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The Culture of Tax Avoidance

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THE CULTURE OF TAX AVOIDANCE

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INTRODUCTION TO THE PROBLEM OF TAX PLANNING FOR TAX AVOIDANCE

When Judge Learned Hand observed: "Any one 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,"[1] he provided the tax planning industry compelling rhetoric to legitimize and mainstream its activities. Identifying a transactional structure that is consistent with the client's business or investment objectives but also produces a more favorable tax outcome than other possible structures enables tax professionals to serve more than their historical support and reporting roles. Tax planners, like deal planners, "add value" as they provide their legal and accounting services.

While I am reluctant to bite the proverbial hand that feeds me both intellectually and economically in my tax planner capacity, I always have found differing tax outcomes for economically identical transactions counterintuitive and counterproductive. Counterintuitive because if two otherwise like taxpayers each receive $100 of income but do not pay the same amount of tax on that $100, the outcome defies my sense of order. A tax

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1. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd sub nom.* Gregory v. Helvering, 293 U.S. 465 (1935) (deciding a case where taxpayer caused a corporation to engage in a divisive reorganization under the statute, spinning off a corporation that held only shares of a third corporation; taxpayer liquidated the spun off corporation in order to sell the third corporation shares and have capital gain, rather than ordinary dividend income on the distribution). Approval of technical compliance with the tax law to achieve a favorable outcome despite possible inconsistency with the intention of the law is older. *See, e.g.*, United States v. Isham, 84 U.S. 496, 506 (1873) (stating "[t]hat if the device is carried out by the means of legal forms, it is subject to no legal censure").

should impose like burdens on like taxpayers,[2] so that the taxpayer engaging the tax planner's services gains no advantage over the taxpayer without a tax planner. Counterproductive in that the possibility of differing tax outcomes distracts attention from the activity of producing goods that might benefit society and directs that attention to the activity of tax planning. While I may be unwilling to go so far, Professor Weisbach indeed makes this point as he argues for elimination of all tax planning.[3] Professor Doctor Drüen makes similar observations from a German perspective[4] but is more tentative about restricting tax planning. Professor Drüen identifies a conflict in applicable constitutional principles between the constitutional freedom to structure one's business affairs to one's advantage[5] and the constitutional equality principle as it generally applies to taxation.[6]

2. The literature identifies this concept as "horizontal equity." *See generally* Joseph J. Cordes, *Horizontal Equity*, THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 164–66 (Joseph J. Cordes et al. eds., 1999); Henry Ordower, *Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted*, 7 FLA. TAX REV. 259, 265 (2006) (exploring United States Supreme Court and German Constitutional Court decisions that apply their respective constitutions to taxation controversies, especially controversies in matters involving equal protection or due process protection).

3. David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 223–24 (2002).

4. Klaus-Dieter Drüen, *Unternehmerfreiheit und Steuerumgehung* [*Entrepreneurial Freedom and Tax Avoidance*], 2008 STEUER UND WIRTSCHAFT [STUW] 154, 158 ("Steuerumgehung volkswirtschaftlich betrachtet den Wettbewerb und führt zur ineffizienten Allokation von Ressourcen, weil beträchtliches Personal in Unternehmen, Steuerberatung und Staat fern von wirtschaftlicher Nutzenmaximierung gebunden wird.") ["From an economic perspective, tax avoidance disrupts competition and leads to inefficient allocation of resources as considerable personnel in business, tax planning industries, and the state remain far from economic production maximization activity."] (author's translation).

5. *Id.* at 155 (identifying the source of this freedom under the decisions of the Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] as Grundgesetz für die Bundesrepublik Deutschland [Grundgesetz] [GG] [Basic Law], Article 2, Paragraph 1). GG Article 2, Paragraph 1 reads: "Jeder hat das Recht auf die freie Entfaltung seiner Persönlichkeit, soweit er nicht die Rechte anderer verletzt und nicht gegen die verfassungsmäßige Ordnung oder das Sittengesetz verstößt." GRUNDGESETZ FÜR DIE BUNDESREPUBLIK DEUTSCHLAND [GRUNDGESTZ] [GG] [BASIC LAW], May 23, 1949, BGBL. I, art. 2(1) (Ger.), *amended by* Gesetz zur Änderung des Grundgestzes [Law Amending Basic Law], July 29, 2009, BGBL. I at 2248, art. 1 (Ger.), *translated in* PRESS & INFORMATION OFFICE OF THE FEDERAL GOVERNMENT, THE BASIC LAW FOR THE FEDERAL REPUBLIC OF GERMANY: PROMULGATED BY THE PARLIAMENTARY COUNCIL ON 23 MAY 1949 AS AMENDED UP TO 16 JULY 1998 14 (Christian Tomuschat & David Curry trans., 1998) ("Every person has the right to free development of his personality insofar as he does not violate the rights of others or offend against the constitutional order or the moral code.").

6. Drüen, *supra* note 4, at 156–57 (identifying the source of the equality principle as GG, art. 3(1)). "Alle Menschen sind vor dem Gesetz gleich." GRUNDGESETZ FÜR DIE BUNDESREPUBLIK DEUTSCHLAND [GRUNDGESTZ] [GG] [BASIC LAW], May 23, 1949, BGBL. I,

Despite my reservations about the utility and logic of tax planning, it seems likely to remain part of the landscape of the economy not only of the United States but also of other modern national economies. Tax planning often enjoys and is likely to continue to enjoy the protection of textualist judicial decisions.[7] With respect to tax planning, including tax sheltering, a rich literature, both in academic and practice circles, addresses the prevalence of tax avoidance through planning as well as the administrative, legislative, and judicial efforts to contain the planning.[8]

art. 3(1) (Ger.), *translated in* PRESS & INFORMATION OFFICE OF THE FEDERAL GOVERNMENT, *supra* note 5, at 14 ("All persons shall be equal before the law.").

7. Textualism in the language of interpretative theory refers generally to interpretation of the law solely from the words of its statutory text without regard to external sources that might provide context or gloss on the statute. *See generally* Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1 (2004) (noting textualism has contributed to the rise of tax shelters and arguing for partnership anti-avoidance rules); Steven A. Dean & Lawrence M. Solan, *Tax Shelters and the Code: Navigating Between Text and Intent*, 26 VA. TAX REV. 879 (2007) (focusing on statutory text to distinguish appropriate from inappropriate application); Brian Galle, *Interpretative Theory and Tax Shelter Regulation*, 26 VA. TAX REV. 357, 362 (2006) (arguing that purposivistic legislation like codification of economic substance will not succeed against textualist arguments so that judicial interpretation of the uncodified doctrine may be more successful in combating shelters); Deborah A. Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445 (1993) (viewing textualism under Scalia's decisions as a form of literalism that unnecessarily confines interpretation).

