IMPERFECT INFORMATION: THE ESSENTIAL COMPONENT OF A SUCCESSFUL TAX SHELTER

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I. INTRODUCTION

Tax shelters are reductions in tax payments that were unintended by the tax law and that have no social or business purpose other than to generate a reduction in a taxpayer's tax liability.[1] The Internal Revenue Service ("IRS" or "Service") identifies tax shelters by auditing taxpayers. Alleged unlawful tax avoidance practices uncovered in audits lead to court rulings that either support or rebut the Service. Courts disallow a tax avoidance practice either because the tax shelter directly violates a statute, or because the tax shelter activity violates one or more of the judicial doctrines prohibiting the practice. Thus, disallowance of a tax shelter requires that the Service, first assert the presence of a tax shelter, second, identify those purchasing it, and third, convince a court to declare the practice unlawful on the basis of a statutory provision or judicial doctrine.

In order to even raise a questioned practice for adjudication, the questioned behavior must first be identified in an audit.[2] The probability of audit is small; so, even if a taxpayer (other than large corporations under continuous examination) is engaged in unlawful tax avoidance, the taxpayer is unlikely to be identified.[3] Even among those audited, the auditor must correctly identify a tax avoidance practice as questionable during the audit or it escapes detection. The low likelihood of detection has meant that the expected cost of investing in tax shelters—detection, disallowance, interest, penalties, legal, and accounting fees—is low relative to the potential for tax savings.

To increase the likelihood of detection and to reduce the expected gain from investing in a tax shelter, the Service has secured legislation requiring those who sell tax avoidance plans that the Service believes may constitute an unlawful tax shelter to report the nature of the tax avoidance plan to the Service and to list those to whom the tax shelter plan was sold.[4] In addition, the Service has now used its authority to require taxpayers, and those

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[1] A tax shelter includes any entity, investment, plan, or arrangement with a *significant* purpose of avoiding or evading federal income tax. *See* I.R.C. § 6662(d)(2)(C)(iii). [Unless otherwise specified, all sections cited herein refer to the Internal Revenue Code of 1986, as amended ("I.R.C." or "Code)].

[2] The decision to audit may be driven by information provided by another source, such as records produced by the vendor who sold the tax avoidance scheme. In general audits, a tax shelter may be identified simply as a result of training auditors as to what to look for.

[3] *See infra.*

[4] I.R.C. §§ 6011, 6112.

who provide legal, accounting, or financial advice, list transactions that have characteristics the Service construes to be indicative of tax avoidance transactions.[5] Both reporting requirements and lists are supposed to focus audits on transgressors so as to make enforcement more effective and the expected costs of investing in tax shelters higher than they have been in the past.

We identify what a tax shelter is, discuss judicial doctrine and statutory tests for determining when a tax avoidance technique will be declared unlawful, and describe the new statutory reporting devices used to discourage tax shelter investment. We conclude that, while promoter reporting may improve targeting slightly, in general, the amount of information produced by the new regulations will be both voluminous and unreliable and the Service's ability to process and make use of it will be limited. Additionally, the complicated reporting and listing requirements and associated costs imposed on taxpayers and tax professionals are very large and burdensome.

II. WHAT IS A TAX SHELTER?

The Internal Revenue Code defines a tax shelter as: (1) a partnership or other entity, (2) an investment plan or arrangement, (3) any other plan or arrangement, if a significant purpose of the plan or arrangement is the avoidance or evasion of federal income tax.[6] The Treasury Department defines a tax shelter as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of tax liability) arising from the transaction, determined on its present value basis.[7]

Surrey and McDaniel define a tax shelter as a "tax expenditure" that Congress has not authorized, as opposed to tax expenditures—reductions from otherwise applicable tax rates—that Congress has authorized.[8] They start with the Haig-Simmons definition of income as the increase in net economic wealth between two points in time plus consumption during that period.[9] Tax expenditures are deductions from the uniform tax rate for governmentally mandated entitlements.[10] In contrast, a tax shelter is any deduction from tax revenue that is unintended by the government.[11] Surrey and McDaniel contrast tax shelters with congressionally authorized tax expenditures such as bonus depreciation or the home interest deductions.[12] In other words, tax shelters

[5] *See* I.R.C. § 6011 and the extensive regulations that have been issued pursuant thereto.
[6] I.R.C. § 6662(d)(2)(C)(iii).
[7] *See* U.S. Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals* (July 1999) which provides a comprehensive overview of tax shelter and tax avoidance and includes the statutory, regulatory and judicial responses to these issues. (hereinafter *Treasury White Paper*) .

[8] *See* Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. Rev. 225 (1979).
[9] *Id.*
[10] *E.g.*, those deductions and exemptions from tax that are specified in the tax code and regulations.
[11] *E.g.*, those tax activities that are deviations from the tax law and regulations.
[12] I.R.C. § 163(h)(3), and I.R.C. § 168(k) respectively.

produce reductions in tax revenues that are unintended by the government and are therefore unlawful extractions from the budget.[13]

Economists explain the harm caused by a shift of benefits from society in general to those who successfully engage in unlawful tax avoidance as caused by misallocation of resources.[14] Tax shelters shift benefits of government programs from the beneficiaries Congress intended to the tax shelter owner. This results in unintended distortions in the social welfare function and causes a reduction in social welfare.[15] The harm caused by the shift includes disrespect for the tax system, both by those who participate in the tax shelter markets and by others who perceive the shift in the tax burden as being unfair.[16] In addition, significant resources are wasted creating the tax shelters that create the uneconomic distortions, as well as in identifying the shelters and closing them down.[17] Elimination of tax shelters broadens the tax base and broader tax bases are generally more efficient than narrower bases.[18] Finally, taxpayers taking advantage of tax shelters shift from activities that would be more personally beneficial and economically efficient, absent tax effects, to those that are personally preferable only because of the tax effects. This shift causes other taxpayers to pay increased taxes because of the reduced taxes paid by those benefiting from tax shelters. Both distortions produce a general reduction in aggregate welfare.[19]

A. TAXPAYERS CONTINUE TO INVEST IN TAX SHELTERS AS LONG AS THEY BELIEVE THAT THE EXPECTED GAIN FROM DOING SO EXCEEDS THE EXPECTED COST OF PROSECUTION AND DISALLOWANCE.

Tax shelters are an attractive investment for risk-taking investors to the extent that the expected value of returns is increased by continuing to invest in them. The "expected benefit" is the tax savings the taxpayer expects to receive less the sum of any economic loss incurred on the transaction, and less fees paid to the promoter. The "potential loss" is the loss resulting from detection and prosecution of the alleged tax shelter benefits. It reduces shelter benefits by the sum of the cost of defense (even if the shelter is found to be lawful), and any amount paid to the Service (as a result of audit or a court decision declaring the tax practice unlawful and requiring payment of additional tax, interest, and penalties). "Expected gain" is therefore the sum of (1) the promised tax savings from the transaction, (2) less promoter's fees, (3) less the expected cost of the sum of legal fees, court costs, and accounting fees paid for defending the shelter multiplied by the probability a defense will be required, and (4) less the expected tax, interest on unpaid taxes, and penalties imposed if the matter is settled or if a court rules against the taxpayer, multiplied by the probability of conviction or negotiated settlement with the Service. As long as the expected gain is positive investors will continue to invest in tax shelters.

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[13] *Id.*
[14] Harvey S. Rosen, PUBLIC FINANCE 336-40 (6th ed. 2002) (Rosen, PUBLIC FINANCE).
[15] *Id.*
[16] *Treasury White Paper* at 3.
[17] *Id.* David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 222 (2002) (*Weisbach, Ten Truths).*
[18] Weisbach, *Ten Truths* at 216, 233.
[19] Rosen, PUBLIC FINANCE

Those seeking to close down tax shelters reduce the expected gain, both to the extent they clarify the tax law by removing conflicting provisions that give rise to schemes that appear to permit a particular tax avoidance scheme, and to the extent they increase the likelihood of detection and conviction under existing law.

Prosecution of tax shelters depends on (1) determining what constitutes a tax shelter by prohibiting a tax avoidance practice by statute or by judicial doctrine, (2) identifying those who have invested in what the Service considers to be a tax shelter, and (3) demonstrating to a court (or administrative audit or appeal to the taxpayer's satisfaction that the tax avoidance does violate the statute or judicial doctrine and is, therefore, unlawful. As the effectiveness of these processes increases, those tax shelters that continue to be used by taxpayers will become easier for the Service to identify and prosecute. Professional advisors find it more difficult to sell tax avoidance schemes, and the Service finds it easier to demonstrate that those that are sold should be disallowed. However, to identify tax shelters and prosecute them, the Service must either audit returns or find some other means of identifying those who have invested in tax shelters.

