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# Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters

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**DISCLOSURE AND CIVIL PENALTY RULES IN THE  
U.S. LEGAL RESPONSE TO CORPORATE TAX SHELTERS**

Daniel Shaviro\*

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**I. INTRODUCTION**

Historians and sociologists frequently debate American exceptionalism, or the “view that America can be understood only by appreciating its singular origins and evolution.”<sup>1</sup> In some areas, ranging from the death penalty<sup>2</sup> to the Bush Administration’s embrace of torture and preemptive war, American exceptionalism has been emergent in recent years rather than a historical constant. In other areas, if the U.S. initially looks different from other economically advanced countries, it may simply have traveled down a common pathway first, without actually being exceptional at all.

Prominent recent scandals and debates in the U.S. regarding aggressive tax planning and breakdowns in corporate governance – the main topics at this conference – reflect, at most, the U.S. getting somewhere first. The U.S. had the Enron scandal; Europe the Parmalat scandal. In the U.S., then-Treasury Secretary Lawrence Summers said in 2000 that the “rapid growth of abusive corporate tax shelters” was “the most serious compliance issue threatening the American tax system today.”<sup>3</sup> European tax

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\* Wayne Perry Professor of Taxation, NYU Law School. This paper was prepared for a conference, entitled Tax and Corporate Governance, jointly sponsored by the International Network for Tax Research, the Max Planck Institute for Intellectual Property, Competition, and Tax Law, Germany, and the German branch of the International Fiscal Association, held in Munich, Germany on December 8-9, 2006. I am grateful to Philip Baker, Edward D. Kleinbard, Alexander Rust, Roman Seer, Michael Schler, and participants in the conference for helpful comments on an earlier draft.

<sup>1</sup> Philip P. Frickey, American Exceptionalism in Federal Public Law, 119 Harv. L. Rev. 431, 433 (2005).

<sup>2</sup> See, e.g., Carol S. Steiker, Capital Punishment and American Exceptionalism, 81 Or. L. Rev. 97 (2002).

<sup>3</sup> Treasury Secretary Lawrence H. Summers, "Tackling The Growth of Corporate Tax Shelters." Remarks to the Federal Bar Association, Washington, D.C., February 28, 2000.

authorities increasingly have similar concerns, albeit more focused on income-shifting within the European Union<sup>4</sup> than on the loss-creating transactions that have drawn the greatest attention from U.S. authorities.

Since the U.S. government response to corporate tax shelters has been unfolding for almost a decade by now, Europeans may naturally want to ask what lessons can be learned from the U.S. experience. Should U.S. responses be adopted more broadly? Could they be improved significantly?

In evaluating the U.S. legal response to corporate tax shelters, two types of issue arise. The first concerns the legal requirements for tax-reducing transactions to be treated as tax-effective. If a company has sufficient leeway under the law to create tax losses by simply shuffling paper and creating circular cash flows, then all the audit review and penalties in the world may not suffice to make it pay tax on its income.<sup>5</sup> Once the substantive rules that define permissible sheltering are in place, however, the issue shifts to one of compliance. How often do companies take reporting positions that would not be upheld if carefully scrutinized, how often are they caught, and what penalties do they face if caught?

This paper seeks modestly to advance inquiry into the compliance issues by reviewing and evaluating some of the main U.S. rules that address tax shelter reporting and penalties. I will argue that the disclosure rules do not impose unreasonable burdens.

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<sup>4</sup> In the U.S., states increasingly have similar concerns about income-shifting. See Joseph Bankman, *State Tax Shelters and State Taxation of Capital* (2006).

<sup>5</sup> See, e.g., Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 *Tax Notes* 1775, 1777-1778 (1999), noting that, if a particular tax planning scheme (the high basis, low value shelter) “were respected (say, approved in a Revenue Ruling), it would reduce corporate taxable income to near zero. Each corporation would place profit-producing assets in a subsidiary and have that subsidiary purchase loss positions from a foreign taxpayer. The only limit on the use of the shelter would be the transaction costs involved in purchasing the loss position, and locating foreign persons who would be willing to serve as accommodation parties.”

Moreover, while it is unclear how much audit benefit they actually offer the Internal Revenue Service (IRS), other than in directing auditors' attention to "listed transactions" that the IRS has already been publicly identified as problematic, they may more generally help the IRS in formulating responses to newly developed transactions. However, the effectiveness of the disclosure rules may be compromised by taxpayer over-disclosure, which might be designed either to avoid penalties for under-disclosure or to overwhelm the IRS with too much of a good thing. The expanded book-tax reconciliation reporting that must be furnished by corporate taxpayers on Schedule M-3 likely does more to offer IRS auditors a useful overview of the likely soft spots on a given tax return.

The penalty rules' main flaw, I will argue, is that they focus excessively on the taxpayer's state of mind regarding the likelihood of prevailing on audit, as a prerequisite for imposing civil penalties. *Mens rea* is, of course, an important element of any criminal offense that could send someone to jail. But there is little need for it in the context of a company facing the chance of, say, a 20 percent addition to the tax deficiency it will face if a given tax return position is rejected upon audit. Here, a penalty merely worsens the company's betting odds on taking a controversial tax return position – odds which may remain unduly favorable even with the risk of a penalty. Nothing should shock the conscience about such an adjustment to "audit lottery" payoffs. If we are uneasy about exposing the company to additional downside risk when it acts in apparent good faith, the answer is to permit insurance, rather than, in effect, to provide the insurance for free by simply not charging a penalty to begin with.<sup>6</sup>

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<sup>6</sup> On the recent growth of tax insurance in the U.S. marketplace and the policy issues raised thereby, see Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 *Va. Tax Rev.* 339 (2005).

Focusing on state of mind not only creates an escape hatch for over-aggressive taxpayers who take advantage of underlying legal uncertainty to claim good faith, but seriously distorts the role of tax lawyers. Taxpayers who might otherwise want objective legal advice devote themselves instead to shopping around for an opinion letter that is sufficiently encouraging about a particular tax return position's prospects if audited to serve as a "penalty shield."

The U.S. rules, having unwisely granted tax lawyers at least limited powers of priestly absolution, then go on to impose more burdensome regulatory oversight on the lawyers than would otherwise be necessary. A relatively trivial example of this regulatory blowback is the virus-like proliferation of Circular 230 notices on even the most casual communications from U.S. tax lawyers.<sup>7</sup> A second, perhaps more serious, instance of blowback is the tax rules' creating incentives to assign opinion-writing duties for a given transaction to lawyers who lack reliable access to the underlying facts (but who ostensibly are freer to be "objective"), rather than to those who have such access.<sup>8</sup>

To explain the intuition that may underlie reliance on fault, suppose a corporate taxpayer's CFO and tax director reasonably believe that a given return position has a 90 percent chance of being found correct. If the position is subsequently held incorrect, wouldn't a 20 percent penalty be "unfair"? Perhaps it would, if we think of penalties as akin to bops on the snout administered to bad puppies by a dog trainer. If, however, we think instead in terms of properly aligning corporate taxpayers' incentives, a penalty in these circumstances may be entirely appropriate. Penalties need not have anything to do

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<sup>7</sup> Thus, e-mails from U.S. tax lawyers discussing, say, dinner invitations or a recent baseball game typically include a disclaimer that says something like the following: "Any U.S. federal tax advice included in this communication was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal tax penalties." Similar legending festoons the paper products sent out by U.S. tax lawyers.

<sup>8</sup> See Code section 6664(d)(3)(B).

with wrongdoing; within limits, taxpayers are only to be expected to respond self-interestedly to uncertainty.

If all potentially erroneous return positions were subject to searching audit inquiry, there might be no need for penalties even where the tax return position had next to no chance of being correct. By definition, a searching inquiry means that the government gets a chance to exercise its judgment on each item, and thus to treat the tax return as little more than the opening bid in a negotiation. In these circumstances, aggressive return positions might do no more than delay full payment of ultimately determined tax liabilities, calling for interest charges but nothing more.<sup>9</sup>

Once we realize that not all taxpayer reporting positions are likely to receive a searching inquiry, however, the merits look different. Suppose a taxpayer who will not be audited is taking ten potentially controversial tax return positions, each of which has a 90 percent chance of being correct. On average, this taxpayer is likely to have, ex post, one error on the tax return in its own favor. The result is systematic under-taxation (relative to ex post “correct” outcomes) of transactions with absolutely certain tax consequences. Even if taxpayers draw the line far short of outright fraud, they end up having good reason to play the “audit lottery.”

Should we assume, however, that audit lottery problems are serious enough for no-fault penalties to be necessary? Recently expanded U.S. rules that mandate extensive information reporting with respect to potentially suspect transactions clearly are relevant

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<sup>9</sup> If every transaction were closely scrutinized and there were penalties for under-payment, without matching rewards for over-payment, taxpayers would have reason to lean towards over-reporting their expected liability and requesting refunds. See Suzanne Scotchmer and Joel Slemrod, *Randomness in Tax Enforcement*, 38 J. Pub. Econ. 17 (1989). Such an asymmetry may seem anomalous unless one relaxes the assumption that everything gets a searching inquiry, and views the procedural structure of the refund demand as likely to affect the review process.

here, as is the development of Schedule M-3. Yet, desirable though these disclosure rules may be, they do not guarantee that each disclosed transaction will end up getting a searching inquiry, especially given the staffing and salary levels at the scandalously under-funded IRS. Nor would taking a close look at everything be cost-efficient, even with adequate funding. Thus, while the optimal penalty level depends on the probability that controversial positions will get a close look, reporting, even for all such positions, does not by itself reduce the optimal penalty level to zero.