8. *See, e.g.*, Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 5–20 (2000) [hereinafter Bankman, *Economic Substance Doctrine*] (identifying flaws and complexities of the dual economic substance test and recommending an ordinary course of business exception); Joshua D. Blank, *What's Wrong with Shaming Corporate Tax Abuse*, 62 TAX L. REV. 539, 541, 590 (2009) (arguing that shaming may be counter-productive and encourage other managers to be less timid in part because there is no public approbrium); Marvin A. Chirelstein & Lawrence A. Zelenak, Essay, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1952–53 (2005) (proposing broad disallowance of all non-economic loss unless Congress specifically sanctions or gives treasury power to disallow losses retroactively and to disallow allocation of gain to tax indifferent parties); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 371 (2002) (arguing lack of political will to respond to tax avoidance and recommending increased disclosure requirements); Weisbach, *supra* note 3, at 222–25 (favoring outlawing all tax planning). *See generally* Cunningham & Repetti, *supra* note 7; Galle, *supra* note 7, at 362; Jay A. Soled, *Tax Shelter Malpractice Cases and their Implications for Tax Compliance*, 58 AM. U. L. REV. 267, 328–29 (2008) (arguing that there has been a breakdown in ethical standards in practice and their enforcement and seeing malpractice jurisprudence as an opportunity to restore standards with penalties and prohibitions on insurance for malpractice in tax sheltering).

In 2001, Southern Methodist University School of Law held a symposium on tax shelters and published the papers in its law journal, including: Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9, 10–11 (2001) (applying FREDERICK SCHAUER, PLAYING BY THE RULES (1991) to anti-avoidance rules); Joseph Bankman, Commentary, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. REV. 149, From the literature, one gets the impression that tax planning and tax avoidance is so prevalent in the countries with developed national economies that tax avoidance always has been or has become acceptable behavior. Judicial sanction of tax planning, however, has not been free from restrictions. Courts in the United States, for example, have imposed broad, general doctrinal limits on permissible tax planning. Even in *Helvering v. Gregory*,[9] Judge Hand quickly added an equally elegant overall limitation on tax planning to his elegant endorsement of tax planning.[10] Judge Hand rejected a strict textualist interpretation of taxing statutes (long before we discussed statutory interpretation in those terms)[11] and sought to limit tax-reducing arrangements to those that are consistent with the intention of the taxing statute.[12] Judge Hand wrote: "but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create."[13] This limitation on tax planning requires that

150–51 (2001) [hereinafter Bankman, *Business Purpose Doctrine*] (observing both an age difference and practice difference with older practitioners aged 45–65 being more comfortable with standards and younger practitionhers being more comfortable with textualism); Peter Cannellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions in Tax Shelters*, 54 SMU L. REV. 47, 51–57 (2001) (seeing a split tax bar between normal and tax shelter bar); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131, 146–47 (2001) (concluding that efforts to solve the problem with anti-abuse rules or other broad rules will not succeed).

And there is considerable literature outside the English speaking world as well. *See* TERESA SIMON ALMENDAL, SKATTEANPASSADE TRANSAKTIONER OCH SKATTEBROTT [TAX-PLANNED TRANSACTIONS AND TAX CRIME] 268 (2005) (addressing tax planning and tax criminality and possible solutions in Sweden); Drüen, *supra* note 4, at 158; Anders Hultqvist, *Skatteundvikande förfaranden och skatteflykt* [*Tax Avoidance Transactions and Tax Flight*], SVENSK SKATTETIDNINGEN [SVSKT] [SWEDISH TAX JOURNAL], June 2002, at 302 (detailing the shortcomings of the Swedish general anti-avoidance rule for lack of consistent application and problems of conflict with other statutory interpretation issues, in particular the need to identify legislative statutory intent where it is necessary to hypothesize that intent in applying the GAAR); Peter Karlsson, *Åtgärder mot skatteflykt och en särskild studie av "handelsbolagslösningen"* [*Provisions Against Tax Flight and a Particular Study of the Partnership Solution*], (Oct. 2, 2008) (unpublished M.A. thesis, Handelshögskolan vid Göteborgs Universitet), *available at* http://www.uppsatser.se/uppsats/93312375a1/ (raising similar concerns and discussing a specific type of tax shelter involving sale of corporate interests to an offshore partnership).

9. 69 F.2d 809 (2d Cir. 1934).

10. *Id.* at 810–11. *See also* Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440, 445–46 (1968) (identifying the limited scope of Hand's opinion).

11. *See, e.g.*, Galle, *supra* note 7, at 394, 401 (contrasting Learned Hand's approach to modern textualism); Geier, *supra* note 7, at 459 (discussing strict adherence to the letter of tax law as textualism).

12. *Gregory*, 69 F.2d at 810–11.

13. *Id.* at 810–11.

the substance of the transaction, rather than its form, control the tax outcome. The outcome must match the intention of the taxing statute that otherwise applies to the transaction's form. Transactions lacking economic and business purpose, other than to capture a tax advantage by meeting specific statutory requirements, fail this judicial test.[14]

Hence the tax collector has not been utterly defenseless in combating tax avoidance plans. Multiple levels of prevention have surfaced and enjoyed varying degrees of success. In the United States, courts have applied interpretive glosses like the sham transaction,[15] business purpose,[16] economic substance[17] and substance over form[18] doctrines to prevent tax reducing schemes.[19]

In addition to judicial doctrines, legislatures increasingly have enacted general anti-avoidance rules (GAARs) to shore up weakened statutory supports of tax collection.[20] Where legislatures perceive a non-compliant use of a statute to be common or especially troublesome, subject to the limitations and sluggishness of the political process, they modify the statute to correct the

14. *Id.* at 811. For a long line of cases following *Gregory*, see, for example, *Knetsch v. United States*, 364 U.S. 361, 366 (1960) (holding that interest paid on insurance borrowing was a sham lacking economic substance); *Dow Chem. Co. v. United States*, 435 F.3d 594, 605 (6th Cir. 2006) (disallowing interest deductions on borrowings to acquire company owned life insurance on employees' lives as without economic substance); *Estate of Franklin v. Comm'r*, 544 F.2d 1045, 1048 (9th Cir. 1976) (holding the taxpayer had no economic interest in property where the debt encumbering the property greatly exceeded the property's value). For recent discussions of the economic substance doctrine, see Tracy A. Kaye, *The Regulation of Corporate Tax Shelters in the United States*, 58 AM. J. COMP. L. 585, 600–04 (Supp. 2010) (examining the Obama Administration's approach to the economic substance doctrine) and Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389 (2010) (arguing the modern economic substance doctrine should be abandoned and replaced by a "Congressional intent" inquiry).

15. *Knetsch*, 364 U.S. at 366.

16. Treas. Reg. § 1.368-1(c) (2010) (requiring the taxpayer to demonstrate a business purpose for tax-deferred reorganization).

17. *Estate of Franklin*, 544 F.2d at 1048.

18. *See Gregory*, 69 F.2d at 810–11 (noting that when interpreting stautes, "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes").

19. I tend to agree generally with Professor Bankman that the economic substance doctrine includes the other doctrines in its operation. *See* Bankman, *Economic Substance Doctrine*, *supra* note 8, at 12.