The Service only audits 0.58% of individual tax returns, and only 1.20% of the tax returns filed by persons earning over $100,000.[20] Only 0.95% of corporate returns are audited.[21] The Service's new reporting requirements, discussed here, were designed to identify which returns to audit in order to target audits so as to increase the probability that tax shelters would be identified. To the extent that the government can improve the information available to it the likelihood of correct identification, prosecution, and disallowance of tax avoidance schemes increases. This raises the probability a taxpayer will be found to have engaged in an unlawful activity and lowers the expected gain (or turns it into an expected loss) to the taxpayer.

B. INFORMATION THEORY EXPLAINS HOW INCREASED INFORMATION INCREASES THE LIKELIHOOD OF IDENTIFYING UNLAWFUL TAX AVOIDANCE.

"Information Theory" provides a theoretical basis for identifying the value of improved information to different players in a market.[22] The literature concludes that expected gain to the IRS given perfect information is substantially higher than the expected gain under uncertainty.[23] In a market with only exchange and not production, the person with better information gains at the expense of those persons with poorer information.[24] In a market with both production and exchange, individuals with

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[20] INTERNAL REVENUE SERVICE DATA BOOK (2001) (hereinafter "IRS Data Book").
[21] *Id.*
[22] *See generally* George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961); Armen A. Alchian, *Information Costs, Pricing and Resource Unemployment*, in Edmund S. Phelps, et. al., eds., MICROECONOMIC FOUNDATIONS OF EMPLOYMENT AND INFLATION THEORY (1970); Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971) (Hirshleifer, *Private and Social Value of Information)*; Hae-shin Hwang, *Information Acquisition and Relative Efficiency of Competitive, Oligopoly and Monopoly Markets*, 32 INT'L ECON. REV. 325 (1995).
[23] Hirshleifer, *Private and Social Value of Information* at 565. The corollary is that as the quality of information improves the gain to the Service increases, though not by as much as it would increase if information were perfect.
[24] *Id.*

improved information and society in general can both gain.[25] In the context of a social welfare function defined by the tax laws, unintended gains from tax avoidance are a social "bad" and limiting tax expenditures to those intended by the government produces a social "good." Thus, in the context of tax policy, the gains of improved information accrue to society, and there is a corresponding and offsetting loss to those engaging in tax avoidance.[26] Those who engage in tax avoidance pay less of the cost of government than is required to optimize the social welfare function. As a result, those who do not engage in tax avoidance must pay a greater share than is optimal to make up for the shortfall when revenue requirements of the government remain constant.[27] If one accepts as optimal the structure intended by the legislature, then deviations resulting from tax avoidance reduce social welfare in the same manner as does theft. Losses resulting from the reallocation of goods caused by theft moves society to a lower level of welfare.[28] Closing down tax shelters has the same effect.

Usher points out that engaging in unlawful tax practices wastes resources because it requires that resources be shifted from productive pursuits to deterrence.[29] Usher quantifies the loss as the cost of the resources devoted to litigation plus the malallocation of resources.[30] His analysis demonstrates that an improvement in the quality of information that reduces uncertainty with respect to identification of a tax shelter is necessarily beneficial to both the tax collector and to society.[31] Thus, if one can increase the quality of information about tax shelter investment that is available, this raises the probability of successful prosecution of tax shelters. To the extent information available to the IRS improves, society benefits.

III. THE CURRENT STATUTORY AND JUDICIAL PROCESSES THE SERVICE MUST FOLLOW TO ELIMINATE A TAX SHELTER IS CUMBERSOME.

A. JUDICIAL DOCTRINES ARE APPLIED TO IDENTIFY TAX SHELTERS.

Courts must adjudicate IRS assertions that certain activities constitute tax shelters whether the assertion is that a statute has been violated or that a practice violates a judicial doctrine. The court decisions produce precedents sufficiently clear to lead to routine settlements of tax shelter disputes when auditors point out to taxpayers established judicial doctrines, violation of which provides evidence of unlawful tax avoidance.

The "sham transaction doctrine" is applied in situations where the economic activity that purports to give rise to the claimed tax benefits does not actually occur.[32] A "sham

[25] *Id.*
[26] *Id.*
[27] For a general discussion of this proposition, *see* Rosen, PUBLIC FINANCE at 325-331.
[28] Dan Usher, 39 OXFORD ECONOMIC PAPERS 235, 243 (1987).
[29] *Id.* at 249 fn. 9.
[30] *Id*.
[31] Jerry Green, *Value of Information with Sequential Futures Markets*, 49 ECONOMETRICA 335, 344-46 (1981).
[32] Sham transactions include "shams in fact," where the transaction does not actually occur, *see, e.g.*, Fox v. Commissioner, 82 T.C. 1001, 1026 (1984) (Straddle created by broker making bookkeeping entries without

in fact" transaction is a transaction where the claimed transaction never occurred at all. A "sham in substance" transaction is one where the transaction did occur but lacked economic substance independent of the tax considerations.[33]

"Substance over form" arises when the written form in which the transaction is cast is inconsistent with the actual substance of the transaction. Sham transactions have no economic substance independent of their tax effects. Thus, economic substance is required for a transaction to have a bona fide purpose. The tax benefits of a transaction will be denied if economic benefits (those benefits derived by the taxpayer independent of any tax savings) are insignificant relative to the tax benefits obtained (i.e., there is no economic gain derived from the transaction independent of the tax savings). The concept is often associated with cases involving offsetting obligations and circular cash flows. Such transactions limit non-tax economic consequences of the transaction to the taxpayer and produce only tax savings.

For example, in *Goldstein v. Commissioner*,[34] the taxpayer negotiated a loan using money received from Irish Sweepstakes winnings that was deposited in a savings account earning a lower interest rate than the loan rate. This produced tax deductions in earlier years and shifted some of the income to later years so as to lower the average tax rate. The loans and bank deposits actually took place and therefore could not be treated as shams. However, they had no economic significance independent of the desire to reduce taxes since it is uneconomic to borrow at a higher rate than the rate at which one invests the money when the loans and the investments both can be cancelled at any time. Similarly, in *Sheldon v. Commissioner*,[35] the taxpayer bought T-bills that matured in the second year and borrowed against the same T-bills to deduct interest in the first year. The court denied the deduction in the first year on the grounds that the transaction had little economic substance once the time value of money was included in the analysis.[36]

Shelter promoters try to create the appearance of economic substance by casting the transaction in a form that looks like a legitimate transaction. Courts address such efforts by applying the "substance over form" doctrine to recast the transaction. The doctrine's

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ever entering the market to purchase or sell silver futures was sham in fact). "Shams in substance" refer to transactions that actually occurred but that had no economic significance absent tax savings; see e.g. United States v. Dial, 757 F.2d 163 (7th Cir. 1985) (Transaction was not a sham in substance because it actually occurred; however, it was devoid of actual substance because the only possible contemplated effect was to avoid taxes).

[33] In Gregory v. Helvering, 293 U.S. 465 (1935), *aff'g* Helvering **v.** Gregory**,** 69 F.2d 809 (2nd Cir. 1934), a corporation was set up to transfer assets from another corporation owned by the same person. The corporation then was liquidated so that the owner could receive a distribution free of corporate tax (prior to repeal of the General Utilities Doctrine). The corporation was actually set up and liquidated, but it had no economic purpose other than to avoid corporate income tax that would otherwise have been due.

[34] 364 F.2d 734 (2nd Cir. 1966).

[35] 94 T.C. 738 (1990).