The remainder of this paper proceeds as follows. Section II discusses the underlying problems of defining and deterring tax shelters, which are critical to evaluating the disclosure and penalty issues. Section III describes and evaluates the U.S. tax rules concerning disclosure of suspected corporate tax shelters. Section IV does the same for the U.S. tax rules concerning accuracy-related penalties. Section V provides a brief conclusion.

## II. DEFINING AND DETERRING CORPORATE TAX SHELTERS

### A. What is a Legally Impermissible Tax Shelter?

#### 1. The Underlying Legal Uncertainty

Justice Potter Stewart of the U.S. Supreme Court famously remarked about pornography that, while he could not define it, “I know it when I see it.”<sup>10</sup> Legally impermissible tax sheltering prompts similar, and similarly unconvincing, assertions that the eye can confidently spot what the brain cannot crisply define.<sup>11</sup> In practice, uncertainty is pervasive if taxpayers choose to navigate near the line, although those whose tax planning is more conservative have less to worry about.

The contested and uncertain nature of identifying legally impermissible tax shelters is nicely illustrated by *Compaq v. Commissioner*,<sup>12</sup> in which the taxpayer tried to buy foreign tax credits from overseas investors who could not use them, by arranging to be the legal owner of Royal Dutch Petroleum stock solely for the moment when a previously declared dividend (subject to Dutch withholding tax) was formally being paid. The Tax Court held that the taxpayer’s position was not only legally unmeritorious, but subject to penalty on grounds of negligence. The Fifth Circuit then reversed, finding the taxpayer’s position not only non-negligent, but indeed legally correct.<sup>13</sup>

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<sup>10</sup> *Jacobellis v. United States*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

<sup>11</sup> See, e.g., *Estate of Baron v. Commissioner*, 83 T.C. 542, 559 n. 47 (1984)

<sup>12</sup> 113 T.C. 214 (1999), rev.d, 277 F.3d 778 (5<sup>th</sup> Cir. 2001).

<sup>13</sup> As I have noted elsewhere, the Fifth Circuit’s opinion in *Compaq* is legally suspect even if one agrees with it on policy grounds. See Daniel Shaviro and David Weisbach, *The Fifth Circuit Gets It Wrong in Compaq v. Commissioner*, 94 Tax Notes 511 (2002). In *Compaq*, the Fifth Circuit ignored its duty, in the exercise of appellate jurisdiction, to accept all findings of fact that were not clearly erroneous, and made fact findings of its own that were flatly contradicted by the case record. In addition, turning prior precedent on its head, the court treated steps that the parties took to insure that the transaction would lack economic substance as actually establishing such substance (on the view that it showed that they cared about the level of economic risk). See Shaviro and Weisbach, *supra*, at 515-516. Yet, however shoddy the Fifth Circuit’s performance, *Compaq* is not unique. The Eighth Circuit similarly mischaracterized a nearly identical transaction in *IES Industries, Inc. v. United States*, 253 F.3d 350 (2001), where it likewise reversed a lower court decision for the government.

The uncertainty that bedevils taxpayers trying to predict how a transaction like that at issue in *Compaq* will fare if it is audited and litigated may be unfortunate, but in practice it is unavoidable. Or more precisely, avoiding it would lead to even worse consequences for the tax system, for two reasons. First, the tax law, at least under a transactional income tax as complicated as those in most OECD countries, cannot be administered effectively without requiring that transactions satisfy minimal economic substance and business purpose requirements if they are to be respected. Second, while precise black letter rules, specified in advance, may be used to implement these requirements in particular settings, they must be supplemented by general standards, applied in practice *ex post*, if tax avoidance is to be kept at acceptable levels. I next address each of these two points.

## 2. The Need for Economic Substance and Business Purpose Requirements

As Edward Kleinbard has noted, a typical income tax system, such as that in the U.S., “works by describing a finite number of idealized transactions and attaching to each a set of operative rules -- what might be termed a set of tax cubbyholes. Tax professionals spend a modest amount of time learning to identify these tax cubbyholes and their consequences, and a great deal of time massaging reality to fit within the desired cubbyhole.”<sup>14</sup>

While Kleinbard was mainly addressing the labels, such as debt or equity, that are given to particular financial instruments, his point applies more generally. Thus, consider the rule that gain or loss from an asset’s change in value is ignored for income tax purposes until the occurrence of a realization event, such as a sale. In the idealized case

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<sup>14</sup> Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 *Texas L. Rev.* 1319, 1320 (1991).

of a pure sale, a taxpayer who previously had physical possession of a given asset, and bore one hundred percent of the upside and downside risk pertaining to its value, completely disposes of both possession and the risk. When this happens, we know beyond any doubt (barring the application of special rules to the contrary) that we have a taxable sale. In the real world of asset relationships, however, things are not always so simple. No matter who formally owns an asset, infinite gradations are possible in who uses and possesses it, and in who bears various upside and downside risks pertaining to it. Moreover, changes in any of these relationships may be substantially independent of changes in legal ownership.

Under these circumstances, if the transaction costs of independently manipulating economic relationships on the one hand and legal ownership on the other are low enough, and if realization depends purely on whether there has been a legal ownership change, then the occurrence of a taxable realization event is purely elective. Taxpayers, without regard to their preferences at any time regarding actual economic relationships to particular assets, can trigger realization whenever they like by inducing a legal ownership change, and can avoid realization whenever they like by avoiding any such change even if they are modifying economic relationships. This state of affairs would be equivalent to ignoring legal ownership changes and making the occurrence of a taxable sale explicitly elective, by permitting taxpayers to state on the face of their returns which assets they want to treat as having been sold.

Purely elective realization is an unacceptable state of affairs. For example, it creates inefficient tax biases in favor of long-lived assets that are affected by realization, as well as risky assets that are more likely to have large changes in value. In addition, it

can lead to permanent exclusion for large swathes of income, along with unlimited loss generation to the extent not addressed by schedular rules (such as capital loss limitations) that restrict the types of income against which particular losses can be deducted. Thus, for a realization-based income tax to be feasible, one is virtually forced to make some sort of inquiry into whether or not, as a matter of economic substance, particular transactions “really” were sales (whether so classified by the taxpayer or not). This, in turn, requires inquiry into actual changes in underlying economic relationships to assets.

U.S. income tax law provides an instructive illustration. At one time, taxpayers with appreciated fungible financial assets, such as corporate stock, could get all of the economics of a sale (including the receipt of cash) without triggering tax on the gain, through a “short against the box” transaction, involving the short sale of an asset identical to that which one continued to hold.<sup>15</sup> The U.S. Congress eventually responded by enacting a provision treating such transactions as constructive sales.<sup>16</sup> In general, a constructive sale occurs when one takes a short position that is “substantially,” even if not precisely, identical to one’s appreciated long position.<sup>17</sup> It also occurs if one overly hedges one’s position by other means, such as by acquiring too tight a “collar” (a combination of put and call options that transfer risks of gain and loss to counterparties).<sup>18</sup>

Each of these two routes to constructive sales treatment involves a matter of degree. One can defeat the rule’s application, therefore, by hedging one’s long position with a short position that, while similar and highly correlated, falls just short of being

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<sup>15</sup> See Kleinbard, *supra*, at 1357-58.

<sup>16</sup> See U.S. Internal Revenue Code, section 1259.

<sup>17</sup> See Code section 1259(c)(1)(A) through (D).

<sup>18</sup> See Code section 1259(c)(1)(E),

“substantially” identical.<sup>19</sup> Or one can acquire a collar that leaves just enough prospect of gain or loss via the spread between the put and call strike prices.<sup>20</sup>

By having such a rule, the tax law, while not eliminating formally driven realization elections, makes their exercise more costly. Avoiding a constructive sale of an appreciated asset may require retaining more economic risk with respect to a given asset than one would otherwise have preferred. Likewise, contriving a tax-effective sale of a loss asset may require departure from one’s risk preferences.<sup>21</sup> There is no sensible reason for imposing these burdens on taxpayers, other than to make the implicit realization election costlier to exercise as a way of reducing the harm that would result from free electivity.<sup>22</sup> From this standpoint, however, “one might as well condition favorable tax consequences on whether the taxpayer’s chief financial officer can execute 20 back-somersaults in the IRS National Office at midnight on April Fool’s Day,”<sup>23</sup> given the risk requirement’s lack of social value other than as a means of burdening electivity. This has come to be known in the U.S. tax policy literature as the “back-flips” view of anti-tax shelter rules.<sup>24</sup>

This basic tax law pattern – assessing the “reality” of a transaction, and thereby inducing taxpayers to massage the economics of what they are doing so as to achieve

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<sup>19</sup> As it happens, Code section 1259 also contains other escape hatches, such as a provision permitting the rule’s application to be avoided where the taxpayer subsequently bears sufficient risk for 60 days. See Code section 1259(c)(3).