20. *See generally* NABIL OROW, GENERAL ANTI-AVOIDANCE RULES: A COMPARATIVE INTERNATIONAL ANALYSIS (2000) (noting that Parliaments in Australia, Canada, and New Zealand have enacted GAARs); Graeme S. Cooper, *International Experience with General Anti-Avoidance Rules*, 54 SMU L. REV. 83 (2001) (noting other countries use GAARs as their preferred strategy for dealing with corporate tax shelters); Tim Edgar, *Building a Better GAAR*, 27 VA. TAX REV. 833 (2008) (addressing design, enactment, and function of GAARs in English speaking countries). This Article will use the acronym "GAAR" for general anti-avoidance rule consistent with the convention in the literature.

statutory flaw and close the possible loophole.[21] Also, legislatures have introduced penalty regimes to dissuade taxpayers and their advisors from engaging in particularly egregious tax planning conduct.[22]

Commentators have suggested a broad range of judicial, administrative, and legislative corrections, most only partial, to the problem of tax avoidance. One commentator views tax malpractice litigation as a growing alliance between taxpayers and tax collectors to reign in the excesses of the tax planning community and invites the bar to assist.[23] Other commentators have proposed a prohibition on tax planning generally,[24] more disclosure requirements for taxpayers,[25] a broad disallowance of all non-economic loss,[26] and an ordinary course of business requirement to allow tax benefits incidental to ordinary business transactions, but not those emanating from transactions planned to capture tax benefits.[27] Commentators even have proposed shaming of corporate taxpayers that invest in aggressive tax shelters as a method to encourage shareholders to pressure managers to comply with the tax laws.[28]

If implemented, each recommendation might accomplish a great deal in limiting tax avoidance. Implementation, however, requires that the recommendation gain necessary political traction. That traction has remained

21. For example, Congress altered the reorganization rules the taxpayer sought to exploit in *Gregory*. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.); *Gregory*, 69 F.2d at 810–11 (noting how the defendant created a subsidiary corporation to exploit a loophole and avoid taxes). The statutory change required that following the reorganization distribution both the parent and the spun off subsidiary continue to actively conduct one or more of the pre-reorganization historical businesses. I.R.C. § 355(b) (1986). Section 355(b) of the Internal Revenue Code of 1986 (the "Code"), as amended, is the current form of the active business limitation on divisive, tax-deferred reorganizations. I.R.C. § 355(b) (2006).

22. *See* I.R.C. § 6601 (2006) (imposing interest charges on underpayment and nonpayment of taxes); *Id.* §§ 6651–6656 (imposing penalties for negligence and fraud, failure to pay estimated income tax, failure to file certain information returns, and failure to pay tax); *Id.* §§ 6662–6663 (imposing penalties for accuracy-related underpayments); *Id.* § 6694 (imposing penalties upon tax return preparer for understating taxpayer's liability). For a discussion of the penalties see *infra*, notes 139–46, 284 and accompanying text.

23. Soled, *supra* note 8, at 328–29.

24. *See* Weisbach, *supra* note 3, at 224 (arguing that tax planning imposes costs on those who do not plan, and that making the tax planners externalize these costs would eliminate tax planning altogether).

25. Schler, *supra* note 8, at 394.

26. Chirelstein & Zelenak, *supra* note 8, at 1952–53. Note that in I.R.C. § 469 (2006), the passive activity loss limitations applicable primarily to individuals rather than corporations, defers the deduction of taxable loss until the taxpayer bears the economic burden of that loss. Chirelstein & Zelenak seem to propose an I.R.C. § 469 on steroids that would apply to all non-economic behavior and to all taxpayers. Chirelstein & Zelenak, *supra* note 8, at 1952–53.

27. Bankman, *Business Purpose Doctrine*, *supra* note 8, at 151.

28. *See* Blank, *supra* note 8, at 547–58 (discussing shaming as a possible sanction); *but see id.* at 559 (arguing that shaming may have little effect and even may prove counter-productive).

elusive. Tax planning, tax sheltering, tax avoidance and evasion remain grave problems for the integrity of tax systems worldwide.

In this Article, I argue that over the past half century or longer, multiple factors have contributed to and fused into a culture of tax avoidance. In the United States, Congress has fueled and continues to fuel the growth of that tax avoidance culture by relying on the taxation system to deliver a variety of subsidies and economic stimuli that are unrelated to the administration and collection of taxes. In some cases, Congress has used the Code to drive social policy.[29] That reliance confuses taxpayers concerning the function of taxation, the nature and importance of governmental services, and taxpayers' own tax compliance obligations. In the presence of that culture, legislatures and national executives lack the political will to adopt those proposals that actually might minimize or even eliminate the tax avoidance problem.[30] Rather, the legislatures and executives settle on political compromises that have their own flaws and produce only limited corrective results, GAARs being one example. I conclude that the cultural change essential to quell tax avoidance requires (i) the political resolve to suppress collateral, non-revenue-collection uses of the taxation system like delivering subsidies and economic stimuli or driving social policy and (ii) dedication of the resources necessary to enforce the tax laws and educate the public about the societal role of tax law and taxpayers' responsibilities under the tax laws.

In Part Two of the Article, I selectively trace the history of tax sheltering in the United States and observe how the legislature increasingly relied on the taxation system to deliver economic subsidies and direct social policy. That reliance or even dependence on the taxation system caused many industry participants to confuse statutorily sanctioned tax planning with securing unintended tax benefits.[31] In the presence of that confusion, courts became unable and unwilling to do the legislature's work of distinguishing intentional from unintentional tax benefits.[32] Moreover, confusion of purpose and the mix of intended and unintended tax benefits for high income or wealthy taxpayers contributed to the growing perception of unfairness in the tax system.[33]

Part Three briefly reviews the role of bar and accounting self-regulatory organizations in the United States with respect to tax avoidance. There, I argue that both types of self-regulatory organizations failed to set and enforce tax practice standards. As practitioners undermined historical barriers between

29. *See* WILLIAM D. POPKIN, INTRODUCTION TO TAXATION at xxxvii, xl–xli (5th ed. 2008) (noting that using tax law to encourage activity with social benefits and discourage activity with social detriments has increased the tax code's complexity).

30. *See supra* notes 24–29 and accompanying text (discussing those proposals).

31. *See infra* notes 167–68 and accompanying text.

32. *See infra* notes 250–52 and accompanying text.

33. *See infra* note 138 and accompanying text.

intended and unintended tax subsidies, the self-regulatory organizations declined to police their memberships adequately to combat aggressive tax planning trends—contributing to the cynicism within the tax professional community concerning the tax administrator's[34] ability to do its job.[35]

Part Four of the article turns its attention to tax avoidance as a problem outside the United States as well. In discussing GAARs and their underlying flaws, I argue that GAARs demonstrate that the governments of many countries perceive tax avoidance to have become a national difficulty. I argue further that GAARs reveal legislatures' and executives' growing public acknowledgement of the inability of tax administrators to combat tax avoidance with their existing administrative and statutory tools. At the same time, GAARs demonstrate legislative and executive ambivalence toward radical problem solving where the problem is tax collection.[36]

Part Five supplements Part Four's identification of misuse of tax statutes outside the United States and provides some examples, as it describes tax planning through structured transactions in Sweden[37] and the use of foreign foundations[38] in Germany and other countries to avoid domestic income taxation.

In Part Six, I look more directly to the developing culture of tax avoidance as it converges with and legitimizes tax evasion. I seek to identify how the various elements combined to form the tax avoidance culture, and I observe that the period of the cultural development was a time of growing wealth disparities[39] that gave greater economic and political influence to the wealthy minority. That minority seemed ever less willing to share that wealth through

34. In the United States, the tax administrator is the Internal Revenue Service that this article will refer as the "IRS."

35. *See infra* notes 280–82 and accompanying text.

36. *See infra* note 313 and accompanying text.

37. *See infra* Part V.

38. "*Stiftung*" (plural "*Stiftungen*") is the German term for foundations. DAS GROSSE DEUTSCHES WÖRTERBUCH [GERMAN DICTIONARY] 3427 (Gerhard Wahrig ed., 1967).