[36] *See also* Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988) (holding that purchase and sale of investment contracts were designed to make the investor both long and short on the same commodity in the same year. In that case, the transaction was designed to create ordinary losses in the first year and capital gains in the second year. The court found the transaction produced only paper gains and losses that created ordinary losses and capital gains on paper but no real economic gains or losses and therefore lacked economic substance.)

purpose is to distinguish between what the taxpayer claims the transaction is and what the court identifies as the actual transaction in economic and commercial terms.[37]

The "business purpose doctrine" requires that taxpayers have a reason other than avoidance of federal taxes for undertaking a transaction. The doctrine often overlaps with economic substance and sham transaction doctrines. If a transaction has tax independent significance, it will be upheld under the business purpose test.[38]

The "step transaction doctrine" describes a series of formally separate transactions, each of which can be defended as a legitimate tax expenditure but which, when recharacterized as a single integrated transaction, has no business purpose - only a tax avoidance purpose. This analysis is used in situations where the transactions are, in substance, part of a single integrated and interdependent plan that is aimed at a particular result. Thus, when the separate transactions are examined as steps of a single transaction, the transaction violates one of the other doctrines.[39]

There are three methods of testing for a step transaction. The first, the "end result test," is applied when it is apparent, looking at the transaction as a whole, that each of a series of steps was undertaken for the purpose of achieving the ultimate result.[40] The second, the "interdependence test," is applied when each of the steps in the transaction is so interdependent that the completion of an individual step would have been meaningless without completion of the remaining steps.[41] The third, the "binding commitment test," is applied if, at the time the first step was entered into, there was a legally binding commitment to complete the remaining steps.[42] The courts will not apply the step transaction doctrine if any of the steps has independent economic significance[43] or if application of the doctrine would require creation of steps that never actually occurred.[44]

These doctrines provide significant guidance to the Service and to the courts once an audit or some other device uncovers the presence of a tax avoidance scheme that falls

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[37] *See generally* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 239 (1999) (hereinafter Economic Substance). In ASA Investerings Partnership v. Commissioner, 76 T.C.M. (CCH) 325 (1998), the partnership created gain that was allocated to a foreign partner who was exempt from U.S. tax and an offsetting loss that was allocated to the U.S. partner. The court concluded that the substance of the transaction was a loan from the foreign partner to the U.S. partner and recharacterized the transaction on the basis of its substance. *See also* Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971) and compare, Litton Indus., Inc. v. Commissioner, 89 T.C. 1086 (1987).

[38] *See* Basic, Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977) *(per curiam)* (holding there must be a business purpose for payment of a dividend); Goldstein v. Commissioner, 364 F.2d 740 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967) (cannot borrow just to reduce tax if there is no business purpose for borrowing). *See also*, Sochin v. Commissioner, 834 F.2d 351 (9th Cir. 1988), *cert. denied*, 488 U.S. 824 (1988); Lukens v. Commissioner, 945 F.2d 92 (5th Cir. 1991).

[39] Penrod v. Commissioner, 88 T.C. 1428 (1987); King Enterprises, Inc. v. United States, 481 F.2d 577, 516 (Ct. Cl. 1969); Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991).

[40] King Enterprises, Inc., 481 F.2d at 616; Associated Wholesale Grocers, 927 F.2d at 1523.

[41] Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181 (1989) (taxpayer had a plan or intention to effect each step).

[42] Commissioner v. Gordon, 391 U.S. 83, 96 (1968*);* Redding v. Commissioner, 630 F.2d 1169 (7th Cir. 1980), *cert. denied*, 450 U.S. 913 (1980).

[43] Reef Corp. v. Commissioner, 368 F2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967). *See also* Rev. Rul. 79-250, 1979-2 C.B. 156, *modified by* Rev. Rul. 96-29, 1996-24 I.R.B. 5.

[44] Grove v. Commissioner, 490 F.2d 241 (2d Cir. 1973); Esmark v. Commissioner, 90 T.C. 171 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989*);* Walt Disney, Inc. v Commissioner, 97 T.C. 221 (1991), *rev'd*, 4 F.3d 735 (9th Cir. 1993).

within the purview of any one of them. Unfortunately, the Tax Court, District Courts, and the Circuit Courts do not always reach the same decision on a given set of facts. As a result, one court finds that a taxpayer has engaged in lawful tax avoidance when another court finds that a different taxpayer who purchased the same tax avoidance scheme engaged in an unlawful tax shelter. Over time, the differences tend to be resolved, but not before many benefit from a shelter and many others find their investment in the same shelter disallowed.[45] When the IRS characterizes a transaction as a tax shelter, it must either secure a statute or a judicial decision supporting the position. During the time it takes to do so many similar tax shelters go unprosecuted.

B. STATUTORY PROVISIONS IDENTIFY AND DISALLOW CERTAIN TAX SHELTER ACTIVITY.

The Internal Revenue Code abounds with specific and general statutory prohibitions of particular activities (tax shelters) as well as specific and general approval of activities that are to be permitted (tax expenditures). The prohibitions can be divided into four categories: (1) prohibition of particular shelters, (2) policy pronouncements prohibiting classes of activities associated with or permitting different forms of tax avoidance, (3) imposition of penalties for certain activities, and (4) reporting and disclosure requirements. All depend on identification of tax shelters in audits for their effectiveness.

The first category, specific prohibition, generally puts an end to the particular tax shelter described.[46] Once a practice has been declared unlawful by statute, the transaction cannot be salvaged by showing that it would have been lawful under a judicial doctrine. Rather, a taxpayer is likely to agree to disallowance of statutorily prohibited tax avoidance schemes when audited. The statute provides the blueprint of what is prohibited and an auditor need only follow the blueprint. The only basis for dispute is whether the disallowed scheme is the scheme the taxpayer invested in.[47]

It is not difficult to find examples of black letter prohibitions and statutes that prohibit specific or general activities that produce tax avoidance or are associated with structures that produce tax avoidance. For example, I.R.C. § 332(c) provides that, in a complete

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[45] For example, in ACM Partnership v. Commissioner, 73 T.C.M.(CCH) 2189 (1997), *aff'd in part, rev'd in part,* 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 119 S. Ct. 1251 (1999), the court found a particular tax shelter to be unlawful just before the District Court for the District of Columbia found the same tax shelter to be lawful, Boca Investerings Partnership v. United States, 167 F. Supp. 2d 298 (D.D.C. 2001). Two years later the DC Circuit reversed the District Court to restore symmetry, Boca Investerings Partnership v. United States, 314 F.3d 625 (D.C. Cir. 2003). The split of authority arose even though the D.C. Circuit had declared the same transaction to be a tax shelter prior to the District Court's decision, ASA Investerings Partnership v. Commissioner, 501 F.3d 505 (D.C. Cir. 2000). More generally, the Third and Eleventh Circuits tend to follow purposive interpretations in applying judicial anti-abuse doctrines. The Fifth and Eighth Circuits tend to follow literal interpretations of the Internal Revenue Code. See Martin J. McMahon, Jr., Beyond a GAAR: Retrofitting the Code To Rein in 21st Century Tax Shelters, 98 TAX NOTES 1721, 1734 (March 17, 2003).

[46] For example, compare the number of tax arbitrage insurance cases such as Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999) with the absence of cases involving tax arbitrage involving insurance after § 264 of the Health Insurance Portability and Accountability Act of 1996 prohibited such deductions; Pub. L. No. 104-191 (1996) modified I.R.C. § 501 to outlaw tax shelters based on company owned life insurance.

[47] This approach is endorsed by much of the tax bar, *see, e.g.* Ken Gideon, Assessing the Income Tax: Transparency, Simplicity, Fairness, 81 Tax Notes 999, 1001 (Nov. 23, 1998).

liquidation of a REIT occurring pursuant to a two year liquidation plan under which the taxpayer had previously been able to avoid reporting of income through use of the dividends received deduction, the taxpayer will have to henceforth report the income. I.R.C. § 357(c) imposes gain recognition on the transferor who transfers an asset to a transferee when the adjusted basis of the property is exceeded by the amount of the liability transferred with the asset. More generally, I.R.C. § 357(c)(3) prevents a basis-shift transaction that was intended to generate increased basis that could be used to shelter other income.

