

Playing the Audit Lottery: The Role of Penalties in the US Tax Law in the Aftermath of *Long Term Capital Holdingv. United States*

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*"If you want to know the law and nothing else, you must look at it as a bad man."*¹

Justice Oliver Wendell Holmes, Jr. (January 8, 1897)

*"[N]obody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions."*²

Justice Learned Hand, C. J (February 20, 1947)

I. Introduction

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¹ Oliver Wendell Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 459 (1897).

² *Commissioner v. Newman*, 159 F.2d 848, 851 (1947).

Tax motivated transactions have become a serious consideration for Congress in recent years. The concerns include the extent of loss of tax revenues, harm to the integrity of the tax system, and equity.³ The equity concern may be described as follows: hard-working taxpayers, who pay their fair share of taxes, should not be disadvantaged compared to more sophisticated taxpayers who are able to create tax shelters for themselves.⁴ As Commissioner Everson stated more than two years ago: ". . . (T)he IRS is committed to ensuring everyone pays his or her fair share, including those who have the resources to move money offshore or engage in abusive schemes or shelters. We must focus our efforts on achieving greater corporate accountability and ensure that high-end taxpayers fulfill their responsibilities. Honest taxpayers should not bear the burden of others who skirt their responsibility." (May 20, 2003)⁵

Although these concerns are understandable, Judge Learned Hand stated many years ago that: "[A]nyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's tax."⁶ Accordingly, a transaction should not be treated as a tax shelter

³ See in general, Joint Committee on Taxation, *Study of Present Law Penalty and Interest Provisions, as Required by Section 3801 of the Internal Service Restructuring and Reform Act of 1998* (JCS-3-99), Released on July 22, 1999. (hereinafter "Joint Committee Report"); U.S. Dep't of the Treasury, *The Problem of Corporate Tax shelters: Discussion Analysis, and Legislative Problems* (1999) (hereinafter "Treasury Report"); Urban Institute Testimony on Tax Fraud, Evasion, 2003 TNT 133-26 (July 9, 2003).

⁴ *Id.* See also Michael Powlen and Raj Tanden, *Corporate Tax Shelters or Plus Ca Change, Plus C'est La Meme Chose*, 431 PLI/TAX 1003 (1998); Amy Hamilton, *Administration Officials Play Good Cop, Bad Cop on Tax Shelters*, 82 TAX NOTES, 1907 (1999).

⁵ Cited in Urban Institute Testimony on Tax Fraud, Evasion, 2003 TNT 133-26 (July 9, 2003)

⁶ Justice Learned Hand stated in the lower court's opinion in *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935). As Judge Learned Hand also observed in *Chisholm v. Commissioner*, 79 F.2d 14, 15 (2d Cir. 1935), revg. 29 B. T. A. 1334 (1934):

[A] man's motive to avoid taxation will not establish his liability if the transaction does not do so without it. It is true that * * * [the Supreme Court] has at times shown itself indisposed to assist such efforts, and has spoken of them disparagingly; but it has never, so far as we can find, made that purpose the basis of liability; and it has often said that it could not be such. The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is

as long as the tax authorities do not specifically prohibit it. It is necessary, as this article will argue, to balance between the taxpayer's right to plan its moves within the tax law and the tax authorities' right to prohibit such transactions.

To date, most legislative attacks on corporate tax shelters have targeted specific transactions and have taken place on an "ad-hoc," after-the-fact basis through legislation, administrative guidelines, and litigation.⁷ Since the first comprehensive action against corporate tax shelters was taken in the Tax Reform Act of 1976, various measures have been introduced by Congress in attempts to crack down tax motivated transactions. In recent years, legislation has become more comprehensive, the important elements of which include enhancement of new penalties, stronger disclosure requirements, and changes in substantive law.⁸ It would seem that these recent attempts to introduce more comprehensive legislation signal legislative dissatisfaction with the existing piecemeal rules.

Accuracy-related penalties have played a key role in those attempts to crack down tax-motivated transactions. This article examines the effectiveness of such penalties on a corporate taxpayer's cost-benefit equation (in deciding whether to consummate a transaction), assuming the taxpayer is a "bad man" (or a "bad corporation"). Pursuant to the "bad man" theory established by Justice Holmes more than a hundred years ago, a rational person decides whether or not to comply with the law by calculating his or her own benefits

different from its appearance. True, it is always the intent that controls; and we need not for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not the whole, transaction would realize. * * * [Citations omitted; emphasis added.]

⁷ The latest and greatest was H.R. 4520, American Jobs Creation Act of 2004, P.L. 108-357 (2004).

⁸ *Id.*

and costs, including the risk of punishment.⁹ The rational person breaks the law whenever his or her potential gain from disobeying the law exceeds his or her risk of punishment.¹⁰

The same equation applies to obeying tax law; a taxpayer chooses a level of compliance by weighing the costs and benefits of compliance with those of noncompliance and then selecting that level of compliance that will lead to the highest expected level of net benefits.

¹¹ The probability of detection and audit combined with the magnitude of the penalties are the major expected costs of underpayment of taxes.¹² Accordingly, the cost-benefit behavior is equivalent to gambling, and is frequently referred to as “playing the audit lottery.”¹³ Penalties are, therefore, an additional “price” on engaging in an activity that might be viewed as tax-motivated; in the absence of penalty, corporations would always play the lottery.¹⁴

The “bad man” theory can explain tax motivated transactions of business entities and individuals; however, with respect to the latter, non-economic consideration may also be involved, while in the case of corporations, the decision whether to enter into a tax-motivated transaction will depend solely on quantitative factors. This article focuses on business entities

⁹ Oliver Wendell Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 459 (1897).

¹⁰ *Id.*

¹¹ Eric A. Posner, *Symposium: The Legal Construction Of Norms: Law And Social Norms: The Case Of Tax Compliance*, 86 Va. L. Rev. 1781, 1783 (2000) (“A simple approach to the problem of tax compliance holds that when people decide whether to pay their taxes, they take account only of the cost of the tax and of the expected legal sanction from noncompliance. If the expected sanction exceeds the tax payment, the person will pay; otherwise, he will not.”). See also Alfred Blumstein, *Models for Structuring Taxpayer Compliance, in Income Tax Compliance, Report of the ABA Section of Taxation, Invitational Conference on Income Tax Conference* (1983). Many commentators, including Posner, have observed that individual taxpayers might have other considerations in deciding whether to comply with the tax law, such as moral values and guilt. This article focuses on corporations, and assumes that corporations have no moral duty.

¹² *Id.* See also Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453, 1463 (2003) (“a rational taxpayer will evade taxes if the expected value of the punishment is lower than the expected gains from evasion.”)

¹³ See Graeme S. Cooper, *Analyzing Corporate Tax Evasion*, 50 Tax L. Rev. 33, 74 (1994).

¹⁴ *Id.* at 92-93.

and assumes that business entities decide whether to enter into a tax motivated transaction based solely on quantitative economic considerations.

It is unquestionable that the primary purpose behind the enactment of the various accuracy-related penalty provisions in the Internal Revenue Code was to deter taxpayers from “playing the audit lottery.”¹⁵ As of today, however, the various penalty provisions have only partially achieved their stated goals. In 1999, Treasury and the Joint committee on Taxation issued lengthy reports pertaining to the problem of tax shelters.¹⁶ While the Joint Committee and Treasury focused on *increasing the rates of penalty* as a means to reduce tax-motivated transactions, in recent years, the pendulum has shifted to disclosure rules (mainly, the reportable transactions rules).¹⁷

This article discusses these two measures as well as various others taken by Congress and Treasury in recent years to crack down tax-motivated transactions. Specifically, using a cost-benefit equation, I will evaluate the effectiveness these measures and show that in order to reduce the taxpayer’s incentive to play the audit lottery, Congress must focus on increasing the likelihood that the taxpayer will pay the penalty rather than the rate of penalty.¹⁸

¹⁵ See Joint Committee on Taxation, “General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982; Commissioner’s Penalty Study, II-3 (IRS 1989); Committees on Civil and Criminal Penalties and on Administrative Practice, Penalties Study Report (American Bar Association Section of Taxation), at 2 (July 28, 1988).

¹⁶ Supra note 1.

¹⁷ Specifically, as discussed in greater detail below, Treasury and the Joint Committee focused on increasing the rate of accuracy-related penalty to 40 percent as a means of deterring taxpayers from entering into tax motivated transactions.

¹⁸ For a similar view, see Charles O. Rossotti, *Modernizing America’s Tax Agency*, 83 Tax Notes 1191, 1195 (1999) (“Historically, the IRS placed great emphasis on direct enforcement revenue, in part because it is precisely measurable and in part because it showed an indirect deterrent effect that increases compliance. However, there are many techniques other than direct enforcement that increased compliance at the IRS and elsewhere, such as better and more targeted taxpayer education, better reporting, voluntary agreements, improved regulations, and earlier intervention through notices and phone calls.”).

The last year saw the occurrence of several important developments in relation to the Government's attempts to crack down tax-motivated transactions. It began in August 2004, with the issuance of the opinion in *Long Term Capital Holding v. United States*,¹⁹ a case in which a District Court in the Second Circuit held that a transaction involving the contribution of stock with a built-in loss to a partnership lacked economic substance and had been entered into without any business purpose other than tax avoidance. The District Court followed the Second Circuit cases, especially *Goldstein v. Commissioner*,²⁰ applied an objective profit potential test and a subjective business purpose, and determined that the disputed transaction had neither reasonable potential for profit nor business purpose.²¹ Most importantly, the court upheld accuracy-related penalties assessed by the IRS despite the taxpayer's argument that it satisfied the reasonable-cause exception by virtue of obtaining and relying on two separate law firm "should" level opinions supporting its position. The Second Circuit affirmed the District Court's decision, upheld tax underpayment penalties against Long Term Capital Holdings for a gross valuation misstatement, found that there was no reasonable cause for the understatement.²²

In *Santa Monica Pictures, LLC et al. v. Commissioner*,²³ another case involving the contribution of high-basis low-value assets to a partnership, the Tax Court held that the

¹⁹ 2004 WL 1924931 (D. Conn. Aug. 27, 2004).

²⁰ 364 F.2d 734 (2nd Cir. 1966).

²¹ Alternatively, the court held that the transaction could be recast under the step-transaction doctrine as a taxable transfer of the loss stock from the contributing partner to the general partner, followed by a sale of the stock by the general partner.

²² *Long Term Capital Holdings LP et al. v. United States* (No. 04-5687) (United States Court of Appeals for the Second Circuit).

²³ T.C. Memo. 2005-104, Nos. 6163-03, 6164-03 (May 11, 2005). The facts in this case were arguably more extreme than in *Long Term Capital Holding*, particularly, as the court pointed out, because three weeks after the formation of the partnership, the original partners that contributed the loss assets to the partnership exited that same partnership.

transactions lacked economic substance and business purpose and, in spite of the taxpayer's reliance on various opinions from several tax professionals, imposed accuracy-related penalties.²⁴

Similarly, in *CMA Consolidated Inc. et al. v. Commissioner*,²⁵ the Tax Court held that lease stripping transactions structured using tax-indifferent parties had no economic substance or profit potential aside from the tax benefits. The court disallowed the claimed deductions and imposed penalties on the participant for negligence and for a gross undervaluation of certain notes.

The Jobs Act of 2004 (P.L. 108- 357) was signed by the president on October 22, 2004. Title IV (Subtitle B) of the Act²⁶, Title VI (Subtitle B) of the House bill²⁷, and Title IV (Subtitle A) of the Senate bill²⁸ include provisions that are designed to curtail the use of abusive tax avoidance transactions and tax shelters by all types of taxpayers individuals, corporations and pass-through entities. The Jobs Act's tax shelter provisions represent the most significant effort by Congress to crack down on purely tax-motivated transactions since the Tax Reform Act of 1986,²⁹ imposing new penalties, defining new categories of abusive tax avoidance

²⁴ The taxpayer attempted to rely on the "reasonable cause" exception under Section 6664, emphasizing that it had relied on "outside" professional tax advice. To support its position, the taxpayer presented several different opinions obtained from several tax advisers pertaining to different aspects of the transaction. The Tax Court reviewed each of these opinions and concluded that none of them could provide the basis for the exception, mainly because they did not address the controversial issues of the transaction and/or made unreasonable assumptions, such as that the transaction had a business purpose.

²⁵ T.C. Memo. 2005-16; No. 12746-01 (January 31, 2005).

²⁶ H.R. 4520, American Jobs Creation Act of 2004, P.L. 108-357 (2004).

²⁷ H.R. 4520, American Jobs Creation Act of 2004, H. REP. NO. 108-548, 108th Cong., 2d Sess., June 16, 2004.

²⁸ S. 1637, Jumpstart Our Business Strength (JOBS) Act, S. Rep. No. 108-192, 108th Cong., 1st Sess., Nov. 7, 2003.

²⁹ According to Sen. Charles E. Grassley (R-IA), "This [Act] is the strongest anti-tax shelter measure since 1986." See Press Release, United States Senator Charles E. Grassley, Grassley Highlights Corporate Loophole Closers in New Tax Bill (Oct. 14, 2004) (on file with Senate Committee on Finance).

transactions and finally unifying the definition of a reportable transaction for purposes of disclosure, list maintenance and registration.³⁰

The unmistakable signal from Congress is that taxpayers and their “material advisors” must disclose, or suffer the consequences.³¹ The proposal to clarify and codify the economic substance doctrine, however, was widely (if not uniformly) criticized, at least in the form that it had been proposed by the Finance Committee and adopted by the Senate, before the conferees dropped the proposal during the final negotiations on the conference agreement.³²

II. The Economics of Penalties

³⁰ *Id.* According to a press release from the Chairman of the Senate Committee on Finance:

[T]he newly passed business tax bill contains the most significant crackdown on corporate abuses and tax dodges in a generation and will lead to many more companies paying their fair share of taxes – tens of billions of dollars more over the next decade. . . . [The Act] closes a lot of the loopholes that allow companies to escape their fair share of U.S. taxes. The message is, if you play by the rules, you’ll get a tax break. If you don’t play by the rules, you’ll be caught and pay a heavy price.

³¹ An important consequence of the Jobs Act of 2004 is also the consolidation of the reporting, registration, listing, and certain accuracy-related penalty provisions under the statutory “reportable transactions” standard, as opposed to the previous incoherent “tax shelter” standard.

³² For a description of the Senate’s proposal to codify the economic substance doctrine, see SOM at 445 (Conf. Rpt. at 650). Subsequent to the enactment of the Jobs Act, three District Courts have held for the taxpayers in cases involving tax motivated transactions. First, in *Black & Decker Corp. v. United States* a U.S. District Court has granted Black & Decker Corp.’s motion for summary judgment in its refund suit for over \$ 57 million in federal taxes arising from a contingent liability transaction. Most notably, the parties stipulated that the taxpayer had no business purpose in entering into the transaction. Nevertheless, because the decision is appealed to the Fourth Circuit, in which the disjunctive test prevails, the District Court held for the taxpayer on the grounds that the transaction had economic substance. In *Coltec Industries Inc. v. United States* a U.S. Court of Federal Claims has ordered the IRS to refund to Coltec Industries Inc. \$ 82.8 million in federal taxes arising from a contingent liability transaction, almost similar to the one in *Black & Decker*, on the grounds that the transaction satisfied the statutory language and requirements of the applicable statutory provisions (section 357) and, only as a backstop, applying the economic substance doctrine to conclude that the transaction had both business purpose and economic substance. Most importantly, as the District Court indicted in *Coltec Industries*, “if a taxpayer clearly satisfies unambiguous statutory and/or regulatory requirements, courts may decline to apply the economic substance doctrine.” Finally, in *TIFD III-E Inc. v. United States* a U.S. District Court (in the Second Circuit) has ordered the IRS to refund \$ 62 million to TIFD, the tax matters partner of Castle Harbour-I LLC, applying the economic substance doctrine and finding that the LLC’s creation was not a sham designed solely to avoid taxes. The District Court held that not only the partnership itself had substance, the transaction as whole had both economic substance and business purpose, despite the fact that the Dutch banks were subject to a very limited risk of loss.

A. Introduction

It has long been recognized that economic analysis can provide an effective measurement of compliance and deterrence.³³ The standard economic model of compliance provides that people are expected to violate the law if the benefits from such a violation exceed the expected sanction attached to this violation.³⁴ One of the most remarkable contributions to the economic analysis of deterrence was Justice Holmes's "bad man" theory.³⁵ According to Holmes's theory, as explained by Robert Cooter:

[T]he 'bad man' treats the law as 'external,' to himself, in the sense that he considers it to lie outside of his own values. Economic models of law typically accept the 'bad man' approach and add a rationality element to it: a rational 'bad man' decides whether or not to obey the law by calculating his own benefits and costs, including the risk of punishment. The rational bad man breaks the law whenever his potential gain from disobeying the law exceeds his risk of punishment. Law and economics scholars typically consider the rational bad man as a 'decision-maker' in their models.³⁶

³³ Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. Econ. & Organization 279, 281 (1986).

³⁴ Eric Posner, *Symposium: The Legal Construction of Norms: Law and Social Norms: The Case of Tax Compliance*, 86 Va. L. Rev. 1781, 1783 (2000) ("A simple approach to the problem of tax compliance holds that when people decide whether to pay their taxes, they take account only of the cost of the tax and of the expected legal sanction from noncompliance. If the expected sanction exceeds the tax payment, the person will pay; otherwise, he will not.").

³⁵ Oliver Wendell Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 459 (1897).

³⁶ Robert Cooter, *The Legal Construction of Norms: Do Good Laws Make Good Citizens? An Economic Analysis of Internalized Norms*, 86 VA. L. REV. 1577, 1591 (2000). This theory was first propounded in Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968). See also ROBERT W. GORDON, *LAW AS A VOCATION; HOLMES AND THE LAWYER'S PATH, THE PATH OF LAW AND ITS INFLUENCE: THE LEGACY OF OLIVER WENDELL HOLMES JR.*, Burton ed., 7 (1998) (The bad man is thus a version of the economists' rational calculator, utilizing legal advice to price behavior and complying with private law norms only when the benefit to himself of compliance exceeds the cost); Stephen McG. Bundy & Einer Elhauge,

Although Holmes did not intend to put forth a practical model of deterrence and punishment in this theory, he has, however, provided some practical interpretations for compliance and punishment.³⁷ In particular, a similar model was put forth by Allingham and Sandmo with respect to compliance with tax law.³⁸ Thus, if Holmes is correct and taxpayers comply with the tax law only because they are afraid of the sanctions imposed on the noncompliant, such sanctions are necessary in order to enhance compliance with tax law.³⁹

Some commentators, however, believe that the “bad man” approach is grounded not only on an economic perspective but on other perspectives as well. As William Twining elaborated:

The Bad Man is not a revolutionary nor even a reformer out to change ‘the system.’ The Bad Man’s concern is to secure his personal objectives within the existing order as painlessly as possible; he is not so much alienated from the law as he is indifferent to all aspects which do not affect him personally. Unlike Sartre’s Saint Genet, he is not one who has a problem of identity--who defines his being in terms of the system and who is driven to do acts because they are criminal or antisocial. Nor is he a

Knowledge About Legal Sanctions, 92 MICH. L. REV. 261, 274 (1993) (“In deciding whether to engage in regulated conduct, the sanction optimizer is a Holmesian ‘bad man’ who considers only the actual level of expected legal sanctions and gives no independent weight to the fact that the conduct is legally prohibited or required”); Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1262 (1995) (“A rational actor will be deterred from insider trading only when the expected sanction associated with an offense exceeds the expected benefit”); Thomas S. Ulen, *Firmly Grounded: Economics in the Future of Law*, 1997 WASH. L. REV. 433, 434 (1997) (“If the expected benefits of illegal activity outweigh the expected costs, “the rationally self-interested criminal commits the crime . . . and refrains if the reverse is true.”).

³⁷ See Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. Pub. Econ. 323 (1972) (applying to tax evasion economic model similar to Becker's model).

³⁸ *Id.* This model is generally, derived from Gary Becker's model of criminal enforcement. See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169, 172 (1968).

³⁹ *Id.*

subscriber to some perverse ethic, which turns conventional morality upon its head. The Bad Man is amoral rather than immoral. He is, like Economic Man and Bentham's 'civilized' actors, a rational, calculating creature. In this and in other respects he does not necessarily reflect in a realistic manner the characteristics of actual deviants. Like Dahrendorf's homo sociologicus, he 'can neither love nor hate, laugh nor cry.' He remains a pale, incomplete, strange, artificial man.⁴⁰

Same arguments have been made with respect to tax evasion; a taxpayer may have non-quantitative considerations (such as moral duty) in deciding whether to evade taxes.⁴¹ Eric Poser concludes that:

A widespread view among tax scholars holds that law enforcement does not explain why people pay taxes. The penalty for ordinary tax convictions is small; the probability of detection is trivial; so the expected sanction is small. [footnote omitted] Yet large numbers of Americans pay their taxes. This pattern contradicts the standard economic model of law enforcement, which holds that people violate a law if the benefit exceeds the expected sanction. Some scholars therefore conclude that the explanation for the tendency to pay taxes must be that people are obeying a norm--

⁴⁰ William Twining, *The Bad Man Revisited*, 58 CORNELL L. REV. 275, 280-287 (1973).