<sup>20</sup> The New York State Bar Association proposed that a 20 percent spread be sufficient to avoid constructive sale treatment with respect to a collar. Thus, for example, where stock is trading at \$100 per share, one could acquire a put to sell it for \$95 and write a call under which one was obligated to sell it for \$115 without thereby engaging in a constructive sale. See New York State Bar Association Tax Section, Comments on H.R. 846 (May 21, 1997).

<sup>21</sup> See, e.g., Code sections 1091 (disallowing losses on wash sales of securities, where one purchases substantially the same asset that one sold within a 30 day period) and 1092 (disallowing losses on straddles, where one retains a substantially identical offsetting position).

<sup>22</sup> See Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 Tax Notes 221, 222-223 (2000).

<sup>23</sup> *Id.* at 223.

<sup>24</sup> See, e.g., Leo Katz, *In Defense of Tax Shelters* (2006).

sufficient “reality” – is pervasive and fundamental. In *Compaq*, it arose via the inquiry into whether the taxpayer’s acquisition of Royal Dutch Petroleum stock was a sham. *Compaq*-style transactions are now subject to a statutory requirement that the taxpayer hold the foreign stock (without excessive hedging) for at least 15 days.<sup>25</sup>

For a recent European example of the same phenomenon, consider the *Cadbury Schweppes*<sup>26</sup> case, in which the taxpayer had established two wholly owned finance subsidiaries in Ireland with no employees, no office, not even a telephone,<sup>27</sup> but, apparently, more than £ 34 million in annual profits that would otherwise have been fully taxable in the U.K. In this case, the European Court of Justice invalidated a U.K. tax rule that had been designed to impede income-shifting from the U.K. to low-tax jurisdictions such as Ireland by making controlled foreign subsidiaries’ profits automatically taxable in the U.K.<sup>28</sup> While rejecting any such per se rule, along with any general adverse reliance on taxpayers’ motive to save taxes by shifting profits between European jurisdictions, the ECJ held that the U.K. could disregard “wholly artificial arrangements.” It thus effectively permitted income-shifting at the price – perhaps a rather low price under the circumstances – of one’s doing just enough in the low-tax jurisdiction to show that one had “genuinely established” a subsidiary that “actually carried out” services there, and that the transaction as a whole was not “devoid of economic purpose with regard to” the group’s activities.<sup>29</sup>

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<sup>25</sup> See Code section 901(k).

<sup>26</sup> *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, C-196/04, SPC 00415.

<sup>27</sup> See Lee Sheppard, *Cadbury Schweppes: The ECJ Versus Tax Administration*, 112 Tax Notes 480 (2006).

<sup>28</sup> See *id.*

<sup>29</sup> *Cadbury Schweppes*, *supra*.

Tax Notes columnist Lee Sheppard characterizes as follows the effects of the *Cadbury Schweppes* decision:

Our readers should rejoice in [Advocate General Philippe] Leger's opinion because it would make tax planning a whole lot more expensive. Imagine having to staff a finance subsidiary. What is the cost of office space in Dublin, anyway? And imagine having to answer a lengthy and messy factual inquiry on every audit. Yes, Leger imagined that a routine audit would feature that inquiry. The professional bills would be high, and it could all be blamed on the ECJ when an unhappy financial officer asked why the tax planning was costing so much. A professional specialty would develop for CFC regime exemption.<sup>30</sup>

### 3. The Need for Standards That Are Applied Ex Post

Burdening taxpayer electivity by requiring that tax-effective transactions have some minimum level of economic substance does not automatically create any special degree of legal uncertainty. Thus, the U.S. constructive sale rules are at least moderately well-specified, as is the 15-day rule for foreign stock ownership in *Compaq*-style transactions. Similarly, one could imagine the U.K. (subject to ECJ review) writing black letter rules for *Cadbury Schweppes*-style transactions – requiring, for example, specified levels of staffing and office space in the low-tax jurisdiction relative to the profit shift being claimed. Uncertainty does increase, however, if one relies on general legal standards of business purpose and economic substance that are applied ex post, rather than purely on precise black letter rules that have been specified ex ante.

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<sup>30</sup> Sheppard, *supra*, at \_\_\_. The subsequent Judgment of the Court in *Cadbury Schweppes* adopted the view of the Advocate General that the U.K. could only disregard “wholly artificial arrangements.”

There are many good reasons for so relying. For example, a standard can be briefer and less complex than all of the rules it implies because it can apply to multiple situations.<sup>31</sup> In addition, using standards reduces taxpayers' incentives to invest in continually finding new schemes that will pay off for a while until detected by the government and prospectively shut down through new rules. The use of broad economic substance-type standards has become increasingly common around the world, at least in specified subject areas, even in countries that resist enacting general anti-avoidance rules (GAARs) that would apply across the board.<sup>32</sup> The consequences of such standards for tax planning have common features across countries even in the face of differences in the standards' breadth of application, precise details, and degrees of stringency.

4. The Worse, the Better: Tax Planning in Response to an Economic Substance Standard

The prior section showed that anti-tax shelter rules and standards often are, in effect, nothing more or less than “back-flip” requirements, inducing otherwise meaningless exertions from those who seek tax benefits. Unedifying though this may sound, the alternative of taxpayers' being able to make self-serving elections at zero cost would be even worse, and indeed would likely make a transactional income tax unfeasible. In this setting, much of what a tax lawyer does is to weigh the odds on whether a given transaction already has enough back-flips built into it, and to recommend

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<sup>31</sup> See generally David A. Weisbach, Formalism in the Tax Law, 66 U. Chi. L. Rev. 660 (1999).

<sup>32</sup> According to Hugh J. Ault and Brian J. Arnold, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS (2<sup>nd</sup> ed., 2004), general anti-avoidance standards of one sort or another are used in Australia, Canada, France, Germany, the Netherlands, and Sweden, in addition to the United States. Japan and the United Kingdom, which have been more resistant to a GAAR-type approach, have been relying more on economic substance-type rules in recent years, at least in particular areas. See Ault and Arnold at 17, 33, 50, 70, 86, 99, 112, and 132.

additional ones if it does not. The client then decides whether to engage in the transaction, and how many back-flips to engage in if it does.

Lawyers therefore may advance compliance by making bad transactions worse, in the sense of adding to the social waste (in the form of undesired economic consequences) associated with particular tax maneuvers. If a given transaction clearly does work, even if it ought not to, lawyers are ethically blameless for bringing it to their clients' attention, and clients are blameless when they do the transactions. Bad behavior consists, not in doing "bad" transactions or making them socially worse, but in treating transactions as lawful when they are not, in reliance on the audit lottery.<sup>33</sup> It is entirely an issue of *malum prohibitum*, not *malum in se*. Where the law does not require back-flips, lawyers have no moral duty to insist on them.

Given pervasive legal uncertainty about the application of economic substance standards to particular cases, however, it is a mistake to think primarily in terms of deliberately wrong behavior. Likelihood of correctness is a continuum from zero to one hundred percent. Even without second-order uncertainty (e.g., concerning whether a transaction is actually 49 percent or 51 percent likely to be respected), it is hard to see why we should take a discontinuous view of gradually changing probabilities, such as by penalizing only those whose *ex ante* chances of correctness were too low. Consider again the taxpayer who does ten transactions, each with a 90 percent chance of being correct, and who therefore has on average the same number of *ex post* errors as a taxpayer who does one transaction with zero chance of being correct. We give taxpayers the wrong

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<sup>33</sup> Other ethical violations by tax lawyers may involve failing to make required disclosures and otherwise concealing or trying to misrepresent transactions that the government authorities might otherwise scrutinize more closely.

incentives if we do not address the 90 percent transactions as well as those with a zero percent chance of correctness.

B. Disclosure and “Back-Flip” Rules

Tax transaction disclosure rules are commonly thought of as posing a tradeoff between (a) the benefit of giving government auditors more information so that they can identify “bad” transactions, and (b) the cost of imposing greater burdens on taxpayers when they engage in “good” transactions. Obviously, the tradeoff would not exist if the disclosure rules could be precisely tailored so that only “bad” transactions were subject to disclosure, in which case taxpayers simply would not do the transactions to begin with unless planning to defy the disclosure requirements as well as the substantive law. It is well understood, however, that no feasible set of disclosure rules could be tailored so accurately, thus requiring in practice that we choose between degrees of over-inclusiveness and under-inclusiveness.

This analysis must be modified once we factor in the “back-flip”-requiring character of economic substance rules, along with the unavoidably probabilistic nature of whether a given transaction will be classified ex post as legally permissible. In particular, the following implications emerge:

--Effective disclosure is vital given the audit lottery, and not just for transactions that are highly likely to be struck down but even those for that have a good chance of being upheld. Even for the latter transactions, an IRS opportunity to engage in serious review, and taxpayer anticipation of such review, may have desirable incentive effects when taxpayers are choosing between transactions (e.g., between the definitely permissible and the probably permissible).