39. *See* MICHAEL PARISI & MICHAEL STRUDLER, IRS STATISTICS OF INCOME, THE 400 INDIVIDUAL INCOME TAX RETURNS REPORTING THE HIGHEST ADJUSTED GROSS INCOMES EACH YEAR 1992–2000 (2010), *available at* http://www.irs.gov/taxstats/article/0,,id=203102,00.html (showing increasing concentration of income in the top 400 group of earners); ARLOC SHERMAN & CHAD STONE, CTR. ON BUDGET & POLICY PRIORITIES, INCOME GAPS BETWEEN VERY RICH AND EVERYONE ELSE MORE THAN TRIPLED IN LAST THREE DECADES, NEW DATA SHOW (2010), *available at* http://www.cbpp.org/files/6-25-10inc.pdf (noting that the gaps in after-tax income between the richest 1% of Americans and the poorest fifth of the country more than tripled between 1979 and 2007); Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States 1913–1998*, 118 Q. J. ECON. 1 (2003) (finding that top wage shares have increased since 1970 and are higher than prior to World War II).

taxation. Pseudo-grass roots[40] anti-tax movements burgeoned and supported the anti-tax goals of the wealthy, the tax planning and sheltering industries flourished, and current technologies contributed to and facilitated that cultural development.[41]

Part seven concludes that it will become necessary to address each element that contributed to the creation of the culture of tax avoidance in order to engender the cultural change toward tax compliance. One critical element of that change I argue demands that we renew our tax systems as revenue collection structures, eliminating the multiplicity of functions they currently serve.

I. TRACING TAX SHELTERING IN THE UNITED STATES

Many structured tax avoidance transactions are tax shelters, but not all tax shelters are tax avoidance transactions. While the most visible application of the economic substance doctrine[42] in the United States in recent years has been in relation to a series of aggressive tax shelter products,[43] tax sheltering is by no means synonymous with tax avoidance in the pejorative usage of that term.

While this article will argue that the growth of the tax sheltering industry contributed significantly to the current prevalence of tax avoidance transactions, the "tax shelter" concept encompasses many transactions and tax structures that are fully consistent with legislative intent. In the United States, the tax sheltering industry builds products to seize tax saving opportunities Congress provided to subsidize specific industries. For example, Congress historically has provided various tax subsidies to industries that explored for

40. I refer to the low to middle income anti-tax rhetoric as pseudo-grass roots because it tends to be against economic interest. Traditional grass roots organizers, unions, and community organizations generally better represent the economic interests of those they organize.

41. *See* Patricia B. Hsue, Comment, *Lessons from* United States v. Stein*: Is the Line Between Criminal and Civil Sanctions for Illegal Tax Shelters a Dot?*, 102 NW. U. L. REV. 903, 909–11 (2008) (noting that the text shelter industry emerged in the late 1970s and early 1980s, and that corporate tax shelters flourished in the 1980s).

42. The economic substance doctrine served as a U.S. non-statutory GAAR, until its codification as I.R.C. § 7701(o) in 2010. Health Care and Education Reconcilation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067 (2010). *See also infra* note 304 and accompanying text. For a recent general discussion of economic substance and corporate tax shelters in the United States, see Kaye, *supra* note 14, at 600–04 and Lederman, *supra* note 14, at 416–41.

43. See discussion of the so-called "son of boss" transactions, *infra* note 232 and accompanying text. *See, e.g.*, Clearmeadow Invs., LLC v. United States, 87 Fed. Cl. 509, 528 (2009) (holding that even if the transaction conforms literally to the Code, it must serve a "business or corporate purpose" and perform a function other than reducing taxes; noting the purpose is measured by "objective economic reality" as determined by a reasonable possibility of yielding a profit and whether "the transaction affected the taxpayer's financial position in any way").

and produced certain natural resources.[44] In some instances, the tax-based subsidies provide resources to activities that the legislatures deem beneficial to the country or community.[45] In other instances, the subsidies may be a function of successful industry lobbying or a political exchange within Congress in order to gain the support of a member of Congress for some unrelated legislation.[46] This article will refer to investments that seek to obtain those subsidies as though the legislature intended them as tax advantaged investments rather than tax avoidance transactions.

Whether the transaction or tax structure is consistent with the legislative intention underlying the applicable tax statutes or not, one finds among tax shelter products: 1) profitable transactions for which the statutorily intended tax benefits materially enhance the return, 2) economically sensible transactions that employ unnecessarily complex structures or insert inessential structural elements to capture a more favorable tax outcome than economically more efficient structures would, and 3) tax driven transactions that, but for tax advantages, would be unprofitable or at best minimally profitable. Early in the development of a tax sheltered investment community in the United States, shelter promoters designed products for investors whose income otherwise

44. Percentage depletion, under I.R.C. § 613, allows a deduction for a percentage of the gross income from production of natural resources without regard to the cost of the underlying production rights or their exhaustion. I.R.C. § 613 (2006). Percentage depletion permits a greater deduction in conjunction with natural resource production than does cost depletion. *Id.* § 611(a). Cost depletion allows a deduction only for recovery of the taxpayer's investment in a natural resource deposit in proportion to relationship between the quantity produced and the quantity in the deposit. *Id.* This longstanding subsidy, along with current expensing of intangible drilling costs for oil and natural gas, encourages exploration and production and lends itself to tax shelter construction when accompanied with economic, borrowing leverage. *See id.* § 263(c). Percentage depletion reduces the taxable income from successful production activities, while leaving the economic return undiminished. Expensing of intangible drilling costs accelerates the recovery of investment expenditures to the moment of investment rather than requiring, as with most investments, that the taxpayer capitalize the expenditure, add it to the taxpayer's tax basis in the production property, and recover it for tax purposes upon sale of the property or, through cost depletion, as the investment produces income and consumes the limited geological resource. Economic borrowing leverage magnifies the benefit from tax expensing, that is, current deduction of the leveraged intangible drilling costs. *See* discussion of borrowing leverage and *Crane v. Commissioner*, *infra* note 91 and accompanying text.

45. Low income housing credits (I.R.C. § 42(a) (2006)); research and experimentation expensing and credits (*Id.* § 174); expensing of certain durable, tangible personal property (*Id.* § 179); accelerated depreciation (*Id.* § 168); and investment tax credits to encourage investment in durable goods (*Id.* § 46); rehabilitation credit (*Id.* § 47); energy credit (*Id.* § 48); qualifying advanced coal project credit (*Id.* § 48A); qualifying gasification project credit (*Id.* § 48B); and qualifying advanced energy project (I.R.C. § 48C (1986)).

46. THOMAS B. CURTIS & DONALD L. WESTERFIELD, CONGRESSIONAL INTENT 87–90 (1992) (support for one's present measure in exchange for future support facilitates reaching a consensus and is frequently used in Congress).

would become subject to a high rate of tax.[47] As time passed, investor demand and promoters' eagerness to expand their investor base combined to render tax sheltering increasingly an upper-middle-income business.[48]

Sheltering embedded itself quickly into the American cultural landscape. Non-corporate taxpayer-investors[49] adjusted their investment portfolios from traditional investments, such as stocks and bonds, to tax advantaged products, including municipal bonds[50] and a variety of syndicated, tax sheltered investment products,[51] sometimes even when it was not clearly economically

47. *See, e.g.*, Knetsch v. United States, 364 U.S. 361 (1960) (denying claimed interest deductions from the interest the taxpayer paid on borrowing involving a scheme to purchase a life insurance product and borrow its cash value as a sham designed to generate interest deductions without any real economic interest cost to the taxpayer). During much of the period from the end of World War II until 1981, individuals were subject to progressive marginal federal income tax rates with a maximum marginal federal income tax rate for individuals reaching 70% or more. I.R.C. § 1 (1954). The taxpayer in *Knetsch v. United States* was subject to a marginal federal income tax rate in excess of 90%. *Knetsch*, 364 U.S. at 366.

