenders to the extent law changes increase certain lending costs.[142] Examples of taxes that would be grossed up under the "increased cost" provision include the "bank tax [enacted] in the United Kingdom and the Obama administration's proposed financial crisis responsibility fee," *if* they were enacted after the date of

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136 Angela L. Fontana et al., Representing Borrowers "Boilerplate" Mechanics, in PLI Corporate Law & Practice: Leveraged Financing 193 (May 2018).

137 Loan Syndications & Training Ass'n, Loan Market Legal & Documentation, https://www.lsta.org/university/legal-documentation (last visited Apr. 14, 2020).

138 The LSTA created these model agreements as part of its goal of "fostering cooperation and coordination among all loan market participants, facilitating just and equitable market principles, and inspiring the highest degree of confidence among investors in corporate loan assets." Loan Syndications & Training Ass'n, https://www.lsta.org (last visited Apr. 14, 2020). LSTA considers "[s]tandardizing loan documentation [to be] a core function of the LSTA." Loan Syndication & Training Ass'n, note 137.

139 See, e.g., Fontana et al., note 136, at 12-13 (borrower side negotiation points include trying to narrow the definition of "Change in Law"); Alan I. Appel & Jessica J. Edwards, Tax Aspects of Credit Agreements: The Lender's Perspective, 29 Tax & Reg. of Fin. Instruments 5, 5 (2015) (lender-side negotiation points); Seth Huffstetler & Jeffrey A. Henson, Treatment of Taxes in Credit Agreements (Oct. 8, 2012) (both sides).

140 Practical Law Finance, Westlaw, Loan Agreement: Overview (search in Westlaw for "Loan Agreement: Overview") (last visited April 13, 2020) (indicating that banks should limit the variation in the terms of the loan agreement "[i]n order for the lead bank to be able to sell the loans to other lenders").

141 Some taxes, such as income taxes and taxes imposed under FATCA, are typically excluded from the gross-up. See Bellucci & McCluskey, note 134, at 102-04, 127-28, 131-32.

142 Michael L. Schler et al., The LSTA Model Credit Agreement: Overview of Tax Changes, Corp. Livewire (Sept. 12, 2011), http://www.corporatelivewire.com/top-story.html?id=the-lsta-model-credit-agreement-overview-of-tax-changes.

the loan agreement.[143] Although "[t]he application of the "increased cost" provision to taxes has often been a point of contention,"[144] the model agreement's "increased cost" section has explicitly applied to taxes since 2011.[145] Nevertheless, parties still disagree about whether this is appropriate,[146] so credit agreements may take different approaches on this issue. Deal-specific negotiations generally determine how this and other issues will be resolved in a particular credit agreement.[147]

Third, if a borrower becomes subject to a tax gross-up obligation, credit agreements generally do not provide the borrower with a termination right[148] but generally do give the borrower a "yank-a-bank" right, which allows the borrower to replace the lender if doing so would reduce borrower's gross-up obligations.[149] A borrower's ability to exercise this right depends on its ability to find an eligible assignee lender that both (a) would be owed lower gross-up payments and (b) wants the borrower's debt with the preexisting terms. Thus, if a law change triggers a borrower's obligation to make tax gross-up payments, the borrower will not be able to avoid that obligation unless it can find an appropriate replacement lender.

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143 Id. at 2.

144 Id. ("Borrowers argue that taxes should be addressed only in the "tax section" [generally regarding gross-ups for changes in law that increase withholding taxes]. Lenders argue that the tax section deals only with taxes on payments under the loan and is insufficient to provide yield protection for taxes that are not imposed on loan payments.").

145 Id.; see also Bellucci & McCluskey, note 134, at 102-04.

146 See Fontana et al., note 136, at 200.

147 Theoretically, the negotiation should result in an agreement with optimal nonprice terms that maximizes the contractual surplus, and then the parties would use the price of the contract to allocate that surplus, with the distribution of that surplus determined by the parties' relative bargaining power. See Albert Choi & George Triantis, The Effect of Bargaining Power on Contract Design, 98 Va. L. Rev. 1665, 1670-71, 1679 (2012) (explaining the bargaining power irrelevance proposition developed in the law and economics literature). Thus, theory suggests that bargaining power affects the price, but not the nonprice, terms of a contract. As a result, differences in bargaining power between the lenders and the borrowers should not directly affect whether the increased cost provision applies to taxes. Nevertheless, differences in bargaining power can affect the optimal nonprice terms of a contract indirectly as a result of wealth or substitution effects. Id. at 1681-83. For example, if the price of the loan increases, the borrower's wealth declines, thereby affecting the borrower's demand for particular nonprice terms (e.g., a limited, rather than broad, increased cost provision) and possibly reducing the likelihood that the borrower's preferred term is included in the agreement. It is also possible that bargaining power differences can lead to *suboptimal* nonprice terms for a variety of reasons including because the contract involves multistage bargaining where the price term is largely fixed before the nonprice terms are negotiated. Id. at 1686-96.

148 This is unsurprising because a party who borrowed funds under a large credit facility would be unlikely to want to exercise a termination right, even if available, because such borrowers may lack the liquidity to repay the loan immediately because the funds are typically deployed in the borrower's business.

149 Loan Syndications & Training Ass'n, Model Credit Agreement § 3.05 (2014); Bellucci & McCluskey, note 134, at 615-17.

Risk-Shifting Achieved. These credit agreement provisions explicitly shift risk of future tax law changes. An increase to withholding taxes on amounts paid to lenders and the imposition of additional taxes on lenders both nominally burden lenders. However, the credit agreement's tax withholding gross-up provision and increased tax cost provision generally shift this economic burden to borrowers, thereby protecting lenders' yields upon particular future adverse tax law changes.[150] This additional yield certainty is valuable to lenders. The borrower's yank-a-bank right reduces this value somewhat because lenders could be replaced rather than grossed-up. However, a lender primarily concerned about tax law changes that affect lenders broadly may not be particularly worried about being replaced if other lenders are likely to be equally affected by the tax law change. Thus, the yank-a-bank provision may not cause lenders to materially discount the value of the yield protection.

Practitioner commentary makes it clear that lenders take the value of these change-in-tax-law provisions into account when pricing loans. For example, lawyers from Cravath explain, "lenders . . . would have to charge higher interest rates if forced to bear [the] risk" of increased "withholding taxes that may result from future changes in law."[151] Similarly, lawyers from Sidley Austin explain that, when negotiating the economics of the credit agreement, lenders should price in both the tax consequences under current law and the yield protection provided under the credit agreement in case of costly future tax law changes.[152] Thus, credit agreement lenders are clearly entering into a REVE—lenders transfer to borrowers the risk of particular future tax law changes, and in exchange, the lenders charge a reduced interest rate, thereby compensating borrowers for taking on the risk. Rational lenders would base the amount of the compensation (i.e., interest rate reduction) on the expected value of the change-in-tax-law yield protection.

3. *Municipal Bonds*

The Change-in-Tax-Law Provisions. Change-in-tax-law provisions in municipal bond indentures often address the exact scenario that is commonly used as a hypothetical in tax transition scholarship—the possibility that the exclusion for municipal bond interest will be elimi-

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[150] This protection is not absolute because, among other reasons, the lender is still subject to credit risk.

[151] Schler et al., note 142, at 1; see also Fontana et al., note 136, at 197.

[152] Fontana et al., note 136, at 199.

nated or reduced by a change in law.[153] The details of the change-in-tax-law provisions in tax-exempt bonds can vary materially,[154] despite some efforts by industry groups to create form indentures.[155] For example, some indentures require the issuer to gross-up the interest payments for the increased taxes.[156] Alternatively or in addition, some provide for "extraordinary . . . redemption" rights,[157] which may be "tax calls" (mandatory or optional)[158] or provisions that are effectively "tax puts" (i.e., redemption at the option of a minimum percentage of holders).[159] These redemptions may be at par or a premium.[160] Any tax law change right is typically triggered by a "determination of

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153 Some municipal bond indentures address other possible tax law changes. For example, in direct bank placements of tax-exempt bonds, the loan documents typically contain gross-ups if corporate tax rates decline (and the tax exemption becomes less valuable to the corporate holder). Nat'l Ass'n of Bond Law., Direct Purchase of State or Local Obligations by Commercial Banks and Other Financial Institutions 5 (2017), https://www.chapman.com/media/publication/783_Chapman_NABL_Direct_Purchases_State_Local-Oblications_Banks_Financial_Institutions_072617.pdf. For *taxable* municipal bonds with federal credits or subsidies, such as Buy America Bonds, the terms of the bonds often include extraordinary redemption provisions triggered if a law change reduces the subsidy. See Jennifer DePaul & Lynn Hume, Barclays: Some Issuers Could Wait Years to Call BABs, The Bond Buyer (Mar. 8, 2013), https://www.bondbuyer.com/news/barclays-some-issuers-could-wait-years-to-call-babs-updated; see also, e.g., Wayne County Bldg. Auth., Official Statement on Building Authority Bonds (Jail Facilities), Series 2010 5 (2010) (federally taxable bonds subject to an extraordinary optional redemption if a tax law change reduces the interest rate subsidy), https://emma.msrb.org/ER432992-ER336642-ER732480.pdf.

154 See Jennifer DePaul, Barclays: Most Tax Calls Have "Minimal Risk" of Being Triggered by 28% Cap, The Bond Buyer (Jan. 16, 2013) (quoting a senior municipal credit analyst at Barclays as saying "there are many variations of tax call language"), https://www.bondbuyer.com/news/barclays-most-tax-calls-have-minimal-risk-of-being-triggered-by-28-cap; Leonard Weiser-Varon, "28% Cap" Unlikely to Trigger Wave of Municipal Bond Tax Calls, Mintz (2013), https://www.mintz.com/insights-center/viewpoints/2891/2013-01-28-cap-unlikely-trigger-wave-municipal-bond-tax-calls.

155 See, e.g., Nat'l Ass'n of Bond Law., Form Conduit Indenture (2d ed. 2019); Nat'l Fed'n of Mun. Analysts, Recommended Term Sheet & Legal Provisions for Hospital Debt Transactions (2005).

156 See, e.g., Board of Educ. of City of Chi., Educational Purposes Tax Anticipation Notes, Series 2016A-3 § 2.2(b) (2016), https://emma.msrb.org/ES987476-ES772899-ES1174235.pdf.

157 See Union Bank of Switz., Guide to Municipal Securities 4 (2010) (explicitly highlighting tax law changes as possible triggers for "extraordinary redemptions"), https://onlineservices.ubs.com/staticfiles/pws/adobe/guide_to_municipal_securities.pdf.

158 See Jennifer DePaul, Proposed 28% Cap Could Force Redemption of Billions of Debt, The Bond Buyer (Jan. 14, 2013) (discussing mandatory calls), https://www.bondbuyer.com/news/barclays-most-tax-calls-have-minimal-risk-of-being-triggered-by-28-cap; Nat'l Ass'n of Bond Law., note 155, at B-5, B-10-11 (including extraordinary redemptions upon tax law changes, with details to be negotiated by the parties); Mun. Sec. Rulemaking Board, Glossary of Municipal Securities Terms 84 (2013) (explaining optional calls).

159 See, e.g., Nat'l Fed'n of Mun. Analysts, note 155, at 37, n.64. and at 37 n.64.

160 See id. at n.63 (premiums); DePaul, note 158 (bond documents specify par or premium); Nat'l Ass'n of Bond Law., note 153, at 7, n.18 (suggesting par).

taxability," the definition of which also varies.[161] It sometimes differentiates between taxability arising from law changes or from other reasons (e.g., action by the issuer).[162] Some indentures are explicit that taxability arising from a tax law change does trigger the gross-up or redemption rights,[163] some are explicit that a change in law does not,[164] and others do not specify.

Notwithstanding this variability, some generalizations can be made. Publicly issued tax-exempt governmental bonds generally do not include gross-ups upon changes in tax law,[165] although, in rare circumstances, these bonds could be subject to an extraordinary redemption upon a change in tax law. It is somewhat more common to include tax-law-change provisions in private activity bonds (including, in particular, exempt facilities bonds).[166] It is, however, very common to include tax law change provisions in private placements of tax-exempt bonds, particularly direct bank placements.[167] In these issuances, changes in law that cause the interest to be taxable typically trigger gross-ups and

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161 See, e.g., Nat'l Ass'n of Bond Law., note 155, at B-4 (explaining that the definition of "Determination of Taxability" "is generally negotiated and thus no consensus exists as to standard language").

162 See id. at B-5 ("consideration should be given to whether a Determination of Taxability will occur as a result of a change in legislation or other circumstance not caused by the Borrower's actions or inactions"); see also Weiser-Varon, note 154.

163 See, e.g., Bd. of Educ. of the City of Chi. Indenture, note 156, at 7-8 (definitions of "Determination of Taxability" and "Event of Taxability").

164 See, e.g., Minn. Higher Educ. Facilities Auth., Official Statement Revenue Bonds, Series Eight-C, at IV-2 (2014) (explicitly keying determinations of taxability to the law as of the date of issuance), https://emma.msrb.org/EA622641-EA487406-EA883948.pdf.

165 See Nat'l Ass'n of Bond Law., note 153, at 6-7; see, e.g., Village of Mundelein, Lake County, Ill., Final Official Statement of $32,790,000 General Obligation Bonds, Series 2019, at 8 (2019), https://emma.msrb.org/ES1298468-ES1016097-ES1417421.pdf.

166 See, e.g., Ohio Air Quality Dev. Auth., Official Statement Exempt Facilities Revenue Bonds (Pratt Paper (OH) LLC Project), Series 2017, at 40, A-7 (2017) (exempt facility bonds subject to mandatory redemption upon a determination of taxability, which can arise from a change in law), https://emma.msrb.org/ER1094873-ER856764-ER1257402.pdf; see generally DePaul, note 158 ("[extraordinary mandatory redemptions, possibly upon a change in tax law] are primarily included in indentures . . . to protect bondholders and are often associated with private activity bonds.").

167 Nat'l Ass'n of Bond Law., note 153, at 6-7. It can also be common to include tax law change provisions when tax-exempt bonds are sold in private placements that, while issued slightly more broadly than a direct bank placement to a single bank, involve sales to qualified institutional investors or accredited investors. Id. at 3 (explaining that the National Association of Bond Lawyers' discussion of "direct purchase[s]" by "banks" generally includes private placements to a limited number of purchasers); see also, e.g., Cal. Mun. Fin. Auth., Limited Offering Memorandum Charter School Lease Revenue Bonds (Santa Rosa Academy Project), Series 2015, at 14, 20 (2015) (limited offering of bonds that are subject to mandatory redemption at a premium upon a determination of taxability, which includes changes in laws causing the interest to be taxable), https://emma.msrb.org/ER917253-ER716533-ER1117945.pdf; Bd. of Educ. of the City of Chi. Indenture, note 156, § 2.2(b), at 22 (limited offering with a gross-up triggered by the occurrence of an Event of Taxability, which includes taxability due to changes in law).

sometimes trigger tax calls.[168] Direct bank placements of tax-exempt bonds also typically include gross-ups if corporate tax rates decline (and the tax exemption becomes less valuable to the corporate holder).[169] While these tax law change provisions are quite common in direct bank placements, the change-in-tax-law provisions can still vary, even in these transactions, due to factors including "the availability of other financing sources to the issuer, . . . [and] the size and term of the transaction" among other things.[170]

Risk-Shifting Achieved. Because tax law change provisions are rare in public issuances of tax-exempt government bonds, public investors are generally unable to shift to the issuer the risk that the exclusion for muni bond interest could be reduced or repealed. Thus, public investors typically bear the risk of tax law change.[171] Whether investors in private activity bonds will be able to shift tax transition risk to the issuer depends on whether tax law change provisions are included in the agreement. Investors in direct bank placements of tax-exempt bonds, however, are quite likely to be able to shift tax change risk to the issuer, although the particular risks shifted depend on the terms negotiated by the parties.[172]

Given that this risk-shifting opportunity is well understood in the direct bank placement context,[173] and given the one-on-one bargaining between issuers and banks in a direct placement,[174] investors in direct bank placements are quite likely to factor in the value of the risk-shifting when pricing the bonds.[175] With a more diffuse set of in-

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[168] See Nat'l Ass'n of Bond Law., note 153, at 6-7, 11; see, e.g., Sacramento County Sanitation Dists. Fin. Auth., Sacramento Reg'l County. Sanitation Dist. et al., Continuing Covenant Agreement § 3.02 (2012) (direct bank placement with an interest rate gross up triggered by an event of taxability, which includes law changes), https://emma.msrb.org/ER681316-ER528123-ER930739.pdf.