The second category, a general statutory prohibition or a general policy pronouncement such as a statutory general anti-avoidance rule ("GAAR") gives the Service discretion to declare certain activities unlawful or to recharacterize activities described in an apparently innocuous manner by the taxpayer.[48] A GAAR must be judicially applied; however, subject to judicially imposed limits, such rules provide substantial enforcement authority to the Service, at least to the extent auditors effectively apply them.[49] Broad prohibitions outlaw activities that support development of tax shelters. The passive activity rules of I.R.C. § 469 are general prohibitions that prohibit classes of transactions and establish a general policy.[50] The passive activity rules eliminate individual tax shelters by limiting the use of losses from activities in which the taxpayer fails to materially participate (passive activity losses) to earnings from the passive activity.[51] Tax shelters based on investment in limited partnership interests were eliminated by the passive activity rules.[52]

The third category, imposition of penalties, authorizes regulations that impose penalties on the taxpayers for failure to report fully relevant tax information, intentional

[48] *See generally* Commissioner v. Gordon, 391 U.S. 83 (1968). *See also* American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), *aff'd. per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 399 U.S. 920 (1950); King Enterprises, Inc. v. United States, 481 F.2d 511 (Ct. Cl. 1969); Redding v. Commissioner, 630 F.2d 1169 (7th Cir. 1980); Associated Wholesale Groceries, Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991) developing the step transaction doctrine underlying the policy pronouncement of I.R.C. §§ 1271-1275 which authorizes the Service to recharacterize transactions.

[49] *See* David A. Weisbach, Costs of Departures from Formalism: Formalism in the Tax Law, 66 U. CHI. L. REV. 860, 877-878 (1999).

[50] *See* esp. Treas. Reg. § 1.469-1(f)(4), prohibiting deduction of losses from passive activities from portfolio income earned from wages, interest, and dividends.

[51] A passive activity is one that involves the conduct of any trade or business in which the taxpayer does not materially participate. I.R.C. § 469(c). Losses from passive activities may not be deducted from non-passive income (wages, interest, or dividends) or used to offset other income, Treas. Reg. § 1.469-1(f)(4). The purpose of the passive activity rules was to prevent the generation of losses from passive investments (These are investments producing fanciful tax losses, that were used to offset income from active income sources). Active participation, as opposed to passive activity, is material participation in an active trade or business (other than certain real estate activities described in I.R.C. 469(c)(2)). Active participation is determined by passing any one of the tests contained in Temp. Treas. Reg. § 1.469-5T(a).

[52] Partnerships have long been favored vehicles for tax shelters. *See generally* Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976) (purchase and effective resale to original owners of a motel designed to permit purchasing doctors to secure the tax deductions from the investment to offset against income from their medical practices disallowed); Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988) (investment "straddles," offsetting trading positions producing economic losses but tax gains, disallowed); Friedman v. Commissioner, 869 F.2d 785 (4th Cir. 1989) (packages of metal trades that produced no possibility of economic gain, only tax gain, disallowed); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985) (investment in a computer for lease that produced no reasonable possibility of profit apart from tax gain disallowed).

understatement of taxes, and the like.[53] Several penalty statutes are also aimed at investors in tax shelters and also at professional tax advisors and tax preparers who do not correctly identify and disclose tax treatment.[54]

The fourth category addresses disclosure and reporting requirements. These rules require those who invest in transactions identified by the Service as potential tax shelters to disclose the investment. They also require that both tax shelter vendors and tax advisors who give advice concerning tax shelters marketed by others maintain lists of persons and entities to whom advice was provided and the nature of the advice.[55]

C. POLICY RULES PERMITTING RECHARACTERIZATION PERMIT THE SERVICE TO FIND THAT ACTIVITIES TAXPAYER CHARACTERIZES AS INNOCUOUS ARE, IN FACT, INCONSISTENT WITH THE STATUTE.

The consolidated return anti-abuse rules act as a backstop to the detailed mechanical rules directly applicable to business entities to prevent tax avoidance.[56] For example, the Commissioner may depart from the Original Issue Discount rules if the departure becomes necessary to prevent taxpayers from achieving results that are unreasonable in light of the enabling statutory provisions of I.R.C. §§ 1271-1275.[57]

Pursuant to another anti-avoidance rule, the Commissioner can recharacterize a taxpayer's characterization of income and expense if (1) a taxpayer acts with a principal purpose contrary to the purposes of excess loss account rules;[58] (2) a taxpayer acts to avoid the loss disallowance rules;[59] (3) a taxpayer acts with a principal purpose contrary to investment adjustment rules;[60] (4) a taxpayer acts with a principal purpose to avoid the effect of consolidated return regulations;[61] (5) extraordinary items are misused;[62] (6) an inter-company transaction is structured with a principal purpose of avoiding the anti-abuse provisions of the intercompany transaction rules (which would permit

[53] Examples of such penalty statutes include the whole family of penalties relating to underpayment of tax, including, I.R.C. § 6662 (imposing a 20% penalty for underpayment of taxes because of negligence or disregard of tax rules).
[54] I.R.C. § 6707(b) (failure of a person claiming a tax benefit from a tax avoidance scheme to report the registration number of the scheme); I.R.C. § 6111(d) (failure of either a promoter or benefiting corporation to register a confidential corporate tax shelter and provide the number to investors); I.R.C. § 6700(a) (imposing penalties on promoters of abusive tax shelters).
[55] *See* I.R.C. §6111 and Temp. Reg. § 301.611102T(a). Tax shelter vendors, tax advisors, and tax payers who fail to report tax activities that the Secretary requires to be reported are discussed further infra.
[56] Treas. Reg. § 1.701-2. *See generally* Notice 94-48, 1994-1 C.B. 357, issued to prevent a corporation from using the partnership rules to issue instruments characterized as debt, but with the characteristics of equity (stock).
[57] Treas. Reg. § 1.1275-2(g).
[58] Treas. Reg. § 1.1502-19(e).
[59] Treas. Reg. § 1.1502-20(e).
[60] Treas. Reg. § 1.1502—32(e).
[61] Treas. Reg. § 1.1502-33(g).
[62] Treas. Reg. § 1.1502-76(b)(3).

recharacterization to prevent abuses);[63] or (7) a taxpayer attempts to abuse rules related to treatment of built-in gains and losses.[64]

If the principal reason a person (including another corporation) acquires direct or indirect control of a corporation is to secure deductions, a tax credit, or other tax allowances possessed by the target company, the Service may disallow the tax benefit to the extent necessary to eliminate the evasion or avoidance that would otherwise be produced by purchasing those tax attributes.[65] This is intended to prevent corporations from purchasing other corporations with large losses to use those losses to offset the profits of the purchasing corporation's businesses. In addition, if a corporation is acquired and then liquidated within two years, and the principal purpose of the transaction is evasion or avoidance of tax, the Secretary of Treasury ("Secretary") may disallow the transaction.[66] Similarly, the Service may allocate income, deductions, credits, and exclusions of a personal service corporation formed or used to avoid or escape income tax.[67]

Sometimes the choice of method of accounting is driven by tax avoidance motives. The Service has statutory authority to prescribe a method of accounting if it determines that an otherwise sanctioned method used by the taxpayer does not clearly reflect income.[68] The Service may also set aside a method of accounting that is not sanctioned by the Code or Regulations if it determines the method does not clearly reflect income.[69] The Service has applied these principles in a number of cases to disallow tax shelters.

The problem with these legislatively created tools is that they require identification of allegedly unlawful tax avoidance as a predicate to the often extensive litigation needed to determine the lawfulness of the underlying transaction. Thus, In *Ford Motor Co. v. Commissioner*,[70] expensing the cost of single premium annuity contracts to fund a multi-year series of payments required under settlements with tort claimants was not permitted because the method of accounting did not clearly reflect income. It allocated expenses of a number of years against the income of only the first year to understate income in that first year. In *ACM Partnership v. Commissioner*,[71] the taxpayer increased basis in transactions with a "tax indifferent" foreign investor,[72] then used the artificially inflated basis to shelter taxable income from other sources. In both instances implementation required extensive litigation to determine how the general principles were to be applied to specific facts.

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[63] Treas. Reg. § 1.1502-13(h)(1)).
[64] Treas. Reg. § 1.1502-90-99.
[65] I.R.C. § 269.
[66] *Id*. at § 269(b).
[67] *Id*. at § 269A.
[68] *Id*. at § 446.
[69] *Id*. at § 446(b).
[70] 102 T.C. 87 (1994), *aff'd* ,71 F.3d 209 (6th Cir. 1995).
[71] 73 T.C.M. (CCH) 2189 (1997), *aff'd in part, rev'd in part*, 157 F.3d 231, 249 (1998), *cert. denied*, 119 S.Ct. 1251 (1999) (hereinafter ACM Partnership v. Commissioner).
[72] "Tax indifferent" has become a term of art to describe charities, pension funds, or foreign investors whose income is not subject to U.S. tax. *Id*. In ACM Partnership v. Commissioner, the transaction was structured so that a foreign bank reported the income from a partnership as foreign income, not subject to U.S. tax. The U.S. corporation reports the losses of the partnership as deductions in the United States, where the losses were used to offset other income.