⁴¹ Joseph Bankman and Thomas Griffith, *Social Welfare and the Rate Structure: A New Look At Progressive Taxation*, 75 Cal. L. Rev. 1905, 1942, n. 169 ("[i]t seems reasonable to attribute some compliance unexplained by the economic model to such things as the 'moral and social costs of dishonesty and the transaction costs of enduring an audit.'").

presumably a norm of tax payment or a more general norm of law-abiding behavior. [footnote omitted]⁴²

Such non-economic considerations, however, are rarely considered by corporations, which are the subject of this article. This distinction between individuals and corporations could be explained by Milton Friedman's 1970 essay in The New York Times magazine section entitled "[t]he Social Responsibility of Business Is to Increase Its Profits."⁴³ As discussed in greater detail below, the elevation of corporate tax departments into profit centers eliminated most if not all non-quantitative considerations of entering into a tax-motivated transaction.⁴⁴

B. *The Utilitarian-Economic Theory*

The utilitarian-economic theory of penalties, according to which penalties should be set at a level that *eliminates all potential gain* to the offender, was introduced by Jeremy Bentham in the eighteenth century.⁴⁵ Two hundred years later, Gary Becker restated the goal of penalties as *internalization of the social costs of offenses*, rather than as the elimination of gain.⁴⁶ Polinsky and Shavell then followed Becker's approach and suggested that offenders generally equate potential punitive damages, discounted by the probability of actually being found

⁴² Eric Posner, *Symposium: The Legal Construction of Norms: Law and Social Norms: The Case of Tax Compliance*, 86 Va. L. Rev. 1781, 1782 (2000).

⁴³ See also Yoram Keinan, *Corporate Governance and Professional Responsibility in Tax Law*, 17 J. Tax'n F. Inst. 10, 11 (2003) ("Entrepreneurs are assumed to seek maximization of the difference between their total receipts and their total costs, [internal footnote omitted] and therefore, tax savings that reduce entrepreneurs' total costs can play a role in this profit maximization.")

⁴⁴ See Bankman, *supra* note XX, at 1784 ("The elevation of the tax department to a profit center has turned corporate norms on their head. Aggressive tax planning is now a desirable trait -- a new norm.")

⁴⁵ Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation*, 166 (J.H Burns Ed., Clarendon Press 1996) (1781).

⁴⁶ Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

liable, with the harm caused.⁴⁷ Finally, Keith Hylton combined these two approaches by proposing that, if the gains to injurers are less than their victims' losses, punitive awards should act to eliminate these potential gains to the injurers and not to compensate all of the victims' losses; conversely, if the injurers' gains are higher than their victims' losses, punitive awards should act to compensate the entire amount of the victims' losses.⁴⁸

C. *Sanctions as Prices*

A positivist defines "law" as an obligation backed by a sanction.⁴⁹ Under this view, people will comply with the law even if the penalty is not set to accurately reflect the "price" of behavior.⁵⁰ According to Robert Cooter, "sanctions" differ from "prices" because

[A] sanction is a detriment imposed for doing what is forbidden, such as failing to perform an obligation. For example, a defendant in a tort dispute may be ordered to pay compensatory damages for an injury caused by his negligence, or a convicted criminal may be sentenced to jail. In contrast, a price is payment of money which is required in order to do what is permitted. For example, a company may buy goods in the marketplace, but it must pay the seller's price. Similarly, individuals are permitted to earn

⁴⁷ Polinsky & Shavell at 872. In spite of the differences between the two approaches, both theories are based on the "Multiplier Principle" according to which, the amount of compensation should equal to the harm/gain divided by the probability to be found liable. This idea is considered as the basic deterrence standard in most law and economics theories. *Id.* at 889.

⁴⁸ Keith N. Hylton, *Symposium: Reply: Punitive Damages and the Economic Theory of Penalties*, 87 Geo. L. J. 421 (1998).

⁴⁹ Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1532 (1984) ("Most people conform to a reasonable obligation backed by a reasonable sanction, even if the legal standard is inefficient or otherwise undesirable. . . . Mistakes in computing the level of the sanction or the frequency of its application are not crucial, because most people will conform in spite of these mistakes"). See also Calvin Woodard, *Symposium The Moral Lawyer: Article: Thoughts on The Interplay Between Morality and Law in Modern Legal Thought*, 64 Notre Dame L. Rev. 784, 791 (1989).

⁵⁰ *Id.*

income, but obliged to pay taxes on their earnings. These definitions of sanction and price are not always consistent with ordinary speech. Tax evasion is forbidden, but in casual speech people often say a fine is the price of tax evasion, when by these definitions it is a sanction.⁵¹

The “bad man” theory, although viewed as a form of positivism, portrays these sanctions as “prices;”⁵² Economic analyses of deterrence are based on applying price theory to activities.⁵³ From an economic perspective people therefore engage in or refrain from injury-causing behaviors depending on how much they may gain or lose from doing so, and if the sanctions or “prices” are too high, rational people will refrain from the injury-causing or prohibited conduct.⁵⁴ As I conclude in this article, the same rational decision applies to tax compliance.

One of Holmes’s most significant and famous arguments is that, in much of private law and, in particular, in torts and contracts law, the bad man regards damages and other sanctions as nothing more than a “tax” on the conduct (that is, the breach of contract or negligence) at issue.⁵⁵ Holmes’s bad man theory thereby simply transforms the general structure of liability rules: rather than issuing commands such as “perform on contracts” and “take adequate care,”

⁵¹ *Id.* at 1524-25.

⁵² See Robert Cooter, *The Path of The Law Today: Models of Morality in Law and Economics: Self-Control and Self-Improvement for the “Bad Man” of Holmes*, 78 B.U.L. REV. 903, 915 (1998).

⁵³ For a similar argument in the context of copyright violations, see Ann Bartow, *Electrifying Copyright Norms and Making Cyberspace More Like a Book*, 48 Vill. L. Rev. 13, 62 (2003) (“most consumers are ‘bad but rational men’ who will infringe copyrights at every opportunity unless they are dissuaded from doing so by the fear of punishment.”)

⁵⁴ Sharon L. Davies, *The Penalty of Exclusion - A Price or Sanction?*, 73 S. CAL. L. REV. 1275, 1282 (2000); Cynthia A. Williams, *Compliance with the Law in the Era of Efficiency*, 76 N.C.L. Rev. 1265, 1286-87 (1998); Ulen, *supra* note XX, at 436.

⁵⁵ See HOLMES 461.

the law in Holmes's theory instead provides the choice to "perform on contracts or pay damages" and "take adequate care or compensate the victim."⁵⁶

Naturally, this idea removes all the moral implications inherent in private law; similar to the notion that earning income is not forbidden, torts should not be forbidden as long as the injurer pays the price for its actions. If a fine is considered to be equivalent to a tax, the bad man's point of view removes any distinction between wrongful conduct, which should be followed by a punitive action, and acceptable conduct, which should be followed by a tax.

Three different theories with respect to the application of the sanctions-as-prices theory to corporations have emerged.

1. The Strict Approach

In 1982, Frank Easterbrook and Daniel Fischel put forth the strict approach for corporate compliance with law according to which, corporations (through their officers) do not have an ethical duty to obey laws just because the laws exist; rather, they can determine the effect of these laws on their individual welfare and then act accordingly.⁵⁷ Thus, the penalties Congress imposes on disobedience measure how much it thinks firms ought to sacrifice in order to adhere to the rules.⁵⁸ In turn, the idea of optimal sanctions depends on the

⁵⁶ David Luban, *the Bad Man and the good Lawyer, the Path of Law and its Influence: The Legacy of Oliver Wendell Holmes Jr.* Burton ed. (1998), p. 39; Philip Soper, *Law's normative Claim, in the Autonomy of Law* (ed. Robert P. George 1996) p, 232. Thus, sanctions cannot be avoided, but if the state does not claim that people should follow the law because it says to, the state invites people to choose their best alternative and, thus, to view sanctions as merely prices on conduct. According to Soper, such a view is inconsistent with normative language, which distinguishes between taxes and fines.

⁵⁷ Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 Mich. L. Rev. 1155, 1168 n.36 (1982) ("Managers have no general obligation to avoid violating regulatory laws, when violations are profitable to the firm...We put to one side laws concerning violence or other acts thought to be malum in se.").

⁵⁸ *Id.* at 1177 n.57.

supposition that corporations not only may, but also *should*, violate the rules when it is profitable for them to do so. In the context of tax law, one commentator has indicated that “[s]ome evasion may be efficient because it relates to productive activity that the taxpayer would not have undertaken if he had to pay tax on it.”⁵⁹ The concept of law thus relies on an analysis of the likelihood of detection and enforcement, and the probability of enforcement becomes a factor in the rational actor’s calculus as to compliance with the law.⁶⁰ Thus, compliance with the standards of behavior set forth in statutes and administrative regulations becomes voluntary; in other words, one has the “right,” although not necessarily a duty, to violate the law, if one is willing to risk the penalties. As a consequence, lawyers have the duty to provide the information necessary for clients to be able to exercise this “right.”⁶¹

The strict approach therefore can be seen as resembling that of Holmes, whose “bad man” can be used just easily to refer to “bad corporate client.”⁶²

2. *The Intermediate Theory*

The strict approach has been criticized by various commentators as “clearly extreme.”⁶³ Specifically, Cynthia Williams argues that following the “law-as-price” view of civil

⁵⁹ Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453, 1456 n.10 (2003).

⁶⁰ David L. Engel, *An Approach to Corporate Social Responsibility*, 32 Stan. L. Rev. 1, 43-45 (1979).

⁶¹ See, generally, Stephen L. Pepper, *Counseling at the Limits of the Law: An Exercise in the Jurisprudence and Ethics of Lawyering*, 104 Yale L.J. 1545, 1576-77 (1995).

⁶² Gordon, p. 17 (“A realistic picture of the usual corporate client of Holmes’s day, inclined to treat all legal rules as prices on conduct, risks to be discounted by the probability of enforcement, data for cost-benefit analysis.”)

⁶³ See, generally, Cynthia A. Williams, *Compliance with the Law in the Era of Efficiency*, 76 N.C.L. Rev. 1265 (1998). See also John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Schylla and Charybdis*, 52 Geo. Wash. L. Rev. 789, 794 n. 11 (1984); See American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1994) (as adopted and promulgated in 1992) 2.01 comment #g (“With few exceptions, dollar liability is not a “price” that can properly be paid for the privilege of engaging in legally wrongful conduct.”).

regulatory law means that regulatory law is viewed as voluntary, or in other words, as something citizens are free to choose to ignore by accepting or risking the known consequences.⁶⁴ According to the intermediate theory of corporate compliance, some laws prohibit actions, such as those generally found in criminal statutes, while some laws put a price on various modes of conduct, such as those generally found in civil law. In this way, regulatory law can be understood as a pricing regime, including even those that include criminal sanctions on violations.⁶⁵ In accordance with Pepper's view, Williams summarizes the following elements of the intermediate theory:

(1) some laws prohibit actions (predominantly criminal law) and some laws price actions (predominantly civil law); (2) regulatory law is properly understood as a pricing scheme, even when it includes criminal sanctions for violations; (3) the concept of law includes a sophisticated analysis of the likelihood of detection of violations, and of enforcement, and of various barriers to aggrieved parties asserting their rights in determining if obeying the law is worthwhile; (4) enforcement-related facts will (and perhaps should) figure prominently in a rational actor's calculus about complying with the standards the law sets forth; and (5) except where legal violations are also serious moral wrongs (*mala in se*), compliance with the standards of behavior that statutes or administrative regulations set forth is philosophically voluntary: one has the "right" to violate the law

⁶⁴ *Id.* at 1270.

⁶⁵ *Id.* at 1295.

by risking paying the penalties (and thus lawyers have the duty to provide information necessary for clients to be able to exercise that right).⁶⁶

In conclusion, pursuant to the intermediate theory, the sanctions-as-prices theory should be limited to civil and regulatory laws. Stated differently, with respect to criminal laws, sanctions should not be “priced.” In my view, tax law ought to be evaluated under the former group; compliance of corporations with tax law could be evaluated in accordance with a cost-benefit analysis, as discussed in greater detail below.

3. *The Moral/Ethical Approach*

Other commentators, however, believe that there is a third approach. This approach assumes that, in the corporate decisionmaking process, social and ethical norms are considered alongside economic factors.⁶⁷ For example, the ALI’s Principles of Corporate Governance provide that a corporation “may properly take into account ethical considerations that are generally recognized as relevant to the conduct of business.”⁶⁸ Thus, rejecting the “sanctions-

⁶⁶ *Id.* at 1330, citing Stephen L. Pepper, *Counseling at the Limits of the Law: An Exercise in the Jurisprudence and Ethics of Lawyering*, 104 Yale L.J. 1545 (1995).

⁶⁷ Eisenberg argued that it is not obvious whether corporations simply do a cost-benefit analysis only, and in fact some corporations explicitly incorporate social norms. See Melvin A. Eisenberg, *Corporate Law and Social Norms* 99 Colum. L. Rev. 1253.

⁶⁸ See American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* 2.01 (1992). Section 2.01 reads as follows:

Section 2.01 The Objective and Conduct of the Corporation

(a) Subject to the provisions of Subsection (b) and section 6.02 (Action of Directors That Has the Foreseeable Effect of Blocking Unsolicited Tender Offers), a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.

(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

(1) Is obliged, to the same extent as a natural person, to act within the boundaries set by

as-prices” theory, according to the ALI, corporations should consider social norms even if corporate profit and shareholder gain are not thereby enhanced.

Many commentators have argued that morality plays an important role in tax compliance as well.⁶⁹

In my opinion, however, this approach may be relevant to individuals, but is almost irrelevant in the context of corporate tax shelters, for it is highly unlikely that corporations and their managers consider social norms when making their tax-related decisions.⁷⁰

D. Conclusions

Two major obstacles confront the concept of sanctions as prices. First, one must define to which areas of the law this concept applies. Apparently, most commentators, including Holmes, believe that this concept applies only to a few areas of the law and to a limited number of situations. Second, one must distinguish between different types of offenders, particularly individuals and corporations. Only with respect to the latter group, it is reasonable to apply the sanctions-as-prices (*i.e.*, the strict) approach.

law;

(2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and

(3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

⁶⁹ Joseph Bankman and Thomas Griffith, *Social Welfare and the Rate Structure: A New Look At Progressive Taxation*, 75 Cal. L. Rev. 1905, 1942, n. 169 (“[i]t seems reasonable to attribute some compliance unexplained by the economic model to such things as the “moral and social costs of dishonesty and the transaction costs of enduring an audit.”).

III. Tax Penalty and Deterrence

A. Cost-Benefit Equation

Consistent with the “bad man” theory, a taxpayer’s decision whether to comply with tax laws is a rational choice to maximize its expected “utility” or well-being.⁷¹ Under this theory, the taxpayer chooses a level of compliance by weighing the costs and benefits of compliance with those of noncompliance and then selecting that level of compliance that will lead to the highest expected level of net benefits.⁷² On the cost side, the probability of detection and audit combined with the magnitude of the penalties are the major expected costs of underpayment of taxes.⁷³ Several other factors, however, may also be considered part of these expected costs, including the taxpayer’s ethics and degree of honesty or, to put it another way, the expected level of guilt arising from tax evasion, damage to the taxpayer’s reputation if underpayment is detected, and the taxpayer’s level of risk aversion.⁷⁴ On the potential gain

⁷⁰ For a similar view, see generally Graeme S. Cooper, *Analyzing Corporate Tax Evasion*, 50 Tax L. Rev. 33, 111-12 (1994).

⁷¹ See Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. Pub. Econ. 323 (1972) (applying to tax evasion economic model similar to Becker’s model). Cf. Stark, Richard C., A *Principled Approach To Collection And Accuracy-Related Penalties*, 91 Tax Notes 115, 116 (Apr. 2, 2001) (“Taxpayers choose to comply or not to comply with our tax laws for many reasons, of which monetary sanctions are one. Psychologists, sociologists, economists, legal scholars, and others have identified many reasons for compliant and noncompliant conduct.”)

⁷² Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453, 1463 (2003) (“a rational taxpayer will evade taxes if the expected value of the punishment is lower than the expected gains from evasion.”)

⁷³ Alfred Blumstein, *Models for Structuring Taxpayer Compliance*, in *Income Tax Compliance, Report of the ABA Section of Taxation, Invitational Conference on Income Tax Conference* (1983); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453, 1463, n.46 (2003).

⁷⁴ See the Joint Committee, *the Problem of Corporate Tax Shelters*, supra note 3, emphasizing that the level of risk aversion is an important element. Taxpayers will vary in their attitudes towards risk taking. Even if the expected costs are lower than the expected gain, a risk-averse taxpayer may choose not to engage in tax evasion under the same scenario, as such taxpayer gives more weight to the costs than to the benefits.

side, the primary expected benefit from a tax-motivated transaction is the additional after-tax income that results.⁷⁵ As Professor Joel Slemrod indicated:

The standard economic model of an individual's choice about evasion portrays taxpayers as completely amoral, deciding about whether and how much to evade taxes in the same way they would approach any risky decision, such as how to construct a portfolio, how much insurance to buy, or whether to go to Reno to gamble -- as a tradeoff between risk and return. Successful tax evasion increases income because it saves on taxes, but detected tax evasion results in a penalty. What to do depends on the chance of getting caught and penalized, what that penalty might be, and how risk-averse one is.⁷⁶

Thus, in the absence of penalties or when the probability of penalties is much less than unity, taxpayers who are not risk-averse will be expected to enter into tax-motivated transaction.

The IRS has recently indicated in a Chief Counsel Notice that “[w]hen properly developed and applied, penalties assist the Service in promoting sound tax administration by increasing the economic costs of noncompliance. In the context of corporate taxpayers, the required disclosure of penalties creates an additional deterrent effect.”⁷⁷ In many cases, corporate

⁷⁵ For example, in the context of transfer pricing, multinational corporations, which are likely to enter into cross-border transactions, are required to conduct a professional research on their pricing policy. This research is required to be available to the inspection of the IRS no later than 30 days after the IRS demand to inspect the company’s pricing policy. Conducting this research and formulating the opinion becomes a big business today, and it imposes significant costs on taxpayers, which might be subject to an audit.

⁷⁶ See Joel Slemrod, *Tax Minimization and Corporate Responsibility*, 2002 TNT 175-20 (Sept. 6, 2002).

⁷⁷ IRS Advises Chief Counsel Attorneys on Role of Tax Penalties (CC-2004-036) 2004 TNT 186-9 (Sept. 22, 2004).

taxpayers offer to agree to all, or a larger portion, of a deficiency in exchange for a government concession of the penalties.⁷⁸ Pursuant to the Government's victory in *Long Term Capital Holdings*,⁷⁹ the IRS has instructed its attorneys not to be flexible in such negotiations because:

Conceding penalties in such cases also risks undercutting efficient tax administration by reducing the deterrent effect of penalties. Taxpayers and tax practitioners will have less incentive to voluntarily comply if they believe that they can routinely bargain away penalties. In the context of tax shelters (especially listed transactions and potentially abusive transactions), the proper imposition and sustention of penalties in Appeals and in litigation can serve as an effective tool to combat the proliferation of abusive tax shelters.⁸⁰

Thus, the IRS has acknowledged that for corporations, the “bad man” theory applies to tax compliance – in the absence of tough penalties, less corporations will comply with tax law, or, stated differently, will choose to “play the audit lottery.”

B. The Tax Department as a Profit-Maximization Unit

⁷⁸ *Id.*

⁷⁹ 2004 WL 1924931(D. Conn. Aug. 27, 2004).

⁸⁰ CC-2004-036.

In recent years, the officers of many companies have come to view their tax liability as a manageable cost that can be reduced like any other ordinary operational cost.⁸¹ Treating a corporation's tax liability in this manner leads to evaluation of the corporate tax department's performance on a quantitative basis.⁸² This perspective not only increases the corporate motivation to enter into tax-motivated transaction, but also eliminates all the non-quantitative aspects of tax evasion.⁸³ Managers of corporate tax departments today are much less risk-averse and more frequently engage in tax-motivated transactions whenever the potential benefits exceed the expected costs. As one commentator indicated, corporate tax evasion could be viewed as any other typical financing/investment activity of the corporation.⁸⁴

C. *Avoiding Overdeterrence*

The sanction attached to wrongdoing should be imposed in proportion to the seriousness of the wrong.⁸⁵ Because the government does not wish to discourage corporate activity,

⁸¹ Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 51, the Tax Executive 231. See Also Hariton, p. 237. See also NYSBA report, p. 11.

⁸² See the Treasury's Report, *supra* note 3, text accompanying notes 20-21, citing Bankman, at 1784 ("At the same time, perhaps part of a general trend of greater management responsiveness to shareholder concerns and returns, and perhaps due to greater management sophistication, tax departments are now looked at in some companies as profit centers."). See also Urban Institute Testimony on Tax Fraud, Evasion, 2003 TNT 133-26 (July 9, 2003); Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), Feb. 2003, at 8 ("As Enron's management came to realize that tax-motivated transactions could generate financial accounting benefits, Enron looked to its tax department to devise large transactions that would increase its financial accounting income. Enron came to view the role of its tax department as more than managing its Federal income tax liabilities. Rather, Enron's tax department became a source for financial statement earnings, thereby making it a profit center for the company.")