[169] Nat'l Ass'n of Bond Law., note 153, at 5.

[170] Id. at 7.

[171] To the extent the muni bonds are issued with a variable rather than a fixed rate of interest, even public investors benefit from some implicit protection from tax changes to the extent that rates adjust upwards due to market changes that result from a repeal of the exclusion. Nat'l Ass'n of Bond Law., Tax-Exempt Bonds: Their Importance to the National Economy and to State and Local Governments 6 (2012), https://www.nabl.org/portals/0/documents/NABL_White_Paper.pdf.

[172] See Nat'l Ass'n of Bond Law., note 153, at 6-7.

[173] Id. at 5 (explaining that change-in-tax-law provisions can be used to "shift to the issuer the risk of future changes in the . . . tax regulatory environment").

[174] Id. at 4 (noting that direct purchase transactions may include some terms that are more similar to commercial lending transactions than to publicly offered exempt bond offerings).

[175] The details of the tax law change provisions would, of course, affect the pricing. For example, if the bonds are callable at par upon a tax law change, that would affect the pricing more than if the bonds were callable at market price. In the former situation, the bondholder might receive more or less than the current fair market value of the bond, whereas the bondholder would get the bond's fair market value in the latter situation. The

vestors (particularly public bonds or perhaps even limited offerings), however, it is less clear that tax transition risk-shifting provisions (where they are included) are accurately incorporated into muni bond prices. This is for several reasons including the variability of tax law change provisions in issuances that are not direct purchases, the possibility that investors may have a limited understanding of those terms,[176] and the inefficiency in muni bond market pricing more generally.[177] That said, it is also possible that the change in tax law provisions are priced in reasonably well even when bonds are issued to a more diffuse set of investors, but that the impact on the pricing is negligible because the risk of a change in law that applies to bonds issued before the date of change is perceived to be quite low.[178]

4. *M&A Agreements*

The Change-in-Tax-Law Provisions. The tax transition risk-shifting agreements found in merger agreements of public corporations are the most varied and least common.

A limited number of public company acquisition agreements include a provision that allows one or both parties to terminate the transaction before closing if a tax law change after signing creates a material adverse change (MAC). These "tax MAC" provisions are tax-specific versions of "regular MAC" provisions commonly included in acquisitions agreements. Regular MAC provisions specify events that, if they occur and have a material adverse effect, entitle one or more parties to terminate the deal before closing.[179] However, regular MAC clauses typically exclude any MAC caused by a change in law or

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former presents more risk, which could have a greater impact on the initial pricing and valuation of the bonds. The latter should have a minimal impact on pricing because investors would receive the same amount whether the bond is redeemed subject to a change in law provision or whether the bond is merely sold to a third party.

176 These tax law change redemption provisions are sometimes not explicitly discussed in the offering document. See, e.g., Bd. of Educ. of the City of Chi., Limited Offering Memorandum $475,000,000 Educational Purposes Tax Anticipation Notes, Series 2016A-3, at 17 (2016) (mentioning that interest could be paid at different rate after a Taxable Date, but not explicitly mentioning the gross-up upon change in tax law), https://emma.msrb.org/ES987476-ES772899-ES1174235.pdf.

177 See, e.g., Kimberly Rodgers Cornaggia et al., Investor Attention and Municipal Bond Returns (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3039098; Pamela W. Peterson, Municipal Bond Pricing, Part I: Fair Pricing 26 Sec. Litig. 6 (2015), https://www.americanbar.org/groups/litigation/committees/securities/articles/2015/fall2015-1215-municipal-bond-pricing-fair-pricing-part-1/.

178 See DePaul, note 158 (explaining that "many market experts argue that [a change in law] should only affect municipal bonds issued prospectively so as not to penalize issuers and bondholders currently holding their tax-exempt debt").

179 Nixon Peabody, NP 2017 MAC Survey 4 (2017). A MAC that allows parties to exit the transaction is called a "MAC out." Id. A MAC "is [also] used in qualifications to various representations, warranties and covenants, establishing a threshold for determining the

regulation.[180] Thus, a tax law change after signing would generally not enable a party to terminate even if the change has a materially adverse impact on the parties or the transaction. Accordingly, if a party wants the right to terminate the transaction before closing upon an adverse tax law change, they would need a tax-specific provision.

The aborted Pfizer/Allergan acquisition mentioned in the Introduction provides an example. Given signaling by lawmakers about possible regulatory crackdowns on inversions, Pfizer and Allergan, when agreeing to combine and effectuate an inversion for Pfizer, included an "Adverse Tax Law Change" clause in their merger agreement allowing either party to terminate if such an event occurred.[181] This clause was triggered in 2016 after the issuance of additional anti-inversion regulations. Pfizer terminated the deal and paid Allergan $150M as reimbursement for transaction expenses.[182]

The Pfizer/Allergan tax MAC is just one example. My study of public filings for M&A deals identified more than a dozen tax MACs from the past five years.[183] The tax MAC provisions vary considerably on several metrics, including (a) whether the tax MAC clause is general (i.e., triggered by *any* tax change that has an adverse effect) or specific; (b) if specific, what tax issues are the subject of the tax MAC clause (e.g., qualification as a reorganization, foreign/domestic status of a corporation following an attempted inversion, availability of tax credits); (c) which changes constitute a "change in tax law" (e.g., regulations, court decisions, proposals, changes not yet effective) that triggers the provision; (d) what precise adverse consequence must arise to trigger the provision; (e) the level of confidence there must be that the adverse consequence arises; (f) the procedures for determining whether the adverse consequence has arisen (e.g., opinion of counsel); (g) what consequences ensue if the tax MAC clause is triggered (e.g., termination right, a requirement to take certain actions to mitigate the tax MAC); (h) the extent of overlap between the tax MAC clause's trigger and any tax opinion required by the agreement; and (i)

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scope of disclosure or compliance relating to risks associated with the changes in the target's business." Id. The MACs discussed herein are generally MAC outs.

[180] See id. at 11 (83% of deals, in general, and 98% of deals valued at $1B or more, have a MAC that excludes "changes in laws or regulation").

[181] Pfizer Inc., Allergan PLC and Watson Merger Sub Inc., Agreement and Plan of Merger 91-92, 100 (2015), https://www.sec.gov/Archives/edgar/data/78003/000119312515385453/d70588dex21.htm.

[182] Press Release, Pfizer Inc., Pfizer Announces Termination of Proposed Combination with Allergan (Apr. 6, 2016) (terminating the agreement after concluding that the inversion regulations issued by Treasury qualified as an "Adverse Tax Law Change"), https://www.pfizer.com/news/press-release/press-release-detail/pfizer_announces_termination_of_proposed_combination_with_allergan.

[183] See Field, note 118.

whether (and how) the tax MAC clause is disclosed in the relevant public filing.[184] The bargaining dynamics also varied from transaction to transaction, with some deals with tax MACs involving mergers of equals and some involving large disparities between the values (and likely leverage) of the parties.[185]

With so much variation, these provisions are clearly bespoke—crafted and negotiated individually for each transaction in response to the particular tax law change risk of concern.

Risk-Shifting Achieved. Tax MAC termination rights, like the provisions in the other case studies, shift the risk of law change among the relevant parties. Absent such a provision, a party that signs a merger agreement might be obligated to consummate the merger even if the economics of the deal change dramatically between signing and closing because of a tax law change. Without the protection provided by the tax MAC provision, a party worried about a possible adverse tax law change might not sign the agreement at all or might demand a better price (higher if the concerned party is the seller, lower if the concerned party is the acquirer)[186] because the deal economics might change. A tax MAC termination right enables the concerned party to transfer risk of an adverse tax law change to the other party, thereby giving the concerned party comfort to proceed without demanding as much of a premium or discount. The concerned party's willingness to accept a lower price or pay a higher price compensates the other party for taking on some law change risk that could adversely affect the concerned party.[187]

Rational taxpayers would base the amount of this compensation on the expected value of the ability to exit the transaction if tax laws change. The valuation must also consider the limited time period during which the tax MAC applies (i.e., between signing and closing, which often spans just months). Ultimately, identifying the exact risk-shifting transactions and their economics can get more complicated depending, for example, on whether there is a termination fee and on the extent to which parties' interests in terminating after a tax law change are likely to be aligned. But the exchanges could be unbundled to identify, and possibly price, each risk-shifting transaction involved.

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[184] Id.

[185] Id. at 831.

[186] For example, the seller might be worried about a change adversely affecting tax treatment of the acquisition itself, and the buyer might be worried about a change adversely affecting the usability of certain tax attributes post-acquisition.

[187] For numerical examples of how this could work, see Part III.A and Part V.A.1.

IV. When Could Tax Transition Risk-Shifting Contracts Be Used?

The case studies demonstrate that private contracting is used to shift tax transition risk. The case studies, however, are only examples,[188] and they suggest that private contracting could be used much more frequently as part of taxpayers' strategies for making decisions in light of possible tax law changes. This Part explores the potential uses of these contracts.

Tax transition risk-shifting agreements could be useful anytime an economic decision is a function of tax law and other market mechanisms (discussed in Part II) do not operate to satisfy risk preferences.[189] Thus, assuming that current tax transition policy remains unchanged, demand for such agreements is likely to grow if the current political dynamic that threatens tax law instability persists and taxpayers price the tax transition risks differently. To satisfy that demand, there must also be a viable counterparty to whom risk could be shifted, whether that counterparty is involved in a preexisting underlying transaction, as in the case studies, or whether the counterparty is a third party, as with tax transition insurance and derivatives.

A. Where Economic Decisions Are a Function of Tax Law

Examples illustrate how tax transition risk-shifting agreements can be helpful in situations where a taxpayer might make a different economic choice if the tax law changes.[190]

Assume an acquisition's economics depend in significant part on the value of the target company's net operating losses (NOLs),[191] and the

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[188] A variety of other examples may come to mind for readers including, for example, the tax gross-up often provided to expatriate employees, which could increase if taxes increase.

[189] Cf. Fennell, note 112, at 1298-99 (reaching a similar conclusion about REVEs in general). In addition, the dollar impact of possible tax law changes must be determinable enough to determine an appropriate value for the REVE. The discussion herein assumes that there is at least some information about the potential tax law change (e.g., about the general direction, timing and possible magnitude of the change (even if a range)) that can be used to price a risk-shifting exchange, even if somewhat inaccurately.

[190] Both the substance of the possible tax law change and the likelihood that transition relief will accompany such change are relevant to the determination of whether a taxpayer would make a different economic choice if the tax law changes. If a taxpayer believes that a possible tax law change is highly likely to be accompanied by transition relief that would protect the taxpayer from adverse economic consequences of the change, the taxpayer's business decision may not be contingent on the possible tax law change, in which case a tax transition risk-shifting agreement may not be particularly helpful. On the other hand, if taxpayers believe they are unlikely to be a beneficiary of transition relief, tax transition risk-shifting agreements are more likely to be useful.

[191] The value of NOLs can be relevant to an acquisition's price. See, e.g., Wei-Chih Chiang et al., Pricing Target NOLs in Mergers and Acquisitions from the Participating

acquirer is concerned that a possible tax law change could impose additional limits on the usability or value of NOLs (i.e., beyond the 2017 Act's changes to § 172). If the parties price the tax change risk the same way, they can agree to an acquisition price that accounts for the tax transition risk,[192] and the deal can proceed. If, however, the parties price the tax change risk differently, they may not be able to agree on a price for the entire deal ex ante. To overcome this obstacle, the parties could use a tax transition risk-shifting agreement that makes the purchase price subject to partial refund ex post if the law change occurs. In M&A deal terms, this is just a "reverse earnout" contingent on a future law change.[193] Alternatively, the agreement could be structured as a regular earnout, where the acquirer pays the lower price up front (i.e., valuing the deal assuming the law changes in a taxpayer-adverse way) but agrees to pay more over time if and as the tax law does *not* change.[194] Either way, the agreement shifts some[195] or all of the economic burden of this potential tax law change from the acquirer (on whom the consequences of the change nominally fall because the acquirer owns the target when the NOLs subject to the law change are used) to the seller.

Agreements that shift the risk of possible NOL-related law changes already occur, albeit implicitly rather than explicitly,[196] as part of tax receivables agreements (TRAs) that are increasingly common in IPOs. In TRAs, the payments due to the pre-IPO owners depend on the *actual* value of tax assets post-IPO, which depends on whatever tax law applies when the tax asset is used.[197] Thus, these TRA provisions shift the economic consequences of certain changes in tax law

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Firms' Perspective, 30 Advances in Accounting 32 (2014); see also Barton W.S. Bassett et al., M&A and Tax Reform—New Tax Considerations with Wide-Ranging Implications, Morgan Lewis Publications: LawFlash (Jan. 4, 2018) (discussing structuring acquisitions with target company NOLs after the 2017 Act), https://www.morganlewis.com/pubs/ma-and-tax-reform-new-tax-considerations-with-wide-ranging-implications.

192 An ex ante price adjustment is the likeliest of the common market mechanisms (from Part II) to be useful here. For example, adjusting the timing might help on the margin (e.g., for one year's worth of NOLs), but if the acquirer expects to use the NOLs over a long period of time during which the tax law might change, a timing change would not fully address the parties' concerns about tax transition risk.

193 Catherine J. Dargan, Structuring and Negotiating Earn-Outs, in PLI Corporate Law & Practice: Acquiring or Selling the Privately Held Company 2-393 (2014).

194 Id. at 2-385.

195 A provision could shift some, but not all, of the tax transition risk if, for example, a reverse earnout provides a purchase price reduction equal to only a portion (e.g., 50% or 75%), but not all, of the value lost because of the law change.

196 It is also certainly possible that such agreements have occurred explicitly, for example in private company acquisitions.

197 Gladriel Shobe, Private Benefits in Public Offerings: Tax Receivables Agreements in IPOs, 71 Vand. L. Rev. 889, 900-01 (2018) (explaining that TRA payments are generally calculated on a "with-and-without" basis).

(e.g., regarding NOLs).[198] More explicit risk-shifting provisions could also be used to shift NOL-related transition risk and transition risk related to any other tax attribute (e.g., to shift the risk that a tax law change could adversely affect the value of the basis step-up achieved in a transaction with a § 338(h)(10) election).

As an additional example,[199] consider a corporation seeking a cash infusion of $\$x$ from an equity investor. A prospective investor's desired ownership stake may depend on the stability of the recently lowered 21% corporate tax rate. If the corporate tax rate goes back up, the investor would have wanted a larger number (and percentage) of shares in exchange for an $\$x$ investment (i.e., more shares at a lower per share price). Thus, the parties could agree, for example, that the investor will invest $\$x$ today in exchange for a certain number of shares, but that the corporation will issue y number of additional shares to the investor for each 1% increase in the corporate tax rate enacted in a defined time period. This agreement would shift at least some of the economic burden of the potential corporate tax increase that the investor would otherwise bear to the other shareholders in the corporation who would suffer dilution upon the issuance of the extra shares.