--The fact that a transaction has good ex ante chances of being upheld, and/or is determined ex post to be permissible, does not necessarily mean that we should regret burdening taxpayers who engage in it with a disclosure requirement. Again, while back-flips are wasteful if we hold constant the taxpayer's choice of transactions, they can change transaction choices in potentially desirable ways.

--Disclosure requirements can be tailored to impede the efficient (but socially undesirable) functioning of the tax shelter market. Along these lines, commentators have noted that making tax planning strategies legally patentable might be undesirable if the risk of having one's innovation "stolen" without compensation helps to reduce over-production (from the social standpoint) of such strategies.<sup>34</sup> Disclosure rules might similarly be tailored to impede the functioning of the tax shelter market by making it harder for innovators to protect their intellectual property, such as by causing confidentiality agreements to trigger disclosure.

### C. Penalties and Taxpayer Incentives

Economic models of behavior have become ever more prominent in policy discussion in recent decades. Thus, Gary Becker founded the modern criminal deterrence literature when he proposed setting criminal penalties to equal the social harm caused by the crime, multiplied by one over the probability of detection.<sup>35</sup> His proposal effectively equated optimal penalty levels with Pigovian taxation<sup>36</sup> (modified to add uncertainty of detection), as well as to the principle that a due care requirement in tort law should equate

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<sup>34</sup> See, e.g., Burk and McDonnell, *Tax Investment Strategies, Business Method Patents, and the Firm* (2006).

<sup>35</sup> Gary Becker, *Crime and Punishment: An Economic Approach*, 76 *J Pol Econ* 169 (1968),

<sup>36</sup> Pigovian taxation seeks to address externalities by requiring, for example, a polluter to pay tax equal to the value of the harm it has caused. For a discussion of such taxes, see, e.g., Richard A. Posner, *ECONOMIC ANALYSIS OF LAW* 391 (6<sup>th</sup> ed. 2003).

marginal cost to marginal benefit.<sup>37</sup> Subsequent writers added administrative cost to the analysis, with the implication that higher penalties should be used to “pay” under the Becker formula for a reduced probability of detection so that the state could economize on enforcement.<sup>38</sup> It was noted as well that risk aversion or a norm of proportionality might set an upper bound on permissible penalties. Thus, we might be uncomfortable with imposing the death penalty on one out of every million jaywalkers even if this permitted us to satisfy the Becker formula at the lowest possible administrative cost.

The analysis of tax evasion, defined as taking a reporting position that has a zero percent chance of being correct, has followed similar principles. Thus, tax evaders are modeled as making risky investments that pay off in the form of reduced taxes unless the evasion is detected, corrected, and penalized.<sup>39</sup> Such analysis suggests that penalties, as in the Becker model, should be set high enough to eliminate any expected net benefit given the taxpayer’s degree of risk aversion. Thus, in the simple case of a risk-neutral taxpayer evading \$1 million of taxes with a 20 percent probability of being caught, a penalty of 400 percent, or an extra \$4 million in the event of a \$1 million correction, would leave both the taxpayer and a risk-neutral government indifferent between evasion and compliance.

These models clearly are less than perfect in their assumptions regarding human behavior - albeit perhaps best suited to the corporate setting, where financial officers may

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<sup>37</sup> See, e.g., Posner, *supra*, at 167-171..

<sup>38</sup> A. Mitchell Polinsky & Steven Shavell, *The Optimal Use of Fines and Imprisonment*, 24 *J Pub Econ* 89 (1984)

<sup>39</sup> See Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 *J. Pub. Econ.* 323 (1972); Shlomo Yitzhaki, *A Note on Income Tax Evasion: A Theoretical Analysis*, 3 *J. Pub. Econ.* 201 (1974).

actually approach tax planning as identical in principle to managing inventory costs.<sup>40</sup> The models fail to explain “pathological honesty,” or taxpayers’ decisions not to cheat even when it seems that they “should” from a purely financial standpoint, given the odds and the risk aversion that they exhibit in other settings.<sup>41</sup> Given the benefit to any given taxpayer when others comply, the decision whether to do so involves a prisoner’s dilemma, and people appear to respond to cues about whether others are cooperating or defecting even if their own actions are not being observed.<sup>42</sup> Yet these departures from pure financial rationality can add to as well as detract from the social payoff to raising expected penalties that were previously too low. A norm of evasion or hyper-aggressiveness may potentially flip over into one of play-it-safe compliance if people discern that cheaters are now being punished or that the odds have suddenly changed for the worse.

Adapting the tax evasion model to deal with ex ante legal uncertainty about permissible transactions is straightforward. Again, taxpayers face two big decisions in evaluating potential tax shelter transactions, which can usefully be separated for analytical purposes here even though in practice they may be considered jointly. The first is whether to engage in a transaction that might ex post be ruled an improper tax shelter, and the second is how many back-flips to build into it so that its chances of being upheld (if detected) will be better.

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<sup>40</sup> See Edward D. Kleinbard, Corporate Tax Shelters and Corporate Tax Management, 51 Tax Executive 231 (May-June 1999).

<sup>41</sup> See Joel Slemrod, Trust in Public Finance, Nat'l Bureau of Econ. Research, Working Paper No. 9187, 2002)

<sup>42</sup> See, e.g., Dan M. Kahan, Reciprocity, Collective Action, and Community Policing, 90 Calif. L. Rev. 1513, 1516 (2002).

Turning clearcut tax evasion into acting with, say, a 50 percent chance of being upheld upon close scrutiny does not change the structure of the basic analysis. Suppose we return to our example of the \$1 million tax evader whose behavior is detected 20 percent of the time, with the added proviso that if detected his transaction has a 50 percent chance of being upheld. Assuming risk neutrality, everyone's incentives are the same as if he had a zero percent chance of being correct but was under-reporting only \$500,000 instead of \$1 million. So the 400 percent penalty if he is detected and loses remains optimal, although the average stakes have been cut in half. Suppose he takes an aggressive stance ten times, and is right (whether or not detected) five of these times. In the five cases where he is right there is nothing more to say. In the five where he is wrong, he pays \$1 million too little on four occasions and pays a \$4 million penalty when caught, giving him the right incentive structure even though we might think of a 50 percent correctness bet as having been made in tolerably good faith.

One argument for a lower penalty for "good faith" taxpayers might be that they should not be required to bear the downside risk of a penalty if they are taking a defensible stance that merely happens ex post to be rejected by the decision-maker. This might well be a compelling line of argument if one were contemplating, say, jail time for taking good faith but ex post erroneous positions. However, a mere financial penalty on top of a corrected tax liability does not raise similar concerns, in particular if it is insurable. As it happens, transaction-specific tax liability insurance that covers penalties has been on the rise in the U.S. in recent years,<sup>43</sup> and the IRS has decided against generally requiring disclosure of insured transactions.<sup>44</sup> While one might conceivably

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<sup>43</sup> See Logue, *supra*, at 389.

<sup>44</sup> See *id.* at 401-405.

object normatively to such insurance as likely to make companies more willing to take erroneous positions, the insurers have self-interested reasons to monitor this behavior (which constitutes moral hazard from their perspective) and to build it into their pricing. Insured parties end up bearing their average costs in any economically sustainable insurance market. Insurers would thus be expected to price the coverage for a given transaction based on the company's own analysis of the risk (albeit taking account of the audit lottery). They might also conceivably at some point begin to experience-rate particular taxpayers or the transactions associated with particular promoters.

Even if one is skeptical about allowing penalty insurance, such skepticism cannot reasonably be combined with a view that penalties should be limited to bad faith situations so that those acting in good faith will not face penalty risk. Such a stance would amount to demanding that taxpayers be given for free the same insurance that they are not being allowed to purchase. It should come as no surprise that U.S. tax lawyers actually use the term "penalty insurance" to describe the legal opinions that taxpayers commonly obtain to avoid penalties by showing good faith.<sup>45</sup>

Now consider the question of how many back-flips to add to a transaction, so that the taxpayer has a better chance of showing economic substance in the event of detection. As David Weisbach notes,<sup>46</sup> Richard Craswell and John E. Calfee have analyzed a similar problem in the setting where it is unclear how much care is needed to avoid, say, a negligence penalty under tort law.<sup>47</sup> The big difference is that, in the tort setting, excessive and inadequate care levels lead directly to expected social loss. In the tax

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<sup>45</sup> See *id.* at 346.

<sup>46</sup> See David A. Weisbach, *An Economic Analysis of Anti-Tax Avoidance Doctrines*, 4 *Am. Law & Econ. Rev.* 88, 106 (2002).

<sup>47</sup> Craswell and Calfee, *Deterrence and Uncertain Legal Standards*, 2 *J. Law Econ. & Org.* 279 (1986)

shelter setting, where back-flips represent, not due care but rather a burden on taxpayer electivity, the tradeoff lies between raising and lowering the burden threshold. Wasteful though inducing extra back-flips may be, in some instances it reduces social waste by causing the taxpayer to abandon a contemplated tax planning transaction. Likewise, while reducing the number of back-flips reduces social waste if the taxpayer goes forward anyway, it increases the likelihood that the taxpayer will do so, and thus that there will be some waste. Still, the tradeoff is analogous to that in the Craswell and Calfee model if we posit that the economic substance standard, absent uncertainty, would have set the friction level just right.