48. *See* STEPHEN E. ROULAC, TAX SHELTER SALE-LEASEBACK FINANCING: THE ECONOMIC REALITIES 55 (1976).

49. Corporations during the post-war period were subject to progressive rates as well but the highest rate remained in the 50% range. *See* I.R.C. § 11 (1954) (providing for a normal corporate income tax of 30% and an additional surtax of 22% for high income corporations).

50. I.R.C. § 103 (2006) generally excludes the interest a taxpayer earns on funds the taxpayer lends to a state or local government.

51. Tax shelter syndications predominantly were private placements of limited partnership interests. *See generally* JACK H. HALPERIN, PRIVATE PLACEMENT OF SECURITIES (1984) (detailing numerous types of tax-sheltered arrangements attorneys could help their clients use). The limited partnership interests were securities under Sections 2(2) and 2(3) of the Securities Act of 1933, as amended, but the offering of the interests was exempt from the registration requirements of Section 5 of the Securities Act as the offering did not involve the public offering of securities, thereby qualifying for the registration exemption under Section 4(2) of the Securities Act. 15 U.S.C. §§ 77b(2)–(3), 77d, 77e (2006). Generally, the promoter would seek to fit the offering into one or more of the various safe harbor, private placement rules under that section, especially Securities Act Regulation D consisting of Rules 501 through 508. 17 C.F.R. §§ 230.502–230.508 (2010); *see also* Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act of 1933 Release No. 33-6389 [1982–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 11,251 (Mar. 16, 1982); HALPERIN, *supra*, at 162–66.

While the offering was exempt from registration, the interests remained subject to the general disclosure requirements and anti-fraud rules of the securities laws, so that legal counsel recommended that promoters provide full disclosure to prospective investors in the form of an offering document, generally called a private placement offering memorandum (PPM). The PPM resembled the prospectus that the partnership and promoter would have provided if the offering had been a public offering. The PPM included disclosures of information concerning the prospective investment that the promoter and the promoter's financial, tax and legal advisors thought that a reasonable investor would deem to be material to his or her investment decision, as Securities Act Rule 502(a)(2) requires. 17 C.F.R. § 230.502(a)(2) (2010).

beneficial to the investors to do so.[52] Loss of money in bad shelters seemed more desirable than payment of like or lesser sums in tax. Moderate income individuals actively sought strategies to limit their income tax liability.[53] The shelter industry survived tax rate reductions and introduction of requirements that taxpayers assume personal liability for partnership debt in order to capture tax benefits.[54] The industry evolved when the passive activity loss limitations of I.R.C. § 469 made sheltering unavailable to the industry's traditional investing community of highly compensated taxpayers.[55] Shelter promoters increasingly developed products for corporations and for individuals and corporations that had large capital gains.[56]

A. Development and Structure of Syndicated Deferral/Conversion Tax Shelters for Income Tax; Tax Exempt Earnings; Estate Tax Sheltering Techniques

Traditionally, syndicated tax sheltered investments in the United States afforded taxpayers the opportunity to secure current deductions that they could use to offset income from other sources—including income from the performance of services.[57] The deductions enabled taxpayers to defer taxation

State and local bonds on which the interest was exempt from taxation under I.R.C. § 103 (1986) were also exempt from registration under Section 5 of the Securities Act but not because of a transaction exemption as applied to private placements but rather because they were themselves exempt securities under Section 3(a)(2) of the Securities Act. 15 U.S.C. § 77c (2006). Despite the exemption, issuers invariably produced a prospectus-like disclosure document in conjunction with the bond offering.

52. Syndicated tax shelter products customarily included financial projections as part of their PPMs. Since most shelters depended upon deductions to deliver their tax benefits, the projections illustrated the anticipated tax impact of the investment under the assumption that the investor would shelter only the highest marginal bracket income. Lower bracket investors and investors who, because of the effect of the shelter, would become subject to a lower bracket on part of their income did not capture the full anticipated tax benefit. In some cases, constant time analysis, present value for example, of investment return for such investors would fall short of similarly analyzed non-shelter investments. *See* HALPERIN, *supra* note 51, at 162–66.

53. Investing in tax shelters even became a measure of one's success, as it showed that one was sufficiently successful to need to shelter income. *See generally* Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 464 (1988) (discussing how tax benefits meant to benefit certain individuals were sought after by individuals not meant to benefit from them).

54. The so-called "at risk" rule required the taxpayer to have economic risk of loss of borrowed funds in order to claim deductions attributable to the additional tax basis from borrowing. I.R.C. § 465 (2006). *See* discussion of the "at risk" rule *infra* note 163 and accompanying text.

55. *See infra* note 191 and accompanying text.

56. *See infra* note 235 and accompanying text.

57. Currently, I.R.C. § 469 (2006) prevents taxpayers from deducting losses from so-called "passive activities" from the taxpayer's active income from the performance of services. *See*

of the income, but generally not permanently free the income from federal income tax. When the deferral ended, and the taxpayer would take the income from the investment into account, that income occasionally would be long term capital gain rather than the ordinary income that the deductions offset. Thus, one observes that the taxpayer converted ordinary deductions into long term capital gain. Sheltering consisted of deferral and conversion. The following example illustrates a fairly traditional deferral/conversion tax shelter structure.[58]

The shelter promoter formed a limited partnership to acquire rental real estate. The promoter, or an entity the promoter controlled, served as the general partner of the partnership, while the investors seeking tax shelter entered the partnership as limited partners. The partnership acquired the rental property with as small a cash investment and as large an amount of borrowed funds as possible. Borrowing enabled the partnership to leverage both its investment return[59] and the tax benefits from depreciation allowances,[60] while

infra note 191 and accompanying text. Passive activities generally are active businesses in which the taxpayer does not participate materially in the sense of providing significant services as was the case with most deferral type tax shelters. I.R.C. § 469(c)(1)(B) (2006).

58. This format was frequent and customary, so that most tax practitioners probably are very familiar with its use. Since 1986, however, such shelters have become less common, so this example may be a helpful reminder. *See infra* note 191 and accompanying text; *see generally* PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION: CASES AND MATERIALS 1191–96 (6th ed. 2008) (discussing three common elements of tax shelters).

59. For example, if the interest rate on the borrowed funds was less than the rate of return from the rental of the property, the excess return on the borrowed funds over the interest payable belonged to the partnership and increased its overall return. As a simple illustration, assume the partnership invests $100 and borrows $100 at 8% but receives a 10% return. It receives $20 on the total $200 investment, pays $8 in interest, leaving the partnership with $12, a $2 enhancement to the partnership's return, boosting its overall return to 12%. Of course, leverage often works negatively when the rate of return is not as expected. Consider what would happen if the partnership's investment yields only 6%. The partnership receives $12, pays $8 interest, leaving the partnership with only $4 net for a return of 4%.