There are countless possible examples. In an acquisition where the value of the target depends on the recently enacted "global intangible low tax income" (GILTI) rules,[200] the parties could agree to a contingent purchase price adjustment if a law change increases the GILTI tax burden (e.g., the GILTI rate is increased, the deemed 10% rate of return on tangible assets is reduced, or the GILTI deduction for corporations is reduced). When a loan is made to a large corporate debtor, the parties could agree to a contingent reduction in the interest rate if a law change further limits the corporation's ability to deduct interest payments (i.e., beyond the 2017 Act's changes to § 163(j)). When a personal residence is sold, the parties could agree to a contingent purchase price reduction if a tax law change adversely affects the availability or value of the buyer's home mortgage interest deduction. There are many additional opportunities for this type of contracting,[201] although some are certainly more plausible than others.

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[198] The pricing of this risk shifting may be inaccurate due to pricing issues in TRA transactions in general. Id. In addition, the value of the NOLs will depend on other factors beyond possible law changes.

[199] Assume that each additional example has the same premise as in the first example—that the parties are unable to agree on a flat price that meets both parties' risk preferences.

[200] IRC § 951A.

[201] All of the examples in this paragraph identify *specific and known* possible tax changes that would trigger the REVE, but parties could also contract to shift the risk of

The foregoing examples generally shift the risk of *taxpayer-unfavorable* law changes, but tax transition risk-shifting contracts can also shift the risk of *taxpayer-favorable* changes[202]—shifting a potential tax *benefit* from the nominal beneficiary to the counterparty. For example, if a law change makes certain income (e.g., interest from private activity bonds) no longer subject to the individual alternative minimum tax,[203] the nominal beneficiary of that change (e.g., the bondholder) could be contractually required to share all or part of that benefit with the other party, perhaps in the form of an interest rate reduction triggered if the change is enacted. Similarly, parties to a recent sale of an expensive home in a high property tax jurisdiction could agree to a contingent purchase price increase if the $10,000 cap on the deduction for state and local taxes (SALT)[204] is repealed. This would make the purchaser (i.e., the nominal beneficiary of the change) share part of the benefit of the SALT cap repeal with the seller.

Ex post price adjustments are not the only possible contractual responses to a law change. As with the case studies, parties can also contract for termination rights, with or without a fee. In addition, parties can agree to contingent restructuring upon a tax law change, and for completed deals, parties could even commit to rescinding (or trying to rescind) the deal if a particular tax law change occurs.

When taxpayers' economic decisions are a function of tax law, the demand for the types of tax transition risk-shifting agreements discussed above is likely to increase if the relevant tax law is (or is perceived to be) unstable.[205] Tax law instability alone, however, is insufficient to drive demand for tax transition risk-shifting agreements. If there is a possibility that the tax law could change (i.e., it is unstable), but the likelihood and magnitude of the potential change

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unspecified or unknown possible future tax changes, by for example, allowing a termination right or requiring a gross-up for any tax costs for a transaction in excess of the tax costs that would arise under the law in effect as of a certain date. See, e.g., Part III.B.2 (syndicated credit agreements may provide for a gross-up if there is any increased tax cost, even if from a tax change not specifically contemplated at the time of the transaction); Part III.B.4 (a general, rather than specific, tax MAC provision is triggered upon any tax change with adverse effect).

202 The focus on possible taxpayer unfavorable changes is common, despite arguments by Kaplow and others who argue that the policy debate should also consider transition relief (i.e., disgorgement) when the rules change in a taxpayer favorable way. Kaplow, note 11, at 552-55.

203 See Steven Maguire & Joseph S. Hughes, Cong. Res. Serv., Private Activity Bonds: An Introduction 7 (2018) (describing the impact of the AMT on private activity bonds).

204 IRC § 164(a)(6).

205 By unstable, I mean that the law is likely to change in a way that alters the taxpayer's tax treatment. In some circumstances, if transition relief is provided that would protect the taxpayer from adverse tax consequences of a law change, the law may not be "unstable" for purposes of this analysis.

are known with 100% certainty and all taxpayers are risk neutral, taxpayers would not need tax transition risk-shifting agreements. The market mechanisms described in Part II, particularly adjusting the price to reflect the tax transition risk, would be enough to enable the taxpayers to satisfy their risk preferences. However, if tax law instability is coupled with something that causes the taxpayers to price the tax transition risk differently (i.e., differences in taxpayers' assessments of the likelihood of change, or differences in taxpayers' risk preferences), the market mechanisms discussed in Part II would be insufficient, and demand for tax transition risk-shifting agreements will likely increase.

Tax law instability is likely to be accompanied by at least some uncertainty given that neither the process of electing political leaders nor the process of lawmaking is akin to rolling a pair of dice (i.e., where the odds of each possible result are always known with precision). As a result, taxpayers might differ in their estimates of the likelihood and magnitude of the possible changes. In addition, ample research demonstrates that people have heterogeneous risk preferences,[206] and there is no reason to think that might not also be true with respect to tax transition risk. Thus, given that tax law instability is likely accompanied by factors that could lead taxpayers to price tax transition risk differently (i.e., uncertainty and heterogeneous risk preferences) and given that today's political environment threatens to change the tax law (perhaps dramatically) upon shifts of political power,[207] demand for tax transition risk-shifting agreements is likely growing.[208]

B. Where There Is a Viable Counterparty

A party might *want* to enter into an agreement to shift away tax transition risk but doing so is impossible unless there is a counterparty willing to accept the risk. A party might be willing to accept tax transition risk (for a fee) if the risk-accepting counterparty has different estimates of the likelihood or magnitude of the potential law change, different risk preferences (e.g., relatively risk neutral when the first party is risk averse), or both. In addition, whether a party is willing to serve as a counterparty in a tax transition risk-shifting agreement

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[206] See, e.g., Alma Cohen & Liran Einav, Estimating Risk Preferences from Deductible Choice, 97 Am. Econ. Rev. 745 (2007) (using data about car insurance deductible choices to assess risk preferences, and finding heterogeneity in risk aversion based on a variety of individual characteristics); Miles S. Kimball et al., Imputing Risk Tolerance from Survey Responses, 103 J. Am. Stat. Ass'n 1028 (2008) (developing a measure for risk tolerance that can be used in a variety of ways, including to control for participants' heterogeneous risk preferences in future studies).

[207] See notes 1-4 and accompanying text.

[208] This may be particularly true among taxpayers who believe that they will be unsympathetic candidates for transition relief.

likely depends on factors including sophistication, wealth, rationality, and price, and other terms of the potential risk-shifting transaction.

Potential counterparties can be divided into two groups: counterparties involved in the preexisting underlying transaction and third-party counterparties. Whether either is a viable counterparty depends on the details of the tax transition risk and the context in which the possible risk-shifting agreement arises.

1. Counterparties Involved in the Underlying Transaction

The risk-accepting counterparties in the case studies are all involved in the preexisting underlying transaction: the payor in derivatives agreements, the borrower in a syndicated credit agreement, the issuer of municipal bonds, and one or more parties to an M&A agreement. In similar transactions (i.e., between sophisticated parties with ongoing relationships and where there is reason to believe that the parties are adequately informed and acting rationally), parties to the transactions may be viable counterparties. In addition, in some situations, a party may be willing to be a risk-accepting counterparty even if that choice is not optimal (e.g., cognitive biases may cause a party to irrationally overestimate the likelihood that a taxpayer-favorable law will not be adversely changed and may lead to a suboptimal preference to accept risk).[209]

However, in some transactions, the potential counterparty is unwilling to accept the tax transition risk. For example, the parties involved in the sale of a home are unlikely to agree to accept transition risk pursuant to the possible risk-shifting agreements posited earlier because, among other reasons, the parties to the transaction may be less sophisticated than those involved in the case studies, the parties likely want to go their separate ways after the sale closes rather than having to maintain an ongoing relationship solely for transition risk-shifting purposes, and the transaction costs are likely too high.[210] Ultimately, if no party to a transaction is willing to serve as a counterparty, a third-party counterparty would be needed if one party to the underlying transaction wants to shift risk away pursuant to a transition risk-shifting agreement.

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[209] As another example, consider the following situation. Assume that, at a high level, it is optimal for a party to be a risk-accepting counterparty for a particular risk, and the party agrees to do so when negotiating the deal price and basic deal parameters. If, however, the details and contractual language describing the precise risk the party ultimately accepts are determined in subsequent negotiation, the tax transition risk-shifting agreement could end up being suboptimal. See Choi & Triantis, note 147, at 1690-96 (discussing how "two-staged (price-first) negotiations" can lead to suboptimal contract details and using MAC provisions as an example of how this could arise).

[210] See Part V.B.1.

In addition, in some transactions, there is no built-in potential counterparty at all because an economic decision is made unilaterally outside the context of a transaction with another party to whom risk could be shifted. For example, a sole proprietor taking account of § 199A's qualified business income deduction (and its current parameters) when deciding which line of business to pursue might want to shift away the risk that § 199A could change in an adverse way. This decision, however, is made unilaterally, meaning that there is no potential counterparty at all. Similarly, a multinational corporation that is deciding whether to onshore its IP in reliance on the FDII deduction might want to shift away the risk that the FDII deduction might be reduced or eliminated. However, again, this transaction does not involve another party to whom risk could be shifted. In these situations, a third-party counterparty would be needed for a tax transition risk-shifting agreement to be used.

2. *Third-Party Counterparties*

The counterparty in a tax transition risk-shifting agreement can be a third party that is not involved in any underlying transaction.[211] As explained in Part III.A, the tax transition risk-shifting component of an agreement (e.g., a gross-up obligation if the exclusion for muni bond interest is eliminated) can be unbundled from the rest of an economic arrangement (e.g., the obligation to pay interest on a bond and repay principal). These components are severable, meaning that the former (i.e., the protection from tax transition risk) could (at least theoretically) be purchased from an unrelated, uninvolved counterparty (i.e., third-party insurance). A risk-shifting agreement could even be between two parties with no stake in any underlying transaction that would be impacted by the tax law change (i.e., a tax transition derivative or prediction market contract).

Tax Transition Risk Insurance. Some scholars have identified third-party insurance as a theoretically possible market-based tool that taxpayers could use to manage the risk of future tax law changes.[212] Tax transition risk insurance (if available) could enable a taxpayer to proceed with a transaction knowing that, if a covered adverse tax law change is enacted, the taxpayer will be protected from economic loss. This may be particularly valuable, for example, to taxpayers concerned about tax transition risk but where other parties to the transaction are not plausible counterparties (e.g., where a home buyer wants

[211] Fennell, note 112, at 1307 (explaining that, with a REVE, "an uninvolved third party could also transfer risk in either direction").

[212] Shaviro, note 10, at 35; Kaplow, note 11, at 527-28.

protection from possible adverse changes to the home mortgage interest deduction) or where there is no possible counterparty at all because there is no transaction with an unrelated party (e.g., where a sole proprietor choosing a line of business wants protection against adverse changes to the § 199A qualified business interest deduction).

Although theoretically possible, stand-alone tax transition insurance does not currently exist.[213] Moreover, legal transition insurance markets are unlikely to develop according to scholars who have studied this question. Jonathan Masur and Jonathan Remy Nash explain that a "major impediment to a private market for legal transition insurance is the chore of pricing."[214] However, they acknowledge that a legal transition insurance market may not be a "pipe dream" if enough information is available to "facilitate pricing" well enough to "sustain a functioning private insurance market."[215]

Legal transition risk insurance may be more viable in the tax context than in other contexts because, as the case studies illustrate, tax transition risk protection is already being priced, at least in some situations, as part of a package of other rights and obligations. The real-world tax transition risk-shifting agreements where the parties explicitly and intentionally take the value of the tax transition risk protection into account (e.g., credit agreements) provide evidence that some people believe they can value tax transition risk protection. Pricing information derived from REVEs among parties to underlying deals could be aggregated to help third parties price unbundled tax transition risk protection. Admittedly, the parties in the case studies might not always accurately price the tax transition risk protection provided as part of a larger agreement.[216] Even if they do, this pricing information may be insufficient to support a robust tax transition insurance market, particularly since the pricing information from individual tax transition risk-shifting agreements primarily provides insight into how other parties price the risk ex ante and not insight into the ex post results of the risk-shifting contracts (i.e., the type of information typically used to develop actuarial pricing models). However, the more common tax transition risk-shifting agreements become among parties to deals, the more robust the pricing information becomes (both ex

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[213] See Daniel W. Gerber et al., New Appleman Insurance Law Practice Guide § 32.03[5][a] (Jeffrey E. Thomas ed., 2017) (tax insurance policies generally do not cover losses arising from changes in law); Richard A. Wolfe, Tax Indemnity Insurance: A Valuable and Evolving Tool for Managing Tax Risks, in 28 The Corporate Tax Practice Series: Strategies for Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 445-1, 445-32 (Louis S. Freeman ed., Tax Law and Practice, Course Handbook Ser. No. J-954, 2014).

[214] Masur & Nash, note 19, at 395.

[215] Id.

[216] See Parts III.B.1 & III.B.3.

ante pricing information, and perhaps even ex post, if and as the tax transition risk-shifting agreements are or are not triggered), and the more plausible tax transition insurance becomes.

Pricing challenges may not be the only barrier to the development and long-term viability of tax transition insurance. One additional impediment is that tax transition risks might be highly correlated, impeding the development of a stable insurance market.[217] However, an insurer that insures tax transition risk and a large portfolio of other risks could overcome this concern.[218] Another potential obstacle is that arguments for tax transition relief may become less persuasive as the tax transition insurance market strengthens.[219] Taxpayers that may be affected by a future law change are still likely to prefer government provided transition relief to private market transition insurance, so they might not want to promote the latter if doing so would inhibit the former.

A further hurdle is that third-party insurers would have to be willing to engage in these transactions. At this point, insurers explicitly exclude tax law changes from the scope of tax insurance coverage, with extremely limited exceptions.[220] Instead, third-party tax insurance, as available today, is generally designed to help taxpayers protect against uncertainty about how the current (or past) tax law applies to them (e.g., whether an acquisition qualifies as a tax-free reorganization, whether a § 338(h)(10) election can be made with respect to an acquisition, or whether § 409A applies in a particular situation).[221] However, tax insurance is a growing industry, so the scope of coverage could expand over time, possibly to include losses due to future changes in tax law.[222]

Ultimately, while it is far from certain that a market in tax transition risk insurance will develop, the fact that tax transition risk protection is being priced, at least in some circumstances, helps overcome a major barrier to the development of such insurance.

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217 Masur & Nash, note 19, at 417-21; see also Part V.B.2.

218 For this strategy to work, state law would have to allow insurers to use profits from one business line to subsidize losses from another line.

219 See Graetz, note 11, at n.75.

220 New Appleman, note 213, at § 32.03[5][a]; Wolfe, note 213, at 445-32. But see Aon, Realizing Certainty Through Tax Insurance 6 (2019) (stating that "[t]ax equity investors can also secure coverage to protect against retroactive change in law . . . with respect to refundable tax credits").

221 See Heather M. Field, Tax Lawyers as Tax Insurance, 60 Wm. & Mary L. Rev. 2111, 2126-29 (2019). Policies typically provide that, if a taxpayer's insured position is successfully challenged, the insurer generally covers the taxpayer's full loss, including additional taxes due, interest, penalties, contest costs, and a gross-up, subject to the policy cap and any other limits specified in the policy. See id.