I.R.C. § 482 permits the Secretary to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more organizations controlled by the same interests if such allocation is necessary to prevent evasion of taxes or to clearly reflect income.[73] This provision is used to prevent fictitious sales, the purpose of which is to shift profits to those with losses for the purpose of offsetting such losses.[74] Similarly, I.R.C. § 7701(*l*) authorizes the Secretary to prescribe regulations recharacterizing multi-party financing transactions as a transaction directly among any two or more parties if necessary to prevent tax avoidance.[75] This provision was designed to prevent recharacterizing financing by obtaining it through foreign companies to provide a tax-free conduit for interest payments.[76]

Some provisions are designed to increase the cost of acquiring tax shelters by imposing penalties on tax payers and tax advisors for engaging in activities associated with tax avoidance. I.R.C. § 6662 imposes penalties equal to 20% of the tax due to any portion of any tax underpayment attributable to substantial understatement of income tax, substantial misstatement of the valuation of assets (on purchase, sale, or preparation of tax return), substantial overstatement of pension liabilities, or substantial gift or estate tax valuation understatement. An individual may avoid the penalty in either of two ways. A taxpayer has an adequate basis for avoiding the penalty if the taxpayer acts in good faith on a professional tax advisor's analysis of the pertinent facts and authorities that unambiguously concludes that there is greater than 50% likelihood that the tax treatment of the item is lawful.[77] In addition, a non-corporate taxpayer who discloses the transaction on the taxpayer's return, will, if challenged, escape the penalty.[78] I.R.C. §6662(d)(2)(C) denies to corporations the use of these disclosure and adequate basis defenses against imposition of penalties when the corporation is convicted of unlawful tax avoidance.

I.R.C. § 6694 is designed to discourage tax preparers from encouraging taxpayers to engage in tax avoidance. The provision subjects the preparer to monetary penalties for any understatement of tax liability on a tax return for which there is not a realistic possibility that the position will be sustained on the merits. The penalty is imposed if the preparer knew or should have known there was no possibility of success and the position was not adequately disclosed or was frivolous. I.R.C. § 6695 requires a tax preparer to sign the return, furnish the taxpayer a copy, include the proper identification number, retain a copy, and engage in due diligence in preparation. I.R.C. § 6700 imposes a penalty on anyone who organizes, assists, or participates in the sale of any interest in a business entity, investment plan, or other arrangement, or makes false statements about valuation or allowability of deductions, excludability of income, or securing of other tax

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[73]Treas. Reg. § 1.482-1(I)(4).

[74] F.S. 199920012 (05/12/99), 199914018 (04/12/99), and 199909005 (03/08/99) provide examples of the use of I.R.C. § 482 as a substantive rule.

[75] *See* Treas. Regs. §§ 1.881-3.

[76] Aikeen v. Commissioner, 56 T.C. 925 (1971). In addition, Treas. Reg. § 1.7701(*l*)-3 was developed from the Code in order to eliminate the use of "fast pay" preferred stock.

[77] I.R.C. § 6662(d)(2)(C)

[78] I.R.C. § 6662(d)(2)(B). *See also* Sheldon v. Commissioner, 94 T.C. 738, 869-70 (1990); Peerless Industries, Inc. v. United States, 94-1 T.C.M. (CCH) ¶ 50,043 (E.D. Pa. 1994); Leema Enters., Inc. v. Commissioner, T.C. Memo 1999-18, 1999 Tax Ct. Memo LEXIS 18, 77 T.C.M. (CCH) 1261, T.C.M. (RIA) 99018 (1999).

benefits, if the person has reason to know the statements are false. The same penalties are imposed on anyone else who aids, assists, procures, or advises with respect to the preparation of any portion of a return, or any supporting affidavit, claim, or other document, who has reason to know the document would result in an understatement of another person's tax liability.[79]

Practitioners before the Internal Revenue Service are governed by practice rules and standards described in Circular 230, Part 10, Title 31 of the Code of Federal Regulations that set forth specific standards addressing tax shelter opinions. The standards require that: (1) the practitioner must make specific inquiry as to all relevant facts; (2) the practitioner must be satisfied that all material facts are accurately and completely described in the offering materials; (3) all representations as to future activities with respect to tax treatment of transactions must be clearly identified, reasonable, and complete; (4) representations about the lawfulness of actions must relate the law to the actual facts of the transaction, and clearly identify what future facts are assumed; (5) if possible, an opinion should be rendered as to whether it is more likely than not that an investor will prevail on the merits of each material tax issue, and on the material tax benefits in the aggregate, if there is a reasonable possibility of challenge by the I.R.S.; and (6) a favorable overall evaluation may be rendered only if the practitioner concludes that substantially more than half of the material tax benefits have a better than 50% chance of being realized if challenged by the Service.[80] Pursuant to the rules of Circular 230, the Director of Practice and his staff are responsible for disciplining tax practitioners who sign a return as a preparer when the return does not have a realistic possibility of being sustained on the merits. To have a realistic probability of being sustained, the position must not be frivolous and must be adequately disclosed to the Service.[81] A practitioner can be disbarred for being willful, reckless, or grossly incompetent as well as for refusing to comply with Circular 230 or violating Circular 230.[82] The Service can enjoin income tax return preparers from filing returns with understatements or other assessable penalties, guaranteeing payment of a refund, allowance of a credit, or engaging in fraudulent or deceptive conduct.[83]

All of these provisions provide means of increasing the costs of promoting or purchasing tax shelters. Unfortunately, they all depend for their effectiveness on identifying and prosecuting those engaging in the purchase or sale of such tax avoidance schemes. The expected cost of penalty imposition is the cost of the penalty multiplied by the probability the transgression will be identified and the penalty imposed. Given the low probability of audit, that probability is low.[84]

D. TAX SHELTER PROMOTERS MUST REPORT EXISTENCE OF THEIR PRODUCTS TO THE IRS AND MAINTAIN LISTS OF BUYERS.

[79] I.R.C. §§ 6700, 6701.
[80] Circular 230, § 10.33(a).
[81] *Id*.
[82] Circular 230, §§ 10.34(b), 10.52.
[83] I.R.C. § 7407. I.R.C. § 7408 permits the Secretary to enjoin a person from further engaging in conduct subject to penalty under I.R.C. § 6700, promoting tax shelters, or I.R.C. § 6701 aiding and abetting understatement of tax liabilities. *See generally* United States v. Estate Preservation Services, 38 F. Supp. 2d 846 (E.D. Cal. 1998).
[84] See the data on percentages of returns audited *supra* at note 20 and the accompanying text.

The percentage of audits does not appear to be likely to increase noticeably in the foreseeable future.[85] If unlawful tax avoidance is to be reduced, the Service's alternative is to target those audits it does conduct at taxpayers with a high likelihood of having invested in tax shelters. In an effort to increase the effectiveness of those audits it does conduct, the Service is making increased use of I.R.C. § 6011, which gives the Secretary freedom to ask for whatever information that will help the Secretary collect tax revenues. Specifically, I.R.C. § 6011(a) authorizes the Secretary to require taxpayers and others to report transactions to the Service. The statute requires the Secretary to prescribe rules, forms, regulations, and reporting requirements and requires each taxpayer to file a return or other statement that includes therein the information required by such forms or regulations.[86] The Service has now issued regulations that require disclosure of six broad classes of transactions the Service considers to be indicative of the presence of unlawful tax avoidance when taxpayers file their returns.[87]

I.R.C. § 6111 requires organizers and sellers of a tax shelter to register the tax shelter with the Secretary not later than the day on which the shelter is first offered to potential users.[88] I.R.C. § 6012 requires organizers and sellers to maintain a list of participants.[89] A tax shelter must be registered if it is (1) required to be registered under Federal or state security laws, (2) formed pursuant to an exemption from registration, or (3) the transaction requires an investment of greater than $250,000 and five or more investors.[90] Once these requirements are met, the transaction must be reported if it is either a listed transaction[91] or if the ratio of the sum of tax deductions and 3.5 times credits to the transaction's investment base is expected to exceed two to one at the close of any of the first five years of the investment's life.[92]

The regulations mandate that following arrangements must be registered whether they exceed the tax shelter ratio or not: (1) a tax avoidance transaction listed by the Service or substantially similar to one that has been listed,[93] (2) any tax avoidance scheme subject to