60. *See* discussion *supra* note 60. I.R.C. § 167 (2006) provides an allowance for depreciation of durable property having a limited useful life and used either in the taxpayer's trade or business or for the production of income. Current depreciation rules for tangible property appear in I.R.C. § 168 (2006). Consider the example in the previous footnote. If each limited partner were taxable at a 70% marginal rate of income tax, and the property were depreciable on a straight line over ten years, the $100 cash investment in the first year yields a tax deferral of $7. In addition, the borrowed funds yield a tax deferral of $7, so that the doubling of the investment with borrowed funds doubles the current tax savings from deferral. The overall return on the investment and borrowing in the first year is $12 net cash plus $14 tax savings. The tax savings is only temporary. As the partnership pays the debt from its investment income, the amortization of principal is not deductible even though amortization reduces cash. Accordingly, the $14 tax savings considerably overstates the value of the enhanced depreciation allowance. The temporary use of the tax benefit represents the enhanced return, that is, the return the limited partners receive on the temporary use of the money from the tax savings. Ideally, investors would use only the

also receiving a deduction for the interest it paid or accrued on the indebtedness.[61] Once the non-deductible amortization of principal on the indebtedness began to exceed the deduction from depreciation allowances, the partnership would sell the property and repay the debt. Depreciation allowances from the borrowed funds as well as the partnership's cash investment had diminished the partnership's adjusted basis in the property.[62] On sale, the partnership's amount realized included proceeds used to repay debt, as well as proceeds distributed to the partners.[63] The gain was often much greater than the amount of cash available to investors.[64] Since the rental property was property used in the partnership's trade or business, the gain generally was long term capital gain.[65] Long term capital gain was taxable to the investors at a much lower rate of tax than that at which they claimed the

return on the tax savings while setting the savings amount aside in order to pay the taxes when they came due. Often investors failed to understand this concept or received inadequate tax counseling and did not prepare for the taxes that would become payable in the later years of the investment.

61. I.R.C. § 163 (2006). Since interest often was payable currently, the tax benefit of the interest deduction reduced the interest cost but was far less significant than the deduction for depreciation allowances that carried no accompanying cash outlay. As the shelter industry became more competitive and aggressive, promoters began to manipulate the interest deduction as well. The partnership might accrue interest but defer payment if the lender was willing (or the promoter were the lender). A cash basis lender might be willing to add interest to principal in the years before Congress added the original issue discount accrual rules to the Code. *See id.* §§ 1271–1275. Other schemes included such accrual methods as the so-called "Rule of 78s," which the IRS succeeded in discouraging with Rev. Rul. 83-84, 1983-1 C.B. 97 (limiting interest deduction to economic accrual even if the contract required accrual under the Rule of 78s).

62. I.R.C. § 1016(a)(2) (2006).

63. Crane v. Comm'r, 331 U.S. 1, 13–14 (1947) (holding that the taxpayer's amount realized on disposition of property included the non-recourse indebtedness, subject to which the buyer took the property).

64. Under I.R.C. § 1001 (2006), gain from the sale or exchange of property is the excess of the amount realized, including both cash the seller uses to repay debt and debt that the buyer assumes or subject to which the buyer takes property, over the seller's adjusted basis in the property.

65. As property used in the partnership's trade or business and subject to an allowance for depreciation, I.R.C. § 1231 (2006) governed gains (or losses) on the sale of the property. Section 1231 classifies the gain from such property as long term capital if § 1231 gains in the year exceed § 1231 losses in the year. If losses exceed gains in the year, both gains and losses are ordinary. Section 1231 classification of the gain as ordinary or long term capital occurs at partner, not partnership level, because the partnership separately states § 1231 gain under I.R.C. § 702(a)(6) (2006).

deductions for depreciation allowances.[66] Hence the investors converted their ordinary 70% deductions into 35% (or 28%) long term capital gain.[67]

The promoter would price the tax shelter investment to provide the investors a return on their cash investment that combined some cash return, permanent tax savings through conversion of ordinary deductions into long term capital gain, and estimated earnings on deferred tax amounts. Projections usually showed the computation of the value of deferral at the highest marginal income tax rates, so that an investor in a lower than maximum income tax bracket would receive a lower return on invested cash. Generally, the projections would estimate the value of the investment's cash flow that consisted of distributed cash, if any, and tax savings over time. The promoter would fix the cash investment based upon that cash flow in order to provide a sufficient return on investment to facilitate sale of the investment units.

Cash investment in excess of the amount that the partnership required to acquire its property went to the promoter as one fee or another. The promoter characterized those fees to make them deductible by the partnership and the limited partner investors in order to increase the return from the tax benefits. Acceleration of depreciation allowances, through short useful lives and accelerated methods of depreciation, further improved the return from tax benefits. For real property, double declining balance depreciation tended to be available, but short useful lives were characteristic of personal rather than real property.[68]

Many shelters offered interests in partnerships that leased equipment having a short economic useful life.[69] Tax shelter partnerships often also invested in motion pictures, video tapes, and sound recordings that qualified

66. I.R.C. § 1202 (1954) allowed a deduction equal to 50–60%, depending on the tax year, of non-corporate taxpayers' net capital gains in the year. Net capital gain is the excess of net long term capital gain over net short term capital loss. I.R.C. § 1222 (2006).

67. At a 50% capital gain deduction, the rate of tax on each dollar of gain would be a maximum of 35%, and at a 60% deduction, 28%.

68. Component depreciation became popular in the 1950s and 1960s to shorten the aggregate useful life of buildings. Component depreciation enabled taxpayers to depreciation elements of a structure separately from the building as a whole; for example, wiring and plumbing might have a shorter useful life than the structural components of the building. *See* Shainberg v. Comm'r, 33 T.C. 241 (1959), *acq. in result*, 1960-1 C.B. 5 (allowing component depreciation of new buildings); Rev. Rul. 73-410, 1973-2 C.B. 53 (extending component depreciation to used building where the taxpayer allocated the purchase price among the components at purchase). When Section 201(a) of the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, § 201, 95 Stat. 172, 204 added I.R.C. § 168 (2006), the accelerated cost recovery system, it shortened and standardized recovery periods for all tangible depreciable property and eliminated the use of component depreciation.

69. Under I.R.C. § 168, most tangible personal property became depreciable over not more than five years.

for the income forecast method of depreciation.[70] The income forecast method concentrated depreciation deductions in the first year or two when a motion picture, video tape, or sound recording generated the bulk of its income.[71] Other shelters developed around industries that Congress subsidized through the tax system in order to encourage capital investment. Those industries sometimes received tax credits or current expensing. Oil and gas exploration is an example of such an industry in which current expensing was available for intangible drilling costs[72] and percentage depletion for production.[73] Other industries, including rehabilitation of real property (especially historic structures), enjoyed a generous subsidy of as much as twenty-five percent through tax credits.[74] More generally, investment in new equipment received a ten percent subsidy through the investment credit.[75]

Critical to the success of the tax sheltered investment were 1) classification of the limited partnership as a partnership for tax purposes, rather than as an association taxable as a corporation,[76] and 2) classification of the partnership's indebtedness as without recourse to the partnership or any partner.[77] Partnership, rather than corporate, tax classification provided the tax transparency that enabled limited partners to use their shares of partnership tax items.[78] Since shelters depended upon borrowing leverage to magnify tax benefits and defer taxes, the borrowing had to be non-recourse in order for the

70. *See, e.g.*, Rev. Rul. 60-358, 1960-2 C.B. 68 (allowing depreciation under the income forecast method).