222 See Heather M. Field, The Rise of Tax Insurance, Parts II.D, III.B.1 (draft on file with author).

Derivatives & Prediction Markets. Tax transition insurance involves one party to the underlying transaction and an uninvolved third party to whom risk is shifted. Conceptually, however, a tax transition risk-shifting agreement need not involve any party to an underlying transaction. The agreement could be between third parties seeking different exposures to the tax transition risk. That is, parties could enter into an event-based derivative via a contract, possibly on a prediction market.[223] For example, a municipality that regularly issues tax-exempt muni bonds would see its future borrowing costs go up if the tax rate on interest goes down, so the municipality might want to hedge against a possible reduction in tax rates applicable to interest. The municipality could do so using a derivative contract based on future tax rates applicable to interest.[224]

These types of contracts already exist. As of 2011, "prediction markets keyed to tax law changes and other legislative changes [had] already emerged," and tax law change contracts were trading on Intrade.[225] Although Intrade shut down in 2013 after legal problems including a suit by the Commodity Futures Trading Commission,[226] other prediction market platforms exist, including at least one with tax law change contracts. PredictIt supported prediction market contracts about whether a corporate tax rate cut would occur by the end of 2017,[227] and other prediction markets could (or may already) also support tax transition prediction contracts.[228]

There are many impediments to further development of tax transition prediction markets, including pricing challenges and the threat of government regulation. However, such markets could become more

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223 For more on prediction markets, see generally Michael Abramowicz, Predictocracy: Market Mechanisms for Public and Private Decision Making (Yale Univ. Press 2007); Justin Wolfers & Eric Zitzewitz, Prediction Markets, 18 J. Econ. Perspectives 107 (2004).

224 A derivative works in this situation while tax insurance would be unlikely to work because the potential impact of the possible future law change on the concerned party (here, the municipality) is not direct (i.e., the tax change of concern does not change the tax due by the municipality, nor does it change the tax treatment of the municipality's bonds). Rather, the potential impact here is indirect (i.e., the tax change affects third parties, and the municipality is only affected via operation of the market).

225 Fennell, note 112, at 1315; see also Jason Ruspini, Tax Futures, "In Real Life," Risk Markets & Pol. (Feb. 6, 2008) (discussing the introduction of tax law futures), http://riskmarkets.blogspot.com/2008/02/tax-futures-reality.html.

226 John Cassidy, What Killed Intrade?, The New Yorker (Mar. 10, 2013), https://www.newyorker.com/news/john-cassidy/what-killed-intrade.

227 PredictIt, Will the Corporate Tax Rate Be Cut by the End of 2017?, https://www.predictit.org/markets/detail/2726/Will-the-corporate-tax-rate-be-cut-by-the-end-of-2017.

228 See, e.g., Augur, https://augur.net (platform allowing prediction bets on "sports, economics, world events and more"); Stox, https://stox.com (another prediction market platform that, like Augur, runs on Ethereum blockchain); Sight, https://sight.pm (a new prediction market platform).

prevalent given that (a) the case studies illustrate that tax transition risk-shifting agreements are in use and being priced, and (b) tax transition prediction markets have arisen at least in a few situations. In addition, the growth of tax transition prediction markets would provide more information to third-party insurers, which could help them price tax transition insurance, further facilitating the growth of the tax transition insurance market.[229]

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Ultimately, many opportunities exist for increased use of tax transition risk-shifting agreements, including agreements between parties involved in an underlying transaction and even those involving third parties. The growth of the tax transition risk protection market likely depends on (a) awareness of private contracting as a strategy for managing tax transition risk, and (b) whether demand for tax transition risk protection is sufficient to make assuming tax transition risk an economically worthwhile proposition for prospective counterparties.[230] This Article contributes to the former. The latter is a function of the political climate, uncertainty about the stability of the tax law, and taxpayers' fears about materially adverse tax law changes without transition relief. All of these factors currently[231] point toward increased demand for and use of contractual tax transition risk protection.

V. Are Tax Transition Risk-Shifting Agreements Normatively Desirable?

Whether the existence and growth of tax transition risk-shifting agreements are good developments depends on the benefits and costs of such agreements. This Part analyzes those benefits and costs and makes recommendations about the use of these agreements, given current transition policy in which decisions about providing tax transition relief continue to be made largely on a case-by-case basis.[232] Possible changes to tax transition policy are considered in Part VI.

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[229] Masur & Nash, note 19, at 395; see Part IV.B.2.

[230] Government regulation of these contracts, changes to articulated tax transition policy, and other factors could also impact the growth of the tax transition risk protection market.

[231] See notes 1-4 and accompanying text.

[232] The discussion in this Part generally assumes that, if a tax change is made without transition relief, the taxes due will be paid regardless of whether the taxpayer nominally affected by the change bears the economic burden of the taxes or whether that economic burden is shifted to another party via a tax transition risk-shifting agreement. Thus, this discussion of the benefits and concerns raised by the use of tax transition REVEs generally sets aside revenue concerns except to the extent that tax transition REVEs' impact on

A. Benefits

Benefits of tax transition risk-shifting agreements include the facilitation of social welfare enhancing transactions, accommodation of taxpayers' heterogeneous risk preferences, possible reduction of obstacles to tax law changes, and revelation of information about the business purpose of a transaction.

1. Facilitating Social Welfare Enhancing Transactions

Questions about future tax law changes can stymie desirable transactions where parties lack enough information about the potential tax consequences to determine whether a deal will be value-enhancing and, if so, at what price. Tax transition risk-shifting agreements can overcome these barriers to productive economic activity by providing more certainty about how the potential tax changes will impact the taxpayer, bridging valuation gaps, and managing transition risk more generally.

Such agreements increase economic certainty[233] for any party who shifts transition risk away. This reduces the number of deals hindered by uncertainty and risk aversion.

The example discussed above in Part III.A (about *Buyer* and *Seller*) helps to illustrate. Uncertainty about a possible future tax law change (i.e., *Buyer* thought there was a 30% chance of a $30 tax on him, and *Seller* thought the chance of that tax was 20%) impedes the sale of the asset. *Buyer* is willing to pay no more than $91 ($100 minus its $9 expected value of the tax), but *Seller* is willing to accept no less than $94 ($100 minus its $6 expected value of the tax). No deal can be reached, even if the parties try to use the market-based responses to transition risk described in Part II. However, with a tax-transition risk-shifting agreement that shifts the burden of the potential tax from *Buyer* to *Seller*, the parties are likely able to consummate the deal (at a price between $94 and $100) despite their different views about the likelihood that the tax law would change.

A tax transition risk-shifting agreement can have a similar impact if the parties have different risk appetites. To illustrate, assume that

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lobbying affects whether a revenue-altering tax law change gets made and except to the extent that the presence (or absence) of a tax transition REVE affects the amount of economic activity available to be taxed. Of course, the choice of whether transition relief is provided for a particular tax change has significant revenue effects. However, this Part does not address whether transition relief should or should not be provided. That will be addressed in Part VI.

233 Even with the tax transition risk-shifting agreement, the party who shifted transition risk away is still subject to counterparty risk (i.e., the risk that the risk-accepting party fails to meet its obligations under the risk-shifting agreement). Thus, tax transition risk-shifting agreements can increase economic certainty but do not guarantee economic certainty.

both parties now believe that there is a 20% chance that the tax law would change to impose a $30 tax on *Buyer* (i.e., there is risk but no uncertainty). If *Buyer* is risk-averse, *Buyer* will value the asset at less than $94, meaning that *Buyer* would only be willing to pay that lesser amount. If *Seller* is risk-neutral (or perhaps even risk-seeking), *Seller* would be unwilling to accept a price less than $94 (higher if *Seller* is risk-seeking). If the parties cannot use a market-based response described in Part II to reach a price that *Buyer* is willing to pay and *Seller* is willing to accept, the parties will again be at an impasse. However, if the parties enter into a tax-transition REVE to shift the tax change risk to *Seller*, a deal could likely be reached so that the transaction could proceed at a price between $94 and $100.

In each of these examples, *Buyer* contractually shifts the tax transition risk to *Seller*,[234] who is more willing and able to bear the risk, either because *Seller* believes that it is less likely that the change will occur or because *Seller* is less risk averse. As a result, the transactions are able to proceed. Of course, differences in parties' assessments of the probability that a tax law change will occur[235] and differences in parties' risk preferences are quite different situations. However, both can prevent socially-welfare-enhancing deals from occurring, and tax transition risk-shifting agreements can help overcome both.

Tax transition risk-shifting agreements can also enable a transaction's price or other terms to vary formulaically if tax changes occur, thereby overcoming valuation challenges caused by tax transition risk and enabling otherwise stymied transactions to proceed. For example, a tax transition earnout (e.g., in an acquisition of a target corporation with NOLs that are difficult to value up front because of possible tax law changes) enables the total price of the deal to be determined based on the tax asset's value as revealed over time depending on whether the law changes (and perhaps on other factors as well). Thus, just like earnouts used when valuation uncertainty arises for reasons

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[234] This process of risk-shifting does not spare *Buyer* from transition costs entirely; rather, *Buyer* pays a negotiated fee to *Seller* in exchange for *Seller*'s acceptance of the transition risk. However, in doing so, *Buyer* is able to increase economic certainty about the magnitude of the impact that the possible tax law change will have on them. Two commentators, when discussing the possibility of insurance for regulatory transitions, identified a similar benefit in that context (i.e., that by contractually shifting the risk of regulatory changes, a party can gain certainty about the magnitude of consequences they will bear, and that with more predictability about the transition costs they will bear, they can have more confidence about the magnitude of resources that they can deploy for other business-enhancing purposes). See Masur & Nash, note 19, at 407 (also citing others who support the "value of a private market for regulatory insurance and transition relief").

[235] Similar examples could be provided where parties had the same assessment of *how likely* it was that a tax change would occur but where they thought the *magnitude* of the change would be different.

other than possible tax law changes,[236] a tax transition earnout bridges pricing gaps and allows deals to proceed when buyers and sellers have different valuation estimates as of signing.

More broadly, tax transition risk-shifting agreements allow taxpayers to manage tax transition risk enough to enable desirable transactions to proceed despite the possibility of tax law changes. Commentary leading up to the 2017 Act acknowledged these benefits. For example, Latham & Watkins lawyers discussing "executing transactions in the face of [tax law] uncertainty" suggested that "some [economic, structuring, and other] issues [arising from possible tax reform] may be addressed by alternative formulae in the acquisition agreement."[237] Other commentators explained that "the uncertainty caused by the [pending] tax legislation sometimes can be managed by determining which company will bear the risk of a tax law change and then drafting the . . . agreement accordingly."[238]

In addition, the case studies show that some taxpayers value these tax transition risk management benefits when undertaking transactions that could be affected by tax law changes. For example, the tax change gross-ups in syndicated credit agreements are important parts of reaching lending agreements at particular prices, and industry groups concluded that tax transition risk-shifting agreements are valuable enough in both derivatives and syndicated lending transactions that these provisions should be industry norms.[239] In M&A transactions, bespoke tax transition risk-shifting agreements are carefully negotiated and central to parties' willingness to consummate the deal.[240] While tax transition REVEs are not used in all transactions where they could be, that may because of lack of familiarity with this technique or "failure of imagination rather than well-informed disinterest."[241]

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[236] Dargan, note 193, at 2-385 to 2-386.

[237] Nicholas J. DeNovio, U.S. Tax Reform: Strategies for Executing Transactions in the Face of Uncertainty, Harvard Law School Forum on Corporate Governance and Financial Regulation (Mar. 12, 2017) (also suggesting negotiating for a termination right if the possible tax change would materially impact the deal economics), https://corpgov.law.harvard.edu/2017/03/12/u-s-tax-reform-strategies-for-executing-transactions-in-the-face-of-uncertainty/.

[238] Cindy D. Barnard et al., Working Through Uncertainty, 14 Taxing Times 1, 5 (Feb. 2018) (article written based on an interview prior to the 2017 Act's enactment).

[239] See Parts III.B.1 & III.B.2.

[240] See Part III.B.4.

[241] Fennell, note 112, at 1335. In addition, the absence of a tax transition risk insurance market and the very thin tax transition derivatives market do not necessarily imply that taxpayers do not value such markets. See id. at 1334; Masur & Nash, note 19, at 406-09. Rather, the markets could merely be hindered by the risk pricing problem that has not yet been overcome. See note 209 and accompanying text.

Ultimately, tax transition risk-shifting agreements can be valuable tools that enable social welfare enhancing transactions to proceed even though they would otherwise be hindered by possible future tax law changes. It is worth noting, however, that tax transition REVEs can facilitate undesirable transactions in addition to desirable transactions,[242] and the benefits described in this section would be reduced to the extent that occurs.

2. *Accommodating Heterogeneous Risk Preferences*

Tax transition risk-shifting agreements enable taxpayers to achieve their preferred positions with respect to tax transition risk not only in the context of multiparty transactions, as discussed above, but also potentially in the context of unilateral decisions that are affected by possible changes in law. For example, the owner of a business that incorporated to take advantage of the low corporate income tax rate is subject to the risk that corporate income tax rates could go back up. If business owners want to reduce their exposure to that risk, they could use a tax transition risk-shifting agreement to achieve their risk preference. More generally, in any situation where a taxpayer factors the tax transition risk into a unilateral decision and chooses one discrete option,[243] it is possible that no option provides the taxpayer with the preferred amount of exposure to the relevant tax transition risk—one option may provide more exposure to the risk than the taxpayer wants and the other option may provide less exposure than desired. In that situation, the taxpayer could make whichever choice believed to be better and add a tax transition risk-shifting agreement to adjust risk exposure to meet that preference. Admittedly, it may be difficult to find a counterparty for these agreements absent the development of a tax transition insurance or derivative market, but if insurance/derivative markets develop or some other counterparty is found, tax transition risk-shifting agreements could be used to "accommodate

[242] It can sometimes be difficult to distinguish between transactions that enhance social welfare and those that do not. See, e.g., Joint Comm. on Taxation, Background and Present Law Relating to Tax Shelters (JCX-19-02), Mar. 19, 2002, at 4 ("taxpayers and tax administrators have struggled in determining the line between legitimate 'tax planning' and unacceptable 'tax shelters.'"). This Article does not try to draw that line, and instead merely notes that not all transactions facilitated by tax transition REVEs are necessarily welfare enhancing. Concerns about the use of tax transaction risk-shifting agreements to facilitate undesirable transactions do not, however, suggest a prohibition on such agreements. That would be impractical and difficult, if not impossible, to enforce.

[243] See Part II.C.

differences in risk preferences and risk-bearing capacities,"[244] even outside of the context of multiparty transactions.

3. *Reducing Obstacles to Tax Law Changes*

Tax transition risk-shifting agreements may also make it more politically feasible to change the law without government-provided transition relief.[245] "If the putative losers under a new legal regime would have their losses covered by private insurance [or by another counterparty in a transition risk-shifting agreement], those parties [that shift transition risk away] would have reduced incentives to obstruct the new legal regime."[246] The magnitude of this benefit likely varies case-by-case and may, in some circumstances, be swamped by political and other considerations. In particular, as will be discussed below in Part V.B.3, the impact of tax transition risk-shifting agreements on lobbying behavior of *risk-accepting* parties is unclear. Nevertheless, if tax transition risk-shifting agreements make it easier to improve the law,[247] more quickly, at less cost to the government, and with fewer opportunities for rent-extraction by government actors, these agreements could benefit more than just the parties that engage in them.[248]

4. *Revealing Information About the Business Purpose of a Transaction*

In addition, tax transition risk-shifting agreements can provide insight into how important the tax treatment is to the consummation of the transaction. Tax transition risk-shifting agreements that only provide for *termination* rights (as opposed to changes in price or other terms) suggest that the tax treatment of the matter is critically important to the transaction.[249] If the parties want to prevent the transaction

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[244] Fennell, note 112, at 1339 (explaining that a "primary attraction of REVEs [which would include tax transition REVEs] is their ability to accommodate differences in risk preferences and risk-bearing capacities").