Craswell and Calfee show that uncertainty can either raise or lower levels of care. However, “if the uncertainty created by the legal system is distributed normally about the optimal level of compliance, and if the uncertainty is not too large – two seemingly plausible assumptions – then the result under normal damage rules will be too much deterrence [reflecting parties’ risk aversion] rather than too little.”<sup>48</sup> This, in turn, could lead to excessive back-flips, from a social welfare standpoint, if the requirement had otherwise been set at the optimal level. However, when cases such as *Compaq* regularly, if unpredictably, come out for the taxpayer, it seems unlikely the back-flips requirement is currently set too high. If set too low and if the Craswell-Calfee base-case scenario does indeed apply,<sup>49</sup> then the uncertainty may conceivably move the back-flips requirement closer to its optimal level.

#### D. Institutional Issues in Penalty Design

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<sup>48</sup> Id. at 299.

<sup>49</sup> Craswell and Calfee emphasize, however, that “we can say very little about how to tell when those assumptions [i.e., those underlying the base-case scenario] are likely to be satisfied.” Id.

While treating bad faith as a penalty prerequisite is dubious enough in theory, it begins to look even worse when we consider its institutional effects. These relate both to tax practitioners and to IRS audits of major corporations.

1. Tax Practice

As we will see in section IV, the requisite good faith for avoiding penalties may depend in certain settings on whether the taxpayer can demonstrate reliance on a sufficiently sanguine opinion of counsel. Tax lawyers therefore have at least a limited power to grant penalty protection. In effect, they can sell absolution for a fee, at the risk of incurring reputational costs if their analysis is ultimately rejected by a court.

Taxpayers' incentive to pay for penalty protection, and even to shop around for it if necessary, leads to waste – in effect, to extra back-flips. While this reduces the incentive to play the audit lottery, the prospect of paying a penalty notwithstanding good faith would have the same deterrent effect, and would involve transferring resources to the government rather than wasting them.

Comparing this genre of “penalty insurance” to the use of actual insurance does not make the practice look any better. Insurers get a fee for lowering the variance in their customers' expected outcomes, but without reducing expected costs. Moreover, while insurance worsens incentives at the margin by creating moral hazard, insurers have an incentive to monitor and address this problem.

The incentive to shop around for penalty protection does more than waste resources, however. It also undermines the use of tax lawyers to provide objective legal advice. Taxpayers have reason actually to want to know their likelihood of success if

audited. This may be outweighed, however, by the expected cash payoff to having in hand a sufficiently sanguine opinion if one is audited and loses.

Tax practitioners are often quite unenthusiastic about offering “penalty insurance” opinions, which expose them to reputational risk, but may face strong internal pressures to issue the opinions. The underlying dynamic reflects the economics of big-firm tax practice. Tax departments in major law firms typically have very low “leverage” (i.e., ratio of associates to partners), reflecting the need for a high level of expertise in tax practice. Since leverage is crucial to per-partner profitability, tax lawyers cannot easily “pull their weight” in large firms through their billings alone, even if they charge high hourly rates and are constantly in demand. They need, therefore, to show their value as facilitators for the transactions being handled by other departments. Withhold a penalty shield opinion and the client may take its business elsewhere, to another firm that is just as capable of doing the lucrative transactional work and has tax partners who are not quite so cautious or scrupulous. The end result may be to undermine scrupulous tax lawyers’ internal standing in their firms, which can affect not just their compensation but their prestige and influence. Accordingly, when a big-firm tax lawyer declines to write a sufficiently sanguine opinion, the consequences may go beyond simply losing the fee that would have been paid for that opinion.

As we will see in section IV, the tax rules for penalty shield opinions address this problem in certain settings, through rules that deny penalty protection to opinions provided by a firm that is too heavily involved in the underlying transaction.<sup>50</sup> The client may therefore have no choice but to shop around for a favorable opinion elsewhere. This creates problems of its own, so far as the opinion’s likely credibility is concerned, for the

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<sup>50</sup> See Code section 6664(d)(3)(B).

same reason that expert witnesses at a trial are commonly disparaged as “guns for hire.” In addition, if the opinion-writer is acting in good faith, he or she may face an irremediable informational disadvantage relative to that of the disqualified advisors, who likely would have had better access to the actual facts and understandings. The lawyers implementing a transaction are likely to respond both more fully and more candidly when the request for background information about it comes from in-house.

A final problem with allowing tax opinions to function as penalty shields goes to the regulatory blowback. As noted in section I, much of the regulatory apparatus that recently has been directed by the IRS at tax lawyers, such as the disclaimers required under Circular 230, responds to the tax law’s having unwisely granted the power of absolution. Some of these rigors could possibly be eased, with no harm to anyone, if good faith were no longer relevant to the imposition of regular civil penalties.

## 2. IRS Audits

A second institutional factor that worsens the impact of a bad-faith standard for penalties concerns IRS auditors. Major U.S. companies are typically audited all the time, with respect to all taxable years although, inevitably, not all potentially controversial issues. IRS auditors have long-term assignments to particular companies, permitting the auditors to develop particularized expertise. In these assignments, the auditors develop long-term relationships with taxpayer personnel who are assigned to the audit process. Inevitably, these relationships work better for everyone if they mix the cooperative with the purely adversarial, and involve tit-for-tat elements with regard to the ratio between these two approaches. Counter-parties therefore become in a sense a constituency to one whom seeks to demonstrate good faith even amidst the expectation of bargaining conflict.

In this setting, I am told, IRS auditors often are reluctant to assert penalties that depend on asserting bad faith. The problem is not the financial consequences of a penalty; taxpayers understand and expect that the auditors will seek more money for the government where they have a plausible legal basis for doing so. Rather, the problem lies in the need to assert bad faith and thereby effectively declare war. Accordingly, auditors are unduly inhibited from seeking penalties by the associated declarative element of needing to impugn the taxpayer's integrity.

E. If Not Bad Faith, Then What?

If taxpayers are strictly liable for taking what prove to be erroneous positions on their returns, a question arises whether absolutely all positive adjustments to tax liability should be penalized. That is one possibility, given the potential audit lottery aspects of any position on the return, but it is subject to a couple of caveats. First, where a tax return position is certain to be seriously scrutinized, the audit lottery justifications for a penalty cease to apply. Merely reporting something, however, does not necessarily mean that it is guaranteed to get a hard look, especially if a lot of things are reported, if auditing resources are limited, and if the reporting is not sufficiently informative about why the auditor might want to pay close attention. Second, the asymmetry of charging an understatement penalty, without offering rewards for over-reporting tax liability, can be thought of as an information-forcing device. It helps the government to identify areas that merit a close look. However, over-use of this technique may tend to blunt its impact. One would not learn much of anything, for example, if taxpayers had to wait until audit before claiming run-of-the-mill business deductions. Thus, some limitation on penalties for understatement may be desirable, even without any reliance on good faith.

Many different approaches are possible. Among the possible filters, some of which the U.S. income tax law currently uses, are (1) the adequacy of taxpayer disclosure, whether affirmatively required or not, (2) the magnitude of the taxpayer's understatement of liability, absolutely or as a percentage of liability, and (3) whether the transaction, even if potentially legally defensible, has a significant tax avoidance aspect.

### III. TAX SHELTER DISCLOSURE RULES

#### A. Transactions Subject to Disclosure

Under Code section 6011, the IRS has broad authority to set reporting requirements for taxpayers, ranging from basic tax return filing to disclosure for suspected tax shelters. For corporate taxpayers that engage in possibly questionable transactions, the most important disclosure requirement may be that relating to the differences between reported taxable and financial accounting income. Since 2004, companies with at least \$10 million in assets have been required to file Schedule M-3, reconciling the two measures in much greater detail than was previously necessary.<sup>51</sup> What makes the information on Schedule M-3 so useful is the evident importance to officials in publicly traded companies of combining high book income with low taxable income. Differences between the two therefore provide a vital roadmap to the potentially most questionable parts of the tax return.

Otherwise, the IRS has exercised its authority under Code section 6011 to establish six categories of reportable transactions.<sup>52</sup> The categories, along with a brief assessment of each, are as follows:

1) Listed transactions – This category covers any transaction that is the same as or substantially similar to any type of transaction that the IRS has identified in any published guidance as a tax avoidance transaction.<sup>53</sup> If a given transaction becomes a listed transaction after the filing of the tax return for the year in which it occurred, but before the statute of limitations has become applicable to that year, the taxpayer must

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<sup>51</sup> See Rev. Proc. 2004-45, 2004-2 C.B. 140.

<sup>52</sup> The categories were most recently modified on November 2, 2006, when the IRS issued new proposed regulations reflecting recent statutory changes.

<sup>53</sup> Prop. Regs. § 1.6011-4(b)(2).

attach a disclosure statement to the next tax return that it files.<sup>54</sup> Thus, taxpayers must continue to monitor IRS listings of tax avoidance transactions as to all open years, in addition to making judgments about whether a given transaction with unique features is “substantially similar” to any that have been listed.