71. *Id.*

72. I.R.C. § 263(c) (2006); *see also* discussion *supra* note 44.

73. I.R.C. § 613; *see also* discussion *supra* note 44.

74. I.R.C. §§ 38, 46 (1954). The 25% credit was only for rehabilitation of historic structures, while a 15% or 20% credit applied to other real property rehabilitation. *Id.* § 46.

75. *Id.* §§ 38, 46.

76. Jeffrey D. Sperling & Lawrence Lokken, *The Limited Partnership Tax Shelter: An Investment Vehicle Under Attack*, 29 U. FLA. L. REV. 1–10 (1976) (explaining the major differences between the two entities and that partnerships are preferred over corporations for tax shelters largely because of flow-through income and deductions).

77. Non-recourse indebtedness is an obligation with respect to which the lender has no recourse to the borrower assets other than the property that secures the debt. Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 462–63 (1997). Promissory notes evidencing non-recourse debt either 1) have specific exculpatory language limiting the lender's recourse, or 2) historically, had a corporation sign as debtor and then liquidate, distributing the property subject to the debt to its shareholders without the shareholders assuming the debt. *See id.* at 460–65 (explaining when non-recourse debt could be advantageous in the corporation context).

78. Under Subchapter K of the Code, tax transparency is the fundamental characteristic of partnership taxation. *See* I.R.C. § 701 (2006) (providing that partners, not partnerships, are subject to tax on the partnership's income); *Id.* § 702(a) (requiring partners to include their shares of the partnership's income, loss, and separately stated items in their own tax computations).

limited partners to include their shares of the partnership's borrowing in their adjusted bases in their partnership interests.[79]

With respect to partnership classification, the Treasury regulations identified four features of a corporation that distinguished corporations from partnerships: continuity of life; limited liability; free transferability of interests; and centralized management.[80] If the partnership had more than two of these features, the IRS would reclassify it as a corporation.[81] As an association taxable as a corporation, the limited partnership would be taxable on its income and would take its deductions into account at the entity level.[82] Income and deductions would not pass through to the limited partners to take into account in computing their individual tax liability.[83] While tax opinions devoted many pages of text to discussing classification, classification as a practical matter was rarely, if ever, a real issue.[84] Years later, the government ceded the classification territory by promulgating the so-called "check-the-box" rules for classification that allowed taxpayers to elect classification relatively freely.[85]

A partner, whether limited or general, may deduct the partnership losses so fundamental to the operation of a tax shelter only to the extent of the partner's adjusted basis in his or her partnership interest.[86] Limited partners, however,

79. *Id.* §§ 752(a), 704(d); *see also infra* text accompanying note 86.

80. Treas. Reg. § 301.7701-2 (1995) (superseded by Treas. Reg. § 301.7701-2 (1997)).

81. *Id.* § 301.7701-2(g).

82. Subchapter C of the Code, I.R.C. §§ 301–385 (2006), prescribes the computation method for the taxable income of a corporation at entity level, and I.R.C. § 11 imposes the tax, if any, at that level. The corporation generally may carry forward and carry back deductions that exceed a corporation's income in a taxable year to take them into account in computing or re-computing the entity's taxable income in another year. *See* I.R.C. § 172 (permitting loss carrybacks for the two previous tax years); *Id.* § 1212 (permitting loss carrybacks for the previous three to ten years, depending on the circumstances). Under Subchapter K of the Code, partnerships compute their incomes, losses, and various separately stated items and allocate that income, loss, and separately stated item among their partners. *Id.* § 702(b). The partners take the allocated items into account in computing their own separate tax liability.

83. *Id.* § 703(a)(2).

84. *E.g.*, Larson v. Comm'r, 66 T.C. 159 (1976) (applying the four factor test to syndicated real estate limited partnerships and finding for the taxpayer because the partnership lacked only two of the four partnership features, limited liability and centralized management). A much later decision, *ASA Investerings P'ship v. Comm'r*, 201 F.3d 505, 512–13, 516 (2000), held that an arrangement between an offshore bank and a partnership was not a partnership for tax purposes, but did not hold that the partners had formed an entity taxable as a corporation.

85. Treas. Reg. § 301.7701-3 (2009) (showing an effective date of January 1, 1997).

86. I.R.C. § 704(d) (2006) limits current deductibility to the partner's adjusted basis in the partnership interest. Losses in excess of that adjusted basis belong to the partner to whom the partnership allocated them under the partnership agreement, and that partner will be able to deduct them when his or her adjusted basis in the partnership interest increases, either as a result of a contribution to the partnership, or the allocation of income from the partnership to the partner. *Id.* §§ 722, 705.

do not share in a partnership's recourse indebtedness, and do not increase their bases in their partnership interests,[87] because only the general partners are obligated to pay that indebtedness if the partnership cannot.[88] Shelter structures depended upon the partnership's ability to include the partners' shares of the partnership's non-recourse indebtedness in the partners' adjusted bases in their partnership interests,[89] so that limited partners would have adequate basis to deduct their shares of the partnership's losses.[90]

The United States Supreme Court's decision in *Crane v. Commissioner* established that the purchaser or seller of property subject to non-recourse indebtedness encumbering that property includes the encumbrance in the amount of the purchase and sale proceeds.[91] The Court equated recourse and non-recourse indebtedness for tax purposes to the extent of the value of the property.[92] In the Court's view, as long as the value of the underlying property was at least equal to the amount of the debt, the owner of the property would treat a non-recourse debt as a genuine obligation and repay it in order to protect the investment in the property.[93] Accordingly, even if the partnership financed its acquisition of property with non-recourse debt, its basis in the property was, as always, the full purchase price.[94] And if the partnership acquired property subject to, but without assuming, existing indebtedness encumbering the property, the partnership's cost included the amount of the debt subject to which it took the property.[95]

87. I.R.C. § 752(a) (2006) treats a partner's share of an increase in the partnership's indebtedness as a contribution of cash by that partner to the partnership under I.R.C. § 721(a) and § 722 (2006).

88. *Compare* Treas. Reg. § 1.752-1T(e) (1990) (superseded by Treas. Reg. § 1.752-1–3 in T.D. 8380, 1992-1 C.B. 218) (allocating recourse liabilities according to the partners' loss sharing ratios, but only to the extent the partners bear the risk of the losses), *with* Treas. Reg. § 1.752-2(a) (2010) (substantially having the same effect).

89. Treasury Regulation Section 1.752-1T(e) (1990) allocated non-recourse liabilities among all partners relative to their profit ratios, because payment of the indebtedness would follow only if the partnership were profitable. At present, Treasury Regulation Section 1.752-3 (2010) allocates non-recourse indebtedness among limited and general partners, but is far more complex. The regulation has a tiered allocation of the partnership's non-recourse liabilities that follows the partnership's allocations of non-recourse deductions under Treasury Regulation Section 1.704-2(b) (2010), and only allocates residual debt according to profit-sharing ratios.

90. I.R.C. § 704(d) (2006).

91. Crane v. Comm'r, 331 U.S. 1 (1947); *see also supra* note 64.

92. *Crane*, 331 U.S. at 6.

93. *Id.* at 14.

94. I.R.C. §§ 1011, 1012 (2006).

95. *Id.* §§ 752(c), 1011, 1012.