⁸³ See Joel Slemrod, *Tax Minimization and Corporate Responsibility*, 2002 TNT 175-20 (Sept. 6, 2002).

⁸⁴ See Graeme S. Cooper, *Analyzing Corporate Tax Evasion*, 50 Tax L. Rev. 33, 89 (1994) ("That is, a corporation that engages in tax evasion can be analyzed as if it had borrowed the unpaid tax from the government and invested the borrowed money in a risky asset. Thus, corporate tax evasion offers the prospect of enhancing the market value of the corporation either because it represents a profitable investment of the corporation's funds or because of the profitable terms on which the money was borrowed.")

⁸⁵ Robert Cooter, *The Path of The Law Today: Models of Morailty in Law and Economics: Self-Control and Self-Improvement for the "Bad Man" of Holmes*, 78 B.U.L. REV. 903, 915 (1998).

however, overdeterrence created by overly harsh penalties is undesirable;⁸⁶ the government is interested in promoting and encouraging business activity in order to stimulate the economy. Therefore, Congress is interested in reducing tax-motivated transactions only with respect to transaction with no economic substance - those that are conducted solely for tax-reduction purposes.

In *Long Term Capital Holding v. United States*,⁸⁷ the District Court asserted that:

The absence of reasonableness sheds light on Long Term's subjective motivation, particularly given the high level of sophistication possessed by Long Term's principals in matters economic. . . . Moreover, the construction of an elaborate, time consuming, inefficient and expensive transaction with OTC for the purported purpose of generating fees itself points to Long Term's true motivation, tax avoidance. Taking fee-generating investments was Long Term's core business and was regularly executed without either the complex machinations related to OTC's contributions or the attendant millions in transaction costs. See *Boca Investorings P'ship*, 341 F.3d at 631-632. For these and the following reasons, the Court finds that fees, strategic value added by B&B, and increasing Long Term's principals' Portfolio investments did not motivate the OTC transaction; rather Long Term possessed no business purpose other than tax avoidance.

⁸⁶ See Polinsky and Shavell p. 907. and David Dana, p. 6. David Dana argues that there are several types of violation in which, the optimal level of deterrence should be significantly less than maximal deterrence. The legislature has to consider whether the harm from an underlying taxpayer's evasion is larger than the benefit to society from the taxpayer's economic activity. If the benefit is higher than the harm, it may be fair to say that over-deterrence is undesirable

⁸⁷ 2004 WL 1924931(D. Conn. Aug. 27, 2004).

Thus, Congress has a complicated task: discouraging wasteful activity (or activity engaged in only for tax purposes), while not distorting decisions pertaining to economically-sound activities. As discussed herein, the current penalty regime is far from perfect to that extent.

IV. Tax Accuracy-Related Penalties

A. Overview

Accuracy-related penalty apply to the portion of any underpayment that is attributable to (i) negligence,⁸⁸ (ii) any substantial understatement of income tax,⁸⁹ (iii) any substantial valuation misstatement, (iv) any substantial overstatement of pension liabilities, or (v) any substantial estate or gift tax valuation understatement. The amount of any understatement generally is reduced by any portion attributable to an item if (i) the treatment of the item is or was supported by “substantial authority,” or (ii) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.⁹⁰ In addition,

⁸⁸ Section 6662(a)(1) imposes a 20-percent accuracy-related penalty on any portion of an underpayment of tax which is attributable to negligence or disregard of rules or regulations. For purposes of section 6662, the term “negligence” includes any failure to make a reasonable attempt to comply with Code provisions. Section 6662(c). “Negligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances.” *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967), affg. in part and remanding in part 43 T.C. 168 (1964) and T.C. Memo. 1964-299. See also *Neely v. Commissioner*, 85 T.C. 934, 947 (1985). For purposes of section 6662, the term “disregard” includes any careless, reckless, or intentional disregard. Section 6662(c). A return position that has a reasonable basis is not attributable to negligence. Reg. § 1.6662-3(a)

⁸⁹ A “substantial understatement” exists when the “correct” tax liability exceeds the tax liability actually reported by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of corporations). The rate of penalty is equal to 20 percent of the underpayment. Section 6662. For this purpose, the term “understatement” generally means the excess of the amount of the tax required to be shown on the return for the taxable year, over the amount of the tax imposed which is shown on the return. Sec. 6662(d)(2)(A).

⁹⁰ Section 6662(d)(2)(B). The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. Reg. 1.6662-4(d)(2). There is substantial authority for a position if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Reg. 1.6662-4(d)(3)(i). Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment. *Id.* Relevant authorities for this purpose are

an accuracy-related penalty will not be imposed with respect to any underpayment if the taxpayer can show that there was a “reasonable cause” for the understatement and that the taxpayer acted in good faith with respect to such understatement.⁹¹ These two exceptions are discussed in greater detail below.

If the transaction constitutes a “tax shelter,” special rules apply. Prior to the Jobs Act of 2004, tax shelter transactions were subject to a special accuracy-related penalty in Section 6662(d)(2)(C).⁹² Section 812 of the Jobs Act replaced this penalty with a completely new accuracy-related penalty that applies to both listed transactions and reportable transactions with a significant purpose of tax avoidance or evasion.⁹³

B. The Evolution of the Accuracy-Related Provisions

limited to materials such as applicable provisions of the Code, regulations, revenue rulings and revenue procedures, court cases, and legislative history. Reg 1.6662-4(d)(3)(iii). See *Santa Monica Pictures, LLC et al. v. Commissioner*, T.C. Memo. 2005-104

⁹¹ Section 6664(c)(1). The determination whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Reg. 1.6664-4(b)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess his proper tax liability. *Id.* Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. *Id.* See *Santa Monica Pictures, LLC et al. v. Commissioner*, T.C. Memo. 2005-104.

⁹² Special rules apply in the case of a “tax shelter”, which means a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Section 6662(d)(2)(C)(iii). In the case of any item of a taxpayer (other than a corporation) which is attributable to a tax shelter, an understatement shall not be reduced on the basis of substantial authority unless the taxpayer reasonably believed that his tax treatment of the item was more likely than not proper. Section 6662(d)(2)(C)(i)(I) and (II). In *Santa Monica Pictures, LLC et al. v. Commissioner*, T.C. Memo. 2005-104, the Tax Court held that “[w]e have concluded that the transaction between the Ackerman group and the Credit Lyonnais group had no economic substance, its only purpose being to transfer built-in tax losses in exchange for a \$10 million cash payment. Consequently, this arrangement is considered a “tax shelter” for purposes of section 6662(d)(2)(C)(iii). . “).

⁹³ Section 6662(d)(2)(C) was repealed and replaced by the Jobs Act § 812(d). Under prior law, a non-corporate taxpayer could reduce the penalty if the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment and there was substantial authority for the position. Both non-corporate and corporate taxpayers could avoid the penalty entirely under Section 6664(c), which is also amended by the Jobs Act, by demonstrating that there was reasonable cause for the underpayment and the taxpayer acted in good faith.

Prior to 1982, penalties existed only for negligent and fraudulent underreporting of tax liability.⁹⁴ In the Tax Equity and Fiscal Responsibility Act (TEFRA),⁹⁵ Congress expressed for the first time its concern about the “Audit Lottery” that corporations play:

An increase part of the compliance gap is attributable to taxpayers playing the ‘audit lottery’. Taxpayers were, generally, not exposed to any downside risk in taking questionable positions on their tax returns since resolution of the issue against the taxpayer required only payment of the tax that should have been paid in first instance.⁹⁶

Originally enacted in 1982, section 6661⁹⁷ introduced a 10% substantial-underpayment penalty,⁹⁸ unless the taxpayer had “substantial authority” or the transaction was disclosed.⁹⁹ Substantial authority exists for the tax treatment of a transaction only if the weight of the

⁹⁴ Sections 6653 (a) and (b), which were enacted in 1954, imposed a 5% penalty for negligence and a 50% penalty for fraud.

⁹⁵ Pub L. No. 97-248, 96 Stat. 324.

⁹⁶ See Joint Committee on Taxation, “General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982; see also Alfred Blumstein, *Models for Structuring Taxpayer Compliance, in Income Tax Compliance, Report of the ABA Section of Taxation, Invitational Conference on Income Tax Conference* (1983) (Increasing the risk of detection and increasing penalties will increase compliance. However, he also added that a change in the structure of the tax laws might increase compliance as well. The penalty should be based on the multiplier principle and thus, be equal to the underpayment (i.e the expected gain) divided by the probability of detection).

⁹⁷ Section 6661 was repealed in 1989 by the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239 (Sec. 7721).

⁹⁸ The understatement was defined as “substantial” if it exceeded the greater of 10% of the correct tax liability, or \$5,000 (\$10,000 for corporations).

⁹⁹ Former section 6661(b)(2)(B). The substantial authority is an intermediate-level standard. While less stringent than the “more likely than not” standard, which is a greater than 50% likelihood of being upheld in litigation, it is stricter than a “reasonable-basis” standard, the standard which, in general, will prevent imposition of the penalty under section 6653 (a), relating to negligence.

authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions.¹⁰⁰

The “reasonable-cause” exception provided a second means for potential relief from the imposition of a penalty.¹⁰¹ Taxpayers could not, however, reduce their penalties through productions of such evidence if the underlying transaction qualified as a “tax shelter,”¹⁰² but the taxpayer could avoid the penalty by showing a reasonable belief that the transaction was “more likely than not” an appropriate one.¹⁰³ The rationale behind those exceptions was that Congress believed that imposing a penalty was not appropriate where substantial authority existed and where both the taxpayer and the government had different but reasonable interpretations of the law.

In 1985, the Treasury issued Regulations 1.6661-3, defining the term “substantial authority.”

¹⁰⁴ Pursuant to these regulations, if substantial authority is established for a questionable

¹⁰⁰ Thus, the weight of authorities depends on the authorities’ persuasiveness and relevance, as well as on their source; the taxpayer’s belief as to whether a given authority constitutes “substantial authority” is irrelevant. The following sources are considered “substantial authority” under the law: (i) Internal Revenue Code and other statutory provisions; (ii) temporary and final regulations, but not proposed regulations; (iii) court cases; (iv) administrative pronouncements, including revenue rulings and revenue procedures; (v) tax treaties and regulations there-under; and (vi) congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of the managers for a particular bill.

¹⁰¹ Former section 6661(c). Under this exception, if a taxpayer had a “reasonable cause” for the understatement, it could avoid the penalty.

¹⁰² For the purposes of former section 6661, a tax shelter was defined as: “a partnership, or other entity, investment plan or arrangement, or any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax”. Former section 6661(b)(2)(C)(ii). Regulations under section 6662 subsequently defined the term “principal purpose” as a purpose that exceeds any other purpose. Treas. Reg. 1.6662-4 (g)(2).

¹⁰³ Former section 6661(b)(2)(C)(i).

¹⁰⁴ T.D. 8017, 50 FR 12016, Mar. 27, 1985. These regulations were repealed in 1989, when former section 6661 was repealed (*see supra*).

transaction other than those viewed as “tax shelters,” it is treated as if the taxpayer had properly reported the transaction on its tax return.¹⁰⁵

Between 1982 and 1988, several other penalty provisions were added to the Code, and most significantly, in 1984, the rate of the penalty for “tax shelters” was raised to 20%.¹⁰⁶ The Tax Reform Act of 1986¹⁰⁷ increased the general penalty rate to 20%, and immediately afterward, the Omnibus Reconciliation Act of 1986 increased it yet further to 25%.¹⁰⁸ The multitude of different penalties as well as their possible overlap with one another created confusion among taxpayers with respect to compliance and among the tax authorities with respect to enforcement of these new laws.¹⁰⁹

In its 1988 Report, the Staff of the Joint Committee on Taxation observed that the penalties should provide taxpayers with economic incentives to comply with tax laws. The Joint Committee concluded that an increase in the probability of detecting noncompliance or in the rate of the penalty for noncompliance would improve the law’s deterrent effect. Congress also felt that it is necessary to consolidate the various penalties into a more coherent standard. In the Omnibus Reconciliation Act of 1989,¹¹⁰ Congress repealed former sections 6659 and

¹⁰⁵ Former Reg. 1.6661-5(c). As a result, omission of the tax liability that would otherwise have been attributable to the transaction in question is not considered an understatement of liability for that year.

¹⁰⁶ Pub. L. No. 98-369, 98 Stat. 494.

¹⁰⁷ Pub. L. No. 99-154, 100 Stat. 2085. One of the most sweeping reforms of the 1986 Reform Act was its attack on tax shelters, particularly its introduction of several comprehensive reforms of substantive law. For an excellent discussion and critique on the 1986 reform, see Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti Tax Shelters Provisions of the Tax Reform Act of 1986*, 67 Texas Law Review 499 (19XX).

¹⁰⁸ One result of this legislative flurry of activity in 1986, however, was the creation of several separate accuracy-related penalty provisions, including those covering negligence, substantial understatement of tax liability, and fraud.

¹⁰⁹ H.R. Rep. No. 101-247 (1989).

¹¹⁰ Pub. L. 101-239, sec. 7721, 103 Stat. 2395.

6661 and consolidated the various accuracy-related penalties into the current section 6662, carrying over the same essential language of those sections.¹¹¹ The penalty for fraud remained at 75%,¹¹² but Section 6662(h) introduced a 40% penalty for certain “substantial valuation misstatements;”¹¹³ under Section 6662(h)(1)(A), the rate of penalty increases from 20% to 40% for substantial misstatements of 400% or more (or 25% or less, for substantial understatements), or for net Section 482 transfer-pricing adjustments of \$20,000,000 (or 20%).¹¹⁴ As discussed below, the substantial valuation misstatement penalty was imposed by the court in *Long Term Capital Holding v. United States*¹¹⁵ and *Santa Monica Pictures, LLC et al. v. Commissioner*.¹¹⁶

¹¹¹ The Act of 1989 consolidated the following penalties into a single accuracy-related penalty under Section 6662, which applies to five different categories of misconduct: (i) negligence, or disregard of rules or regulations; (ii) substantial understatement of income tax liability; (iii) substantial misstatement of property valuation for income tax purposes; (iv) substantial overstatement of pension liabilities; and (v) substantial misstatement of estate or gift tax liability.

¹¹² A penalty under section 6663 equal to 75% of the understatement may be imposed. The IRS must establish by clear and convincing evidence that an understatement of tax exists and that an understatement is attributable to fraud. The courts have defined fraud to mean an intentional wrongdoing on the part of a taxpayer motivated by a specific purpose to evade a tax known or believed to be owing.

¹¹³ Under section 6662(e)(1)(B), there is a “Substantial Valuation Misstatement” if: “(i) The price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or (ii) The net section 482 transfer pricing adjustment for the taxable year exceeds the lesser of \$5,000,000 or 10 percent of the taxpayer’s gross receipt”.

¹¹⁴ A 20-percent accuracy-related penalty applies to the extent that any portion of an underpayment is attributable to any “substantial valuation misstatement”. Sections 6662(a) and (b)(3). There is a “substantial valuation misstatement” if “the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed * * * is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)”. Section 6662(e)(1)(A). In the case of a “gross valuation misstatement”, the penalty increases from 20 to 40 percent. There is a “gross valuation misstatement” if the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed is 400 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be). Sections 6662(e)(1) and (h)(2).

¹¹⁵ 2004 WL 1924931(D. Conn. Aug. 27, 2004). This decision was affirmed by the Second Circuit.

¹¹⁶ T.C. Memo. 2005-104.

Another important consolidation in the 1989 Act was the introduction of a single “reasonable cause exception” under section 6664(c).¹¹⁷ As indicated in the legislative history, the reasons for the enactment of a single reasonable-cause exception provision were: (i) to allow taxpayers to understand more readily what the law requires and how to comply with the law; (ii) to simplify the administration of penalties by the IRS; (iii) to provide the IRS with better tools to evaluate whether to impose penalties in any given case; and (iv) to provide courts with improved tools for judicial review.¹¹⁸

The most significant change in the substantial-authority standard was an increase in the level of likelihood to 50%.¹¹⁹ This change followed the IRS’s February 1989 Task Force Report, in which the IRS proposed significant changes to the definition of “substantial authority.” In particular, the Task Force suggested raising the substantial-authority standard to one approaching a 50% probability, or perhaps a 51% probability or possibly even a 45% probability, of prevailing in litigation.¹²⁰

In 1994, in the Uruguay Round Agreement Act,¹²¹ the “substantial-authority” exception for corporations was abolished and replaced by a different exception under section 6664(c). The

¹¹⁷ Both the reasonable-cause and the substantial-authority exceptions were revised and re-introduced in the Penalty Administration and Compliance Act of 1989. *See infra*. Section 6664(c) was subsequently revised in 2004, as discussed in greater detail below.

¹¹⁸ H.R. Rep. No. 101-247 (1989). The former version section 6664(c) provided a single reasonable-cause provision applicable to all types of misconduct.

¹¹⁹ Section 6664(c) exempts taxpayers from accuracy penalties for undisclosed and erroneous tax return positions, including even those positions leading to substantial understatement of tax liability, provided “substantial authority” supported the stance in question.

¹²⁰ The Internal Revenue Service’s “Report on Civil Tax Penalties,” which was released in connection with a February 21, 1989, hearing of the Subcommittee on Oversight of the House Committee on Ways and Means. Cited in: TEI Submits Proposals For Civil Penalty Tax Reform, 89 TNT 127-26.

¹²¹ P.L. No. 103-465, 108 Stat. 4809. Thus, for the first time a clear distinction between individuals and corporations was introduced, such that the latter could no longer use the “substantial-authority” or the “reasonable-belief” arguments.

legislative history indicates that Congress was concerned that the substantial-understatement penalty was not effectively deterring corporations from using into tax shelters and that the goal of the proposed changes was to tighten the standards applicable to these corporations.¹²² The modified 1994 rules imposed a penalty of 20% on any understatement of income attributable to corporate “tax-shelter items” unless the taxpayer demonstrates “reasonable belief.”¹²³ Relevant “tax shelters” were defined as any partnerships, entities, investment plans, or other plans or arrangements whose “significant purpose” is the avoidance or evasion of tax liability.¹²⁴

To clarify the operation of the reasonable cause exception, Treasury issued Regulation 1.6664-4, which set forth the circumstances under which taxpayers can invoke the protection of the exception.¹²⁵ Under these regulations, the exception applies only after determination of all the pertinent facts and circumstances.¹²⁶ Reliance on the advice of a professional tax adviser constitutes reasonable cause and good faith if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith.¹²⁷ The advice must not be based

¹²² H.R. Rep. No. 103-826 (1994).

¹²³ Section 6662(d)(2)(C)(i)(I) and (II). A taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if the taxpayer reasonably relies in good faith on the opinion of a professional tax adviser; and if the opinion is based on the tax adviser's analysis of the pertinent facts and authorities and unambiguously states that the tax adviser concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS. Reg. 1.6662-4(g)(4)(B).

¹²⁴ Section 6662(d)(2)(C)(iii). Recently, the Tax Court has indicated that a transaction with no economic substance would be treated as a “tax shelter” for this purpose. See *Santa Monica Pictures, LLC et al. v. Commissioner*, T.C. Memo. 2005-104.

¹²⁵ T.D. 8381 (12/30/1991).

¹²⁶ Reg. 1.6664-4(c)(1). All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on the opinion of a professional tax adviser as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law.

¹²⁷ Regs. 1.6664-4(b) and (c)(1)(i). The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. *Id.* In addition, the taxpayer cannot establish reasonable reliance if he fails to disclose a fact that he knows, or should know, to be relevant to the proper tax treatment of an item. *Id.*

on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person.¹²⁸

Furthermore, the regulations provide that in the case of a “tax shelter,” the taxpayer must satisfy both the authority and belief requirements -- (A) The taxpayer satisfies the authority requirement only if it demonstrates substantial authority for its tax treatment of the transaction in question;¹²⁹ and (B) the taxpayer satisfies the belief requirement only if, at the relevant time, the taxpayer reasonably believed that its tax treatment of the transaction in question was “more likely than not” the proper treatment.¹³⁰ Nevertheless, even these minimum requirements are met, the taxpayer may still be subject to a penalty if the transaction in question lacks the following: (i) significant business purpose; (ii) economic substance, such that the investment benefits outweigh any potential tax benefits; and (iii) publication of the agreement between the taxpayer and the shelter’s vendor.¹³¹

In February 1999 the Clinton Administration proposed several modifications to the substantial-understatement penalty as it applies to corporate tax shelters, including: (i) raising the rate of the penalty to 40% with respect to any tax return item attributable to a corporate tax shelter; (ii) redefining a corporate tax shelter as any entity, plan, or arrangement in which

¹²⁸ Reg. 1.6664-4(c)(1)(ii). For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. *Id.*

¹²⁹ Reg. 1-6664-4(f)(2)(i)(A).

¹³⁰ Reg. 1.6664-4(f)(2)(i)(B). The “more likely than not” requirement translates into a 50% probability that the treatment would prevail in litigation. The taxpayer must satisfy the belief requirement without taking into account the likelihood being audited or of being able to settle its case. In other words, the taxpayer can meet the reasonable belief requirements only when it did not consider the “audit lottery” in its 50% probability calculation.