[245] See Masur & Nash, note 19, at 402-03.

[246] Id. at 402; Kaplow, note 15, at 197-98,

[247] Law changes do not always improve the law, particularly when political choice problems impede thoughtful, deliberative lawmaking. See Shaviro, note 10, at 64-91. Where the law change is not (or may not) be an improvement, the arguments in this section become less persuasive.

[248] See Ramseyer & Nakazato, note 66, at 1171-73 (arguing that a policy of government-provided transition relief for tax changes similarly lessens legislators' abilities to extract rents, thereby improving overall societal welfare).

[249] Tax transition REVEs that provide for changes to the price or other transaction terms, but do not provide a termination right, provide less information about the parties' intentions. A tax transition REVE without a termination provision does indicate that the parties want to pursue the transaction even if the tax law changes (albeit on X terms if

from being consummated if the tax law changes, the tax treatment under current law is at least a significant purpose motivating the transaction, suggesting that the tax detriment created by a change in tax law would outweigh the nontax benefits of the transaction. Of course, not all transactions that are significantly, or even primarily, motivated by tax considerations are problematic.[250] Nevertheless, the fact (revealed by the existence of a termination right contingent on a tax law change) that the tax treatment of the matter was quite important to the transaction could be useful in an IRS enforcement action.

B. Concerns

Tax transition risk-shifting agreements also have potential downsides, including the imposition of transaction costs, opportunities for inefficient risk-shifting, impact on lobbying incentives, and monetization of political intelligence.

1. Transaction Costs

The benefits of tax transition risk-shifting agreements are reduced by transaction costs because the contracting required to create such agreements is not frictionless.[251] Although transaction costs can be significant, the case studies provide insights into features of tax transition risk-shifting agreements that help minimize transaction costs. Specifically, transaction costs are likely reduced by the involvement of sophisticated parties, presence of a ready counterparty, existence of an ongoing relationship between the parties, use of standardized terms, and determinability of the consequences. In addition, the larger the expected value of the risk and the larger the potential maximum exposure, the smaller the transaction costs are likely to be in comparison, increasing the likelihood that a tax transition risk-shifting agreement will create net benefits.

Sophisticated Parties. A sophisticated party is likely to face lower transaction costs than an unsophisticated party entering into a tax

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current law persists and on Y terms if the law changes). This might suggest that the transaction has an important nontax business purpose. However, the transaction might still be tax-motivated, but by a tax consideration that is not the subject of the REVE.

[250] Such transactions could merely be applying the Code as intended. For example, if an agreement to effectuate a spin-off is subject to termination if § 355 is repealed, that does not mean that the spin-off was abusive or otherwise not social welfare enhancing. Section 355 is included in the current Code explicitly to allow tax-free corporate divisions under specified circumstances; if a taxpayer undertakes a spin-off under those circumstances, the Code is being applied as intended.

[251] See generally Ronald H. Coase, The Problem of Social Cost, 3 J.L. & Econ. 1, 15 (1960) (real-world contracting around default allocation of rights generally imposes nonzero transaction costs).

transition risk-shifting agreement on the same matter. Sophisticated parties likely start with better information about possible tax law changes and their potential impact, and their sophistication makes it easier and less costly for them to collect and analyze any additional information needed to make thoughtful decisions about tax transition risk-shifting. Indeed, all of the parties to the agreements in the case studies, except perhaps some muni bondholders, are sophisticated parties that likely have an understanding of the risk-shifting provisions and the economic stakes of the possible law changes.

Ready Counterparty. In addition, because all tax transition risk-shifting agreements require a counterparty to whom risk can be shifted,[252] transaction costs are reduced if a willing counterparty is easy to identify. For example, another party to an underlying transaction might be a ready counterparty (as is the case in all of the case studies) or, if a robust tax transition insurance market develops, insurers could be ready counterparties. On the other hand, transaction costs increase if a party seeking to offload tax transition risk must search for an appropriate counterparty or convince that party to participate.

Ongoing Relationship. Transaction costs also depend on whether the parties have an ongoing relationship that would, without the tax transition risk-shifting agreement, last at least for the duration of the tax agreement. If so, the tax transition risk-shifting agreement adds only marginal costs (e.g., the cost of discussing one more issue on a conference call or trueing-up one more payment). On the other hand, if the tax transition risk-shifting agreement would extend the parties' relationship beyond when they would otherwise want to go their separate ways (e.g., after a home sale), the risk-shifting agreement can create significant additional costs. Incurring the costs of maintaining an ongoing relationship and enforcing ongoing obligations solely for the purpose of managing tax transition risk will often be untenable.

Not surprisingly, all of the case studies involve parties with ongoing relationships that would, even without the tax transition risk-shifting agreement, last for at least the duration of the tax agreement. The period during which the tax transition risk-shifting provision applies under the ISDA master agreement, a credit agreement, and a muni bond indenture is generally coextensive with the duration of the parties' relationship under the rest of the agreement. Tax MACs generally only last until the acquisition closes (i.e., for the period of time when the parties are certain to have an ongoing relationship).[253] Similarly, if parties to a corporate acquisition already have a complex earnout

[252] See Part IV.B.

[253] Sellers in public deals generally have no post-closing relationship with the buyer.

based on other deal factors, adding an additional tax transition earnout may not be particularly onerous. And ongoing investors in a corporation could add tax law change contingencies to their preexisting shareholder agreements. Where the tax transition risk-shifting agreements are merely incremental additions to preexisting ongoing relationships, the marginal costs of the tax transition agreement are likely relatively low.

Standardization. Even with sophisticated parties, ready counterparties, and ongoing relationships, bespoke tax transition risk-shifting agreements, like tax MACs, can involve significant transaction costs. Standardized agreements, on the other hand, can dramatically reduce the costs of contractually shifting tax transition risk because the parties need not negotiate or analyze novel risk-shifting provisions anew in each transaction (assuming the parties are familiar with and comfortable with the terms).[254]

Standardized transition risk-shifting agreements can be especially useful where participants within an industry have relatively homogeneous preferences or where settled expectations about industry norms increase the speed and reduce the costs of transactions.[255] A representative industry group can create tax transition risk-shifting contractual provisions that are both (i) tailored to the needs of the industry and preferences of industry participants and (ii) standardized within the industry.[256] This is what ISDA and LSTA did for the derivatives and syndicated credit industries, respectively. Such an effort means that the costs of creating the provision are incurred only once[257] and spread among industry participants that support the centralizing industry group leading the effort. Once standardization occurs, sophisticated parties can rely on the standardized terms that they understand well and can reasonably price with limited effort. Thus, the industry participants benefit from using the tax transition risk-shifting provision with very little additional cost.

Nevertheless, the consequences of standardization can be complex,[258] particularly for less sophisticated parties. On one hand, stand-

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254 Fennell, note 112, at 1344, n.247; see also Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate"), 83 Va. L. Rev. 713, 719-27 (1997).

255 Fennell, note 112, at 1344-45 (discussing the benefits of risk-shifting provisions that "form settled expectations" within communities).

256 See generally Kevin E. Davis, The Role of Nonprofits in the Production of Boilerplate, 104 Mich. L. Rev. 1075 (2006) (discussing welfare implications when trade associations and other nonprofits create standardized contract forms).

257 A standardized form may also get updated periodically.

258 See generally Omri Ben-Shahar et al., Foreword [to Boilerplate: Foundations of Market Contract Symposium], 104 Mich. L. Rev. 821 (2006) (symposium on "boilerplate" contracts).

ardization can make the tax transition risk-shifting strategy accessible to less sophisticated parties at a reduced cost because they do not have to incur information-gathering, analysis, negotiating, drafting, or other costs of entering into the agreement. Further, if the industry has a relatively efficient market that incorporates the value of standardized risk-shifting provisions into market prices, unsophisticated parties would be spared the costs of valuing and pricing the risk-shifting agreement.[259] On the other hand, standardized provisions might be written in a way that disadvantages unsophisticated parties, particularly those who were not involved in the drafting of the language.[260] In addition, unsophisticated parties using standardized risk-shifting terms may not understand the package of rights and responsibilities provided, and they may not know enough to opt out when doing so would be beneficial to them. Thus, it may be unwise for less sophisticated parties to use tax transition risk-shifting agreements even if standardized, particularly if the risk-shifting provision shifts transition risk to, rather than away from, the less sophisticated party.

One additional downside to standardization is that it reduces the risk-shifting provision's ability to accommodate heterogeneous risk preferences. Thus, the cost-reduction benefits of standardization must be balanced against the risk-preference meeting benefits of tailoring.[261]

Determinability of Consequences. Complexity of the determinations required by the tax transition risk-shifting agreement (e.g., determining whether the "trigger" for a tax transition risk-shifting agreement has occurred or determining the consequences of triggering the agreement) also increases transaction costs. The case studies generally involve relatively well-defined possible tax changes that trigger easily determinable consequences. For example, if a tax rate increases, an identifiable payment increases by a formulaically determined amount, or if the tax rules related to inversions are changed in an adverse way, the parties can terminate. The relative simplicity of the determinations required by these agreements reduces transaction costs.

Nevertheless, even some relatively simple determinations (e.g., in M&A agreements with tax MACs about changes to the inversion rules) are complex enough so that the parties include in their agree-

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[259] See Douglas G. Baird, The Boilerplate Puzzle, 104 Mich. L. Rev. 933, 936 (2006) ("When the market works effectively, however, [the unsophisticated buyer] benefits from the presence of other, more sophisticated buyers.").

[260] See Eric A. Zacks, The Moral Hazard of Contract Drafting, 42 Fla. St. U.L. Rev. 991, 991-1011 (2015).

[261] See Henry E. Smith, Modularity in Contracts: Boilerplate and Information Flow, 104 Mich. L. Rev. 1175, 1176 (2006) (discussing the trade-off between "portability of boilerplate" and "tailoring").

ments detailed procedures articulating how the determination will be made (e.g., by one party or the other, by relying on an opinion of particular counsel, or with disputes about whether the change has occurred resolved in accordance with particular dispute resolution rules).[262] Creating and following these procedures entails transaction costs, but not having any such procedures could entail even larger transaction costs if disputes over whether the relevant tax law change has occurred devolve into expensive disputes.

Consider an even more complex change, such as the transition from an income tax to a consumption tax. This change likely involves multiple changes to the tax system,[263] and given that the U.S. tax system is a hybrid between an income tax and a consumption tax, it could be difficult to determine whether a particular change is sufficient to constitute a "switch to a consumption tax" that would trigger the tax transition risk-shifting agreement. This difficulty could increase costs. It could also be complex to determine exactly how a switch to a consumption tax would affect a given taxpayer, which would also increase costs (and likely engender disputes) if the payment required under the tax transition risk-shifting agreement is based on the change's actual dollar impact to a particular party. On the other hand, transaction costs are reduced if the consequences are simple and discrete (e.g., requiring that one party pay the other a *fixed* amount of money, as is typical in a prediction market contract).

Magnitude of Risk. The net benefit of entering into a tax transition risk-shifting agreement depends on how the agreement's benefits compare to its costs. Thus, transaction costs matter not only in absolute terms, but also as a percentage of the expected value of the tax transition risk. Typically, as the expected value of the transition risk increases, transaction costs are likely to decrease as a percentage of the expected value, even if they increase in absolute terms. The larger the impact of the possible law change, the more likely it is that the benefits of a tax transition risk-shifting agreement will exceed the transaction costs. On the other hand, where the monetary impact of the possible law change is small, the transaction costs of tax transition risk-shifting agreements could swamp the benefits—and using tax transition risk-shifting agreements would provide little or no net benefits. However, taxpayers may still be able to manage the tax transition risk using other market mechanisms as described in Part II.

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[262] See Field, note 118, at 843-45.

[263] See Joel Slemrod & Jon Bakija, Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform 307-08 (5th ed. 2017).

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Ultimately, transaction costs of tax transition risk-shifting agreements can be significant but can also be minimized in certain circumstances.

2. *Inefficient Risk-Shifting*

Tax transition risk-shifting agreements also raise concerns about moral hazard, adverse selection, correlated risks, and other inefficient risk-shifting. These issues are often discussed in the insurance context,[264] but they are relevant to any risk-shifting agreement, regardless of whether the risk is shifted to a party in the business of accepting risk.[265]

Moral Hazard. Moral hazard reflects a concern that a party may take less than the efficient level of care to avoid losses because the risk of loss was shifted to another.[266] With tax transition risk-shifting agreements, multiple moral hazard problems could arise.

First, the party who shifted away tax transition risk might engage in additional activities that increase the party's exposure to the covered tax transition risk.[267] For example, a party who contracts to shift away the risk that tax depreciation rules might change in a taxpayer-unfavorable way might overinvest in additional depreciable assets because it is protected from losses arising from such a change. However, this concern is easily addressed in the risk-shifting contract, which can limit the covered risk to current or specifically identified assets/transactions or can cap the potential payout.[268]

Second, a party who shifted away tax transition risk might change its lobbying behavior, thereby increasing the probability that the covered tax change will occur.[269] The party might stop lobbying against

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[264] See, e.g., Tom Baker & Peter Siegelman, The Law and Economics of Liability Insurance: A Theoretical and Empirical Review (Faculty Scholarship at Penn Law, Paper No. 350, 2011) (discussing moral hazard, adverse selection, and correlation as concerns in insurance law), https://scholarship.law.upenn.edu/faculty_scholarship/350; Tom Baker & Peter Siegelman, Behavioral Economics and Insurance Law: The Importance of Equilibrium Analysis, The Oxford Handbook of Behavioral Economics and the Law (2014) (also discussing cognitive biases in insurance law), https://www.oxfordhandbooks.com/view/10.1093/oxfordhb/9780199945474.001.0001/oxfordhb-9780199945474-e-019.

[265] Peter Siegelman, Adverse Selection in Insurance Markets: An Exaggerated Threat, 113 Yale L.J. 1223, n.1 (the concept of adverse selection is now "central . . . in a variety of contexts that have nothing to do with insurance").

[266] Kenneth J. Arrow, Uncertainty and the Welfare Economics of Medical Care, 53 Am. Econ. Rev. 941, 961 (1963); see Tom Baker, On the Genealogy of Moral Hazard, 75 Tex. L. Rev. 237 (1996).

[267] Masur & Nash, note 19, at 409-11 (discussing "internal" activities posing a moral hazard problem).

[268] Id. at 410-11.

[269] Id. at 412-16 (discussing "external" activities posing a moral hazard problem).

the change because it no longer has an economic incentive to work to prevent the adverse tax law change.[270] A party that is fully protected from the tax law change might even start lobbying *for* the change if it would hurt competitors that lack the same tax transition protection.[271] One way to address this concern, at least partially, is through the design of the coverage, including by shifting only risk above a certain threshold (e.g., by imposing a retention or deductible). This approach ensures that the protected party remains at risk to some degree, thereby reducing that party's incentive to engage in the problematic lobbying behavior.[272] Alternatively or in addition, the tax transition risk-shifting agreement could impose lobbying obligations or restrictions.[273] For such restrictions to address the potential moral hazard problem, however, compliance with the lobbying provisions would have to be adequately monitored.[274] Monitoring may be plausible in limited circumstances where parties know each other and given that there is some visibility available into tax-related lobbying behavior by high-profile individual firms.[275] However, monitoring tax-related lobbying could also be very challenging, especially where there are anonymous counterparties (as with predictions markets) or where lobbying is done by taxpayers indirectly via trade associations,[276] and not just by the specific taxpayers who might be parties to the tax transition risk-shifting contract. Thus, problematic lobbying behavior is likely most effectively curtailed by ensuring that the party shifting risk away still retains at least some portion of the risk.