One could certainly criticize the ongoing burden that this rule places on taxpayers, especially given the strict liability penalties, discussed below, for noncompliance. I would argue, however, that such criticism is misguided, for the following reasons:

--Whether or not the IRS is correct that every listed transaction it identifies (including all “substantially similar” versions) is impermissible under present law (i.e., would lose in court if litigated), it would have to be radically and surprisingly wrong if it did not consistently succeed in identifying transactions that have at least some significant chance of losing on economic substance, business purpose, or similar grounds. As discussed above, burdening such transactions may have desirable incentive effects even if we recognize that some of them will be upheld.

--Listed transactions are likely to have the highest payoff in terms of actual close scrutiny. IRS auditors with limited time and resources will not necessarily pay close attention to every single disclosure statement that they receive. However, when they are informed that a given transaction is one that the IRS has listed as a tax avoidance transaction, one would expect close scrutiny to follow as a matter of course.

--The IRS inevitably lags behind the tax bar in learning what new types of transactions are being used to promote aggressive tax planning. It cannot always reasonably be expected to respond within the same year that a new transaction emerges or first becomes popular. Effectively grandfathering transactions, so far as disclosure is

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<sup>54</sup> Prop. Regs. § 1.6011-4(e)(2)(i).

concerned, if they were completed before the year in which the IRS first listed them creates incentives to keep on developing new aggressive transactions that can be adopted widely before the IRS catches on.

In practice, the big problem posed for taxpayers by the listed transactions rule is that of how broadly to interpret the concept of substantial similarity. For example, even clearly permissible transactions may exploit the same gaps, anomalies, and inconsistencies in the tax law as listed transactions, even allowing for big differences in economic substance and business purpose. The safest way to respond to the uncertainty, if one wants to minimize the risk of penalties, is to lean decidedly in the direction of over-disclosure. Here the problem for the IRS is that disclosing everything may effectively become equivalent to disclosing nothing. Indeed, taxpayers have little downside (the costs of the extra paperwork aside) to engaging in strategic over-disclosure, motivated not just by over-scrupulousness but by the aim of burying the really important disclosures in a blizzard of irrelevant filings. The seemingly logical government response of penalizing over-disclosure (thus creating symmetry between it and under-disclosure) is unlikely to be adopted, and might in any event prove too much of a distracting and costly detour from litigating issues of substance.

Over-disclosure not only impedes the ability of the IRS to identify the most pertinent items, but also may dilute the effect of the disclosure rules in burdening legally questionable transactions relative to those that are certain to be upheld. So far as transaction choice is concerned, burdening all of the taxpayer's options may be no better than burdening none of them, potentially converting the extra back-flips into pure waste.

2) Confidential transactions – Disclosure is required for transactions that were offered to the taxpayer under conditions of confidentiality and for which the taxpayer paid a minimum fee (\$250,000 if the taxpayer is a corporation).<sup>55</sup> Conditions of confidentiality exist where “the advisor who is paid the minimum fee places a limitation on disclosure by the taxpayer of the tax treatment of the transaction and the limitation on disclosure protects the confidentiality of that advisor’s tax strategies.”<sup>56</sup> Such conditions may exist even if the limitation is not legally binding,<sup>57</sup> a detail that rightly recognizes the importance of expectations and informal norms when the parties have ongoing interactions and broader business reputations to worry about.

This disclosure requirement has two separate virtues. First, it may serve as a useful filter for identifying suspect transactions, since those with confidentiality requirements may be unusually likely to involve aggressive tax planning that the IRS would want to review. Second, taxpayers have an incentive to over-invest, from a social standpoint, in lawful as well as unlawful tax planning.<sup>58</sup> Impeding the functioning of the tax planning market by making it harder for innovators to protect their intellectual property may therefore have social benefits by reducing investment in this realm of activity. This, of course, is simply an inverted form of the argument for patent protection and protection of trade secrets, based on viewing the affected innovations as socially costly rather than beneficial.

3) Transactions with contractual protection – This category covers transactions in which the fees paid by the taxpayer are contingent (including through a right to total or

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<sup>55</sup> Prop. Regs. § 1.6011-4(b)(3).

<sup>56</sup> Prop. Regs. § 1.6011-4(b)(3)(ii).

<sup>57</sup> Id.

<sup>58</sup> See, e.g., David A. Weisbach, Ten Truths About Tax Shelters, 55 Tax L. Rev. 215, 222 (2002).

partial refund) on whether all of the intended tax consequences are sustained.<sup>59</sup> Once again, such protection is likely to be a good filter for transactions that the IRS either might want to audit in a given case or to consider identifying as a newly listed transaction. After all, absent significant legal uncertainty, taxpayers have less reason to value this type of coverage, which effectively constitutes insurance, albeit offered by an advisor relying on its knowledge about the transaction and its own good judgment, rather than by an insurance company relying on the law of large numbers.<sup>60</sup> Taxpayers that forego contractual protection so that they will not have to disclose the transaction in effect face an extra back-flip if they are risk-averse and do not simply go to an insurance company for the same protection.

4) Loss transactions – Disclosure is required for transactions that result in losses by a corporate taxpayer of at least \$10 million in any single taxable year or \$20 million in any combination of taxable years.<sup>61</sup> Again, the rationale is that transactions producing such large losses are likely to be ones that the IRS has reason to want to know about, either for purposes of a given audit or more generally.

5) Transactions of interest – This category is a new one, having been added on November 2, 2006, when the Treasury issued proposed regulations modifying the previously existing regulations. Like listed transactions, transactions of interest are those

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<sup>59</sup> Prop. Regs. § 1.6011-4(b)(4)(i).

<sup>60</sup> Contractual protection might not denote likely aggressiveness in cases where it serves to ensure that the counterparty will not create a “foot-fault” by botching compliance with detailed technical preconditions for the receipt of a tax benefit.

<sup>61</sup> Prop. Regs. § 1.6011-4(b)(5). The relevant losses are those that allowable under Code section 165, concerning losses sustained during a given taxable year, as distinct from Code section 162, concerning ordinary and necessary business expenses. The relevant losses are measured without regard to offsetting gains and without regard to whether they are currently allowable to the taxpayer. See Regs. § 1.6911-4(b)(5)(iii).

specifically identified as such by the IRS, along with substantially similar transactions.<sup>62</sup> However, the IRS does not purport to be certain of the abusive character of transactions of interest. The preamble that accompanied publication of the new proposed regulations describes a transaction of interest as one “that the IRS and Treasury Department believe has a potential for tax avoidance or evasion, but for which the IRS and Treasury Department lack enough information to determine” whether it in fact involves either of these ills. Once such information is available, a given transaction may either become a full-fledged listed transaction or else simply be removed from the transactions of interest list and thus made non-reportable.<sup>63</sup> While holding this intermediate status, transactions of interest do not trigger the further adverse consequences that, as we will see below, attach to listed transactions. They do, however, similarly require updating of one’s disclosures for prior taxable years that remain open, when new items are added to the list.<sup>64</sup>

For two reasons, this new category may prove important and valuable notwithstanding the usual twin dangers of over-disclosure and under-disclosure. First, it offers the IRS information that, even if not used extensively in particular audits, may help it in formulating broader regulatory responses to new transactions. Second, as with listed transactions, the prospect that a deal not currently required to be disclosed may subsequently become so may serve as a socially valuable deterrent when taxpayers are contemplating in questionable newly designed transactions.

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<sup>62</sup> Prop. Regs. § 1.6011-4(b)(6). This category replaces that of transactions with a significant book-tax difference, eliminated in the proposed regulations by reason of the overlap with reporting on Schedule M-3.

<sup>63</sup> See Treasury Department, AJCA Modifications to the Section 6011 Regulations, 71 Fed. Reg. 64488 (11/2/06).

<sup>64</sup> Prop. Regs. § 1.6011-4(e)(2)(i).

6) Transactions involving a brief asset holding period – Disclosure is required for transactions in which the taxpayer claimed a tax credit (other than a foreign tax credit) exceeding \$250,000 with respect to an asset that the taxpayer held for 45 days or less.<sup>65</sup> This requirement is a natural complement to that concerning loss transactions, since credits and losses are the two main routes to sheltering the tax that otherwise would be due on other income and gains.

B. Possible Additions to the List of Reportable Transactions

While this is not the place for a detailed inquiry into how the disclosure requirements in the U.S. rules could be expanded, several main possibilities come to mind. In particular:

--Disclosure could be required for transactions as to which the taxpayer has third-party insurance coverage. The original proposed regulations concerning tax shelter disclosure applied to such transactions, covering insured transactions under the same rubric as that for contingent fee arrangements,<sup>66</sup> but the insurance industry persuaded the IRS to retreat on the grounds that there is insufficient reason to infer abuse from the purchase of insurance.<sup>67</sup> While the merits here can reasonably be debated,<sup>68</sup> a back-flip view of burdening under-audited transactions that have uncertain tax consequences might support the earlier IRS position.