¹³¹ Reg. 1.6664-4 (f)(4).

direct or indirect corporate participants attempt to obtain tax benefits from tax-avoidance transactions; (iii) reducing of the 40% penalty to 20% if the corporation fulfilled specified disclosure requirements; and (iv) making unavailable the reasonable-cause exception from the substantial-understatement penalty for any item attributable to use of a corporate tax shelter.¹³²

Similarly, in its July 1999 Report,¹³³ Treasury proposed that:

“Ideally, tax penalties would be set to achieve the goals mentioned at the outset of this study. That is, they should (1) encourage voluntary compliance, (2) operate fairly, (3) deter undesired behavior, and (4) be designed in a manner that promotes efficient and effective administration of the provisions by the IRS.”

The Treasury suggested the following penalty structure:

	Defined as a “Tax Shelter”	Not Defined as a “Tax Shelter”
Disclosure	20% (subject to the reasonable-belief exception)	20% (subject to the reasonable-basis exception)
No Disclosure	40% (no exception)	20% (subject to the substantial-

¹³² See also H.R. 2255, 106th Cong., 1st Sess (June 17, 1999) (Congressman Doggett introduced H.R. 2255 (The Abusive Tax Shelter Shutdown Act (1999)) to curb tax abuses by disallowing tax benefits allegedly arising from transactions without substantial economic justification and by increasing the understatement penalty with respect to such transactions. Similar to the FY 2000 Administration’s proposal, the Act suggested an increase in the rate of the tax shelter penalty to 40% but with reductions when the taxpayers fully discloses the transaction in question).

¹³³ U.S. Dep’t of the Treasury, *The Problem of Corporate Tax shelters: Discussion Analysis, and Legislative Problems* (1999). Treasury explained that in spite of the 1994 modification, current laws still provide generous exceptions to the understatement penalty, and taxpayers can easily fit into one of these exceptions.

		authority exception)
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The Report stated that not only did the IRS and the Joint Committee think that the exceptions ought to be narrowed, but the ABA¹³⁴ and the NYSBA¹³⁵ also believed that taxpayers escape penalties too easily because of the generous exceptions that continue to exist.¹³⁶

The Joint Committee of 1999 specifically addressed the taxpayers' cost-benefit decision and observed that the then existing penalty regime was insufficient to change the cost side of the equation and that current law did provide solid ground for further improvements, with certain clarifications and modest changes.¹³⁷

Based on the above proposals, in May 24, 2000, the Senate Finance Committee's majority and minority staffs released draft legislation pursuant to which, proposed section 6662A would increase the penalty on "large corporations," defined as those with gross receipts over

¹³⁴ Although the ABA did not specifically support an increase in the penalty rate to 40%, it did acknowledge that an expanded penalty regime might be necessary.

¹³⁵ NYSBA report, p. 894-897. The NYSBA did not specifically support a 40% penalty rate but did suggest revision of the current rates. In particular, the NYSBA proposed a penalty of at least 10% for disclosed tax shelters and a higher penalty for undisclosed transactions. Finally, the NYSBA suggested that the Congress should determine what specific penalty rates would be appropriate. Significantly, the NYSBA supported elimination of the reasonable-cause exception. The NYSBA determined that most tax shelters could obtain a "more likely than not" opinion, and thus, the IRS would find it very hard to impose any penalties. Nevertheless, the NYSBA was concerned about giving the IRS with too much power and encouraged the IRS to formulate guidelines with respect to this issue.

¹³⁶ See the Treasury Report, citing the Statement of Stefan Tucker, on Behalf of the Section of Taxation, American Bar Association, before the Committee on Ways and Means, March 10, 1999, in p. 4-6, and also, the Statement of Harold Handler, on behalf of the Tax Section, New York State Bar Association, before the Committee on Finance, April 27, 1999, on p.892-893.

¹³⁷ These included (i) clarification of the corporate tax shelter definition for purposes of the understatement penalty: if a corporation enters into an entity, plan, or arrangement that is described by one or more tax shelter indicators, then a significant purpose of the entity, plan, or arrangement will be considered to be the avoidance or evasion of federal income tax; (ii) abolishment of the requirement that the understatement be substantial; and (iii) increase of the penalty rate from 20% to 40% for any understatement attributable to use of a corporate tax shelter. Finally, The Joint Committee of 1999 suggested that the 40% penalty may be abated if the taxpayer satisfies certain requirements, such as a belief that the taxpayer's tax treatment of the transaction at issue is at least a 75% likely to be sustained, and disclosure of certain information.

\$10 million that engage in the use of corporate tax shelters.¹³⁸ In October 2000,¹³⁹ the U.S. Senate Finance Committee's minority and majority staffs released a revised draft that reflected taxpayer submissions the Committee received following the release of its original proposal on May 24, 2000.¹⁴⁰ Neither of the above two proposals was enacted.

In 2001, the Senate Finance Committee released another draft legislative proposal, which would require greater disclosure of potentially abusive tax shelters.¹⁴¹ This draft moved away from the strict liability penalty standard proposed under the October 2000 draft and instead would provide a safe harbor from penalties if taxpayers properly disclose potentially abusive transactions.¹⁴²

It took three more years until the penalty provisions were revised. The Jobs Act of 2004 revised the accuracy-related penalties under section 6662 and added a new penalty for certain reportable transactions and listed transactions (section 6662A). Section 819 of the Jobs Act significantly modified the substantial understatement penalty under Section 6662 for non-reportable transactions by providing a special rule for the calculation of the understatement

¹³⁸ The proposed penalty rate would be set at 40% of the understatement "if there is a significant purpose of tax avoidance or evasion." The penalty rate could be reduced to 20% if the following requirements are satisfied: (i) the transaction in question actually has a business purpose; (ii) the taxpayer using the transaction discloses it on its tax return; and (iii) the taxpayer reasonably believes when it enters into the transaction that it will more likely than not prevail on the merits if challenged by the IRS.

¹³⁹ 2000 WTD 196-32 U.S. Senate Finance Committee Releases Revised Draft Of Tax Shelter Legislation.

¹⁴⁰ The new draft created a special class of highly abusive tax shelters, called "abusive tax shelter devices," that would be subject to a strict liability penalty of 40% on any understatement attributable to such a device.

¹⁴¹ "We remain concerned that taxpayers continue to use abusive tax shelter transactions to avoid paying taxes that they properly owe," Baucus and Grassley said in a joint statement. "We are equally concerned, however, that any legislative proposal not be overly broad so as to impede legitimate business transactions."

¹⁴² While the new draft would still increase the penalty for tax understatements attributable to tax shelters from 20% to 40%, it would provide a safe harbor from the 40% rate if: (i) substantial authority supported the taxpayer's tax treatment of the shelter; (ii) the taxpayer adequately discloses the relevant facts affecting its treatment of the shelter in its tax return; and (iii) the taxpayer reasonably believes it would more likely than not prevail on the merits if the IRS challenged its tax treatment. Under the proposal, a taxpayer would be able to establish "reasonable belief" if it relied on the opinion of a tax adviser independent of the contested tax shelter transaction but would be unable to avoid the 40% percent penalty if it relied on an opinion rendered by a tax adviser with a financial interest in the transaction or a conflict of interest or lack of independence otherwise.

amount for corporate taxpayers.¹⁴³

Congress indicated that the modification is intended to have the effect of applying the substantial understatement penalty in Section 6662 to a broader range of transactions for large corporations.¹⁴⁴ Moreover, Congress apparently felt that an understatement of \$10 million is substantial by itself even though it may represent much less than 10 percent of the taxpayer's overall tax liability.¹⁴⁵

In addition, new section 6662A sets forth completely new accuracy-related penalty that applies to both listed transactions and reportable transactions with a significant purpose of tax avoidance or evasion ("reportable avoidance transactions.")¹⁴⁶ The penalty rate and defenses available to abate the penalty vary depending on whether the transaction was adequately disclosed under the reportable transaction regulations. The penalty rate is generally 20 percent, although for undisclosed listed transactions or undisclosed transactions the new penalty is a 30 percent strict liability penalty.¹⁴⁷ The only exception to the penalty is if the taxpayer satisfies a more stringent "reasonable cause" and "good faith" exception.¹⁴⁸ The 20

¹⁴³ The understatement penalty for reportable transactions under Section 6662A applies to reportable avoidance transactions and listed transactions. Under the new legislation, a corporate taxpayer will have a substantial understatement of income tax if the amount of the understatement exceeds the *lesser of*: (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or (2) \$10,000,000. IRC § 6662(d)(1)(B). S corporations and personal holding companies are excluded from this special rule for corporations as they had been under prior law.

¹⁴⁴ The House Report suggests that the "greater of" threshold under prior law effectively allowed large corporations to avoid the accuracy-related on any "questionable" transaction of significant size. House Rpt. at 274. The Jobs Act, however, did not increase the rate of penalty, expect for establishing a new 30 percent strict liability penalty for undisclosed listed transactions and reportable avoidance transactions.

¹⁴⁵ *Id.*

¹⁴⁶ The terms "reportable transaction" and "listed transaction" have the same meanings as used for purposes of the penalty for failing to disclose reportable transactions. Other reportable transactions and any non-reportable transactions are not subject to this new penalty, although such transactions may still be subject to the accuracy-related penalty under section 6662, which also has been revised by the act.

¹⁴⁷ IRC § 6662A(a), (c).

¹⁴⁸ Section 6662(d)(2)(C) was repealed and replaced by Jobs Act § 812(d). Under prior law, a non-corporate taxpayer could reduce the penalty if the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment and there was substantial authority for the position. Both non-corporate and corporate taxpayers could avoid the penalty entirely under section 6664(c), which is also amended by the Act, by

percent reportable transaction penalty will not apply if the taxpayer satisfies a more stringent reasonable cause and good faith exception.¹⁴⁹

The new (and significantly strengthened) reasonable cause exception that has been added to Section 6664 applies solely for purposes of abating penalties for reportable transaction understatements imposed under Section 6662A. New Section 6664(d) provides that no penalty shall be imposed with respect to that portion of a reportable transaction understatement if the taxpayer shows that there was “reasonable cause” for such portion and the taxpayer acted in good faith with respect to such portion.¹⁵⁰ However, the new statute provides that the reasonable cause exception will not apply unless the following additional three items are satisfied: (i) the taxpayer adequately disclosed the relevant facts affecting the tax treatment;¹⁵¹ (ii) there is or was substantial authority for the claimed tax treatment; and (iii) the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.¹⁵²

demonstrating that there was reasonable cause for the underpayment and the taxpayer acted in good faith. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

¹⁴⁹ Taxpayers who do not adequately disclose the transaction are not eligible for the strengthened reasonable cause exception and are subject to a strict-liability penalty equal to 30 percent of the reportable transaction understatement. Prior to amendment by the Jobs Act, Section 6664(c) provided that the understatement penalty could be avoided if the taxpayer demonstrated that there was “reasonable cause” for the underpayment and the taxpayer had acted in good faith. Treasury regulations then provided that reasonable cause existed where the taxpayer “reasonably relies in good faith on an opinion” of a tax advisor and that opinion “unambiguously concludes that there is a greater than 50-percent likelihood” that the tax treatment of the item would be upheld if challenged. Reg. §§ 1.6662-4(g)(4)(i)(B) and 1.6664-4(c). *Cf. Long Term Capital Holdings v. United States*.

¹⁵⁰ IRC § 6664(d)(1). This is the same basic exception that applied to all understatements (including tax shelters) prior to the Jobs Act.

¹⁵¹ If a failure to disclose penalty is rescinded by the IRS Commissioner under Section 6707A(d), then a taxpayer will still be treated as meeting this requirement even if the taxpayer otherwise failed to adequately disclose the transaction.

¹⁵² IRC § 6664(d)(2).

V. Playing the Audit Lottery: A Cost-Benefit Analysis

A. The Cost-Benefit Equation

As set forth above, a cost-benefit equation is an efficient tool for analyzing the behavior of violators and, more importantly, for analyzing the best ways to deter such behavior.¹⁵³ This type of analysis is therefore extremely relevant to those who enter into tax-motivated transactions and has been discussed by the Treasury,¹⁵⁴ the Joint Committee,¹⁵⁵ and many commentators.¹⁵⁶ A rational taxpayer uses a cost-benefit comparison in its decision whether to enter into a tax-motivated transaction; therefore the way to discourage the taxpayer from doing so is by influencing its cost-benefit balance.¹⁵⁷

As set forth above, business entities weigh the estimated benefits with the associated costs of a transaction in their business decision processes, and in recent years corporations have applied a similar cost-benefit analysis with respect to tax-motivated transactions as well.¹⁵⁸

The benefit from such transactions obviously consists of the expected tax savings, which

¹⁵³ Stark, at 122 (“there are taxpayers, and probably every tax practitioner has encountered them and most of us have represented them, who deliberately take advantage of ambiguities in the code and who carefully do their penalty algebra in evaluating whether to disclose positions and how aggressively they should act.”)

¹⁵⁴ Supra note 3.

¹⁵⁵ Joint Committee on Taxation, Study of Present Law Penalty and Interest Provisions, as Required by Section 3801 of the Internal Service Restructuring and Reform Act of 1998 (JCS-3-99), Released on July 22, 1999.

¹⁵⁶ Graeme S. Cooper, *Analyzing Corporate Tax Evasion*, 50 Tax L. Rev. 33, 93-101 (1994); Alfred Blumstein, *Models for Structuring Taxpayer Compliance*, in *Income Tax Compliance, Report of the ABA Section of Taxation, Invitational Conference on Income Tax Conference* (1983); Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775 (1999).

¹⁵⁷ JCT and Treasury Documents on Tax Shelters and Penalties and Interest, For March 8 Hearing of Finance Committee, BNA, Text Supplement, March 9, 2000.

¹⁵⁸ “The costs of compliance include the value of the taxes, and other compliance expenses. A consequence on non-compliance is based on the probability to be audited, and the probability to be identified as a non-complier. Moreover, additional interest might be imposed. The expected benefit to the taxpayers is equal to the value of failing to pay tax without detection, minus the chance of being caught times the perceived costs, if caught”. See Loren D. Prescott, *Challenging the Adversarial Approach to Taxpayer Representation*, 30

sometimes amount to billions of dollars. The costs associated with the tax-motivated transaction, on the other hand, include: (i) direct costs; and (ii) costs associated with the risk of penalties, such as (a) the risk of detection on audit; (b) the risk of losing subsequent appeals to the IRS and to the courts; and (c) the risk of consequent underpayment penalties and interest.¹⁵⁹ As set forth above, all of these constitute “prices” of engaging in the particular activity.

The discussion below will use the following to signify the various factors, or “building blocks,” that affect a taxpayer’s cost-benefit analysis:

M – The taxpayer’s expected tax savings, or gain. Section 6662 defines the amount of expected gain as “substantial underpayment;” that is, the potential gain to the taxpayer equals the gap between the potential tax liability of the taxpayer and its actual tax liability.¹⁶⁰

Z – The probability of being subject to penalties (that is, the probability that the taxpayer would have to pay penalties because of the transaction in question).¹⁶¹ This probability is divided into four components:

*Z*₁ – The probability of being audited.

*Z*₂ – The probability that the IRS will detect the transaction on an audit.

*Z*₃ – The probability that the IRS will win its subsequent case against the taxpayer.

*Z*₄ – The probability that the taxpayer will not be able to escape the penalty.

¹⁵⁹ Joint Committee, p. 25 (Volume I part 2).

¹⁶⁰ For the purpose of our paper, we will assume that courts’ decisions as well as the IRS reallocation of income (in cases, which have not arrived to court) reflect the best judgment of what should be the true liability.

F – The rate of the penalty.

C – The taxpayer's lump-sum costs associated with the transaction.

I assume that the taxpayer is rational and therefore will seek to maximize its utility. Thus, a rational taxpayer will enter into a tax-motivated transaction as long as:

$$M - C > Z x (F + M)^{162}$$

As long as the expected amount on the left-hand side exceeds than that on the right-hand side, the rational taxpayer will decide to enter into a tax-motivated transaction.¹⁶³

Two other elements, which do not appear in the above equation, are the level of the taxpayer's aversion to risk and the social costs the taxpayer suffers if it is found liable. For the purposes of the following discussion, I will ignore both of these elements.

¹⁶¹ Note that for purposes of this article, I assume that Z does not change over time. Thus, each year's Z is independent from last year's.

¹⁶² $F+M$ consists on the amount of the underreported liability, and the amount of penalty, and is equal to the total amount, which the taxpayer has to pay if the IRS wins the case and is able to impose the penalty. For purposes of this article, I ignore the time value of money component, which frequently results from the passage of time between the audit and the conclusion of the case.

¹⁶³ The NYSBA presented the same rationale arguing that as long as the corporate taxpayer has reasonably relied on an opinion, the only downside to the taxpayer will be the payment of interest on the deficiency. When the cost-benefit analysis is done and the chances of audition, detection and unfavorable outcome are combined with the lack of probability that penalties be imposed for the, a rational corporate taxpayer can conclude that engaging in a tax shelter is, financially, well worth the risk. See NYSBA report, p. 13. See also Michael Powlen and Raj Tanden, *Corporate Tax Shelters or Plus Ca Change, Plus C'est La Meme Chose*, 431 PLI/Tax 1003,1009

This cost-benefit equation is the foundation of my entire analysis and resulting recommendations, and as described in further detail below, I conclude that by changing the balance so that tax-motivated transactions become either less beneficial or more expensive for the taxpayer to engage in, the government can reduce commerce in such products.¹⁶⁴ In other words, reducing the expected amount on the left-hand side or increasing the expected amount on the right-hand side of the equation above should be a key legislative goal. The optimal legislative strategy is also a matter of degree, however: as the discussion below explains, some changes to the taxpayer's expected costs and benefits are more effective than others in changing taxpayer incentives.

1. The taxpayer's prospective gain (M)

A taxpayer's gain from engaging in a tax-motivated transaction is generally mirrored by resulting harm imposed on other parties. The savings generated from a tax-motivated transaction have a harmful effect on all of society, where the benefit to the taxpayer equals the economic harm to society (in that the reduction in tax revenues equals the taxpayer's tax savings). With the additional social (non-financial) costs attributable to a tax-motivated transaction, which I can safely assume always exist to some extent, the basic assumption becomes one in which the expected gain to the individual taxpayer is always less than the costs to society.¹⁶⁵ Therefore, as the discussion above suggests, the cost-benefit equation should be used so as to deprive the taxpayer of its prospective gains rather than to force the taxpayer to internalize the harm it causes to the society.¹⁶⁶

¹⁶⁴ Based on the equation, four potential changes are applicable: (i) reducing the potential gain (Reducing M); (ii) increasing the lump sum costs (Increasing C); (iii) increasing the probability that the taxpayer will be subject to the penalty (Increasing Z); and (iv) increasing the rate of penalty (Increasing F).

¹⁶⁵ See Keith N. Hylton, *Symposium: Reply: Punitive Damages and the Economic Theory of Penalties*, 87 Geo. L. J. 421 (1998), *supra* note.

¹⁶⁶ *Id.*

2. The taxpayer's lump sum costs (C)

Several types of potential costs are typically attributable to tax-motivated transaction: (i) promoters' fees; (ii) pre-litigation costs, including lawyers and accountants' costs and procedural costs such as registration fees, etc.; and (iii) litigation costs, including lawyers' fees, economists and other experts' fees, and court fees.¹⁶⁷ Promoters' fees can be paid either as a fixed amount or as a percentage of the resulting gain from the tax savings.¹⁶⁸ With respect to the former type of fee, the fixed-amount fee, larger companies with arguably more disposable and taxable income will bear a relatively smaller burden than mid-size taxpayers.¹⁶⁹ Conversely, with respect to the latter type of fees, the percentage-based fee, corporate size and disposable income do not matter. For the purposes of this article, however, I will assume that promoters' fees are paid on a fixed, not contingent, basis.

3. The probability of being subject to penalties (Z)

This factor is subdivided into four different components:

*The probability of being audited (Z₁)*¹⁷⁰

¹⁶⁷ Promoter fees are not only the most significant type of costs, but also the clearest type of costs, since the fees are paid upfront, while the other costs may be calculated indirectly. Another significant and clear cost is the cost of opinion formulating by tax lawyers, which are separate from the promoter fees. According to Saunders and Noback, such costs can amount to \$500,000. See Noback and Saunders, "The Hustling of X rated Shelters" *Forbes*, December 14, 1998, p. 11. For a thorough discussion of these costs in relation to tax-motivated transaction, see *Long Term Capital Holding v. United States*.

¹⁶⁸ Noback and Saunders, *The Hustling of X rated Shelters*, *Forbes*, December 14, 1998, and see also Bankman., *supra*. In recent years, promoters of tax shelters are trying to "beat" the market and to offer companies fees, which are based on success.

¹⁶⁹ Since the costs are presented in a lump sum, smaller companies have more burden as a portion of the taxable liability under dispute.

¹⁷⁰ For a discussion on the role of probability to be audited and detected in the cost-benefit analysis, see Johnson, p. 1606, and also the Joint Committee, p.25-26 (Volume I part 2). See also the Treasury Report, p. 32. See also ABA Report, p. 4, and James Holden, *Dealing with Aggressive Tax Shelters*, 52 *Tax Lawyer* 369.