Third, a party that shifted away its risk of loss arising from a possible law change may not try to reduce the magnitude of the loss if the

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[270] Id. at 412-13; see text accompanying note 66; see also Part V.B.3 (discussing the impact on the risk-accepting party's incentive to lobby).

[271] Masur & Nash, note 19, at 412-13.

[272] See Baker & Siegelman, The Law and Economics of Liability Insurance: A Theoretical and Empirical Review, note 264, at 13, 16-19.

[273] Masur & Nash, note 19, at 412-13.

[274] Id.

[275] See Center for Responsive Politics, OpenSecrets.org, Issue Profile: Taxes (listing clients lobbying on taxes by year and providing information about how frequently they lobbied on taxes and on what specific tax issues), https://www.opensecrets.org/federal-lobbying/issues/summary?cycle=2019&id=TAX.

[276] Tax lobbying is often done by trade associations, such as America's Health Insurance Plans and National Association of Real Estate Investment Trusts, which are composed of taxpayers who could be affected by tax law changes. Center for Responsive Politics, OpenSecrets.org, Issue Profile: Taxes (listing both trade associations as having lobbied on taxes in 2019), https://www.opensecrets.org/federal-lobbying/issues/summary?cycle=2019&id=TAX. Where trade associations do the lobbying, it can be difficult to ascertain which individual firms are leading or influencing the trade association's efforts. Notably, some industry associations, such as the ABA Section on Taxation and the New York State Bar Association Tax Section, often write excellent and neutral assessments of the tax law and are less likely to be involved in activities that pose moral hazard concerns.

tax law change actually occurs.[277] For example, if a party shifted away the risk that additional limits would be imposed on the use of NOLs and the law change did occur, the party might not take action to maximize the value of the NOLs (e.g., try to use the NOLs sooner if the change has a delayed effective date) because the party is protected from the loss. However, this concern can again be addressed in the risk-shifting contract by requiring loss mitigation efforts or by specifying the amount of loss protection formulaically, perhaps based on certain assumptions, rather than providing that the loss protection is determined based on the actual loss experience.

Given that potential moral hazard concerns arising from tax transition risk-shifting agreements can largely be mitigated by contract, such concerns generally should not weigh against the use of these agreements, except perhaps in prediction markets and other contexts where behavioral covenants may be particularly hard to enforce.

Adverse Selection. Inefficiencies can also arise from adverse selection, which refers to the idea that parties subject to more risk are likelier to seek protection from that risk and that informational asymmetries may prevent the party accepting that risk from pricing the risk transfer accurately.[278] However, adverse selection requires informational asymmetries,[279] and tax transition risk-shifting presents limited opportunities for such asymmetries.

One party could have nonpublic information about the likelihood and details of possible tax law changes. In general, however, when changes are "created by state and federal governmental entities[,] . . . there is negligible private information about these types of [changes] (except the information held by the government actors themselves)."[280] If most relevant information is public, the parties (at least sophisticated parties) are likely to know and understand it. Nevertheless, one party could have closer ties to government actors and, as a result, could have more information about likely tax law changes,[281] which could present some adverse selection problems. It is not clear, however, which party is more likely to have this additional information. If the party *assuming the risk* has the additional information, the

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[277] Baker & Siegelman, The Law and Economics of Liability Insurance: A Theoretical and Empirical Review, note 264, at 17-18 (discussing "ex post" moral hazard).

[278] See Siegelman, note 265, at 1226-1240; Michael Rothschild & Joseph Stiglitz, Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information, 90 Q.J. Econ. 629 (1976) (developing the theory of adverse selection).

[279] Baker & Siegelman, The Law and Economics of Liability Insurance: A Theoretical and Empirical Review, note 264, at 29.

[280] Masur & Nash, note 19, at 417.

[281] See Part V.B.4 (discussing the political intelligence industry and its efforts to gather and monetize nonpublic information about future law changes).

party *transferring away the risk* would not have an informational advantage that could cause typical adverse selection problems.[282]

The party shifting tax transition risk away could also have private information about how a prospective tax law change could affect them.[283] However, if the impact of a tax law change is likely to vary materially from taxpayer to taxpayer, the party assuming the risk could perform due diligence to gauge the risk exposure. Due diligence to assess risk is quite common in other types of tax insurance as part of the underwriting process,[284] and similar diligence could be done when shifting tax transition risk. Alternatively, the tax transition agreement could be drafted to provide a standardized payout (as in prediction market contracts) rather than a payout based on the particular circumstances of an individual taxpayer. As a result, private information about the taxpayer-specific impact of a tax law change would be irrelevant and could not lead to an adverse selection problem.

Ultimately, where tax transition risk-shifting agreements involve sophisticated parties and where concerns about unique risk exposure can be gauged with due diligence or avoided using standardized payouts, it is unlikely that material informational asymmetries would lead to adverse selection problems.

Correlated Risks. Correlated risks could be problematic for tax transition insurance because any tax law change applies equally to all covered taxpayers.[285] Where risks are correlated rather than largely independent, one event could trigger payment obligations on a large percentage of the insurer's policies, thereby threatening the economic viability of the insurer and undermining the effort to distribute risk efficiently.[286] The correlation concern facing tax transition insurance could be managed if insurers only issue a limited number of policies per possible tax change, thereby allowing for diversification of the as-

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[282] Cf. Kaplow, note 15, at 185 (even if "a reform will be limited to a particular industry—it seems unlikely that this would be both known to the private actors and unknown to the insurers and other financiers who specialize in dealing with actors in that industry"); see also Siegelman, note 265, at 1251-52 ("informational asymmetries [may] favor[ ] insurers" which undermines the "standard adverse selection story").

[283] A party could also have private information about its plans to lobby about the possible change, but that becomes a moral hazard concern. See Part V.B.2.

[284] Field, note 222, at Parts I.A, III.B.2; see also Baker & Siegelman, Behavioral Economics and Insurance Law: The Importance of Equilibrium Analysis, note 264, at 6 (underwriting can help manage adverse selection concerns); Ronen Avraham, The Economics of Insurance Law—A Primer, 19 Conn. Ins. L.J. 29, 45-56 (2013) (discussing strategies for addressing adverse selection concerns).

[285] Masur & Nash, note 19, at 420-21; Kyle D. Logue, Optimal Tax Compliance and Penalties When the Law Is Uncertain, 27 Va. Tax Rev. 241, 274-75 (discussing the problem of correlation with the regular, non-transition, tax insurance).

[286] Sherilyn Pastor, New Appleman Insurance Law Practice Guide § 1.05 (2017); Avraham, note 284, at 102-04; Baker & Siegelman, The Law and Economics of Liability Insurance: A Theoretical and Empirical Review, note 264, at 26-27.

sumed risks.[287] However, risks associated with different possible tax changes might not be independent, particularly if there is "a large political transition."[288] For example, the risk of increased corporate tax rates and the risk of increased tax rates on dividends might be correlated if political power shifts to a less business-friendly party. Thus, concern about the impact of correlated risks may reduce the desirability of tax transition insurance, unless an insurer can diversify effectively by having a large portfolio of insurance policies on a wide range of risks far beyond tax transition risks.

On the other hand, correlation is largely irrelevant for a party agreeing to assume tax transition risk in a one-off transaction. A one-off risk-shifting agreement, by definition, involves only one risk transfer, meaning there is no opportunity for correlation among multiple risks. Moreover, even if a party assuming the tax transition risk is a repeat player, the tax transition risk-shifting agreements between parties to an underlying transaction (as opposed to risk-shifting agreements with third parties) are generally about risk *shifting and allocation*, not risk *distribution*. The party assuming the tax transition risk is generally not depending on diversification to manage its exposure to tax law changes; rather, that party is generally making an individual decision to bear the risk of a particular tax law change in a particular situation.

Thus, except perhaps in the tax transition insurance context, concerns about risk correlation should not reduce the normative desirability of tax transition risk-shifting agreements.

Other Causes of Inefficient Risk-Shifting. Tax transition risk-shifting agreements could lead to suboptimal risk allocation for several other reasons.[289] Taxpayers may lack adequate information about the probability of a tax law change, or they may not have the expertise to, or access to expertise that would enable them to, appreciate how the tax law change could affect them. Taxpayers may not fully understand their rights and obligations under a tax transition risk-shifting agreement, which could be particularly problematic if they are accepting risk rather than shifting it away. Taxpayers may be subject to cognitive biases, such as "myopia or a tendency to discount hyperbolically,"[290] which could lead them to accept a lump sum payment today in exchange for assuming a risk that they may not be able to bear in the future, which may ultimately externalize the losses back onto parties

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287 Masur & Nash, note 19, at 419-20.

288 Id. at 420.

289 Kaplow, note 15, at 186; Kaplow, note 11, at 549-50; Fennell, note 112, at 1336-39, 1348-50; Chason, note 63, at 630-32 (discussing biases and strategic behavior); Shaviro, note 10, at 19-25, 36 (cognitive biases).

290 Fennell, note 112, at 1348.

that thought they were protected.[291] Taxpayers might be subject to other cognitive biases, such as overestimating low probability identified risks[292] or regret aversion,[293] causing them to irrationally overpay for unnecessary or very limited tax transition risk protection. Worse, parties seeking a quick payday might prey on parties likely to make irrational risk-shifting decisions,[294] which could create fairness concerns in addition to efficiency concerns.

These problems are more likely to impact unsophisticated parties than sophisticated ones,[295] suggesting that tax transition risk-shifting agreements are less appropriate for unsophisticated parties and thus should be limited or perhaps regulated. Exactly what that should entail is unclear because, as other scholars have noted, it can be quite difficult to identify appropriate interventions that respond to heterogeneous causes of imperfect decision-making.[296]

3. *Altering Lobbying Incentives*

Tax transition risk-shifting agreements also change incentives to lobby. Although a party that uses a tax transition risk-shifting agreement to shift away tax transition risk likely has less incentive to lobby against an adverse possible tax law change,[297] the party to whom the risk is shifted likely has more incentive to lobby. This shift may reduce the aggregate magnitude of the lobbying incentives because the party that assumed the risk may be less risk averse or more able to bear the risk than the party that shifted the risk away. Thus, tax transition risk-shifting agreements may have the salutary effect of decreasing lobbying. On the other hand, the shift could increase aggregate lobbying incentives if, for example, the party that accepted the risk in the tax transition REVE did so because they thought the change was quite unlikely to occur, and it turns out they were wrong. In that case, the risk-accepting party may have a supercharged incentive to lobby against the change to protect themselves from unexpected loss.

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[291] Id. at 1336 (the party assuming risk in a REVE might be judgement-proof).

[292] See Sarah Lichtenstein et al., Judged Frequency of Lethal Events, 4 J. Exper. Psychol.: Hum. Learning Memory 551, 551 (1978); Nicholas C. Barberis, Thirty Years of Prospect Theory in Economics: A Review and Assessment, 27 J. Econ. Persp. 173 (2013).

[293] Baker & Siegelman, Behavioral Economics and Insurance Law: The Importance of Equilibrium Analysis, note 264, at 10.

[294] Id. at 5-6, 10-11 (consumers are "vulnerable to insurer opportunism" and "high-pressure" or "abusive" tactics).

[295] That said, sophisticated parties are certainly not immune from making suboptimal decisions.

[296] Id.

[297] See Part V.A.3 & text associated with notes 262-64.

In addition, if a single party (like an insurer) accepts tax transition risk on the same issue in multiple transactions, the concentration of the lobbying incentive increases. A single party has the incentive to do the lobbying that, absent the risk-shifting agreements, many different taxpayers would have been incentivized to do. The concentration of lobbying incentives may make it easier to overcome collective action problems that might have hindered effective lobbying by the dispersed taxpayers or that might have made such lobbying more expensive.[298] Ultimately, it is unclear, however, whether this "more efficient system of lobbying . . . [will] diminish the social harm caused by lobbying as a whole," in part because "it is difficult to know whether [this centralization of lobbying incentives will cause] the absolute amount of lobbying [to] decrease or increase."[299]

4. Monetizing Political Intelligence

Tax transition risk-shifting agreements also provide opportunities for government actors and private parties to profit off of nonpublic information about the lawmaking or regulatory process.[300] This could undermine public confidence in government because it raises questions about the incentives of government employees who should be working for the public good. These concerns are similar to those discussed in the literature about the application of insider trading rules to government officials[301] and the political intelligence industry.[302]

If government officials and employees entered into tax transition risk-shifting agreements, they would be incentivized to use nonpublic political information for personal gain when deciding whether to enter into a risk-shifting agreement, and they would be incentivized to use

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[298] See Chason, note 63, at 643-44 (expressing concern that concentrating tax transition risk in the hands of insurance companies could lead insurers to become "a nexus for political organization" that could exacerbate the "protection racket").

[299] Masur & Nash, note 19, at 414-15.

[300] Government actors and private parties can profit off of this information without tax transition risk-shifting agreements. For example, the information could enable the party to price assets more accurately than the market does and then buy when the market underprices the asset. However, tax transition risk-shifting agreements increase the opportunities for profiting off of nonpublic information about possible law changes.

[301] See, e.g., Stephen M. Bainbridge, Insider Trading Inside the Beltway, 36 J. Corp. L. 281 (2011); Jonathan R. Macey & Maureen O'Hara, Regulation and Scholarship: Constant Companions or Occasional Bedfellows?, 26 Yale J. on Reg. 89, 103-09 (2009); J.W. Verret, Applying Insider Trading Law to Congressman, Government Officials, and the Political Intelligence Industry in Research Handbook on Insider Trading 156-61 (Stephen Bainbridge ed., 2013).

[302] See, e.g., Bud W. Jerke, Cashing in on Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit, 158 U. Pa. L. Rev. 1451 (2010); Ernie C. Jolly, The Poli-Intel Industry: Considering the Common Law's Application in Insider Trading Under the STOCK Act, 2 Am. U. Bus. L. Rev. 421 (2013); Verret, note 301, at 161-64.

their official positions to influence the direction of tax policy to increase the likelihood that their investments in tax transition risk-shifting agreements would pay off.[303] These "perverse incentives" create "the potential for immeasurable harm in a legal system in which public trust and confidence is critical."[304] Thus, these concerns, which led commentators to condemn insider trading by government actors[305] also argue against allowing government actors to enter into tax transition risk-shifting agreements.

The analysis is a little different with the political intelligence industry, in which *third parties* seek out and monetize nonpublic government information about the likely direction of laws and regulations.[306] On one hand, political intelligence, used to inform decisions about tax-transition risk-shifting agreements or otherwise, can serve a "price discovery function"[307] by gathering and disseminating information that increases the efficiency of the market[308] and can be a tool to help constituents understand and engage with the democratic process.[309] On the other hand, some uses of political intelligence could cross the line into insider trading, misappropriation, or other problems that could harm lawmaking institutions.[310] Even if political intelligence is used in a manner that is not corrupt, using political intelligence for private financial gain can create the perception of corruption—that powerful people with access to and influence over government actors can use their access to nonpublic information to make money off of people who lack that access and these powerful people can use their influence to steer policies in ways that inure to their personal financial benefit rather than to society's benefit. These concerns are not newly created by tax transition risk-shifting agreements; these are long-standing concerns discussed in the lobbying and campaign finance contexts because even the mere perception of corruption can under-

303 See Bainbridge, note 301, at 299–300.

304 Macey & O'Hara, note 301, at 108.

305 See, e.g., Bainbridge, note 301, at 297-301 ("there is no plausible justification for allowing members of Congress or other governmental actors to use material nonpublic information they learn as a result of their position for personal stock trading gains").