[85] The historical trend has been to audit smaller percentages of returns; *see* IRS Data Book.
[86] I.R.C. § 6011 is a code provision that, by delegating Congressional authority to the Secretary, makes the regulations issued thereunder legislative regulations that have the force and effect of statute, rather than interpretative rules made pursuant to I.R.C. § 7805(a). United States v. Mead Corp., 533 U.S. 218 (2001); Christensen v. Harris County, 529 U.S. 576 (2000).
[87] Treas. Reg. § 1.6011-4.
[88] I.R.C. § 6111(a)(1).
[89] I.R.C. § 6112.
[90] I.R.C. § 6111(c)(1)(4)).
[91] Listed transactions are created in Treas. Reg. § 1.6011-4(b)(2). The regulations are promulgated pursuant to the legislative mandate to the Secretary contained in I.R.C. § 6011(f).
[92] The numerator of the ratio is the aggregate amount of deductions plus 350% of the expected tax credits at the close of a tax year, I.R.C. § 6111(c)(2); The denominator is the investment base contributed by the investor(s) at the close of the tax year, reduced by any liability to which contributed property is subject, I.R.C. § 6111(c)(3).
[93] Treas. Reg. §1.6011-4(b)(2). In addition, the rule is to be construed in favor of disclosure, Treas. Reg. § 1.6011-4(c)(4). This includes short sales, futures, and derivatives used in offsetting transactions that would inflate basis, Notice 2000-44. It also includes "midco" transactions (sale of stock to an intermediary who sells the assets to a buyer without recognition of gain on the sale of assets) that was described in Notice 2001-16, 2001-1 CB 730.

a confidentiality agreement,[94] (3) transactions where the taxpayer is provided with contractual protection providing for a partial or full refund of fees in the event the projected tax consequences are not sustained,[95] (4) transactions that produce more than a $10 million loss in one year, or $20 million overall for C corporations, a $2 million loss in one year, $4 million overall for a partnership or S corporation, or a $50,000 loss for individuals or trusts,[96] (5) transactions with significant book-tax differences,[97] (6) transactions involving an asset holding period of 45 days or fewer, and involving a tax credit exceeding $250,000.[98]

The registration must include information identifying and describing the tax shelter and the tax benefits of the tax shelter represented to investors,[99] information of the tax identification number of the shelter assigned by the Secretary (which number must also be included in the taxpayer's return),[100] and such other information as the Secretary may prescribe.[101] Failing to register subjects the promoter to a penalty equal to the greater of 1% of the aggregate amount invested or $500 plus $10,000 or 50% of the fees payable to the promoter, and the penalty rises to 75% if the registration requirement is intentionally disregarded.[102]

The listing rules of I.R.C. § 6112 require organizers and sellers to maintain lists of investors, identifying each person who was sold an interest in any tax shelter with respect to which registration was required pursuant to I.R.C. § 6111. The provision defines potentially abusive tax shelters as any tax shelter with respect to which registration is required, as well as those the Secretary determines by regulation have a potential for tax avoidance or evasion.[103]

New regulations interpreting I.R.C. § 6112 go beyond reporting by purchasers and sellers of tax shelters. They require list maintenance with respect to anyone who sells an interest in a potentially abusive tax shelter, whether it must be registered pursuant to I.R.C. § 6111 or even if the Service determines that it has any potential for tax avoidance or evasion.[104] Any organizer or material advisor who receives or expects to receive a minimum fee in connection with such a transaction and who makes any oral or written

[94] I.R.C. § 6111(d)(2)(A), Treas. Reg. § 1.6011-4(b)(3). In addition to confidential transactions, the statute itself prohibits (1) any scheme, a significant purpose of which is avoidance or evasion of Federal income tax for a corporate participant, I.R.C. § 6111(d)(1); (2) any arrangement, explicit or implicit to limit disclosure of the features of the tax shelter, I.R.C. § 6111(d)(2)(A); or (3) any arrangement which any promoter of the tax shelter has reason to know is proprietary to any person other than the potential participant, I.R.C. § 6111(d)(2)(B).
[95] Treas. Reg. § 1.6011-4(b)(4).
[96] Treas. Reg. § 1.6011-4(b)(5). The Service has identified numerous exceptions that serve to make the application both of the rule more complex, discussed *infra*.
[97] Treas. Reg. § 1.6011-4(b)(6). The Service has identified numerous exceptions, discussed *infra*.
[98] Treas. Reg. § 1.6011-4(b)(6).
[99] I.R.C. § 6111(a)(2)(A)(B).
[100] I.R.C. § 6111(b)(1)(2).
[101] I.R.C. §§ 6111(a)(2),(b). Treas. Reg. § 1.6011-4(d)-(f) provides reporting rules, including the announcement of Form 8886, on which reports are to be made.
[102] I.R.C. § 6707(a), Treas. Reg. § 301.6707-1; A tax shelter organizer must register the tax shelter (Treas. Reg. § 301.6111-1T(A-4)(I)) and maintain lists of investors pursuant to I.R.C. § 6112 and Treas. Reg. § 301.6111-1T(A)(4)(I).
[103] I.R.C. § 6112(b).
[104] Requirement to Maintain a List of Investors in Potentially Abusive Tax Shelters, REG-103736-00, 67 F.R. 64807; Treas. Dec. Int. Rev. 9018.

statement about the transaction as to potential tax consequences must register.[105] An attorney or federally authorized tax practitioner may claim privilege pursuant to the confidentiality privilege of I.R.C. § 7525(a); however, the practitioner must still maintain the list. The practitioner may only assert the privilege as a basis for not producing the list.[106]

The Service has created a self-reporting system for organizers and sellers who may (or may not) have offered tax avoidance products. Organizers and sellers must maintain, and produce on demand, a list of each of the buyers. Advisors, who neither organized nor sold the product, must also maintain lists of those who received tax advice that arguably related to the products. All of the provisions are designed to improve the quality of information available to the government. The information is supposed to aid in targeting audits to increase the likelihood of identification and prosecution of those who purchase tax shelters. Unfortunately, the registration and listing requirements are extremely broad and very complex. As a result, many will report lawful transactions to be safe. Others will, innocently or with premeditation, decline to report transactions that are arguably within the scope of the rules. The following discussion illustrates both propositions.

IV. THE NEW RULES WILL NOT SIGNIFICANTLY IMPROVE THE QUALITY OF INFORMATION ALREADY AVAILABLE.

The proposal to secure better information through mandatory reporting has been around for a while. It was made by both the Secretary of Treasury[107] and the Joint Committee on Taxation.[108] Representatives of both the legal and accounting professions have supported mandating increased disclosure.[109] Whatever the theoretical merits of such proposals, development of reporting and listing requirements fails the practicality test.

There is an inherent tension between the right of a taxpayer to arrange transactions and affairs so as to minimize tax liabilities and the minimization of tax liabilities through unlawful means.[110] As a result, what one person views as a lawful tax minimization scheme another views as a tax shelter.[111] The benefits of improved information described by Hirshleifer and his colleagues are not attainable from the information the Service seeks to collect.[112] Instead, the reporting will increase the quantity of distracting "noise."

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[105] *Id.* at 64807.
[106] Temp. Treas. Reg. § 301.6112-1(e)(3)(ii).
[107] Treasury White Paper, 1999.
[108] Joint Committee on Taxation of the Congress, JOINT COMMITTEE ON TAXATION, STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY § 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATED TO CORPORATE TAX SHELTERS), Washington, D.C., July 22, 1999.
[109] *See*, *for* example, New York State Bar Association Tax Section, COMMENTS ON DRAFT TAX SHELTER LEGISLATION, 2001 TNT 151-8 10-30-01, American Bar Association Tax Section, COMMENTS ON DRAFT TAX SHELTER LEGISLATION, 2001 TNT 174-214, 9-6-01, American Institute of Certified Public Accountants Comments on Draft Tax Legislation, 2001 TNT 179-221, 9-10-01.
[110] Commissioner v. Newman, 159 F.2d 848 (1947); Gregory v. Helvering, 293 U.S. 465 (1935); National Investors Corporation v. Hoey, 144 F.2d 466, 467-8 (1944).
[111] Weisbach, *Ten Truths*.
[112] *See* Hirshleifer, *Private and Social Value of Information*.