One of the major mysteries in the business community is exactly how efficient the IRS is in auditing and detecting tax-motivated transactions.¹⁷¹ We do know, however, that the size of a company is a factor in determining audit rates: the larger the company is, the higher the probability of an audit.¹⁷² In fact, large companies are regularly audited. The Treasury and the IRS, however, reported that audit rates for large corporations (those with assets greater than a hundred million dollars) have fallen dramatically over the past several years: in 1980, the audit rate was 77% but fell to 59% in 1990 and in 1997 fell again to only 35%. Moreover, the overall audit rate for corporations in general declined to 2% in 1998. Thus, corporate tax departments might be less worried about detection than they used to be twenty years ago.¹⁷³ Recent studies have noted the continuing decline in audit rates across virtually all categories of taxpayers, even though the Service has indicated that audit rates, at least for corporations, have begun to recover.¹⁷⁴

The probability that the IRS will detect the use of a tax shelter on an audit (Z₂)

The probability that a tax-motivated transaction will be detected on an audit is one of the more significant aspects of the taxpayer's cost-benefit equation.¹⁷⁵ This risk is sometimes referred to as "playing the audit lottery."¹⁷⁶ Nevertheless, even if a taxpayer made all the appropriate disclosures about its business transactions, many auditors might not be able to

¹⁷¹ Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane*, 16 VA Tax Rev. 155, 189 (1996) ("Because of limited resources available to the Service,[footnote omitted] audits are relatively rare, so that the Service may well not audit the taxpayer.")

¹⁷² The IRS has a separate department for big businesses and is relatively more efficient with respect to auditing such taxpayers. See also Graeme S. Cooper, *Analyzing Corporate Tax Evasion*, 50 Tax L. Rev. 33, 96 (1994).

¹⁷³ Saunders and Noback, *supra*, at 12; The Treasury Department, *The Problem of Tax Shelters*, *supra*, at 17.

¹⁷⁴ See "Study Disputes IRS has Turned Corner on Enforcement," 2004 TNT 212-2 (Nov. 2, 2004) (describing a study prepared by Syracuse University's nonpartisan research group, Transactional Records Access Clearinghouse, which indicates that audit rates for fiscal year 2004 are on pace to lag the 2003 audit rate by 25 percent and overall corporate audit coverage dropped for the ninth consecutive year in 2003 to .87 percent).

¹⁷⁵ Graeme S. Cooper, *Analyzing Corporate Tax Evasion*, 50 Tax L. Rev. 33, 95-101 (1994).

¹⁷⁶ Joint Committee, *supra*, at 26 (Volume I part 2)

distinguish the tax-motivated transaction from other corporate activities.¹⁷⁷ Detection of tax-motivated transactions thus depends on several elements, including the quantity and quality of auditors working on a particular case, a company's efforts to hide its tax-motivated transactions, and the nature and complexity of the underlying transaction. As indicated by Cooper:

In other words, uncertainty arises not from playing the "audit lottery" but from playing an "auditor lottery" - it is the skill of the auditor rather than the risk of selection for audit that will determine whether the evasion succeeds or fails. This uncertainty translates into a probability of success or failure, and while the audit rate for corporations will not be a good indicator of this probability, it sets the base from which all further conditional probabilities emerge.¹⁷⁸

Accordingly, even when a tax-motivated transaction is audited, auditors are at a disadvantage because of the complexity and sophistication of these products. Furthermore, companies may employ several techniques to conceal their tax-motivated transactions from the auditors.¹⁷⁹ Because the IRS also has limited resources, auditors cannot devote the time needed to analyze fully all of the relevant facts and law.

¹⁷⁷ See Rosenberg, *supra* at 9 ("Even if the Service does audit the taxpayer, it may not notice whatever tax evasion the taxpayer may have engaged in. To the extent that it must rely on the taxpayer's own records to incriminate the taxpayer, the Service is in a difficult position."). For a similar view in the inside trading context, see Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1262 (1995) ("By one estimate, fewer than one in five cases of insider trading is successfully prosecuted, [footnote omitted] and in retrospect that estimate probably is too high by several orders of magnitude. [footnote omitted] It is often very difficult to tell when insider trading is taking place, and even when insider trading is suspected it is very difficult to identify the responsible party if many people had access to the information. Finally, even when insider trading is detected, it often can be difficult to build a persuasive case against the inside trader.").

¹⁷⁸ Cooper, at 96.

¹⁷⁹ *Id.* at 100.

Specifically, as observed by the ABA in 1999:

A sad additional fact is that all parties to these transactions know there is substantial likelihood that the device employed, including the imaginative assertion of the proper factual setting, will not be uncovered by IRS agents even if the corporation is audited, as most large taxpayers are. The tax law is too complex and the returns of major taxpayers are too voluminous. Many tax shelter products involve numerous parties, complex financial arrangements and invoke very sophisticated provisions of the tax law. It often takes time and painstaking analysis by well-informed auditors to ascertain that what is reported as a legitimate business transaction has little, if any, purpose other than the avoidance of Federal income taxes. Accordingly, there is a very reasonable prospect that a product will win the ‘audit lottery.’ This aspect of the problem is compounded by the fact that present law gives no reward for full disclosure in the case of corporate tax shelter transactions.¹⁸⁰

According to the Joint Committee of 1999, the audit rate is also not nearly as important as the selection and identification of issues for audit: audits of large corporations usually follow an agreed- upon agenda of issues that is negotiated between the IRS and the corporate taxpayer. Accordingly, “playing the audit lottery” entails not only the probability of detection but also the taxpayer’s ability to have only its most legitimate issues included on the audit agenda while excluding its tax motivated transactions. A corporation that is successful in

¹⁸⁰ ABA testimony, *supra*, at 6

implementing this strategy may, in effect, “win the audit lottery” despite losing the gamble that it would not be audited in the first place.¹⁸¹

Recent statements by the IRS Commissioner are revealing to the extent they suggest that the Service’s litigation enforcement strategy has focused on corporations and high-income individuals, not because the most revenue is to be gotten from this sector of the taxpaying public, but rather because it provides the greatest “political resonance” and a “sense of fairness.”

We are starting with high-income individuals and corporations not because they are the biggest contributors to the tax gap -- they are not. The largest chunk (sic) of the tax gap comes from self-employed and small businesses,” Everson said. “But there is political resonance and a sense of fairness that comes from compliance at the high end.”¹⁸²

The IRS Strategic Business Plan for 2005-2009 indicates that the “tax gap” is roughly \$312 billion per year and less than half of that amount is attributable to large corporations and high-income individuals.¹⁸³

The probability that the IRS will win its subsequent case against the taxpayer (Z₃)

¹⁸¹ Joint Committee, *supra* note 3, at 26-27 (Volume I part 2).

¹⁸² See “Everson Defends IRS’s Enforcement Focus on High Earners, Corporations, Practitioners,” Daily Tax Report, 220 DTR G-1 (Nov. 16, 2004) (hereinafter, Everson on Enforcement).

¹⁸³ IRS Strategic Plan, 2005 – 2009, Publication 3744 (Rev. 6-2004), at page 18 (the tax gap numbers are based on compliance models developed from tax return data for fiscal year 1988 and earlier years). See also Everson on Enforcement (estimating the tax gap as exceeding a quarter of a trillion dollars per year based on a combination of nonfiling, nonreporting, and nonpayment).

Even when the IRS audits and detects a tax-motivated transaction, it may still not prevail in court. Recently, taxpayers won clear-cut victories in *Black & Decker*,¹⁸⁴ *Coltec Industries*,¹⁸⁵ and *Castle Harbour*,¹⁸⁶ which followed closely on the heels of a government win in *Long Term Capital Holdings*.¹⁸⁷ The IRS, however, has recently won in *CMA Consolidated Inc. et al. v. Commissioner*.¹⁸⁸ Generally, the government's chances of winning cases depend on the adequacy of substantive tax rules and, as a second best solution, the existence of anti-abuse rules. This article focuses on the latter. Current U.S. tax law employs two types of anti-abuse rules: statutory rules¹⁸⁹ and common-law rules. Since *Gregory v. Helvering*,¹⁹⁰ courts have been applying various anti-abuse common law doctrines to deny the tax benefits of tax motivated transactions.¹⁹¹ When a transaction is challenged by the Internal Revenue Service,

¹⁸⁴ *Black & Decker Corp. v. United States*, 2004 U.S. Dist. LEXIS 21201 (D. Md. Oct. 22, 2004).

¹⁸⁵ *Coltec Indus. v. United States*, 2004 U.S. Claims LEXIS 286 (Fed. Cl., Oct. 29, 2004).

¹⁸⁶ *TIFD III-E Inc. v. United States*, 2004 U.S. Dist. LEXIS 22119 (D. Conn. Nov. 1, 2004) (hereinafter, *Castle Harbour*).

¹⁸⁷ *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 2004 U.S. Dist. LEXIS 17159, 94 A.F.T.R.2d (RIA) 5666, 2004-2 U.S. Tax Cas. (CCH) P50351 (D. Conn. 2004).

¹⁸⁸ T.C. Memo. 2005-16; No. 12746-01 (January 31, 2005).

¹⁸⁹ Examples of statutory anti abuse rules include: (i) Section 269, which grants authority to disallow certain benefits; (ii) Section 446, which prescribes a change of method of accounting if necessary to clearly reflect income; (iii) Section 482, which grants authority to reallocate income and deductions between related parties if necessary to prevent evasion or to clearly reflect income; (iv) Section 1092, which grants authority to disallow benefits in the case of a straddle; and (v) Section 1259, which requires recognition of income upon a "constructive sale."

¹⁹⁰ 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).

¹⁹¹ See *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S. Ct. 1291, 55 L.Ed 2d 550 (1978) (court looked at economic substance or reality of sale and leaseback transactions); *Knetsch v. United States*, 364 U.S. 361, 81 S. Ct. 132, 5L Ed. 2d 128 (1960)(interest expense deductions disallowed because only thing of substance to be realized from transaction was tax deduction); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) (recognizing step transaction doctrine, whereby courts must consider all steps of transaction in light of entire transaction, so that substance of transaction will control over form of each step); *ACM Partnership v. Commissioner*, 157 F.3d 231, 233-43 (3d Cir. 1998), *aff'g* in part, T.C. Memo. 1997-115, cert. denied, 119 S. Ct. 1251 (1999) (court held that the sophisticated investment partnership were formed solely to generate a capital loss to shelter some of Colgate-Palmolive's capital gains); *Kirchman v. Commissioner*, 862 F.2d 1486, 1488-89(11th Cir. 1989); (court held that option straddles were entered into to produce deductions with little risk of real loss); *Karr v. Commissioner*, 924 F.2d 1018, 1021 (11th Cir. 1991); *cert. denied*, 112 S. Ct. 992 (1992) (court held that energy enterprise were developed solely to produce deductible losses for investors); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985) (court held that sale-leaseback of a computer by a car dealership, was entered into solely to generate depreciation deductions). See, generally Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5 (2000); Boris I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 Howard Law Journal 693, 707 (1978);

the court may apply one of these doctrines to determine if the tax benefits associated with the transaction would be allowed. As of today, as opposed to other countries such as Canada, New Zealand and Australia for example,¹⁹² there is no general anti-abuse rule (GAAR) in the United States Internal Revenue Code, and, therefore, except for particular statutory and regulatory anti-abuse rules, general anti abuse rules remain common law doctrines.

In its 1999 report, the Treasury agreed that anti-abuse rules could be used to provide more clear-cut answers on cracking down tax-motivated transactions and suggested for the first time to codify the doctrine.¹⁹³ The Joint Committee also supported a codification; however, the Joint Committee also stated that the problem lies not in the current anti-abuse rules but in the fact that the IRS does not possess the necessary tools for litigating cases.¹⁹⁴ The Joint Committee saw the glass as half-full: for every case the IRS wins, there are hundreds more that it loses. As discussed in greater detail below, all proposals to clarify and codify the economic substance doctrine have been widely (if not uniformly) criticized, at least in the form that they have been proposed, and as of today, there is no general anti abuse rules in the Internal Revenue Code.

The probability that the taxpayer will not be able to escape the penalty (Z₄)

As set forth above, the accuracy-related penalty provisions contain exceptions that allow taxpayers to avoid the penalties even if the IRS wins a case against the taxpayer. In general,

Department of the Treasury, General Explanations of the Administration's Revenue Proposals, Corporate Tax Shelters (Feb. 1999).

¹⁹² For a comprehensive discussion on general anti avoidance rules in common law countries, see Graeme Cooper, *International Experience with General Anti-Avoidance Rules*, 54 SMU L. Rev. 83 (2001).

¹⁹³ Treasury report, *supra* note 3, at 6 (part 1).

¹⁹⁴ JCT and Treasury Documents on Tax Shelters and Penalties and Interest, For March 8 Hearing of Finance Committee, BNA, Text Supplement, March 9, 2000, on p. 11.

pursuant to the “reasonable-cause exception,” a taxpayer who is found liable for underpayment of taxes can nevertheless maintain the same position as if it had never entered into tax motivated transaction in the first place.¹⁹⁵ Therefore, taxpayers are even less discouraged from entering into tax motivated transactions, knowing that, even if detected and prosecuted, at worst, they would have to make up the underpaid tax plus normal interest, but at best, they might escape the penalties altogether by invoking one of the law’s exceptions.¹⁹⁶

Pursuant to the changes in the Jobs Act of 2004, however, the strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment. Recently, in *Long Term Capital Holding v. United States*,¹⁹⁷ the court upheld penalties assessed by the IRS despite the taxpayer's argument that it had obtained and relied on two separate law firm "should" level opinions supporting its position from two reputable law firms. Finally, under Section 6662A, the penalty for undisclosed listed transactions or undisclosed “reportable avoidance transactions” is a strict liability penalty.¹⁹⁸

4. The rate of the penalty (F)

One of the most important features of the current penalty regime is that it is not based on the multiplier principle, which is, as described above, a fundamental principle of utilitarian economic theory. This principle was illustrated by Eric Posner as follows:

¹⁹⁵ See *supra*.

¹⁹⁶ Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453, 1458-59 (2003).

¹⁹⁷ 2004 WL 1924931(D. Conn. Aug. 27, 2004).

¹⁹⁸ IRC § 6662A(a) and (c).

[S]uppose that a person, P, has earned \$ 1000 in income that has not been reported to the Internal Revenue Service ("IRS") and has not been subjected to withholding. At a marginal rate of 30%, it costs him \$ 300 to report the income to the IRS and pay the appropriate tax. If P does not report the income, and there is a 1% chance that he will be audited and his deception detected, then the proper sanction is a fine of \$ 30,000 (or an equivalent imprisonment). Considered ex ante, P would comply with the tax law only if he anticipated a sanction of this amount or higher, given the 1% probability of detection.¹⁹⁹

Instead, under the current accuracy-related penalty regime, the penalty is based on a percentage of the underpayment, regardless of the taxpayer's likelihood of being subject to the penalty.²⁰⁰ Currently, a forty percent penalty is imposed only on a "gross valuation misstatement." The Jobs Act of 2004 added a third possibility; under section 6662A, for undisclosed listed transactions or undisclosed "reportable avoidance transactions" the new penalty is a 30 percent strict liability penalty.²⁰¹ This alternative, however, is not discussed herein.

¹⁹⁹ Eric Posner, *Symposium: The Legal Construction of Norms: Law and Social Norms: The Case of Tax Compliance*, 86 Va. L. Rev. 1781, 1783 (2000).

²⁰⁰ Specifically, Section 6662, which was modified in 1989 to include all accuracy-related penalties, imposes a twenty percent penalty on the portion of an underpayment attributable to, among other things, substantial understatement of income and misstatement of valuation.

²⁰¹ IRC § 6662A(a) and (c).

The amount of underpayment under section 6662 is generally equal to the amount of expected gain to the taxpayer, M .²⁰² Thus, depending on the size of the underpayment, the rate of the penalty, F , could be calculated as either:

$$F = 0.2M, \quad \text{or}$$

$$F = 0.4M.$$

If the taxpayer is found liable, the taxpayer will have to remit its entire underpayment, M , plus the penalty, F (such that the taxpayer would have to pay either $1.2M$ or $1.4M$). For purposes of this article, I ignore any interest charges that might be added to the taxpayer's liability.

B. Analysis of the Cost-Benefit Equation

1. Assumptions

For the purposes of the following discussion, I assume that: (i) the lump sum costs (C) and the expected gain (M) are both positive and unrelated (meaning that the promoters' fees are not contingent); (ii) the rate of the penalty is either 0%, 20%, or 40%; (iii) the probability of being subject to the penalty (Z) is either 25%, 50% or 75%; (iv) the taxpayer's level of risk aversion is irrelevant; and (v) non-economic considerations are also irrelevant.

2. Determining what is a Sufficient Level of Deterrence According to the Taxpayer's Cost-Benefit Equation

²⁰² As set forth above, an understatement of tax under section 6662 is the excess of the amount of tax required to be shown on the return over the tax imposed reduced by any rebate.

The cost-benefit equation consists of the four variables of expected gain (M), lump-sum costs (C), the rate of the penalty (F), and the probability of being subject to the penalty (Z). I assume that the last two variables are *exogenous*, such that the taxpayer can exert no control over either the rate of its penalty or its probability of being subject to the penalty and must take these variables as given. The first two variables are *endogenous*, however, such that the taxpayer can negotiate and control the amount of expected gain and expected lump-sum costs before entering into the transaction.

The taxpayer, therefore, will make the following cost-benefit analysis: given a certain penalty rate and probability of being subject to that penalty, the taxpayer must minimize lump-sum costs in order to net a positive gain from the transaction. The higher the rate of the penalty and the probability of being subject to it are, the lower the lump-sum costs could be in order to deter the taxpayer. For example, when the rate of penalty and the probability of being subject to it equal 0% and 25% respectively, the taxpayer will enter into the transaction as long as the lump-sum costs do not exceed 75% of the expected gain. Under such circumstances even a very expensive tax-motivated transaction is still expected to be profitable.

As a factual matter, however, even the most expensive tax-motivated transactions do not entail lump-sum costs of more than 30% of the expected gain. In fact, as the empirical evidence described below indicates, in the majority of cases lump-sum costs constitute only a small fraction of the expected gain. Therefore, the taxpayer in this first illustration will likely not be deterred from entering into a tax-motivated transaction.

3. The Impact of Changes in the Rate of the Penalty

- i) Illustration 1: the rate of the penalty is 0% and the probability of being subject to it is 25% ($F = 0$ and $Z = 0.25$):

In this case, a taxpayer will enter into a tax-motivated transaction whenever:

$$M - C > Z(F + M)$$

$$M - C > 0.25M$$

$$C < 0.75M$$

Conclusion: As long as C is less than $0.75M$, the taxpayer will have incentive to enter into a tax-motivated transaction. As mentioned above, it is very unlikely that the lump-sum costs will exceed seventy-five percent of the expected gain from its use. Thus, under such low F and Z , most taxpayers will decide to enter into the tax-motivated transaction.

- ii) Illustration 2: the rate of the penalty is 20% and the probability of being subject to it is 25% ($F = 0.2M$ and $Z = 0.25$):

Again, applying the cost-benefit equation above, we find that a taxpayer will enter into tax-motivated transaction whenever:

$$M - C > Z(F + M)$$

$$M - C > 0.25(1.2M)$$

$$C < 0.7M$$

Conclusion: As long as C is less than $0.7M$, the taxpayer will have incentive to enter into tax-motivated transaction. Again, it is very unlikely that the lump-sum costs will exceed seventy percent of the expected gain.

- iii) Illustration 3: the rate of the penalty is 40% and the probability of being subject to it is 25% ($F = 0.4M$ and $Z = 0.25$):

The calculation shows that:

$$M - C > Z(0.4M + M)$$

$$M - C > 0.25(1.4M)$$

$$C < 0.65M$$

Conclusion: As long as C is less than $0.65M$, the taxpayer will enter into a tax-motivated transaction.

- iv) Illustration 4: the rate of the penalty is 100%²⁰³ and the probability of being subject to it is 25% ($F = M$, $Z = 0.25$):

The calculation shows that :

$$M - C > Z(M + M)$$

$$M - C > 0.25(2M)$$

$$C < 0.5M$$

²⁰³ Even though it is unrealistic that the penalty rate will be raised to 100%, the purpose of this section is to demonstrate that even if such a change occurs, the deterrence will not be significant yet.

Conclusion: As long as C is less than $0.5M$, the taxpayer will enter into a tax-motivated transaction. **Note that even a 100% rate of penalty is not effective to deter the taxpayer as long as Z is low.**

- v) Illustration 5: the rate of the penalty is 20% and the probability of being subject to it is 50% ($F = 0.2M$ and $Z = 0.5$):

The calculation shows that:

$$M - C > Z(0.2M + M)$$

$$M - C > 0.5(1.2M)$$

$$C < 0.4M$$

Conclusion: As long as C is less than $0.4M$, the taxpayer will enter into a tax-motivated transaction.

- vi) Illustration 6: the rate of the penalty is 40% and the probability of being subject to it is 50% ($F = 0.4M$ and $Z = 0.5$):

The calculation shows:

$$M - C > Z(0.4M + M)$$

$$M - C > 0.5(1.4M)$$

$$C < 0.3M$$

Conclusion: As long as C is less than $0.3M$, the taxpayer will enter into a tax-motivated transaction.