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<sup>65</sup> Prop. Regs. § 1.6011-4(b)(7). Until their modification on November 2, 2006, this disclosure requirement applied to foreign tax credits as well as other tax credits, and thus to transactions such as that in *Compaq*. Foreign tax credit transactions were removed from the list by reason of the amendment of the foreign tax credit rules to require a 15-day holding period. See Code section 901(k) and (l); Treasury Department, AJCA Modifications to the Section 6011 Regulations, 71 Fed. Reg. 64488 (11/2/06).

<sup>66</sup> See Regs. § 1.6011-4T(b)(4).

<sup>67</sup> See Logue, *supra*, at 404. In proposed regulations issued on November 2, 2006, the IRS provided that the provision of “tax result protection that insures some or all of the tax benefits of a reportable transaction” may cause one to be subject to the material advisor disclosure rules, described below. Prop. Regs. § 301.6111-3(b)(2)(ii)(A).

<sup>68</sup> See Logue, *supra*, at 404-405.

--Tax shelter transactions often involve tax-indifferent counterparties, who are useful for absorbing taxable income that may accompany the taxpayer's reporting of a loss. At least in cases where the taxpayer could reasonably be expected to know that the counterparty is tax-indifferent (e.g., because it is a tax-exempt organization or a foreign taxpayer, or because the transaction structure required finding such a counterparty), arguably a reporting requirement would be useful. Given the variety of transactions in which tax-exempt parties participate, however, some further filtering devices might be needed here to avoid self-defeating over-breadth.

--Disclosure could be required for tax planning strategies that have patent protection, whether or not they are covered by the disclosure rule pertaining to confidential transactions.<sup>69</sup> While patents are public documents, the IRS may have difficulty finding important planning information that they contain without the aid of taxpayer disclosure.

### C. Penalties for Failure to Meet Disclosure Requirements

In 2004, Congress enacted Code section 6707A, imposing penalties on taxpayers that fail to disclose reportable transactions. For corporations, the penalty is \$200,000 per listed transaction, and otherwise \$50,000 per reportable transaction.<sup>70</sup> Other than with respect to listed transactions, the IRS can elect to rescind a given penalty if doing so would "promote compliance ... and effective tax administration."<sup>71</sup> Such rescission would then be reportable to Congress,<sup>72</sup> likely deterring IRS exercise of its rescission

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<sup>69</sup> The confidential transactions rule applies if the advisor "places a limitation on disclosure by the taxpayer." Regs. § 1.6011-4(b)(3)(ii). In the case of patent protection, arguably the taxpayer is merely subject to the same legal limitation as all other parties, rather than being specifically placed under such a limitation by the advisor.

<sup>70</sup> Code section 6707A(b).

<sup>71</sup> Code section 6707A(d).

<sup>72</sup> See H.R. Rep. No. 755, 108<sup>th</sup> Cong., 2<sup>nd</sup> Sess. 599 (2004).

authority.<sup>73</sup> The penalty gives especial teeth to the requirement that listed transactions and transactions of interest, along with their “substantially similar” variants, be disclosed even if they only obtained this status in a subsequent taxable year. If one regards the disclosure rules as important and beneficial, it is difficult to argue with penalizing noncompliance.

D. Disclosure Requirements Pertaining to Material Advisors

Under Code section 6111, each material advisor with respect to any reportable transaction must file an information return with the IRS that provides information identifying and describing both the transaction and its expected tax benefits. For purposes of this rule, a material advisor is any person who both (a) provides “any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction,”<sup>74</sup> and (b) receives a fee of at least \$250,000 in the case of a corporate taxpayer,<sup>75</sup> an amount that is reduced to \$50,000 for listed transactions.<sup>76</sup> Material advisors also are required to retain investor lists with respect to reportable transactions that are open to inspection by the IRS.<sup>77</sup> Failure to supply required customer lists within 20 business days of an IRS request for them leads to penalties of \$20,000 per day unless excused by the IRS on grounds of reasonable cause.<sup>78</sup>

These rules are potentially burdensome on tax advisors, and some have questioned the extent to which the IRS actually makes commensurate use of the

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<sup>73</sup> See Susan T. Edlavitch and Brian S. Masterson, Practical Guide for Compliance with Circular 230 and the Reportable Transaction Disclosure Framework Post-AJCA, 46 Tax Management Memorandum No. 9 (2005).

<sup>74</sup> Code section 6111(b)(1)(A)(i).

<sup>75</sup> Code section 6111(b)(1)(B)(ii).

<sup>76</sup> See IRS Notice 2004-80, 2004-50 I.R.B. 963.

<sup>77</sup> Code section 6112.

<sup>78</sup> Code section 6708.

potentially voluminous information thus reported to it or required to be retained for possible inspection. The rules' main virtue may relate to taxpayers who are considering whether to comply (or how hard to try to comply) with their own reporting requirements. One is less likely to get away with non-disclosure if reporting or record retention by one's advisors increases the chance of IRS detection. The value of the rules therefore depends not only on how much direct use the IRS makes of the information retained by tax advisors, but also on the effects on taxpayer disclosure. One also can make "back-flip" arguments in favor of the requirement if, as one would expect, material advisors effectively pass on these costs to taxpayers engaging in transactions that have uncertain legal merits.

#### IV. ACCURACY-RELATED PENALTIES

Even with disclosure that will not always result in a searching inquiry, government tax authorities need significant penalties in order to address taxpayer incentives to play the audit lottery with respect to legally uncertain transactions. I argued in section II that the penalties should apply even in cases where the taxpayer reasonably believed that there was a significant chance that a transaction would be upheld, and all the more so if the inquiry into such reasonable belief simply means that one has to shop around for a sufficiently sanguine tax opinion.

The U.S. rules at one time very clearly placed strong reliance on ostensible good faith. The extent to which they continue to do so today is unclear, due to ambiguities in recently enacted rules. These ambiguities relate in particular to the phrase “a significant purpose of tax avoidance or evasion,” which the rules crucially rely on at several different points. This phrase plays a crucial role to both of the main statutory provisions imposing statutory-related penalties, Code sections 6662 and 6662A, which I discuss next.

##### A. Code Section 6662A Accuracy-Related Penalty With Respect to Reportable Transactions

Under Code section 6662A, “reportable transaction understatements” trigger a 20 percent penalty, raised to 30 percent if applicable disclosure requirements were not met.<sup>79</sup> For purposes of this rule, all understatements relating to listed transactions are treated as reportable transaction understatements.<sup>80</sup> However, for all other reportable transactions,

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<sup>79</sup> Code section 6662A(a) and (c).

<sup>80</sup> Code section 6662A(b)(2)(A).

the penalty under Code section 6662A does not apply unless “a significant purpose of such transaction is the avoidance or evasion of Federal income tax.”<sup>81</sup>

This may initially sound like a good-faith-based prerequisite for application of the penalty. One should keep in mind, however, that it does not necessarily have anything to do with the likelihood that the transaction will be upheld, either by some putatively objective measure or in the belief of the taxpayer. Avoidance or evasion need only be a significant purpose, not the exclusive or even primary purpose served by a transaction. Innumerable clearly permissible transactions may involve a significant purpose of legal tax avoidance. An example might be engaging in a tax-free corporate reorganization.

Importantly, while “evasion” seems to require violating the law, “avoidance” can in common usage mean as little as legally reducing one’s tax liability through an expressly permitted planning move (e.g., paying workers tax-free fringe benefits in lieu of cash salary). Commentators on the U.S. rules have therefore speculated that a significant purpose of avoidance might exist whenever taxpayers seek to avoid the most highly-taxed route to a given business objective, and indeed whenever they seek tax advice at the transactional planning stage.<sup>82</sup> Under this view, the requirement might always be met unless the tax consequences at issue were bordering on trivial.

While logically defensible, this interpretation of the “significant purpose” requirement is far from being clearly correct. If intended, it might more straightforwardly have been implemented by having the requirement refer simply to significant tax consequences. “Tax avoidance” is not an entirely neutral-sounding way of

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<sup>81</sup> Code section 6662A(b)(2)(B).

<sup>82</sup> See, e.g., Nathan Glessleman, A Significant Problem Defining a “Significant Purpose” and the Significant Difficulties That Result, 111 Tax Notes 1119 (2006).

referring to a goal of paying less rather than more tax. Pairing it with the word “evasion” arguably strengthens the inference that it is meant to sound condemnatory.

The IRS and Treasury Department have not as yet directly addressed the proper interpretation of the significant purpose requirement. It seems clear, however, that they do not in fact regard it as coextensive with the existence of significant tax stakes. Thus, recall the statement in the preamble to the recently issued proposed regulations that transactions of interest have a “potential for tax avoidance or evasion” but are not yet clearly identifiable by the government as tax avoidance transactions. This professed lack of full information seems more likely to denote uncertainty about the legal merits of the taxpayer’s position than about whether significant tax dollars are involved.

Under the view of penalties that I have advanced in this paper, the rule would be a better one if “a significant purpose” were interpreted to require nothing more than significant tax stakes. However, such a reading is clearly somewhat tone-deaf from the standpoint of statutory interpretation, and does not seem to be what the IRS has in mind. Pending more definite guidance, however, some taxpayers may treat it as a mandate to disclose just about everything, whether out of an abundance of caution or affirmatively to hamper IRS review of the really pertinent disclosures.