A. TAX SHELTER REPORTING AND LIST MAINTENANCE WILL GENERATE MANY FILINGS AND MORE LISTS.

An organizer, who must report the schemes described above and keep lists of buyers, is one who discovers, creates, investigates, or initiates the tax shelter investment, devises the business or financial plans for the tax shelter, or carries out those plans through negotiations or transactions with others, or any person who participates in the organization or management of the tax shelter.[113] An organizer is, therefore, shorthand for a large subset of the legal, accounting, insurance, banking, and financial products professionals. Anyone in those fields that would have otherwise been left out is likely to be included as a material advisor. A material advisor is anyone who receives a fee for any oral or written statement made in connection with a transaction that is a potentially abusive tax shelter. Those who do so become subject to list maintenance rules.[114] Material advisor fees must exceed $250,000 for a transaction involving a C corporation or $50,000 for transactions involving individuals and partnerships to trigger the listing requirements. However, because all fees for any kind of advice are included in computing the threshold, whether the fee is for tax advice or not,[115] the number of professionals required to maintain lists will be large indeed. The new regulations effectively coordinate the rules for disclosure and list maintenance by requiring that all transactions subject to disclosure are also subject to list maintenance. If a client chooses to disclose a transaction, the attorney, accountant, and/or financial advisor involved must also list it.[116] As a practical matter, this means that all transactions of any size in which the word "tax" is mentioned will have to be listed since former clients may choose to disclose a transaction without a material advisor's knowledge.

The list must be maintained for ten years after making the last oral or written statement. It must contain: (1) the name of each transaction and registration number if any; (2) the taxpayer identification number of each transaction; (3) the name address and taxpayer identification number of each person purchasing an interest; (4) the number of units acquired by each person; (5) the date the interest was acquired; (6) the amount invested by each person; (7) a detailed description of the transaction, describing both the structure and its expected tax consequences; (8) a summary of the expected tax consequences each taxpayer is intended to derive from the transaction; and (9) copies of all written materials, including tax analyses and opinions, provided to any person who acquired an interest or to their representatives.[117]

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[113] Treas. Reg. § 301.6111-1T; Treas. Reg. § 301.6111-2T(A-5). In addition, any agent or investor who transfers any interest in a tax shelter must maintain lists of all of the clients to whom a transfer was made, Treas. Reg. § 301.6111-2T(A-6)

[114] Treas. Reg. 301.6112-1(c)(2).

[115] Treas. Reg. § 301.6112-1(c)(3);

[116] Treas. Reg. § 301.6111-2T(b). The regulations pursuant to I.R.C. § 6112 provide that a potentially abusive tax shelter is subject to list maintenance if it is within the definition of a registerable transaction, i.e. is either subject to registration under I.R.C. § 6111 or if its significant purpose is tax avoidance.

[117] Requirement to Maintain a List of Investors in Potentially Abusive Tax Shelters, REG.-103736-00, 67 F.R. 64807, 64810-11; Treas. Dec. Int. Rev. 9018; Treas. Reg. § 301.6112-2(e)(3)(A)-(J).

A taxpayer who has indirectly participated in a reportable transaction must also report the transaction if the taxpayer's (or partner's or shareholder's) Federal tax liability is reasonably expected to be affected by the transaction.[118] Some commentators assert that most firms and many individuals are likely to have to both file and maintain records of all transactions entered into about which advice is given, or for which accounting or legal services are provided.[119]

B. TAXPAYERS MUST REPORT SUSPECT TRANSACTIONS.

Prior to the new proposed regulations, reporting was subject to certain relatively broad exceptions. Activities need not have been reported if the taxpayer participated in the transaction in the ordinary course of business in a form consistent with customary commercial practice and would have participated irrespective of expected income tax benefits.[120] Second, they did not have to be reported if the taxpayer participated in the ordinary course of business and there was a generally accepted understanding that the taxpayer's intended tax treatment was properly allowable under the Internal Revenue Code for substantially similar transactions.[121] A third exception was available if the taxpayer reasonably determined that there was no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits from the transaction (under the standard of Treas. Reg. § 1.6662-3(b)(3)).[122] The Service concluded the old rules were not sufficiently broad and were being ignored because they gave taxpayers an opportunity to decline to report what the taxpayer chose to classify as routine transactions. The Service explained that reporting and record keeping were expanded because: "[t]he IRS and Treasury have found that taxpayers are interpreting tax shelter characteristics in an overly narrow manner and are interpreting reporting exceptions in an overly broad manner."[123] To remedy what the Service saw as underreporting, the old rules were repealed and replaced with the broad rules described above.

C. DETERMINING WHAT MUST BE REPORTED OR LISTED IS MADE MORE DIFFICULT TO DETERMINE BY A MYRIAD OF SPECIFIC EXCEPTIONS TO THE ABOVE RULES.

In response to complaints that the reporting and listing requirements were excessively broad, the Service developed a myriad of specific exceptions identified in Rev. Proc. 2003-24, 11 I.R.B. 599 and Rev. Proc. 2003-25, 11 I.R.B. 601. The new exceptions to the requirements provide a large number of very specific criteria. They generally relate

[118] *Id*. at 64804.
[119] *See* Richard M. Lipton, *New Tax Shelter Disclosure and Listing Regulations Promise Headaches for Everyone*, 95 J. TAX'N (2003) (hereinafter Lipton).
[120] Treas. Reg. § 1.6011-4(b)(2)(A).
[121] *Id*. at § 1.6011-4(b)(ii)(B). However an opinion of counsel supporting the position is not sufficient.
[122] *Id*. at § 1.6011-4(b)(ii)(C). It is not clear what this meant since a position that is merely "arguable" or "colorable" is not enough; it must also take into account the entirety of the circumstances surrounding the transaction.
[123] Tax Shelter Disclosure Statements, 67 F.R. 64799 (10/22/02) (hereinafter Tax Shelter Disclosure).

to how deviations between book and tax accounting are adjusted and list differences that may be disregarded in analyzing transactions. The new rules are designed to accomplish the same end as the earlier exceptions. The difference is that the new rules rely on quantifiable exceptions that provide few opportunities for taxpayers to conclude they do not have to report without providing accounting records to justify non-reporting. The problem with the new approach lies in its complexity and in the difficulty the Service will have determining whether the rules are followed.

Rev. Proc. 2003-24 identifies specific losses that are not to be considered in determining whether a transaction is reportable pursuant to Regs. § 1.6011-4(b)(5). Losses from a sale or exchange of an asset with a qualifying basis do not trigger reporting if the loss occurs pursuant to I.R.C. 165, which allows deduction of losses not otherwise compensated, if: (1) the asset is not an interest in a pass through entity;[124] (2) the loss is not an ordinary loss under I.R.C. § 988, "foreign currency transactions;"[125] (3) the asset has not been separated from any portion of the income it generates;[126] and (4) the asset is not part of a straddle, other than a "mixed straddle" permitting aggregation of like classes of activities, as described in Treas. Regs. § 1.1092(b)-4T.[127]

A qualifying basis is a taxpayer's basis less adjustments for allowable depreciation, amortization, or casualty loss, as long as the adjustments are determined in one of the following manners: (1) basis is determined by payments in cash for the assets and improvements;[128] (2) basis is determined under I.R.C. § 358, by reason of I.R.C. § 355 "distribution of stock in a controlled corporation," or I.R.C. § 368 corporate reorganizations that are part of a sale or exchange;[129] (3) the property has a carryover basis because it is inherited from a decedent pursuant to I.R.C. § 1014, or by gift pursuant to I.R.C. § 1015;[130] (4) the property has a basis determined under the tax-free exchange rules pursuant to I.R.C. § 1031(d);[131] (5) basis results from a normal computation after a casualty loss, a compulsory or involuntary conversion, or a loss arising from any mark-to-market treatment;[132] or (6) basis results from a loss attributable to an identified hedging transaction.[133]

In addition, losses that arise from a bulk sale may be ignored if the basis of the inventory is determined under I.R.C. § 263A and must be capitalized and included in inventory costs.[134] Loss is determined by reference to a payment by the taxpayer, such as a guarantor, that is treated as a loss due to termination of a right or obligation, loss from