The results so far indicate that the efficiency of increasing the rate of the penalty is very limited. Even a penalty rate of 100% will not provide reasonable deterrence when the probability of being subject to the penalty is no more than 25%.

4. The Impact of Changes in the Probability of Being Subject to the Penalty

By varying the taxpayer's probability of being subject to a penalty, we can see the effect on deterrence of changing this latter variable.

- vii) Illustration 7: the rate of the penalty is 20% and the probability of being subject to it is 25% ($F = 0.2M$ and $Z = 0.25$):

Again applying the cost-benefit equation above, we can see that the taxpayer's calculation becomes:

$$M - C > Z(0.2M + M)$$

$$M - C > 0.25(1.2M)$$

$$C < 0.7M$$

Conclusion: As long as C is less than $0.7M$, the taxpayer will have an incentive to enter into a tax-motivated transaction.

- viii) Illustration 8: the rate of the penalty is 20% and the probability of being subject to it is 50% ($F = 0.2M$ and $Z = 0.5$):

The calculation becomes:

$$M - C > Z(0.2M + M)$$

$$M - C > 0.5(1.2M)$$

$$C < 0.4M$$

Conclusion: As long as C is less than $0.4M$, the taxpayer will have an incentive to enter into a tax-motivated transaction.

- ix) Illustration 9: the rate of the penalty is 20% and the probability of being subject to it is 75% ($F = 0.2M$ and $Z = 0.75$):

The calculation becomes:

$$M - C > Z(0.2M + M)$$

$$M - C > 0.75(1.2M)$$

$$C < 0.1M$$

Conclusion: As long as C is less than $0.1M$, the taxpayer will have an incentive to enter into a tax-motivated transaction.

- x) Illustration 10: the rate of the penalty is 40% and the probability of being subject to it is 50% ($F = 0.4M$ and $Z = 0.5$):

The calculation becomes:

$$M - C > Z(0.4M + M)$$

$$M - C > 0.5(1.4M)$$

$$C < 0.3M$$

Conclusion: As long as C is less than $0.3M$, the taxpayer will have an incentive to enter into a tax-motivated transaction.

5. Summary of the Results

Rate of the Penalty	$Z = 0.25$	$Z = 0.5$	$Z = 0.75$
0% penalty	$C < 0.75M$	$C < 0.5M$	$C < 0.25M$
20% penalty	$C < 0.7M$	$C < 0.4M$	$C < 0.1M$
40% penalty	$C < 0.65M$	$C < 0.3M$	<i>Full deterrence</i>
100% penalty	$C < 0.5M$	<i>Full deterrence</i>	<i>Full deterrence</i>

C. *Conclusions*

1. Increasing the rate of the penalty reduces taxpayer's incentives to enter into tax motivated transaction.

2. Increasing the probability of being subject to a penalty also reduces their incentives to enter into tax motivated transaction.
3. The most important conclusion, however, is that increasing the rate of the penalty is less efficient than increasing the probability that the taxpayer will be subject to the penalty.²⁰⁴

To conclude, it is clear that both an increase in the likelihood of being subject to the penalty and in the rate of penalty will have a deterrence effect. Nevertheless, it is also clear that a change in the probability of being subject to a penalty has a significantly greater impact on the taxpayer's cost-benefit balance than does a change in the rate of penalty. As discussed in greater detail below, the changes to the penalty regime in the Jobs Act of 2004 were consistent with this conclusion; rather than increasing the rate of penalty, Congress broadened the scope of taxpayers who might be subject to the tax.

VI. How to Change the Corporate Taxpayer's Cost-Benefit Equation: Recent Developments and a Proposal

A. General

²⁰⁴ For similar conclusions, see Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. Pub. Econ. 323, 330 (1972):

Summing up the comparative static analysis of our model, we may note that although it does not yield any clear-cut results in the analysis of changes in actual income and in the tax rate, unambiguous results can be derived for the two parameters of the model which are of particular interest for policy purposes in this field, viz. the penalty rate and the probability of detection. The former is a parameter over which the tax authority exercises direct control; the latter it may be assumed to control indirectly through the amount and efficiency of resources spent on detecting tax evasion. The model implies that these two policy tools are substitutes for each other. While the expected tax yield would fall with a decrease of p , the loss of tax revenue could be compensated by an increase of p .

As discussed above, The Joint Committee and Treasury acknowledged in 1999 that the then-existing penalty regime was insufficient to provide a significant disincentive to play the audit lottery.²⁰⁵ Based on the above analysis, I believe that Congress and Treasury must focus on how to increase the likelihood that the taxpayer will eventually pay the penalty and not on what the rate of penalty should be. In terms of the above cost-benefit equation, Congress and Treasury must, therefore, focus on increasing Z .

There are several ways by which Z could be raised. The probability of being subject to a penalty, as mentioned above, consists of four components: the probability of being audited (Z_1); the probability of being detected as a tax shelter participant (Z_2); the probability that the IRS will win its case against the taxpayer (Z_3); and the probability that the taxpayer will not otherwise escape paying the penalties (Z_4). As also demonstrated above, increasing the overall probability (Z) most efficiently deters from entering into tax-motivated transactions and therefore is extremely important.

Set forth below is a summary of the four most efficient alternatives, in my view, that would reduce the extent taxpayers are willing to play the audit lottery:

1. The most effective measure with respect to Z_1 and Z_2 is to require *greater disclosures from taxpayers and registration and listing from promoters and advisors* involved in tax-motivated transactions.²⁰⁶ The Jobs Act of 2004 has improved these rules not only by unifying all three measures

²⁰⁵ Back then, however, Congress and Treasury thought that a combination of rate increase and disclosure would provide the best answer.

²⁰⁶ The Joint Committee in 1999 specifically mentioned the key role of disclosure in improving the audit and detecting rates, p. 31.

under the single standard of “reportable transactions” but also by imposing penalties for non-disclosure. Nevertheless, the most important improvement of these rules has yet to come; Treasury must provide taxpayers with appropriate guidance on what should be disclosed, and as of today, the confusion among practitioners and the IRS pertaining to these rules is enormous.

2. My proposals with respect to Z_3 are more comprehensive. In order to provide the IRS with better tools for prosecuting and winning cases, Congress must create more effective anti-abuse rules. Congress has yet to adopt all the recent proposed codifications of the economic substance doctrine, and this rejection, in my view, is justifiable on the grounds that it is inconsistent with the majority of courts’ decisions pertaining to the economic substance doctrine. In my view, however, the current proposed codification rules should be revised and re-proposed in accordance with the prevailing standards set forth by the courts. Several commentators have also suggested replacing the current piecemeal variety of anti-abuse rules with a single comprehensive general anti-abuse rule (GAAR),²⁰⁷ which exists in other common-law countries such as Australia and Canada.²⁰⁸

3. My proposal with respect to Z_4 focuses primarily on the reasonable-cause exception. Many taxpayers are able to escape penalties either by using

²⁰⁷ Hariton, p. 241, and Treasury p. 12 (part 2), and Appendix C.

²⁰⁸ See, e.g., Section 245 of Canada’s Income Tax Act (the “Act”), known as the General Anti-Avoidance Rule or “GAAR.” The Canadian GAAR allows an “avoidance transaction” to be recharacterized to deny the “tax benefit” that would otherwise arise as a result of the transaction. An “avoidance transaction” is defined as any transaction that would result in a tax benefit unless the transaction (or series of transactions) may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit. “Tax benefit” includes a reduction, avoidance or deferral of tax payable under the Act. Even if a transaction is an avoidance transaction, the GAAR will not apply where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act, read as a whole. See, generally, Graeme S. Cooper, *International Experience with General Anti-Avoidance Rules*, 54 SMU L. Rev. 83 (2001).

the reasonable cause exception or by negotiations with the IRS if a tax-motivated transaction is detected. The Jobs Act of 2004 has tightened the rules for the exception, and the decision in *Long Term Capital Holdings* (discussed below) made it clear that a “should” opinion from a reputable law firm may not suffice. It should be clear that not any opinion would provide the support for the reasonable cause exception; only the ones founded on solid legal grounds.

4. Finally, the least efficient proposal in my view is to change the rate of accuracy-related penalty (F). As the above analysis illustrates, increasing the rate of penalty could have effect only if the rate structure is altered to be based on the multiplier element.

Each of these alternatives is discussed in greater detail below.

B. Increasing Z1 and Z2: Reporting, Listing and Disclosure

1. *General*

The foundation of the statutory provisions (disclosure, reporting and list maintenance) is the list of six “reportable transactions”²⁰⁹ that the Treasury has defined (and refined) over time in the regulations under Section 6011.²¹⁰ In October 22, 2002, Treasury issued Temporary

²⁰⁹ The term transaction includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan.

²¹⁰ Reg. § 1.6011-4(b). The Jobs Act adds the concept of a reportable avoidance transaction, or a reportable aviodance transaction, but otherwise made no changes to the six categories of reportable transactions under the Section 6011 regulations.

Regulations 1.6011-4T that established the concept of “reportable Transactions.”²¹¹ The Treasury issued final regulations regarding the disclosure of “reportable transactions” on February 27, 2003.²¹² The Regulations require a taxpayer to disclose with its tax return certain information with respect to each “reportable transaction” in which the taxpayer participates. The final reportable transaction regulations rely on “objective” rules for determining whether a transaction is reportable, eliminating the “tax effect test” and other subjective exceptions that had been included in earlier versions of the regulations.²¹³

2. *Jobs Act’s Revisions*

Prior to the Jobs Act of 2004, taxpayers were not subject to a specific penalty for the failure to comply with these disclosure requirements. Under the Jobs Act, new Section 6707A²¹⁴ imposes a penalty on any taxpayer who fails to disclose a “reportable transaction” as required under the Section 6011 regulations.²¹⁵ The amount of the penalty, which applies regardless

²¹¹ Preamble to Temporary Regulations for Tax Shelter Disclosure Statements, T.D. 9017, 2002 C.B. 815, 817 (“These new temporary regulations provide more objective rules. The regulations redefine a reportable transaction as a transaction that satisfies any one of six categories of transactions. The regulations also eliminate the projected tax effect test and the general exceptions.”)

²¹² T.D. 9046, 68 F.R. 10161 (Mar. 4, 2003).

²¹³ Treas. Reg. sec. 1.6011-4(b)(2) – (7). The sixth categories include; (i) any transaction that is the same as (or substantially similar to) a transaction that is specified by the Treasury as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (a “listed transaction”); (ii) any transaction that is offered under conditions of confidentiality; (iii) any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained; (iv) any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) \$10 million in any single year or \$20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) \$2 million in any single year or \$4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) \$50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses; (v) any transaction done by certain taxpayers in which the tax treatment of the transaction differs (or is expected to differ) by more than \$10 million from its treatment for book purposes (using generally accepted accounting principles) in any year; and (vi) any transaction that results in a tax credit exceeding \$250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.

²¹⁴ Jobs Act § 811.

²¹⁵ IRS and Treasury have continued to refine the six categories of reportable transactions since the reportable transaction regulations were finalized on March 4, 2003. For example, TD 9108 subsequently narrowed the

of whether the transaction ultimately results in an understatement of tax and is in addition to any accuracy-related penalty, is \$10,000 for an individual and \$50,000 for all corporations and other entities.²¹⁶ The Jobs Act also repealed and significantly revamped the rules for the registration of tax shelters under Section 6111²¹⁷ and the list maintenance requirements under Section 6112.²¹⁸ Finally the Jobs Act repealed and revamped the related penalty provisions under Section 6707 for the failure to register a tax shelter transaction and under Section 6708 for the failure to satisfy list maintenance requirements.²¹⁹

Sections 6111 and 6112 now apply to “reportable transaction as opposed to “tax shelters.”²²⁰ The legislative history indicates a preference for requiring “material advisors” to provide essentially the same type of information that the Secretary requests from taxpayers in connection with the disclosure of a reportable transaction.²²¹ Accordingly, the prior-law

filter for confidential transactions in response to concerns that the factor was overly broad in scope. IRS and Treasury have continually added to and, occasionally, subtracted from the category of listed transactions. *See, e.g.*, Notice 2004-19, 2004-11 I.R.B. 606 (withdrawing Notice 98-5 because IRS and Treasury decided not to issue regulations in the form described in the Notice and also modifying Notice 2003-76 by eliminating the reference to Notice 98-5 in the identification of listed transactions). The Jobs Act does not define or redefine a “reportable transaction” but, rather, relies upon the currently existing regulations under Section 6011, which are subject to continual review and change by IRS and Treasury, particularly the category of listed transactions.

²¹⁶ IRC § 6707A(b)(1). For a listed transaction, the penalty is \$100,000 for an individual and \$200,000 for all corporations and other entities. IRC § 6707A(b)(2).

²¹⁷ Under prior law, a tax shelter was defined as an investment that exceeded a 2 to 1 tax shelter ratio based on a comparison of the expected tax benefits from the transaction (including deductions and 350 percent of credits) to the taxpayer’s investment in the transaction. In addition, certain “confidential” corporate transactions in which promoters received fees in excess of \$100,000 were also defined as tax shelters.

²¹⁸ Jobs Act § 815.

²¹⁹ Jobs Act §§ 816, 817. A reportable transaction is defined for these purposes in Section 6707A. IRC §§ 6111, 6112. Section 6707A(c) defines reportable transaction by reference to the Section 6011 regulations. *See Reg.* § 6011-4.

²²⁰ Jobs Act § 815; IRC § 6111(a). Section 815 of the Jobs Act requires “material advisors” to file an information return with respect to any “reportable transaction” that includes information: (1) identifying and describing the transaction; (2) describing any potential tax benefits that are expected to result from the transaction; and (3) that may be prescribed by the Secretary in future guidance.

²²¹ SOM at 385; Conf. Rpt. at 595. A “material advisor” includes any person: (1) who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction; and (2) who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such advice or assistance. IRC § 6111(b)(1)(A).

penalty that was on a taxpayer who failed to register a “tax shelter” transaction has been replaced with a penalty that is imposed on a material advisor who fails to file an information return or files a false or incomplete information return with respect to any reportable transaction (including a listed transaction).²²² In addition, under revised section 6112, a material advisor is required to maintain a list with respect to reportable transactions, including listed transactions, whether or not the material advisor is also required to file an information return under Section 6111 with respect to the same transaction(s).²²³

3. *The Impact on the Cost-Benefit Analysis*

The unmistakable signal from Congress in the Jobs Act is that taxpayers and their “material advisors” must disclose reportable and listed transactions or suffer the consequences. The revision of sections 6111 and 6112 also signals a shift from the unclear concept of “tax shelters” to the statutory standard of “reportable transactions.” The definition of a “tax shelter” under section 6111 was subject to uncertainty, and Congress decided to unify the reporting, registration and listing rules (in also to impose a separate accuracy-related penalty) using a single standard, namely the reportable transactions standard.

The revised registration and listing rules, with the help of the additional disclosure, may help to shore up the continuing drop in audit rates and, indeed, may reflect a tacit understanding by Congress that the Service, at least for the time being, has conceded that the audit process is either too slow or simply incapable of uncovering the types of transactions that led to the legislation’s enactment. The result, in my view, would be that the IRS would be able to

²²² Section 6707 – Penalty for Failure by Material Advisors to File Information Returns for Reportable Transactions. Act § 816.

²²³ Jobs Act § 815. The list must include information that (1) identifies each person with respect to whom such advisor acted as a material advisor with respect to such transaction, and (2) contains such other information as the Secretary may require in regulations. IRC § 6112(a).

increase the audit and detection of tax motivated transactions, and, therefore, the cost side of the equation would increase.

Nevertheless, what is necessary now is guidance. Both taxpayers and the IRS are still unsure with respect to the scope of the rules. On the one hand, many transactions that are not tax-motivated might technically fall under the disclosure, registration and listing requirements, while many abusive transactions might not be subject to the rules. Thus, to reduce the incentives to play the audit lottery, Treasury and the IRS must clarify the scope of the rules, provide assistance to the taxpayers in complying with the rules, and devote resources to enforce and implement the rules.

C. Increasing Z3: Codification of the Economic Substance Doctrine

Another way of increasing the likelihood of being subject to the tax is providing the IRS with more tools to win cases (*i.e.*, increasing Z3). One of the most significant proposals to provide the IRS with such tools includes the proposal to codify, or clarify, the economic substance doctrine.²²⁴ Under the general application of the judicial economic substance doctrine, the tax benefits of transactions lacking such attributes may be denied.²²⁵ A transaction that

²²⁴ H. REP. NO. 108-548 (2004); American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. (2d Sess. 2004). The proposed codification was included in the Senate Bill (S. 1637, Jumpstart Our Business Strength (JOBS) Act, S. Rep. No. 108-192, 108th Cong., 1st Sess., Nov. 7, 2003), but rejected by the House.

²²⁵ *Killingsworth v. Commissioner*, 864 F.2d 1214, 1216 (5th Cir. 1989) (“Since *Gregory* was decided, courts have consistently held that although a transaction may, on its face, satisfy applicable Internal Revenue Code criteria, it will nevertheless remain unrecognized for tax purposes if it is lacking in economic substance.”); *Karr v. Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991) (“expenses incurred in connection with a sham transaction are not deductible.”); U.S. Dep’t of the Treasury, *The Problem of Corporate Tax shelters: Discussion Analysis, and Legislative Problems* (1999), at 56 (“the third, and final, way the IRS can use non-statutory standards to challenge the tax benefits of a particular tax-advantaged transaction is through the application of the economic substance doctrine. This doctrine allows the IRS to deny tax benefits if the economic substance of a transaction is insignificant relative to the tax benefits obtained.”); *Horn v. Commissioner*, 296 U.S. App. D.C. 358 (“The economic sham doctrine generally works to prevent taxpayers from claiming the tax benefits of transactions, which, although they may be within the language of the Code, are not the type of transaction Congress intended to favor.”); *Yosha v. Commissioner*, 861 F.2d 494, 497 (7th Cir. 1988) (“There is a doctrine

would otherwise result in beneficial tax treatment to a taxpayer will be disregarded if the transaction lacks economic substance.²²⁶ Nevertheless, as numerous courts have indicated, taxpayers are generally free to structure their affairs so as to minimize their tax liability; therefore, a transaction does not lack economic substance merely because it is tax motivated.²²⁷ Accordingly, a finding that a transaction lacks economic substance will result in disallowance of any tax benefits from the transaction.²²⁸ In general, the economic substance doctrine is based on an objective and subjective determination of whether a

that a transaction utterly devoid of economic substance will not be allowed to confer [a tax] advantage."); *Ferguson v. Commissioner*, 29 F.3d 98, 101 (2d Cir. 1994) (per curiam) ("An activity will not provide the basis for deductions if it lacks economic substance.")

²²⁶ *Killingsworth v. Commissioner*, 864 F.2d 1214, 1216 (5th Cir. 1989) ("It is a well settled rule of law that transactions that lack economic substance will not be recognized for tax purposes."); *Boynton v. Commissioner*, 649 F.2d 1168, 1172 (5th Cir. 1981) *cert. denied*, 454 U.S. 1146 (1982) ("Transactions that have no economic effect other than the creation of income tax losses are shams for tax purposes and will not be recognized.").

²²⁷ *United Parcel Services of America, Inc. v. Commissioner*, 254 F.3d at 1019 ("A 'business purpose' does not mean a reason for a transaction that is free of tax considerations. "); *Salina Partnership LP, FPL Group, Inc. v. Commissioner*, T.C. Memo 2000-352 ("It is well settled that taxpayers generally are free to structure their business transactions as they please, even if motivated by tax avoidance considerations." citing *Gregory v. Helvering*, 293 U.S. 465 (1935) and *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 196, *aff'd. in part, rev'd. in part, remanded*, 752 F.2d 89 (4th Cir. 1985)); *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury"); *Rosenfeld v. Commissioner*, 706 F.2d 1277, 1281 (2d Cir. 1983) ("a transaction which is otherwise legitimate, is not unlawful merely because an individual seeks to minimize the tax consequences of his activities."); *Owens v. Commissioner*, 568 F.2d 1233, 1237 (6th Cir. 1977) ("We begin with the principle that a taxpayer, working within the law, may legitimately seek to avoid taxes."); *Northern Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d 506, 511 (7th Cir. 1997) ("A tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what otherwise would be his taxes."); *Yosha v. Commissioner*, 861 F.2d 494, 497 (7th Cir. 1988) ("There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes."); *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925, 933 (1971), *acq.*, 1972-2 C.B. 1 ("The fact that the actions taken by the parties in this case were taken to minimize their tax burden may not by itself be utilized to deny a benefit to which the parties are otherwise entitled under the convention."); *Bass v. Commissioner*, 50 T.C. 595, 600 (1968) ("[A] taxpayer may adopt any form he desires for the conduct of his business, and . . . the chosen form cannot be ignored merely because it results in a tax saving."). *Cf. Saviano v. Commissioner*, 765 F.2d 643, 654 (7th Cir. 1985) ("the freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of the transactions to their economic substance and to apply the tax laws accordingly.")