306 See Verret, note 301, at 156; U.S. Gov't Accountability Off., GAO-13-389, Political Intelligence: Financial Market Value of Government Information Hinges on Materiality and Timing 4 (2013).

307 Verret, note 301, at 163.

308 Jerke, note 302, at 1519-21.

309 Id. at 1518-19; U.S. Gov't Accountability Off., note 306, at 20-21.

310 See U.S. Gov't Accountability Off., note 306, at 6-8, 11-13 (explaining that existing laws can apply to political intelligence activities); Peter J. Henning, When "Political Intelligence" Meets Insider Trading, N.Y. Times (May 29, 2017) (discussing the Justice Department's pursuit of an insider trading case against political intelligence operatives); Verret, note 301, at 161-63.

mine "the health of a representative government."[311] While one-off tax transition risk-shifting agreements among sophisticated parties involved in an underlying substantive transaction are unlikely to make the concerns worse, the existence of a robust tax transition insurance market or prediction market might, especially if powerful players in those markets repeatedly win their "bets."

The foregoing concerns about self-serving activities by government employees and monetization of political intelligence could be mitigated by increasing the transparency of the lawmaking process. Reducing available nonpublic information that could be used for personal financial gain by lawmakers or political intelligence gatherers reduces the threats to trust in government created by private use of nonpublic information.[312] However, "there are both practical and political limits to how predictable and transparent government action can become. . . . And it is unreasonable to believe that all relevant policy making could (or should) be forced into public view."[313] Thus, opportunities for gathering political intelligence will remain.

Certainly, not all efforts to monetize political intelligence are corrupt, and not all tax transition risk-shifting agreements involve monetization of political intelligence. However, tax transition risk-shifting agreements increase the incentives for parties to gather tax-related political intelligence that can be used for profit, which can undermine trust in government. Ultimately, whether tax transition risk-shifting agreements are likely to threaten public confidence in government depends on several factors, including what information is used when deciding whether to enter into such an agreement, who uses that information, and how that information was obtained.

C. Recommendations

The costs and benefits of tax transition risk-shifting agreements vary by situation, so these agreements cannot be universally endorsed or condemned. Several recommendations, however, can be distilled from the foregoing analysis.

First, tax transition risk-shifting agreements are most likely to be normatively desirable where there are sophisticated parties on both sides of the deal and they seek to undertake a social welfare enhancing transaction, but where a possible tax law change could have a ma-

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311 Jeremiah W. (Jay) Nixon & Paul R. Maguffee, Money Talks: In Defense of a Common-Sense Approach to Judicial Review of Campaign Contribution Limits, 52 Admin. L. Rev. 661, 678 (2000) (campaign finance); see also, e.g., Suzanne Dovi, The Ethics of the Revolving Door, 12 Geo. J.L. Pub. Pol'y 535, 535-36 (2014) (lobbying).

312 Masur & Nash, note 19, at 426-28.

313 Id. at 428.

terial impact on the transaction's economics, other market mechanisms for managing tax transition risk fail to satisfy the taxpayers' risk preferences, and the transaction costs of using a tax transition REVE can be sufficiently minimized.[314] Otherwise, taxpayers should generally use another strategy for managing tax transition risk. Thus, as an initial matter, if other market mechanisms meet the taxpayers' risk preferences, those mechanisms should generally be used, and REVEs should not because the transaction costs of the former are almost certainly lower. Even in situations where a REVE meets taxpayers' risk preferences better than other market mechanisms, using a tax transition REVE still might not be desirable. In particular, unsophisticated parties[315] should generally be discouraged from using tax transition risk-shifting agreements because of the high transaction costs those parties would likely incur, cognitive biases that could lead them to make suboptimal risk-shifting choices, and the risk that sophisticated parties could take advantage of unsophisticated parties. In limited situations, however, it is possible that these concerns could be overcome so that tax transition risk-shifting agreements would be appropriate even for unsophisticated parties if their risk preferences cannot be met by other market mechanisms. In addition, where the dollar impact of the potential law change is relatively low, the costs of such agreements likely outweigh the benefits and should generally not be used.

Second, although the social utility of tax transition risk-shifting agreements varies by situation, these agreements should be part of the tool belt of all tax advisers, especially in times of political flux and tax law instability, because these agreements can be valuable for transition risk management in appropriate situations.

Third, when used, tax transition risk-shifting agreements should be carefully drafted to minimize the downsides of the agreements. Provisions should be included to manage adverse selection and moral hazard concerns. In addition, to reduce transaction costs, efforts to standardize language should be considered, particularly where members of an industry/group likely have relatively homogeneous risk management preferences with respect to a particular possible tax law change and where an organization is available to develop industry norms.

Fourth, government actors should be precluded from participating in tax transition risk-shifting agreements involving tax issues over

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[314] See Part V.B.1 (regarding minimizing transaction costs).

[315] For example, where parties lack information about the potential law change or its likelihood, lack an understanding of how a potential tax law change could affect them, or lack low-cost access to such information or understanding.

which they have any control or about which they have any nonpublic information. In addition, if tax transition REVEs become more common, tax transition risk-shifting activity by the political intelligence industry should be analyzed to assess whether it involves inappropriate access to nonpublic information and to evaluate the impact on public confidence in democratic governance.

Fifth, the policy implications of tax transition insurance, derivatives, and prediction market contracts are ambiguous and should be reassessed as those markets develop. On the one hand, these tax transition REVEs with third-party counterparties could allow taxpayers to manage tax transition risks for various tax issues (e.g., allocation of human capital) that are not deal-related or for which there is unlikely to be a ready counterparty that is otherwise involved in the matter. Tax transition insurance and derivatives also accommodate a greater range of risk preferences from a greater range of possible participants than one-off tax transition risk-shifting agreements between parties to an underlying transaction. Also, the more robust the tax transition insurance markets, the less likely that unsophisticated parties will be taken advantage of in a tax transition risk-shifting transaction.[316] On the other hand, both tax transition insurance and derivatives present greater adverse selection and moral hazard problems than tax transition risk-shifting agreements between parties to an underlying transaction. In addition, even if pricing and other impediments to the creation of a tax transition insurance market could be overcome, it may be economically unstable and may ultimately externalize tax transition risks onto parties that thought they were protected from such risks. Further, tax transition insurance and derivatives increase the chance that political intelligence is used in a way that undermines public confidence in government. Plus, tax transition insurance concentrates lobbying incentives that would otherwise be dispersed among multiple taxpayers, which could make lobbying efforts more efficient (for better or worse). In addition, tax transition derivatives present a greater possibility that taxpayers are merely betting on tax law changes for speculative purposes rather than using these risk-shifting agreements for prudent social welfare enhancing risk management. On balance, it is unclear whether the benefits of these agreements outweigh the costs. Ultimately, the social welfare implications of tax transition insurance and derivatives likely depends on how these markets begin to develop, and such a development would merit further analysis.

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[316] Fennell, note 112, at 1351 ("competition [in transition insurance, while not a panacea] . . . , does provide some check against monopolistic or exploitative pricing.").

VI. The Transition Policy Implications of Private Contracting in Response to Tax Transition Risk

The foregoing discussion analyzed tax transition risk-shifting agreements in light of the existing approach to tax transition policy. However, understanding how taxpayers do and could contract to allocate tax transition risk should also *inform* tax transition policy.

A. Applying the New View

For proponents of the new view of tax transition policy, a tax transition REVE indicates that the parties anticipated possible changes in tax law and used market mechanisms to manage the risk—just as the new view expects.[317] Specifically, the existence of a contract that allocates tax transition risk among the contract's parties provides strong evidence that the parties are aware that a particular tax law could change; they considered the impact that the possible tax law change could have on each of them; they factored that risk into their analyses about whether to engage in the transaction, at what price, and pursuant to what terms; they availed themselves of at least one market mechanism (contracting) for managing the tax transition risk; and, taking all of the foregoing into account, they decided to engage in the transaction despite the possibility that the tax law could change. Thus, where taxpayers enter into tax transition risk-shifting agreements, new view proponents would conclude that transition risk should be allocated to the private sector and transition relief should be denied.

Admittedly, different tax transition risk-shifting agreements reflect different degrees of explicit thinking about possible tax law changes. Bespoke risk-shifting provisions (as with tax MACs) or even risk-shifting provisions that are negotiated starting from standard language (as with syndicated credit agreements) likely reflect careful (or at least some) consideration of the impact of a possible change in tax law. However, boilerplate provisions (as with ISDA master agreements) suggest that parties might not have considered the tax transition risk as carefully. With OTC derivatives, the parties are generally fairly sophisticated, so they likely consider tax transition risk even if they do not explicitly negotiate about its allocation. However, with less sophisticated parties, the analysis might be different. Thus, new view proponents would likely argue that the case for non-mitigation is particularly compelling where there is a *negotiated* tax transition risk-shifting agreement and somewhat weaker if the risk-shifting provision is boilerplate or the agreement involves less sophisticated parties.

317 See Part I.B.

Taxpayers in some situations have limited (or no) real ability to enter into tax transition risk-shifting agreements because of lack of sophistication, cognitive biases, lack of information about the possible change, lack of access to good advice about how to manage the risk, market imperfections, transaction costs, and other factors.[318] In these situations, tax transition policy should not assume that taxpayers can use private contracting to manage their exposure to tax transition risk. Thus, even proponents of the new view might support transition relief in these circumstances particularly if these taxpayers also lack meaningful opportunities to use other market mechanisms to manage tax transition risk.[319]

The implications of tax transition risk-shifting contracts, however, may not be quite so clear cut, even for new view proponents. This is for at least two reasons.

First, although some generalizations can be made about when and where tax transition risk-shifting agreements can and should be used,[320] the line between taxpayers who can use these contractual provisions and those who cannot is not always easy to draw. A taxpayer's failure to enter into such an agreement might mean that the taxpayer cannot enter into such an agreement and has not anticipated the possible law change. However, it might also mean that the taxpayer used other market mechanisms to manage risk, is comfortable bearing the transition risk, or has sufficient confidence that government relief would be provided in the event of a law change. Thus, the fact that a taxpayer does not use a tax transition risk-shifting agreement could, but does not necessarily, weigh in favor of government-provided transition relief. In addition, taxpayers' abilities to use tax transition risk-shifting agreements likely change over time. There may be more opportunities to enter into such agreements as there is more awareness about tax transition REVEs as a risk mitigating technique, if concern about tax law instability grows and tax transition risk mitigation efforts consequently increase, and (if and) as tax transition insurance and/or prediction markets develop. Thus, a taxpayer that cannot use a tax transition REVE today may be increasingly able to use one over time. This presents a challenging question: how available and widely used must the tax transition risk-shifting technique be to make the argument for non-mitigation compelling under the new view?

Second, the above discusses tax transition REVEs on a taxpayer-by-taxpayer or context-by-context basis, but transition rules for tax law changes are generally imposed on a change-by-change basis. Thus,

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318 See Parts V.B.1 and V.B.2.

319 See, e.g., Kaplow, note 11, at 550.

320 See Parts IV and V.C.

when analyzing whether to provide transition relief for a particular law change, it is not enough to know that some taxpayers enter into tax transition risk-shifting agreements with respect to that possible law change. Instead, policymakers need to use insights provided by the existence of tax transition risk-shifting agreements to determine whether to provide transition relief not only to those taxpayers who entered into tax transition risk-shifting agreements, but also to all other taxpayers who would be affected by the tax law change. This depends, at least in part, on how representative the taxpayers who did enter into such agreements are of all taxpayers who would be affected by the tax law change. This determination may not be terribly challenging if the risk-shifting agreement is the norm throughout most economic transactions that would be affected by the change. However, such agreements might not be so common, making it harder to determine whether taxpayers who are likely to be affected by the change generally anticipate, and use market mechanisms in response to, the possible tax law change.

Notwithstanding these challenges, for a new view adherent, the argument for non-mitigation is particularly compelling where taxpayers use tax transition risk-shifting agreements and indeterminate where taxpayers can use these agreements but do not. However, arguments for transition relief may be more sympathetic, even for a new view adherent, where taxpayers cannot use transition risk-shifting agreements or other strategies to manage transition risk.

B. Choosing Between the Old View and the New View

Where a policymaker has not already adopted the new view but is, instead, trying to decide whether to apply the new view or old view, the above argument for non-mitigation where there are tax transition REVEs suffers from a chicken-and-egg problem. It is generally fear of tax law change without mitigation that leads taxpayers to engage in private mitigation strategies such as using tax transition risk-shifting agreements, the existence of which is then used to argue for making tax law changes without mitigation. If taxpayers knew transition relief would be provided, they would be less likely to create tax transition risk-shifting agreements, which would then weaken the case for non-mitigation.

Thus, the long-standing tax transition policy question remains—should transition risk be borne by the private sector or the public sector? A clear answer to this question is not provided by understanding tax transition risk allocations *within* the private sector. However, insights into how tax transition risk-shifting agreements are used to shift transition risk among private sector parties add nuance and complex-

ity to the fundamental tax transition policy analysis in several respects.[321]

1. *Understanding the Costs of Allocating Transition Risk to the Private Sector*

One consideration relevant to determining whether the government or the affected taxpayers should bear tax transition risk is which party can bear the risk at least cost.[322] That analysis should consider not only the costs already discussed in the literature, but should also consider the costs of private sector contracting (i.e., tax transition risk-shifting agreements) that can be used to protect against the potential consequences of the law change. Those costs might affect the determination of whether the private or public sector can bear tax transition risks at the least cost and might alter the decision about whether to provide transition relief.

As this Article explains, tax transition risk-shifting agreements can involve substantial transaction and other costs.[323] Where efforts to create such agreements likely involve high costs, those costs may make it less desirable to allocate the tax transition risk to the affected taxpayers. This could weigh in favor of providing transition relief.

Transaction costs of tax transition risk-shifting agreements, however, can be minimized where taxpayers are sophisticated and behave rationally, where there are appropriate counterparties to whom determinable risk can be shifted, and where taxpayers are perhaps assisted by an industry group that can help overcome collective action impediments to information gathering and responses.[324] In addition, where the transition risks faced by those parties are large, the costs of tax transition REVEs may be small as a percentage of the potential loss being shifted.[325] Further, costs arising from the possibility of inefficient risk-shifting can often be managed via contract as described in Part V.B.2.

Where taxpayers can use tax transition risk-shifting agreements at low costs, several arguments may strengthen the case for allocating transition risk to the private sector. First, the identity of the more efficient bearer of risk (i.e., the cheapest cost avoider) could change if taxpayers can contractually shift tax transition risk to other private

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[321] The considerations discussed in this section are clearly not the only ones relevant to the choice about whether or when to provide transition relief. This discussion merely adds to the many other considerations discussed in extensive literature about the tax transition policy choice. See Part I (discussing the tax transition policy debate).

[322] See Part I.C.

[323] See Part V.B.

[324] See Part V.B.1.

[325] See id.

parties at low cost. Private actors may be better risk bearers than they would otherwise appear to be if they can use tax transition REVEs at low cost to shift transition risks to other private parties that may be particularly well-suited to bear the risk.[326] That may bolster arguments for allocating the transition risk to the private sector. Second, where there are low-cost opportunities to enter into tax transition REVEs, taxpayers have meaningful ability to achieve their preferred risk positions by using these contracts. In these situations, allocating transition risk to the affected taxpayers likely achieves taxpayers' risk preferences better than allocating the transition risk to the government would.[327] Third, where taxpayers can use tax transition REVEs at low cost to self-insure against repeal of tax incentives, the government's cost of these behavior-influencing tax incentives likely declines, possibly weakening the case for transition relief.[328]

Lobbying-related costs arising from the use of tax transition risk-shifting agreements can also impact choice of transition policy. On the one hand, the argument for government-provided transition relief is strengthened if tax transition REVEs cause an increase in the concentration of lobbying incentives that stymie welfare-enhancing law changes further or provide policymakers with even more lucrative rent extraction opportunities.[329] On the other hand, if tax transition risk-shifting agreements merely increase lobbying efficiency and reduce taxpayers' aggregate lobbying incentives, thereby reducing the total lobbying costs and limiting policymakers' opportunities to extract rents,[330] that could weaken the argument for providing transition reliefs.