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[124] Rev. Proc. 2003-24 § 4.02(1)(b).
[125] *Id*. at § 4.02(1)(c).
[126] Id. at § 4.02(1)(d).
[127] *Id*. at § 4.02(2)(1)(e). I.R.C. § 1092 and Treas. Reg. § 1.1092(b)-4(T) provides for aggregating of gains and losses of a designated class of activities in one account in accordance with procedures designed to prevent conversion of ordinary gain and short term capital gain into long term capital gain.
[128] *Id*. at § 4.02(2)(a).
[129] *Id*. at § 4.02(2)(b).
[130] *Id*. at § 4.02(2)(c)(d).
[131] *Id*. at § 4.02(2)(e). Debt financing transactions can be financed with a debt instrument provided that it is negotiated in an arms' length transaction and is not between related parties [*Id*. at § 4.02(3)].
[132] *Id*. at § 4.03(1)-(3).
[133] *Id*. at § 4.03(4).
[134] *Id*. at § 4.02(4)(7).

sale of a capital asset, or loss from a securities future contract under I.R.C. §§ 1234A or 1234B.[135]

Differences between book and tax accounts are not taken into account in determining whether a transaction is reportable when the difference arises because of any of the following causes: (1) book losses that are reported before or without a loss or deduction for federal tax;[136] (2) gain for federal tax that is not reported for book purposes;[137] (3) depreciation or depletion expense that relates solely to difference in method of depreciation or depletion;[138] (4) use of percentage depletion under I.R.C. § 613 or § 613A and intangible drilling costs that are deductible under I.R.C. § 263(c);[139] (5) capitalization and amortization that is made pursuant to I.R.C. § 195, "startup expenses," I.R.C. § 248, "organizational expenditures," and I.R.C. § 709, adjustments associated with "continuation of a partnership;"[140] (6) bad debt loss or cancellation of indebtedness income;[141] (7) differences due to Federal, state, local, and foreign taxes;[142] (8) differences in reporting of compensation of employees and independent contractors including stock options and pensions;[143] (9) charitable contributions of cash or tangible property;[144] (10) receipt of tax exempt interest;[145] (11) dividends (including differences resulting from the dividends received deduction), amounts previously taxed as income and income inclusions;[146] (12) dividends paid deduction by a publicly traded REIT;[147] (13) patronage refunds or dividends of cooperatives;[148] (14) items resulting from involuntary conversions;[149] (15) items resulting from various stock exchanges in controlled corporations, reorganizations, and transfers to and from foreign corporations;[150] (16) items resulting from debt-for-debt exchanges;[151] (17) items resulting from treatment as a sale, purchase, or lease for book purposes and as a financing for tax purposes;[152] (18) treatment of a transaction as a sale for book purposes and as a nontaxable transaction for tax purposes, so long as the differences do not result from application of different valuation methods;[153] (19) items resulting from hedge accounting methodologies producing differences for book and tax purposes;[154] (20) items resulting from use of mark-to-market method of accounting for book purposes and not for tax purposes, for tax purposes but not for book purposes, or using different mark-to-market

[135] *Id*. at § 4.02(4)(8).
[136] Rev. Proc. 2003-25 § 4.01.
[137] *Id*. at § 4.02.
[138] *Id*. at § 4.03.
[139] *Id*. at § 4.04.
[140] *Id*. at § 4.05.
[141] *Id*. at § 4.06.
[142] *Id*. at § 4.07.
[143] *Id*. at § 4.08.
[144] *Id*. at § 4.09.
[145] *Id*. at § 4.10.
[146] *Id*. at § 4.11.
[147] *Id*. at § 4.12.
[148] *Id*. at § 4.13.
[149] *Id*. at § 4.14.
[150] *Id*. at § 4.15.
[151] *Id*. at § 4.16.
[152] *Id*. at § 4.17.
[153] *Id*. at § 4.18.
[154] *Id*. at § 4.19.

methodologies for tax and book purposes;[155] (21) differences resulting from treatment of stripped bonds;[156] (22) inside buildup, death benefits, or cash surrender value of life insurance or annuity contracts;[157] (23) life insurance reserves determined under I.R.C. § 807 and non-life insurance reserves determined under I.R.C. § 832(b);[158] (24) capitalization of policy acquisition expenses of insurance companies;[159] (25) imputed interest income or deductions on deferred payments, original issue discount, and contingent payment debt instruments;[160] (26) gains and losses on previously taxed earnings and profits, branch transactions, exclusions from income, and treatment of foreign currency transactions;[161] (27) items excluded from gross income under treaties addressing a foreign corporation's income that would otherwise be subject to tax under I.R.C. § 882 tax on income of foreign businesses associated with the U.S.;[162] (28) adjustments resulting from change in accounting methods, and inventory valuation differences;[163] or (29) expensing of environmental and remediation costs.[164]

Determining whether losses or differences between financial accounts and tax accounts are due exclusively to these adjustments is a monumental job for both the taxpayer and the auditor. Determining whether a transaction was not reported or listed because it fell within the exceptions identified above will often be impossible to demonstrate without a full audit. Without the exceptions, reporting would be massive and would not help target audits. With the exceptions, determining whether a taxpayer is complying with the reporting rules will require an audit.

V. THE RULES WILL PRODUCE SO MUCH REPORTING THAT THE SERVICE WILL BE UNABLE TO PROCESS AND UTILIZE IT FOR ANY BUT LARGE CORPORATIONS.

All large corporations are audited every year. Neither reporting nor listing transactions increases the likelihood of identifying tax shelters. An audit that focuses on whether the taxpayer has complied with the reporting rules will not provide any better indicator of whether the taxpayer has engaged in tax avoidance than would an audit looking for the tax shelters themselves because what the Service considers to be evidence of a tax shelter is not what the courts have necessarily found to be tax shelters.[165]

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[155] *Id*. at § 4.20.
[156] *Id*. at § 4.21.
[157] *Id*. at § 4.22.
[158] *Id*. at § 4.23.
[159] *Id*. at § 4.24.
[160] *Id*. at § 4.25.
[161] *Id*. at § 4.26.
[162] *Id*. at § 4.27.
[163] *Id*. at §§ 4.28-29.
[164] *Id*. at § 4.30.
[165] Names of purchasers of tax shelters can be secured through discovery without separately requiring listing of purchasers, and vendors can be identified once a taxpayer has been found to have purchased a tax shelter. Given the tenuous relation between reporting requirements and identification of actual tax shelters shown above, it is difficult to see how reporting is going to improve either identification of cases or conviction rates.

Auditors will still have to determine whether there has been unlawful tax avoidance or simply a reporting violation.[166]

The quantity of material that is reported by small and midsize firms, trusts, and individuals could be so large that it will provide little, if any, additional direction as to who should be audited. Some taxpayers may report extensively, as is encouraged by the regulations. Others may choose not to report, claiming their activities fall within the exceptions. Such a schism would make what is reported of questionable reliability.

To the extent that taxpayers correctly follow the reporting requirements, tax shelter promoter reporting and listing of transactions will act as a substitute for discovery in identifying who purchased a tax shelter from a promoter. Tax advisors will have to maintain detailed records to comply with the regulations. However, too many legitimate as well as illegitimate transactions will be reported to permit the limited IRS staff to identify unlawful practices from the data provided. The new rules' major contribution will probably be to raise the penalties for failure to report that can be assessed if a taxpayer is convicted of engaging in an unlawful tax shelter - a result more easily achieved by simply increasing penalties.

VI. CONCLUSION.

Improved information would reduce the prevalence of tax shelters. The issue is whether more reporting will result in improved information. Unfortunately, analysis of the current rules does not suggest that there will be a significant increase in usable information with which to target audits. The process of taxpayer reporting, unlike the requirement for promoter reporting, does not increase the probability of identification and prosecution of tax shelter providers. Promoter reporting may help the Service identify practices it wants to attack; however, the Service is already auditing the large firms most affected by the reporting rules. The relatively small penalties associated with not reporting can only be assessed if a tax shelter is found and will do little to increase costs faced by a potential tax shelter purchaser. A law making failure to report transactions subject to penalty even when no tax shelter is proved will only result in massive over reporting. Large corporations already are fully audited. Reporting will do little to alter the risk of audit of S corporations, partnerships, and individual taxpayers. At this point, the major effect of the new reporting requirements is likely to be increased cost to the taxpayer who will require additional legal, accounting and financial services[167] associated with compliance of the new "code" within a "code."

[166] *Tax Shelter Disclosure.*
[167] Lipton, *supra* note 119, at 21.