²²⁸ *United States v. Wexler*, 31 F.3d 117, 122 (3d Cir. 1994) ("The general rule on sham transactions in [the Third] circuit is well-established: 'If a transaction is devoid of economic substance . . . it simply is not recognized for federal taxation purposes, for better or for worse. This denial of recognition means that a sham transaction, devoid of economic substance, cannot be the basis for a deductible loss.'"). See also *Karr v. Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991); *Horn v. Commissioner*, 296 U.S. App. D.C. 358.

transaction has real, nontax economic benefit.²²⁹ Under this general two-prong test, the economic substance doctrine is based on an objective and subjective determination of whether a transaction has real, nontax economic benefit (i.e., the “two-prong” test).²³⁰

In recent years, several legislative proposals to “codify” or “clarify” the economic substance doctrine have been made.²³¹ In 2004, the codification of the doctrine was rejected by the

²²⁹ *Frank Lyon v. United States*, 435 U.S. 561 (1978), rev'g 536 F.2d 746 (8th Cir. 1976) (the United States Supreme Court set forth the two prong test); *ACM Partnership v. Commissioner* 157 F.3d 231, 248 (3d Cir. 1998) ("In assessing the economic substance of a taxpayer's transactions, the courts have examined "whether the transaction has any practical economic effects other than the creation of income tax losses'...." quoting *Jacobson v. Commissioner*, 915 F.2d 832, 837 (2d Cir. 1990)); *Sochin v. Commissioner* 843 F.2d 351, 354 (9th Cir. 1988) (articulating the objective analysis as whether "the transaction had 'economic substance' beyond the generation of tax benefits"); *Rice's Toyota World, Inc v. Commissioner*, 752 F.2d 89, 94 (4th Cir. 1985) (stating that “To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.”).

²³⁰ *Frank Lyon v. United States*, 435 U.S. 561 (1978), rev'g 536 F.2d 746 (8th Cir. 1976) (the United States Supreme Court set forth the two prong test); *Rice's Toyota World, Inc v. Commissioner*, 752 F.2d 89, 90 (4th Cir. 1985) (stating that a transaction will be treated as having no economic substance if "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists.”). See also *ACM Partnership v. Commissioner* 157 F.3d 231, 248 (3d Cir. 1998) *aff'g in part, ACM Partnership v. Commissioner*, T.C. Memo. 1997-115, *cert. denied*, 119 S. Ct. 1251 (1999); *Sochin v. Commissioner* 843 F.2d 351, 354 (9th Cir. 1988) (articulating the objective analysis as whether "the transaction had 'economic substance' beyond the generation of tax benefits").

²³¹ House Ways and Means Committee member Lloyd Doggett's H.R. 2520, 107th Cong. 1st Sess. (July 17, 2001); House Ways and Means Committee Chair William Thomas's H.R. 5095, 107th Cong. 2d Sess., "American Competitiveness Act of 2002," (July 11, 2002); S. 1054, 108th Cong., 1st Sess. (May 16, 2003). See Joint Committee on Taxation (JCT), "Summary of Conference Agreement on H.R. 2, the Jobs and Growth Tax Relief Reconciliation Act of 2003," JCS-54-03 (May 22, 2003); Title VII, Subtitle A, Section 701, "Clarification of Economic Substance Doctrine", of the Care Act of 2003, S.476, reported in S. Rpt No. 108-11, 108th Cong., 1st Sess. (February 27, 2003). See also similar proposals introduced, among others, by Sen. Mark Dayton, D-Minn. (S. 135), 108th Cong., 1st Sess. (January 9, 2003); Rep. Charles B. Rangel's H.R. 2286, 108th Cong., 1st Sess. (June 22, 2003); Rep. Lloyd Doggett's "Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2003," H.R. 1555, 108th Cong., 1st Sess. April 2, 2003); Rebuild America Act of 2003, S. 1409, 108th Cong., 1st Sess. Section 1101 (2003); Sales Tax Equity Act of 2003, S. 1436, 108th Cong., 1st Sess. Section 201 (2003); Tax Shelter Transparency and Enforcement Act, S. 1937, 108th Cong., 1st Sess. (2003); Tax Shelter Transparency and Enforcement Act, H.R. 3560, 108th Cong., 1st Sess. (November 25, 2003); Progressive Tax Act of 2003, 108th Cong., 1st Sess. (Dec. 8, 2003), 2003 TNT 236-29; S.1072, Title V, Highway Reauthorization And Excise Tax Simplification Act, passed by the Senate on February 12, 2004 and introduced by Senators Grassley and Baucus on February 9, 2004, Section 561 (proposing codification of the economic substance doctrine in new section 7701(n), to be effective for transactions entered into after February 2, 2004), and Section 5614 (proposing new section 6662B, the strict liability economic substance penalty, effective for transactions entered into after February 2, 2004); Senate Amendment No. 2645 to S.1637, the Jumpstart Our Business Strength Act (March 3, 2004), Section 401; Substitute amendment to S. 1637, the Jumpstart Our Business Strength Act, Section 401, 2004 TNT 57-19 (March 23, 2004); Substitute for S. 1637, the Jumpstart Our Business Strength Act, Section 401 (April 5, 2004), 2004 TNT 67-38; S.2210, the Tax Shelter and Tax Haven Reform Act, Section 301 (codification of economic substance doctrine) and 303 (economic substance strict liability penalty), 2004 TNT 51-15 (March 12, 2004), introduced by Senator Levin, Chair of the Senate Permanent Subcommittee on Investigations.

House of Representatives²³² and was not included in the Conference Report for The Jobs Act of 2004.²³³ These proposals, however, have been criticized not only by commentators but also by Government officials on various grounds.²³⁴

The criticism on the proposed codification took two major different forms. The first one was that rather than “codifying” or “clarifying” a common law doctrine, the proposed legislation would set forth a new and higher standard, which has not been adopted by the vast majority of courts.²³⁵ The proposal to codify the economic substance doctrine was widely (if not uniformly) criticized, at least in the form that it had been proposed by the Finance Committee and adopted by the Senate, before the conferees dropped the proposal during the final negotiations on the conference agreement.²³⁶ The most criticized point pertains to the proposed conjunctive test,²³⁷ which is consistent only with a minority of circuits.²³⁸ Another

²³² H.R. 4520, American Jobs Creation Act of 2004, H. REP. NO. 108-548, 108th Cong., 2d Sess., June 16, 2004.

²³³ H. REP. NO. 108-548 (2004); American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. (2d Sess. 2004). The proposed codification was included in the Senate Bill (S. 1637, Jumpstart Our Business Strength (JOBS) Act, S. Rep. No. 108-192, 108th Cong., 1st Sess., Nov. 7, 2003), but rejected by the House.

²³⁴ Samuel C. Thompson Jr. and Robert Allen Clary II, *Coming In From The 'Cold': The Case For ESD Codification*, 2003 TNT 102-33 (May 23, 2003) (citing Assistant Secretary of the Treasury for Tax Policy Pamela Olson’s statement in her nomination hearings before the Senate Finance Committee: “I do not think that codification of the Economic Substance Doctrine will help.”).

²³⁵ See Kevin D. Dolan, *Notice 98-5 Foreign Tax Credit Arbitrage*, 455 PLI/Tax 1029, 1047-1050 (1999).

²³⁶ For a description of the Senate’s proposal to codify the economic substance doctrine, see SOM at 445 (Conf. Rpt. at 650).

²³⁷ See proposed IRC 7701(n)(1)(B)(i)(I) and (II).

²³⁸ *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) (“The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction. . . . If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the second inquiry is never made.”). Cf. *Rice’s Toyota World v. Commissioner*, 752 F.2d 89, 90 (4th Cir. 1985) (“The purpose of this test is to ascertain both the subjective motivations of the taxpayer and the objective reasonableness of the investment to determine whether the transaction contained economic substance aside from the tax benefits.”); *Hines v. United States*, 912 F.2d 736, 740 (4th Cir. 1990), citing *Rice’s Toyota*, 752 F.2d 96 (“Under the test in *Rice’s Toyota*, however, a transaction with an expected loss may not be a sham if the taxpayer was motivated by some legitimate business reason other than to obtain tax benefits.”); *Black and Decker v. United States*, 340 F. Supp. 2d 621, 2004 U.S. Dist. LEXIS 21201 (N.D. Md. 2004) (confirming that the Fourth Circuit applies the disjunctive standard. The District Court relied also on *Hunt v. Commissioner*, 938 F.2d 466, 471 (4th Cir. 1991) and *Hines v. United States*, 912 F.2d 736, 738-39 (4th Cir. 1990) for its decision).

criticized aspect of the proposed codification pertains to the attempt to require from the taxpayer at least a risk-free return²³⁹ and a comparison between tax and nontax benefits,²⁴⁰ both of which, again, are inconsistent with the majority of court cases. Thus, under this view, codification may be appropriate, but only if the codified rules are consistent with the case law pertaining to the doctrine.

The more general form of criticism relates the question whether the doctrine should be codified at all.²⁴¹ As discussed above, codification of the economic substance doctrine was proposed by the Treasury Department during the Clinton Administration as part of its proposals to curb corporate tax shelters,²⁴² but was subsequently criticized as being unnecessary and potentially harmful to the overall tax shelter effort by the Bush Treasury.

An exchange between the Chairman of the Senate Committee on Finance, Senator Charles E. Grassley (R-IA), and the Acting Assistant Secretary of the Treasury for Tax Policy, Pamela

²³⁹ *Hilton v. Commissioner*, 74 T.C. 305 (1980). Commentators, generally, have disagreed with such a standard. See, for example, *NYSBA Objects To Codification of Economic Substance Provisions*, 2003 TNT 102-19 (May 21, 2003) (“the economic substance doctrine is fundamentally an anti-abuse rule, and not all transactions that lack either a pre-tax return greater than a risk-free return or a substantial non-tax business purpose are abusive. It depends on the provision under consideration.”); Alvin C. Warren Jr. *the Requirement of Economic Profit in Tax Motivated Transactions*, 59 *Taxes*, 985 (1981) (stating that on the one hand that a “very small economic profit” is insufficient to validate a transaction, but on the other, that a requirement of a full market return in “incoherent.”)

²⁴⁰ *Sheldon v. Commissioner*, 94 T.C. 738 (1990). Cf. Joseph Bankman, *The Economic Substance Doctrine*, 74 *S. Cal. L. Rev.* at n. 33 (stating that: “the court [in *Saba*] favored an approach that compared tax benefits to pretax profits - an approach consistent with the Treasury Department's shelter proposals but inconsistent with most case law on point.”)

²⁴¹ See *CRS Reviews Revenue-Raising Proposals Of The 108th Congress*, 2005 TNT 38-68 (Feb. 7, 2005), footnote 13, citing the following commentary opposing the codification: the letter from Andrew Berg to Chairman Thomas and Senator Grassley on the economic substance doctrine and the Apr. 24 letter to Chairman Grassley and Ranking Member Baucus from Herbert Beller of the American Bar Association (reprinted in the Bureau of National Affairs, *Daily Tax Report*, Apr. 28, 2003). See also New York State Bar Association Tax Section, “Economic Substance Codification,” *Tax Notes*, June 23, 2003; Peter L. Faber, letter to the Chairman Thomas, reprinted as “Practitioner to Congress: Don't Try to Codify Economic Substance,” *Tax Notes*, Oct. 21, 2002, pp. 423-424; James M. Peaslee, letter to the Finance Committee, reprinted as “More Thoughts on Proposed Economic Substance Clarification,” *Tax Notes*, May 5, 2003, pp. 747-750, May 5, 2003.

²⁴² See General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals, Office of Tax Policy, Department of the Treasury, Washington DC, Feb. 2000, p. 124 (available on the Department of the Treasury's web site at www.treas.gov/offices/tax-policy/).

F. Olson, at a Finance Committee hearing during August 2002 succinctly describes Treasury's rationale for not codifying the economic substance doctrine:

Senator Grassley. Let us go back to this committee's effort to crack down on tax shelters.

* * *

Do you believe that codification of the Economic Substance Doctrine will help or hinder our goal of combating tax shelters?

Ms. Olson. I do not think that codification of the Economic Substance Doctrine will help. I do not think it will help for several reasons, but I would like to maybe mention a couple of them.

One, is that the doctrine right now is a very flexible doctrine that is applied by the courts as needed. I think any codification of it, even if in codifying it we say that we do not intend to override any other doctrines, I think it is going to make it more wooden and less flexible than it currently is. If that happens, then it has the potential for being both too broad and too narrow. So, that is a real danger.

A more serious danger I see with it, is I think it adds to the complexity for the IRS in its enforcement of the laws and assertion of penalties in appropriate cases because it is yet another set of things that they need to consider, work through, and look at in doing an audit of a taxpayer.

So I think that it has the potential to slow IRS audits, and anything that slows IRS audits is not a good thing. I think that what we need at this point is

more enforcement, and the IRS being able to complete more audits as rapidly as possible.²⁴³

In *Coltec Industries*, the court discussed the legislative history of the proposal to codify the economic substance doctrine.²⁴⁴

In fact, a few days ago Congress passed a major federal tax bill, but again declined to codify the “economic substance doctrine.” See American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. (2004).

Under our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare.

Accordingly, the court has determined that where a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the “economic

²⁴³ Hearing before the Committee on Finance, United States Senate, 107th Cong. 2d Sess., on the Nomination of Pamela F. Olson to be Assistant Secretary of the Treasury, S. Hrg. 107-742 (Aug. 1, 2002), pp. 8-9. Interestingly, at the time of this hearing, Chairman Thomas of the Ways & Means Committee had proposed to codify economic substance as part of his international reform bill that was introduced for mark-up by the Ways & Means Committee on July 11, 2002 (H.R.5095, “American Competitiveness and Corporate Accountability Act of 2002”), but the Senate Finance Committee had not yet included codification in any of its tax shelter legislation. The Committees would subsequently switch positions on the issue, with the Senate Finance Committee championing codification in numerous tax shelter bills (most notably S.1637, The Jumpstart Our Business Growth Act, introduced on Sept. 18, 2003), while Chairman Thomas dropped the proposal from all subsequent tax shelter legislation. For recent comments by the IRS Chief Counsel, Donald L. Korb, opposing codification, see “Korb Speculates on Codification of Economic Doctrine,” Doc 2004-21647, 2004 TNT 217-2 (Nov. 9, 2004) (IRS Chief Counsel Donald Korb is reported as being opposed to the efforts on Capitol Hill to codify the economic substance doctrine).

²⁴⁴ *Coltec Indus. v. United States*, 2004 U.S. Claims LEXIS 286, (Fed. Cl., Oct. 29, 2004). The court prominently noted that Congress on many previous occasions had debated and rejected codification of the doctrine. On that basis, the court concluded that it would violate “separation of powers” for the court to rely upon a doctrine rejected by Congress to deny benefits that would otherwise be available to taxpayers who have satisfied all the statutory requirements imposed by Congress.

substance” doctrine to trump “mere compliance with the Code” would violate the separation of powers.²⁴⁵

Thus, in my view, codification may be useful for the government in reducing the “audit lottery;” however, it must be consistent with the majority of court cases pertaining to the economic substance doctrine. I believe that a possible solution, which would be consistent with the majority of circuits, could be to transform (and codify) the two-prong test into a single, flexible objective standard. Such a standard would, in fact, revive the original substance-over-form analysis conducted by the U.S. Supreme Court in *Gregory v. Helvering*, and would not seem to contradict the current standard applied by all circuits.

In addition, it seems that despite what may properly be described as a general lack of support for codification of the economic substance doctrine and its recent rejection by the conferees during negotiations over a bill that eventually included nearly 50 provisions relating to tax shelters,²⁴⁶ the 109th Congress has reconsidered the issue , because the revenue associated with the provision (estimated at more than \$13 trillion over 10 years)²⁴⁷ is one apparent reason that the proposal cannot be completely written-off.²⁴⁸

²⁴⁵ *Id.* While at first blush it may seem that a “separation of powers” reference elevates this issue to an unwarranted constitutional level, the court in *Coltec* may simply be making a relatively straightforward and common sense point. That is, if Congress wants to provide the IRS (and its litigators, including the litigators at the Justice Department) with general anti-abuse authority, it must explicitly do so. But, until Congress takes that step (and adopts economic substance or some other broad-based anti-abuse doctrine), the IRS is generally estopped from stretching common law principles to deny taxpayers the ability to apply the Code as written. *Cf. Gitlitz v. Comm’r*, 531 U.S. 206, 220, 148 L. Ed. 2d 613, 121 S. Ct. 701 (2000) (The Court refused to rely on policy arguments in order to look beyond the plain words of the statute and deny tax benefits claimed by the taxpayer).

²⁴⁶ Title VIII, Subtitle B of the Act, entitled “Provisions Relating to Tax Shelters”, includes 49 separate provisions.

²⁴⁷ See Estimated Revenue Effects of S.1637, The “Jump Start Our Business Strength (‘JOBS’) Act,” as passed by the Senate, JCX-36-04 (May 20, 2004) (\$13.314 trillion of revenue estimated to be raised over ten years related to the codification of economic substance).

²⁴⁸ Possibly more significant, however, is the recent taxpayer victories in three different courts (discussed above) that rejected the government’s reliance on the economic substance doctrine to deny tax benefits from structured transactions.

D. The Reasonable Cause Exception

1. *Jobs Act of 2004*

As set forth above, the effect of revising the substantial understatement penalty in Section 6662 and modifying the reasonable cause exception is that the penalty would apply to a broader range of transactions for large corporations.²⁴⁹ The revised “reasonable cause” and “good faith” exceptions are more stringent than the previous standards.²⁵⁰ Specifically, the strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are *adequately disclosed*, there is or was *substantial authority* for the claimed tax treatment, and the *taxpayer reasonably believed* that the claimed tax treatment was *more likely than not* the proper treatment.²⁵¹ The Jobs Act also imposed 30 percent strict liability penalty for undisclosed listed transactions and reportable avoidance transactions.²⁵²

In terms of the cost-benefit equation, the most notable element of the Jobs Act of 2004 was strengthening the reasonable cause exception, which would increase the likelihood that taxpayers that lose their case on the merits would also be subject to the penalty. In addition, the introduction of the strict liability penalty for undisclosed listed and reportable avoidance transactions signals that taxpayer may be subject to penalty regardless of obtaining tax opinions. Certainly, Congress has moved in the right direction by limiting the applicability of the exception and thereby, exposing more taxpayers to the potential penalty if the case is won

²⁴⁹ *Id.*

²⁵⁰ *Id.*

²⁵¹ *Id.*

²⁵² *Id.*

by the IRS. The following two cases illustrate the courts' application of the reasonable cause exception in transaction have no economic substance.

2. *Long Term Capital Holding v. United States*²⁵³

The essence of the transaction was to allow loss duplication through the contribution by Onslow Trading & Commercial LLC ("OTC") of stock with a built-in loss to a partnership, the sale of the contributor's partnership interest to the general partner, and the subsequent sale of the loss stock by the partnership.²⁵⁴

During 1996, OTC contributed cash and the loss stock to Long-Term Capital Partners LP ("LTCP") in exchange for a partnership interest. OTC borrowed the cash component of its contribution from a UK entity related to Long-Term Capital Management LP ("LTCM"), the general partner of LTCP. In addition, OTC purchased from LTCM a "liquidity put" and a "downside put" with respect to its interest in LTCP.²⁵⁵ In December 1997, LTCP sold some of the preferred stock with a basis of \$107M for approximately \$1M, producing a loss of \$106M, which was allocated to LTCM under section 704(c). The taxpayer obtained a "should" level opinion from two law firms: King & Spalding and Shearman & Sterling.

²⁵³ 2004 WL 1924931 (D. Conn. Aug. 27, 2004).

²⁵⁴ The stock with the built-in loss was created by contributing cash subject to a pre-paid lease obligation to two different corporations in a section 351 transaction. The key was that the lease obligations were not treated as a liabilities under section 357, so the basis in the preferred stock was amount of cash contributed, even though its value was much lower (because it reflected the liabilities).

²⁵⁵ In general, these puts, each of which could only be exercised on or between October 27, 1997 and October 31, 1997, gave OTC the right to put its interest in LTCP to LTCM for an amount equal to the greater of (i) the value of such interest at the date of the put or (ii) OTC's original capital investment in LTCP. OTC exercised its liquidity put on October 28, 1997, selling its entire interest in LTCP to LTCM for \$12,614,188, representing approximately a 22% return on OTC's investment. Of course, no section 754 election was made.

Economic Substance: The taxpayer argued that the standard in the Second Circuit is a disjunctive test. The court, however, held that the prevailing standard in the Second Circuit is the unitary test. Nevertheless, even if the court would have accepted the disjunctive test, it does not matter, because the court held that the transaction had neither objective economic substance nor subjective business purpose.

The court rejected the taxpayer's argument that a meaningful change in the parties' economic positions is enough to give economic substance. Applying a cost v. benefit analysis similar to the one in *Goldstein v. Commissioner*, the court held that LTCM had no realistic expectation of economic profit after taking into account fees.²⁵⁶ The court reviewed the costs incurred by LTCM and held that the taxpayer could not have reasonably expected to generate a pre-tax profit after considering these costs and fees.²⁵⁷ With respect to the potential profit, the court held that the maximum reasonably expected gross earnings were estimated at \$2M.