B. Code Section 6662 Accuracy-Related Penalty on Underpayments

For tax underpayments not involving “reportable transaction understatements” to which Code section 6662A applies, the operative accuracy-related penalty provision is Code section 6662. This provision likewise attaches a 20 percent penalty, triggered by negligence or disregard of rules or regulations and also by “[a]ny substantial

understatement of income tax.”<sup>83</sup> Negligence and disregard raise state of mind issues, although to some extent the existence of contrary authority might be discerned objectively. The question of whether “substantial understatement” turns on state of mind issues is subject to the same interpretive uncertainties as those described above.

“Substantial understatements” that trigger the penalty are subject to a quantitative threshold. For corporate taxpayers, the penalty does not apply unless the amount of the understatement for the taxable year either (i) exceeds \$10 million, or (ii) is more than 10 percent of the amount the taxpayer was supposed to pay and also is more than \$10,000.<sup>84</sup> In determining the amount of the relevant underpayment, however, the effect of transactions subject to the Code section 6662A penalty is ignored, to prevent overlap. Also ignored are underpayments that result from what I will call “substantial authority items” and “adequate disclosure items.”<sup>85</sup> Each of these two items requires further elucidation.

Substantial authority items – These are items as to which the taxpayer had “substantial authority” for the position it took.<sup>86</sup> While this seems to put us back in the realm of using a tax opinion to show good faith, and indeed of not even requiring anything close to a “more likely than not” opinion, the exception’s reach is modified by a rule treating it as inapplicable to “any item attributable to a tax shelter.”<sup>87</sup> A “tax shelter,” in turn, is defined as any plan or arrangement that had as a “significant purpose

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<sup>83</sup> Code section 6662(b)(1) and (2). Penalties under Code section 6662 also apply to substantial valuation misstatements, substantial overstatements of pension liabilities, and substantial estate and gift tax valuation understatements. Code section 6662(b)(3) through (5).

<sup>84</sup> Code section 6662(d)(1)(B).

<sup>85</sup> Code section 6662(d)(2)(B).

<sup>86</sup> Code section 6662(d)(2)(B)(i).

<sup>87</sup> Code section 6662(d)(2)(C)(i). Any such reliance on a legal opinion would, however, be further limited by rules in Circular 230 that are outside the scope of this paper.

... the avoidance or evasion of federal income tax.”<sup>88</sup> Once again, good faith is irrelevant if we interpret this as simply requiring significant tax stakes, but that interpretation arguably is hard to square with the tenor of the language – and of using the term “tax shelter” – which arguably imply that something at least borderline improper is going on.

Adequate disclosure items – These are items as to which the relevant facts affecting their proper tax treatment were adequately disclosed, and as to which there was a reasonable basis for the taxpayer’s position.<sup>89</sup> Once again, however, the exception does not apply to a “tax shelter,” defined in terms of a significant purpose of tax avoidance or evasion.<sup>90</sup>

Accordingly, for Code section 6662, as for Code section 6662A, the standard for imposing a penalty approaches strict liability if one interprets the “significant purpose” requirement as mandating little more than that there actually were significant tax stakes. This might be discerned by comparing the actual reported tax treatment to the least favorable one that had any possibility of applying either to the actual transaction or to an alternative transaction that could have been engaged in to serve the same substantive business ends. Such a reading, while in my view the best one from the standpoint of giving desirable incentive effects to the penalty rules, is considerably more open to criticism from the standpoint of proper statutory interpretation. I would therefore advise tax policymakers from other countries, if examining and considering generally adopting something like the U.S. rules, to avoid using limiting phrases that go beyond requiring significant tax stakes.

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<sup>88</sup> Code section 6662(d)(2)(C)(ii).

<sup>89</sup> Code section 6662(d)(2)(B)(ii). For corporate taxpayers engaged in multiple-party financing transactions, there is an additional requirement that the tax treatment clearly reflect the income of the corporation. *Id.*

<sup>90</sup> Code section 6662(d)(2)(C)(ii).

C. Remaining Role of “Penalty Shield” Opinions

Under Code section 6662, “penalty shield” opinions retain an important role if (as seems highly likely) the “significant purpose” language does not effectively create strict liability whenever there are significant tax stakes. In particular, a tax opinion may help provide the basis for a claim of substantial authority, and may directly establish that a relying taxpayer had a reasonable basis for its position with respect to an adequate disclosure item. Such an opinion is not given this effect, however, if it comes from a “disqualified tax advisor,” defined as any of the following:<sup>91</sup>

1) A material advisor who participates in the organization, management, promotion, or sale of the transaction or is related to one who so participates. A material advisor does not become a disqualified participant merely by reason of rendering an opinion regarding the tax consequences of the transaction. However, if this involves suggesting modifications to the transaction that are “material” and that “assist the taxpayer in obtaining the anticipated tax benefits,” the advisor is disqualified.<sup>92</sup>

Given this rule, tax lawyers for the law firm that is implementing a given transaction are highly unlikely to be able to issue an effective penalty shield opinion. As discussed previously, while this mitigates the conflict of interest problem that such a tax lawyer would otherwise face, it also is likely to diminish the quality of the information that is available to the opinion writer.

2) Anyone who is compensated directly or indirectly by a material advisor with respect to the transaction,

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<sup>91</sup> Code section 6664(d)(3)(B).

<sup>92</sup> IRS Notice 2005-12, 2005-1 C.B. 494.

3) Anyone who has a contingent fee arrangement that depends on the transaction's intended tax benefits being sustained,

4) Anyone who has a "disqualifying financial interest" with respect to the transaction, such as an agreement or understanding, whether oral or written, that the advisor is expected to render a favorable opinion with respect to a reportable transaction.<sup>93</sup> This rule presumably does not bar sufficiently careful taxpayers from delicately probing a potential opinion writer's view of a given transaction before deciding whether to request an opinion.

Even when not written by disqualified tax advisors, opinions fail to offer penalty shield protection if they are based on unreasonable factual or legal assumptions, unreasonably rely on the taxpayer's representations, or do not identify and consider all relevant facts.<sup>94</sup> This recently enacted requirement potentially makes getting a penalty shield opinion much less of a pro forma exercise than taxpayers, in some cases, had previously assumed. It thus adds to the back-flip character of the rules in addition to pushing penalty shield opinions to be more credible.

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<sup>93</sup> See *id.*

<sup>94</sup> Code section 6664(d)(3)(ii).

## V. CONCLUSION

In controlling tax shelters, once the substantive rules for identifying permissible transactions are in place, much depends on the effectiveness of disclosure and penalty rules. Well-targeted disclosure rules are vital to avoiding too low a probability of detection. Penalties are needed to ensure that taxpayers have appropriate incentives given the inevitability of legal uncertainty and of the audit lottery in terms of issues that get thorough review (even with extensive disclosure).

Taxpayers sometimes complain about the burden from disclosure requirements, and about being penalized for taking in good faith positions that were determined *ex post* to be incorrect. As for disclosure burdens, while increasing them may be socially wasteful if transaction choice remains the same, the “back-flips” character of economic substance rules suggests a possibility of decreasing overall waste if transactions of uncertain legal merit are discouraged relative to those that are clearly permissible. No-fault penalties should not even be controversial once we understand that taxpayers can hardly be expected to refrain from responding strategically to legal uncertainty. We need not condemn such taxpayers or such responses in order to be concerned about the incentive effects of legal uncertainty when audit review is potentially so incomplete. Insurance can be permitted if we are concerned about imposing downside risk on parties that believe their tax return positions have a decent chance of being correct.

The U.S. disclosure rules’ main problem lies in the inherent difficulty of addressing the twin perils of under-disclosure and over-disclosure with respect to transactions that might or might not be deemed “substantially similar” to listed transactions and transactions of interest. Under-disclosure occurs if taxpayers can dodge

reporting requirements by relying on relatively trivial variations between transactions. Over-disclosure occurs if so much is being reported to the IRS that it cannot use the reports to focus its audit efforts effectively, and if the back-flips effect of requiring disclosure is being overly diluted by its extension to transactions that approach legal certainty of correctness. Reporting about book-tax differences under Schedule M-3 does not suffer from this conundrum, making it inherently a more powerful tool even if we are confident that the disclosure rules provide some added value.

The main problem with the U.S. rules concerning accuracy-related penalties is that they continue to rely unduly on fault, all too often meaning in practice that one need only shop around for a penalty shield opinion in order to be assured of a positive expected return when one plays the audit lottery. The demand for penalty shield opinions interferes with the market for providing sound legal advice, and has led the IRS to impose burdensome rules on U.S. tax lawyers (such as Circular 230) that might not otherwise be necessary. The disqualified tax advisor rules, while salutary insofar as they address the conflict of interest problem faced by the tax lawyers in a firm that is doing the transaction work on a given deal, may tend to make the opinions obtained less well-informed and thus less credible. The weakness of the normative case for penalty shield protection suggests that other countries should consider applying strict liability for ex post legal error, without regard to the objectively or subjectively determined reasonableness of the taxpayer's position, if they otherwise follow the general outlines of the substantial understatement penalty in U.S. tax law.