Ultimately, taking the costs of tax transition REVEs into account certainly does not provide a definitive answer to the tax transition policy question. However, understanding the impact of tax transition REVEs may affect the analysis (at least on the margin), particularly where such agreements are likely to be used.

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[326] For example, consider a possible tax law change that would directly affect *Private Actor 1*. If the government is a better bearer of transition risk than *Private Actor 1*, transition risk would typically be allocated to the government, and transition relief would be provided. If, however, *Private Actor 1* can use a tax transition risk-shifting agreement at low cost to shift the transition risk to *Private Actor 2* and *Private Actor 2* is a better bearer of the tax transition risk than the government, that might support allocating the transition risk to *Private Actor 1* rather than the government, thereby changing the sector (public or private) to which the transition risk is initially allocated. This may be particularly likely if *Private Actor 2* is a third-party insurer or derivative counterparty.

[327] See notes 56-57 and accompanying text.

[328] See note 68 and accompanying text.

[329] See Part V.B.3; see also note 66 and accompanying text.

[330] See Parts V.A.3 and V.B.3.

2. *Analyzing the Use of Non-Mitigation to Incentivize Taxpayer Anticipation of Changes*

Where policymakers are selecting a transition rule in an intentional effort to encourage taxpayers to take possible law changes into account when making decisions, it is important to understand the full range of taxpayers' anticipatory behaviors. This includes the possibility that taxpayers may enter into tax transition REVEs to manage the transition risk.

The availability of a private contracting option may affect the efficacy of the behavioral incentive that policymakers are seeking to create through a non-mitigation approach.[331] If policymakers want to incentivize taxpayers to make efficient investment decisions taking account of the possibility that the law might change, then taxpayers' abilities to use tax transition REVEs likely advances the goal behind allocating transition risk to the private sector. However, if policymakers hope that a non-mitigation rule will encourage taxpayers not to undertake a particular transaction at all, the policymakers may be disappointed because tax transition risk-shifting agreements may enable taxpayers to manage the transition risk well enough to proceed with the transaction that the policymakers hoped to curtail.[332] Thus, if the goal of using a non-mitigation approach is to stop the transaction, policymakers should consider whether taxpayers are likely to contract around the initial allocation of transition risk. If taxpayers are likely to do so, that does not mean transition risk should be allocated to the government; it likely just means that policymakers should temper their expectations about how well a non-mitigation approach will curtail the transaction during the period leading up to the law change. Even where allocating transition risk to the private sector will be effective in encouraging taxpayers to make efficient decisions that anticipate possible law changes, those benefits will have to be weighed against the costs of tax transition risk-shifting agreements[333] as part of reaching a conclusion about the appropriate transition rule.

More fundamentally, the analysis of tax transition REVEs emphasizes a factor—knowledge about the possible change—that is critically important if government hopes a non-mitigation approach will encourage taxpayers to change their behavior in anticipation of the future change in law. Without sufficient awareness of the tax law change

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331 If policymakers want to incentivize taxpayers to innovate in their efforts to manage transitions effectively, then tax transition risk-shifting contracting may be exactly the type of behavior they are hoping to encourage. In such a case, policymakers should commit to a policy of non-mitigation, lest the possibility of government-provided transition relief crowd out the desired transition risk-shifting behavior.

332 See id.

333 See Part VI.B.1.

possibilities and the directionality and probability of such changes,[334] the taxpayer's initial economic decisions would be unlikely to be functions of tax law, and the taxpayer likely could not design or price a tax transition risk-shifting agreement.[335] Taxpayers would be similarly impeded from taking other actions in response to the possibility that tax law could change. In contrast, the more taxpayers are aware of a potential change and the lower their information-gathering costs about the change, the less costly it becomes to enter into tax transition REVEs[336] or take other anticipatory action. Thus, if policymakers' goals are to incentivize taxpayers to anticipate changes, policymakers must ensure that taxpayers have enough information about the possible change.

That taxpayers know about possible law changes is certainly not a sufficient reason to conclude that transition risk should be allocated to the taxpayers to encourage them to take transition risk into account when making decisions.[337] There are many other considerations.[338] However, if taxpayers lack meaningful knowledge about the risk, it makes little sense to use a non-mitigation approach in an effort to encourage taxpayers to anticipate possible law changes when making decisions. In these circumstances, the analysis likely reverts to reliance arguments or inquiries into who is the more efficient bearer of the risk, both of which are likely to point toward allocating the transition risk to the government.[339] Nevertheless, for truly unknown or random risks (i.e., where government has not intentionally created the risk of change),[340] perhaps Graetz's and Kaplow's analogy to market risks is a good fit, suggesting that allocating the transition risk to the private sector may be better than allocating the risk to the government.[341] That is, potentially the same allocation of transition risk—to the pri-

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[334] The concept of tax transition *risk* contemplates that, although the tax law changes discussed herein are to some degree unknown, taxpayers generally have at least some ability to gauge the likelihood of a change and its consequences. See note 10.

[335] See Parts III.A and IV.A.

[336] See Parts V.B.1 and V.B.2 (highlighting the importance of having information about the change).

[337] In addition, if government takes action to ensure that taxpayers know about a possible law change, some taxpayers will have already anticipated that action and altered their behavior (or not) in anticipation.

[338] For example, policymakers should consider taxpayers' ability to take the possible law change into account, the potential costs of anticipatory behavior, and the potential efficiency gains of anticipation.

[339] See Part I.A and notes 59-63 and accompanying text.

[340] Perhaps this would include an exogenous shock to the tax system. For example, suppose an act of war that was completely unexpected causes a revenue shock, and government needs to raise rates or eliminate tax benefits to raise revenue. Providing transition relief would be counterproductive because it defeats the unexpected critical revenue raising goal. Thus, this tax transition risk is likely better allocated to the private sector.

[341] See Part I.B and notes 59-63 and accompanying text.

vate sector—as when policymakers are intentionally trying to influence taxpayer behavior, but for a different reason.

3. *Viewing Tax Transition Rules Through a Contractarian Perspective*

Tax transition risk-shifting agreements, which make explicit that taxpayers can contract out of the transition policy provided by the government,[342] also suggest drawing on normative theories of contract default rules[343] when analyzing tax transition policy. Yet, the contractarian frame is not a perfect fit for analyzing the default allocation of transition risk (i.e., to the private sector or to the government) because the sector (public or private) to which the transition risk is initially allocated generally cannot be changed by private contracting. If the default allocation places tax transition risk on the private sector, a private actor generally cannot contract to reallocate the transition risk back to the government, nor can the government generally contract around a default allocation of transition risk to the public sector to reallocate that risk to a private actor. Nevertheless, from the perspective of the affected taxpayer, the transition risk is either allocated to them or not, and if it is and the taxpayer does not want to bear it, the taxpayer may be able to contract to shift the risk to *another private party*. In that respect, the choice of transition rule does establish a default allocation of rights around which parties can contract.

According to the contracts literature, the default allocation of transition risk should not matter if the affected taxpayers can costlessly contract around the default transition policy[344] using tax transition risk-shifting agreements, for example. However, defaults are sticky,[345] and tax transition REVEs can involve significant transaction costs.[346] Thus, a "majoritarian" default rule[347] (likely providing transition relief, assuming that is what most affected taxpayers would want)

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[342] Others also considered a contract-based approach to transition policy. See, e.g., Shaviro, note 10, at 36-40; Chason, note 63, at 641-42; Fennell, note 112, at 1357-62; Ramseyer & Nakazato, note 66, at 1167-69. However, the intentional use of contracts to shift tax transition risk, as discussed in this Article, highlights the contractual nature of the tax transition policy question.

[343] See, e.g., Ayres & Gertner, note 14; Russell Korobkin, The Status Quo Bias and Contract Default Rules, 83 Cornell L. Rev. 608 (1998).

[344] See Coase, note 251; Shaviro, note 10, at 36 (citing Coase).

[345] See generally John A.E. Pottow & Omri Ben-Shahar, On the Stickiness of Default Rules, 33 Fla. St. U.L. Rev. 651 (2006).

[346] See Part V.B.1.

[347] Ian Ayres & Robert Gertner, Majoritarian vs. Minoritarian Defaults, 51 Stan. L. Rev. 1591, 1591 (1999) (calling "majoritarian" default rules those that set terms based "by simply asking what most parties would have contracted for had they written a complete contract").

reduces opt-outs (here, tax transition risk-shifting contracting activity),[348] likely reducing transaction costs and aggregate disutility[349] and protecting taxpayers who may make poor risk-allocation choices for reasons including cognitive biases or lack of information. The more homogeneous taxpayer preferences are and the less sophisticated the affected taxpayers are, the fewer the opt-outs and the greater the benefits likely produced by a majoritarian default of government-provided transition relief.[350] In these situations, the government is likely the cheaper and more effective risk protection provider, especially because the government controls whether possible tax law changes occur.[351]

On the other hand, a default rule that provides transition relief to sophisticated taxpayers may be less valuable because they likely have more heterogeneous transition risk preferences, more ability to use tax transition risk-shifting agreements or other mechanisms to opt out of default rules and achieve their preferred risk positions, less susceptibility to cognitive biases, and greater risk-bearing capacity. In these situations, the private sector could play a larger role in management of tax transition risk, perhaps making arguments for non-mitigation more persuasive.

Moreover, if tax transition risk is initially allocated to these sophisticated parties, that could serve, at least in part, as an information-forcing default.[352] If the taxpayer does not want to bear the risk and uses a tax transition risk-shifting agreement to opt out of the default allocation of transition risk, the details of the agreement (e.g., whether it provides for termination rights or for changes to the price or other terms) can provide insight about whether tax is a significant purpose behind the transaction.[353] That information might be particularly useful, for example, where the law is being changed to reduce opportunities for tax shelters or other potentially abusive transactions and where the IRS might want to challenge the taxpayer's tax position under the prior law using judicial doctrines where business purpose is

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[348] If the default rule allocates the transition risk to the government, tax transition risk-shifting contracting activity could involve private parties entering into derivative contracts with each other in which one party bets that the law will change, thereby explicitly accepting tax transition risk from a counterparty that bets that the law will not change.

[349] But see Shaviro, note 10, at 37 (explaining that a majoritarian default might not yield the best result if "there is asymmetry between transaction costs or the average social cost of error in one direction or the other").

[350] On the other hand, if more transition relief is provided, taxpayers might value transition relief more, making them more likely to oppose future non-mitigation. See Korobkin, note 343, at 611.

[351] See notes 56-57 and accompanying text.

[352] See Ayres & Gertner, note 14, at 91 (discussing the information forcing function of assigning a default rule that is not what the party would want).

[353] See Part V.A.4.

relevant. Where that information is likely to be useful, policymakers might want to allocate transition risk to the private sector.

4. Considering Distributional Implications

The foregoing discussion generally supports arguments that government-provided transition relief should play a larger role in tax changes that affect less sophisticated, less informed, less rational taxpayers who have less ability to use tax transition risk-shifting agreements or other market mechanisms to manage transition risk effectively and perhaps a smaller role in tax changes that affect more sophisticated, more informed, more rational taxpayers (including firms) who are more able to manage transition risk using market mechanisms.[354] There is a distributional component to this conclusion that merits explicit mention. The characteristics (e.g., sophistication, rationality, ability to gather complex information and factor it into financial decision-making) that make a taxpayer more likely to be able to take future tax changes into account in their decision-making by entering into tax transition risk-shifting agreements at relatively low cost may correlate with wealth or income. The characteristics are not perfectly coextensive, but this Article's analysis of the implications of tax transition risk-shifting agreements also may weigh in favor of having the public sector bear more transition risk for tax law changes affecting individuals with less income and wealth than for tax law changes affecting wealthy and high-income taxpayers.

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Ultimately, the incorporation of tax transition risk-shifting agreements into the analysis of tax transition policy enriches the debate but does not provide a definitive resolution about whether tax transition risk ought to be borne by the private or public sector. Indeed, tax transition REVEs' impact on tax transition policy likely varies from case-to-case because the costs and benefits of these agreements vary depending on their details and contexts.

C. Deciding Whether to Change the Tax Law at All

Tax transition risk-shifting agreements are relevant not only to the choice of tax transition policy, but also to the decision whether to change the tax law at all. Although many commentators advocate for

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[354] See Shaviro, note 10, at 40-41; Kaplow, note 15, at 186; Logue, note 62, at 213, 222-29, 231-35 (all making similar recommendations for different reasons).

tax reform to implement better tax policy,[355] many also advocate for tax law stability on grounds including confusion faced by taxpayers when tax laws change frequently, costs to both taxpayers and administrators of learning and applying new laws, administrators' struggles to produce regulatory guidance quickly after statutory changes, shortcomings in laws enacted rapidly, taxpayers' inability to plan their affairs reliably in an unstable and uncertain tax environment, and obstacles to economic growth created by uncertainty about tax law stability.[356]

Where there is uncertainty about the stability of the tax law, taxpayers are more likely to enter into tax transition risk-shifting agreements, thereby achieving tax law stability and transition relief via self-help. Thus, if legislators favor tax law stability but believe they will be unable to prevent tax law changes or ensure transition relief, they should consider encouraging taxpayers to undertake market-based efforts, including via tax transition risk-shifting agreements, to provide the economic equivalent of tax law stability for themselves. In addition, a legislator who is concerned about the net costs imposed by tax transition risk-shifting agreements should consider advocating for more tax law stability or precommitment to transition relief. On the other hand, legislators who believe that tax transition REVEs are, on net, welfare-enhancing should be undeterred, and perhaps even emboldened, when considering tax policy improvements without transition relief where there are meaningful opportunities for taxpayers to enter into tax transition risk-shifting agreements. Moreover, they should consider explicitly signaling the possible tax law changes to enable taxpayers to enter into whatever market transactions help them achieve their risk preferences.

VII. Conclusion

Will tax law change again soon in a dramatic and partisan fashion? I do not know. But taxpayers are concerned and with good reason given

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355 See, e.g., Martin J. McMahon Jr., Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself, 50 Wash. & Lee L. Rev. 459, 459 (1993) ("the need for further [tax] reform cannot be denied"); Michael C. Duest, Inflation and the Tax Code: Guidelines for Policymaking, 73 Minn. L. Rev. 1217, 1289 (1989) (describing a "view of the tax policy process, according to which successive changes can be expected to lead the tax system progressively toward a more nearly perfect state").

356 See, e.g., President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 4 (2005); Duest, note 355, at 1290 (drawing on testimony by IRS Commissioner Lawrence Gibbs); Green, note 15; John R. Mendenhall, Presidential Address, 77 Proceedings of the Annual Conference on Taxation Held Under the Auspices of the National Tax Association-Tax Institute of America 16 (1984); Oh & Tausanovitch, note 3, at 487; Schwartzstein, note 97, at 62, 77; Shavell, note 68, at 77-82.

the polarized political climate and the way the 2017 Act was passed. Private contracting to allocate the benefits and burdens of a tax law change is an important, but previously unexplored, tool for managing this tax transition risk. Both taxpayers and policymakers should be aware of this strategy and its implications.