As to subjective business purpose, the court found that the transaction was purely tax-motivated, notwithstanding the parties' efforts to imbue it with a business purpose (earning fees). Most notably, the court asserted that the transaction was brought to the taxpayer as a tax product. The court elaborated that Long Term did not carry out the transaction in a way that indicated it had any motive other than tax savings.

²⁵⁶ As manager of the underlying portfolio, LTCM earned fees for assets under management, proportional to the return achieved for the investors. Long Term relied on the additional fees it would earn from both the OTC and the B&B investment to justify its ability to earn a pre-tax profit.

²⁵⁷ In particular, the costs included legal fees of \$1M, the B&B fee of \$1.2M, the Turlington settlement of \$1.25M, and various internal allocations and bonuses paid to Long Term principals.

Alternatively, the court held that under the “end result” test of the step transaction doctrine, the court collapsed the several steps taken by the taxpayer and held that OTC ought to be viewed as if it sold its preferred stock to LTCM, so LTCM had a cost basis in the stock.

Accuracy-Related Penalties: The court found the taxpayers liable for valuation overstatement and substantial understatement penalties.²⁵⁸ The court held that the legal opinions did not allow the taxpayers to qualify for the “reasonable cause/good faith” exception to the penalties because: (i) the King & Spalding written opinion was delivered late, and the record did not establish that Long Term had reasonably relied on King & Spalding’s oral advice; (ii) there was no evidence that any of the Long Term partners other than one actually read the opinion; (iii) the favorable authorities cited in the opinion were based on facts materially different from those found by the court, so could not be relied upon; (iv) the opinion did not adequately address Second Circuit precedent, nor the “end result” variation of the step-transaction doctrine; and (v) Long Term lacked good faith, as evidenced by the steps it took to conceal the preferred stock losses on its tax return.

To conclude, the court’s primary reason for sustaining the penalties asserted by the IRS appeared to be that the transaction lacked economic substance and business purpose. But the

²⁵⁸ *Santa Monica Pictures, LLC et al. v. Commissioner*. T.C. Memo. 2005-104, quoting *Gilman v. Commissioner*, 933 F.2d 143 (2d Cir. 1991), affg. T.C. Memo. 1990-205, where the Court of Appeals for the Second Circuit applied the valuation overstatement penalty under former section 6659 to an underpayment of taxes derived from a transaction that was disregarded for lack of economic substance. Because the taxpayer was deemed to have a zero basis, the taxpayer’s claimed basis was infinitely larger than the amount determined to be the correct basis (as would be any amount of claimed basis, compared to zero). Acknowledging that applying the valuation overstatement penalty “somewhat strains the natural reading of the statutory phrase ‘valuation overstatement’”, the court nevertheless held, consistent with other judicial precedents applying the valuation overstatement penalty in the context of tax shelter transactions, that the penalty was applicable. *Id.* at 151. The Court of Appeals observed: “application of the section 6659 penalty surely reenforces the Congressional objective of lessening tax shelter abuse.” *Id.* The Court of Appeals in *Gilman* acknowledged that former section 6659 might require some nexus with an overvaluation but determined: “A transaction that lacks economic substance generally reflects an arrangement in which the basis of the property was misvalued in the context of the transaction.” *Id.* at 152. The Court of Appeals determined that the lack of economic substance in that case

opinion also suggests that the opinion did not protect the taxpayer because it was deficient in its legal analysis and because at most one of the partners in LTCM had read the opinion.

4. *IRS's Reaction to its Victory*

Subsequent to the court's decision in *Long Term Capital Holdings*, in a chief counsel notice, the IRS has advised chief counsel attorneys on the role penalties play in tax administration.²⁵⁹

With respect to the reasonable cause exception, the IRS stated that:

One of the most common taxpayer defenses is the claim that the taxpayer reasonably relied in good faith on the advice of a professional tax advisor in taking a return position. I.R.C section 1.6664(c). While professional tax advice can afford taxpayers a defense to the imposition of penalties, the mere fact that the taxpayer obtained such advice does not necessarily, in and of itself, meet the requisite burden of proof. Circumstances may show that the taxpayer did not rely on the advice in good faith, or that the taxpayer's reliance was not reasonable. The regulations under section 6664 provide a nonexclusive description of circumstances where taxpayers may not rely on the advice of others as a defense to accuracy-related penalties.

See Treas. Reg. section 1.6664-4(c); Long-Term Capital Holdings.

Note, however, that this notice was issued prior to the enactment of the Jobs Act of 2004 and to the three straight losses in economic substance cases (discussed above). In light of the

was due in part to a valuation overstatement, relying on the absence of any reasonable expectation of profit and the lack of value in the property that the taxpayer purchased. *Id.* at 151.

²⁵⁹ 2004 TNT 186-9 IRS Advises Chief Counsel Attorneys on Role of Tax Penalties (CC-2004-036) (Sept. 22, 2004).

Government's losses in *Black & Decker*,²⁶⁰ *Coltec Industries*,²⁶¹ and *Castle Harbour*,²⁶² it is possible that the government will re-evaluate its position.

5. *Second Circuit's Decision*

In affirming the district court decision, the Second Circuit has upheld the Service's imposition of penalties against Long Term Capital Holdings (LTCH), finding that LTCH is subject to the 40% penalty for gross valuation misstatement and, in the alternative, to a 20% penalty for substantial understatement of tax. The Second Circuit found ample evidence in the record to support the district court's finding that LTCH had made a number of assumptions that it knew to be false and that it was unreasonable for its tax experts at the second law firm to rely on those assumptions when a reasonably diligent review of the pertinent facts and circumstances would have shown those assumptions to be false. The court also found that the district court was justified in concluding that LTCH's decision to report a \$106 million loss as a net unrealized gain on its Schedule M for the 1997 tax year was not undertaken in good faith within the meaning of Reg. Section 1.6664-4.

Additionally, the court stated that it disagreed with LTCH's argument that the district court erred in applying the step transaction doctrine. The court found that the district court did not err in finding that LTCH's sole purpose of entering into the transaction with OTC was to transfer losses from OTC to LTCH and that any intervening steps taken in pursuit of that goal were economically meaningless. Transferring the losses to OTC was economically meaningless because "[u]nder the step transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective

²⁶⁰ *Black & Decker Corp. v. United States*, 2004 U.S. Dist. LEXIS 21201 (D. Md. Oct. 22, 2004).

²⁶¹ *Coltec Indus. v. United States*, 2004 U.S. Claims LEXIS 286, (Fed. Cl., Oct. 29, 2004).

²⁶² *TIFD III-E Inc. v. United States*, 2004 U.S. Dist. LEXIS 22119 (D. Conn. Nov. 1, 2004) (hereinafter, *Castle Harbour*).

more directly, but instead included the step for no purpose other than to avoid U.S. taxes."²⁶³ The Second Circuit followed the district court in holding that the partnership at issue was a mere formalism that was created for the sole purpose of tax avoidance. The steps taken under the partnership agreement were pre-planned, guaranteed, and lacking in independent significance, the court noted. Under these circumstances, the court found that application of the step transaction doctrine was warranted.

LTCH argued that the 40% penalty should not be applied because (1) there was not a misstatement of value, only a misstatement of basis; (2) the basis misstatement was the result of a legal dispute, not a factual dispute; and (3) the underpayment was not attributable to the basis misstatement. The court found that LTCH's arguments were without merit because (1) Section 6662(e)(1)(A) defines a valuation misstatement to include misstatements concerning the correct amount of the valuation or adjusted basis; therefore, valuations misstatement as it appears in Section 6662(b)(3) includes both valuation and basis misstatements; (2) Section 6662(e)(1)(A) does not differentiate between factual and legal determinations and it is not correct that "the penalty cannot apply where the transaction is 'recast' for tax purposes using a legal doctrine such as the step transaction or economic substance doctrine"; and (3) the underpayment was directly dependent on the valuation misstatement because the amount of the tax benefit was determined by the amount of the misstatement.

The court's decision affirms the district court holding and highlights once again the importance of analyzing the objective economic substance and subjective business purpose any of transaction involving tax planning. The case reaffirms the importance of a taxpayer contemporaneously documenting its transactional thought processes as well as preparing to

²⁶³ Citing *Del Commercial Properties, Inc. v. Comm'r*, 251 F.3d 210, 213 (D.C. Cir. 2001); cf. *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613.

demonstrate its reliance on the reasoned legal analyses of its tax advisor. In upholding the penalties, the decision emphasizes that if a taxpayer wants to rely on an opinion of its tax advisor for penalty protection, that opinion cannot be based on any false or unreasonable assumptions.

The second law firm seemed to have assumed away the economic substance and business purpose issues by relying on a representation on those points without making any effort to demonstrate why it was reasonable to rely on those assumptions and representations. In this case, according to the district court opinion, "a reasonably diligent analysis of all facts and circumstances would have revealed at least some of those assumptions to be unreasonable and unsupportable." The case highlights the need for a tax advisor to evaluate independently the reasonableness of a taxpayer's asserted business purpose for a transaction as well as the taxpayer's analysis as to the transaction's purported economic substance.

6. *CMA Consolidated Case-Lease Stripping Transaction*

The Tax Court held that deductions claimed by a promoter of lease stripping transactions, who acquired a position in an arrangement that it had tried to market to other investors, should be treated as lacking economic substance. In evaluating whether the transaction lacked economic substance, the court applied the two-pronged inquiry: (1) A subjective inquiry as to whether the transaction(s) was carried out for a valid business purpose; and (2) an objective inquiry concerning the non-tax economic effect of the transaction(s).²⁶⁴

²⁶⁴ *ACM Pship. v. Commissioner*, supra at 247-248; *Casebeer v. Commissioner*, supra at 1363; *Kirchman v. Commissioner*, 862 F.2d 1486, 1490-1491 (11th Cir. 1989).

The factual circumstances in this case consisted of a “Byzantine labyrinth of complex transactions,” the Tax Court said. The Tax Court further noted that most of the transactions were undertaken solely to achieve a tax effect.

Facts: The taxpayer was generally involved in equipment leasing transactions and the structuring of equipment financing. During the early 1990s, the taxpayer began to arrange deals designed to separate equipment rental income from the related rental expenses.²⁶⁵ The specific lease stripping transaction here involved computer and photo processing equipment which was subject to two existing end-user leases and a prior lease stripping arrangement.²⁶⁶ The arrangement involved the purchase of the lease by a partnership where 99% of the taxable income resulting from a rent sale to finance the purchase was allocated to a tax-exempt Indian nation and then the property was transferred to the taxpayer in exchange for preferred stock of minor value. As structured, the lease strip interest was intended to generate over \$4.2 million of potential tax deductions at an out-of-pocket cost of \$40,000.

Economic Substance: With regard to the first prong of this test, the court found that the lease strip deals in this case “are mere tax-avoidance devices or subterfuges mimicking a leasing transaction.” The court further noted that the obvious purpose was to obtain unwarranted and substantial tax benefits. The taxpayer could only enjoy a return from the lease rentals after expiration of the user leases and prior to the ultimate equipment return but the documents were incorrectly drafted with incorrect dates that eliminated this period entirely, thus even though taxpayer argued that this should be corrected, the fact that no attention was paid to the

²⁶⁵ In those deals, the rental income was allocated to a tax-indifferent or tax-neutral party in order to allow another party to claim a greatly disproportionate share of the related tax benefits.

²⁶⁶ Here, an “upper lease” interest was created between the equipment owner and the existing head lease and user lease.

error, which was never corrected, is evidence that the taxpayer had no interest in the underlying leasehold interest. Accordingly, the court held that taxpayer had no valid non-tax business purpose for entering into the lease strip deal apart from tax benefits.²⁶⁷

With regard to the second prong of the test, the court noted that the other participants involved in the lease strip deals, in most instances, were not acting at arm's length and shared a common interest in inflating the values of the underlying equipment and the values of the leases and residual interests to generate substantial potential tax benefits for the ultimate beneficiaries/customers. The court concluded that the IRS's appraisal expert was correct in determining that there was no expectation of any residual value even if the drafting error were corrected, thus there could be no reasonable expectation of a pre-tax return. As such, the court held that the deals lacked economic substance.

Accuracy-Related Penalties: The court further imposed penalties on the taxpayer for negligence (20 percent) and gross valuation overstatement (40 percent). The taxpayer argued that it had relied on a tax opinion and appraisal information provided to the original lease strip investors in the equipment but did not receive any such assurance itself. The court determined that this did not rise to reasonable cause or good faith supporting removal of the asserted penalties. With respect to the appraisal and tax opinion, the court observed that they "... among other things, had not been furnished by *disinterested, objective advisers* but by advisers involved in marketing the first lease strip deal to [the taxpayer]." (Emphasize added) Thus, the court held that not all opinions would qualify for the exception, especially the ones issued by the same advisers who marketed the transaction.

²⁶⁷ The court seemed to suggest a ratio type of test, comparing the tax benefits to the pre-tax profit. As set forth above, such a standard was rejected by the vast majority of courts. Note that other than the finding that the tax benefits were overwhelming here and the pre-tax profit was non-existent, the court did not articulate how this balancing might be applied to these or other facts.

The court also rejected the taxpayer's argument pertaining to a reliance on an accounting firm's review of the taxpayer's tax return and held that the "reasonable cause" exception generally does not apply because the transaction lacked economic substance:

Because we have found that the subject transactions are without substance or business purpose and that petitioner and its officers were fully aware of the lack of bona fides of the factual underpinnings for the transactions, there could be no substantial authority or reasonable belief or cause on petitioner's part that would allow it to avoid the application of the section 6662 penalties in this case.²⁶⁸

E. Changing the Structure of the Penalty Rates

The least efficient method would be to increase the amount of a penalty is either to raise the rate of penalty (as a percentage of the underpayment) or to restructure the way the penalty is calculated. The current method of calculating the penalty as a percentage of the underpayment does not provide sufficient deterrence, so restructuring the system according to the *multiplier principle* may yield greater efficiency. Harsh penalties may be considered unfair, however, and may perversely create the opposite effect: instead of increasing compliance, overly harsh penalties may spur taxpayers on to even more tax evasion. Moreover, overly harsh penalties may lead to over-deterrence. A practical problem with

²⁶⁸ Specifically, the Tax Court observed that the taxpayer failed to prove that:

(1) The accounting firm's advice was based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances; (2) petitioner had disclosed all relevant facts to the accounting firm; and (3) the accounting firm's advice was based on reasonable factual or legal assumptions.

respect to the multiplier principle also concerns how to set the probability of being subject to the penalty (Z). One solution may be to introduce several, graduated penalty rates, such as 20%, 40%, 60%, and on up to 100%.

Under current law the maximum penalty rate equals 20% of the amount of underpayment (30 % for undisclosed listed and reportable avoidance transactions and 40 percent for gross valuation), and therefore even taxpayers whose transaction is detected and successfully prosecuted face, at worst, a payment of $1.4M$. As illustrated above, this rate thus obviously falls short, especially with respect to deterring use of large-scale transactions. According the utilitarian theory of punitive damages and penalties, the rate of penalty should instead reflect the probability of being subject to such a penalty, as under the multiplier principle. For example, if Z , the probability of being subjected to a penalty, equals 50%, the rate of the penalty should fall between 60% and 100 % in order to achieve full deterrence.

To illustrate:

If a tax-motivated has no lump-sum costs, such that $C=0$, and we set the other variables at the following levels: $Z= 40\%$ ($Z_1 + Z_2 = 40\%$, and Z_3, Z_4 are 100%),²⁶⁹ the taxpayer's cost-benefit equation becomes:

$$M = 0.4(F + M)$$

$$M - 0.4M = 0.4F$$

$$F = 1.5M$$

²⁶⁹ Note that is example assumes that the IRS wins the case for 100%, and that there is a strict liability.

Conclusion: For optimal deterrence, the rate of penalty should equal 150%. Likewise, when Z falls to 20%, the rate of penalty should equal 400%.

If: $C = 0.2M$ and $Z = 0.5$:

$$M - 0.2M = 0.5(F + M)$$

$$0.8M = 0.5F + 0.5M$$

$$0.5F = 0.3M$$

$$F = 0.6M$$

Thus, when $Z = 0.5$, and $C = 0.2M$, we need at least a 60% penalty rate to achieve full deterrence.

When Z falls to 25%, a more realistic assumption, the results are much different, however:

Assuming $C = 0.2M$:

$$M - 0.2M = 0.25(F + M)$$

$$0.8M = 0.25F + 0.25M$$

$$0.25F = 0.55M$$

$$F = 2.2M$$

Thus, under the more realistic assumption of $Z = 0.25$, the rate of penalty should rise very high, a practical impossibility. Thus, increasing the rate of penalty is not the right answer. The current regime clearly does not even come close to full deterrence when viewed through the lens of the multiplier principle. Congress has a difficult time in attempting to increase the

rate to 40% in certain cases, but nevertheless, the penalty regime should be based the multiplier principle. Thus, under the assumption that $Z = 0.5$ and that $C \leq 20\%$ of M , the penalty rate should be at least 60%.²⁷⁰

VII. Conclusions

The *Long Term Capital Holding* and *CMA* share many common elements. First, in both cases, the courts clearly concluded that the disputed transaction had neither economic substance nor business purpose. Second, based on this determination, both courts concluded that an opinion from a tax adviser may not satisfy the reasonable cause exception when the disputed transaction lacked economic substance. In other words, the courts set the “reasonable cause” threshold very high— if a transaction lacks economic substance, taxpayers are presumed to have no reasonable cause. This standard is almost equivalent to a strict liability standard. Note that in both cases, the opinions were rendered by reputable law firms, and stated a “should” level opinion. In *CMA*, the court elaborated that a law firm that is involved in marketing the transaction may not give an opinion that satisfies the exception. Finally, in both cases, the courts did not stop short with a 20 percent penalty and imposed the 40 percent gross valuation penalty.

The Jobs Act of 2004 is not the first occasion, and undoubtedly will not be the last occasion, on which there appears to be a widely-held perception that an increasing use of tax-motivated transactions by corporations and individuals is eroding the tax base and fundamentally

²⁷⁰ For similar proposals, see Bankman, and also James Holden, *Buyers Beware of Aggressive Tax Shelters*, 82 Tax Notes 707, 712.

undermining a general sense of fairness in the tax system.²⁷¹ The subject of tax shelters, while it has been studied literally for decades and resulted in a number of voluminous reports being produced, has yet to be fully defined with any specificity.²⁷² Defining the line between what is permissible tax planning and impermissible tax evasion has proved to be extremely difficult for both taxpayers (at least those taxpayers for whom defining that line is a relevant inquiry) and the government. Perhaps this is because there is a strongly held belief rooted in well-established case law that one does not, even out of a sense of patriotic duty, have to maximize the amount due to the tax collector.²⁷³

What is rather unique in this instance, besides the rather extensive time period between the identification of a “serious” tax shelter problem (certainly by the time of the Treasury’s and Joint Committee’s Study in July 1999) and Congressional action (late fall 2004), is the sweeping scope of the Congressional grant of authority that has been delegated to the IRS under the guise of identifying and penalizing abusive tax avoidance transactions.

It is impossible to predict how the IRS will administer the broad new powers that Congress has bestowed upon it. As concluded above, based on a cost-benefit analysis, the current legislation does not adequately deter the use of most types of shelters because the current penalty rates and probability of being subject to such penalties are too low as compared to the potential gains. Thus, a simple cost-benefit analysis would show that, in most cases,

²⁷¹ See, generally, Anthony B. Casarona, “Regulating Corporate Tax Shelters: Seeking Certainty in a Complex World,” 50 Cath. U.L. Rev. 111, 119 (2000) (“The history of tax law reveals that the use of corporate tax shelters is not a new phenomenon” and stretches to the beginning of the 20th century.)

²⁷² See, e.g., Department of the Treasury, “The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals” (July 1999).

²⁷³ Justice Learned Hand stated in the lower court’s opinion in *Gregory v. Helvering* that a taxpayer “may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.” *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d* 293 U.S. 465 (1935).

taxpayers would be well advised to take their chances and “play the audit lottery,” and the current penalty provisions deter only transactions with relatively small expected gains. To crack down tax motivated transactions more efficiently, Congress must find better methods for changing the taxpayers’ cost-benefit balance.

The tax shelter provisions of the Jobs Act are intended to accomplish at least one rather straightforward goal; that is, to alter the cost-benefit analysis of entering into tax shelter transactions, however defined, by significantly increasing the economic risk to the taxpayers who might otherwise choose to invest. As it turns out, the cost/benefit analysis is altered not only for tax shelter transactions but, indeed, potentially for *any* tax planning transactions. This will become most apparent where the mere act of identifying a transaction as a “listed” transaction, including something “substantially similar” to a listed transaction, brings with it a cornucopia of restrictions and limitations that may apply to the taxpayer and any material advisors (and there will frequently be more than one material advisor to a transaction, at least until regulations are written), including reporting requirements, extended statute of limitations, strict liability penalties, SEC reporting requirements and promoter penalties.

The challenge for the IRS will be to use these broad new powers judiciously and to avoid the trap of overusing the “listing” process simply to identify transactions that the government wants to know more about or otherwise does not “like,” for whatever reason, rather than listing only those transactions that are truly the most abusive tax avoidance transactions.