That adjusted basis, including the financed portion of the purchase, formed the partnership's basis for determining its depreciation allowances,[96] and limited partners shared in that debt.[97] By design, in the early years of a tax shelter partnership, depreciation allowances and other deductible expenses of the partnership significantly exceeded operating income, so that each limited partner's loss allocations quickly exceeded the amount of cash the limited partner contributed to the partnership.[98]

As shelter demand increased and reached taxpayers with smaller incomes subject to lower rates of tax, promoters became increasingly aggressive in seeking tax-based return enhancements. Techniques included removing non-depreciable, non-deductible assets from the syndicated partnerships. In real estate, that meant the partnership would lease the land rather than own it.[99] Debt instruments, often in the form of wrap-around mortgages that a party related to the promoter provided, would overlay the underlying third party financing, accruing interest in amounts far greater than what was payable currently.[100] Fees structured for deductibility proliferated.[101]

In addition, investors entered cash basis partnerships at the end of the year. The partnership then paid its accrued expenses for the entire year, and sometimes expenses for subsequent years in advance. Since the partnership paid the expenses after it admitted the limited partners as members, it could allocate a full share of all expenses paid to the limited partners in order to

96. I.R.C. § 167(c)(1) (2006) controlled the determination of depreciation. Land is not a wasting asset and is not depreciable. EARL A. SALIERS, PRINCIPLES OF DEPRECIATION 112 (Ronald Accounting Ser., 2d prtg. 1916).

97. Treas. Reg. § 1.752-1T(e) (1990) (superseded by Treas. Reg. § 1.752-1–3 in T.D. 8380, 1992-1 C.B. 218 and current Treas. Reg. § 1.752-3 (2010)).

98. I.R.C. § 722 (2006). The partner's basis in his or her partnership interest is equal to the amount of cash and the adjusted basis of property the partner contributed to the partnership, less losses and distributions that the partnership previously made to the partner. *Id.* § 705(a).

99. Rental payments on the leased land were deductible under I.R.C. § 162 (2006), but owned land yielded no deduction since it was not depreciable.

100. A wrap-around mortgage resembles a second mortgage. The wrap-around lender lends funds in addition to the original debt but does not discharge the original debt. Rather the wrap-around lender takes a note from the property owner in the amount of the original debt and the additional funds and agrees to make the payments on the original debt when they are due. The original mortgage and note retain priority and their payment schedule. The wrap-around might have a higher interest rate or accrue interest more rapidly than the wrapped debt and might even be non-recourse while the original debt is recourse. *See generally* R. Kymn Harp, *When Wrap-Around Mortgages Return—The Time to Plan is NOW*, PROB. & PROP., July/Aug. 2004, at 42 (explaining how wrap-around mortgages can be used to preserve the benefits of a long-term, low-interest loan).

101. *See* I.R.C. § 162 (2006) (allowing as a deduction from a business's taxable income all the ordinary and necessary expenses paid during the taxable year).

cause the expense deduction to match the timing of the investment.[102] Promoters also arranged for investors to pay for their partnership interests over several years to match the tax benefit returns with the investment more closely and increase the investment return relative to the invested funds. At the same time, Congress continued to fuel the growth of the shelter industry by eschewing direct subsidies in favor of providing subsidies through tax benefits.[103]

Syndicators marketed deferral/conversion type tax shelters largely to self-employed professionals, such as medical doctors, dentists, architects, lawyers and others who had substantial income from their professional services. To a lesser extent, highly compensated employees, such as corporate executives, were also a market for these products, but those individuals frequently had a broader range of tax deferral opportunities available to them than did the self-employed.[104] Keogh and individual retirement account-qualified retirement arrangements had significantly lower contribution limits for self-employed individuals than employer plans had for employed individuals.[105] Similarly, corporate stock based compensation plans facilitated long term deferrals. Over the years, a variety of plans used incentive options,[106] restricted stock,[107] and non-qualified stock options to accomplish that objective for key corporate employees.[108] Life insurance products in the form of split-dollar arrangements rapidly grew in popularity.[109] And for those with substantial bargaining power, the emergence of "rabbi" trusts enabled long term elective deferrals.[110]

102. *See id.* Congress prohibited that practice in 1984. Section 72(a) of the Deficit Reduction Act of 1984 (DEFRA), Pub. L. No. 98-369, 98 Stat. 494, 589, added I.R.C. § 706(d)(2) (2006) (compelling matching expenses and allocations of the deductions attributable to those expenses).

103. *See infra* note 169 and accompanying text.

104. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS, AND LEGAL PROPOSALS 3–5 (1999).

105. Section 238 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, 512, eliminated the distinctions in maximum contributions for employed versus self-employed individuals.

106. I.R.C. § 421(a)(1) (2006) provides for incentive stock options that result in no income at the time of transfer of the incentive stock upon option exercise, but the employer corporation does not receive a deduction under I.R.C. § 162 when I.R.C. § 424(a) is applied. Only the purchase price paid under the option will be considered received by any corporation for the transferred share.

107. *Id.* § 83 (deferring the employee's inclusion of the excess of the value of the stock over the amount of the employee's purchase price until the employee's right to the stock no longer is subject to a risk of forfeiture).

108. Under I.R.C. § 83(e) (2006), non-traded stock options an employee might receive as compensation do not have an ascertainable fair market value and are not includable in the employee's income until the employee exercises the options.

109. *Id.* § 101.

110. Rabbi trusts are trusts an employer establishes for the benefit of the employee. The assets of the trust remain subject to the claims of the employer's creditors. The IRS concluded in

Investors garnered tax advantages not only through deferral and deferral/conversion arrangements, but also by way of non-taxable investment products. As the shelter industry grew, so did the market for tax exempt municipal bonds.[111] Interest on state and local obligations is exempt from federal income tax.[112] The interest exemption provides a federal tax subsidy to the states by enabling them to borrow at a lower interest cost than the market demands for taxable obligations. In an efficient market, lenders should be indifferent as to the identity of the borrower, as long as bond ratings reflect comparable risk profiles for all borrowers the lender is considering, so that net after tax return to the lender should be the same for exempt and non-exempt bond issues. To illustrate: Assume that the market interest rate for obligations with risk profiles identical to the municipal bonds is 10%. Since the interest on the municipal bond is exempt from federal income tax, it should pay interest at 3% to a taxpayer whose income is subject to a 70% marginal rate of tax in order to yield for the taxpayer identical returns from investments in taxable and tax exempt debt.

But while not traditionally categorized as tax shelters, state and local obligations offered and continue to offer high marginal bracket taxpayers a significant tax advantage through inefficient tax subsidy allocation. The deeper the market for exempt indebtedness became, the higher the interest rate the issuer had to offer to sell all its bonds. Since the issuer could not discriminate among bond purchasers to sell lower rate bonds to higher bracket taxpayers, higher bracket taxpayers than the target group would buy some portion of the issue and get part of the state subsidy. For example, if, in the example in the preceding paragraph, the state had to price the obligations competitively with the taxable market for a 50% marginal bracket taxpayer in order to find sufficient buyers for its bonds, a 70% marginal bracket bond

private letter rulings that the employer does not transfer the trust assets to the employee for purposes of inclusion in the employee's income under I.R.C. § 83 until the trust ceases to be subject to those claims. In the interim, the employee may direct the investment of the trust's assets. *See* Henry Ordower, *A Theorem for Compensation Deferral: Doubling Your Blessings by Taking Your Rabbi Abroad*, 47 TAX LAW. 301, 313–16 (1994) (tax-based economic analysis of rabbi trusts and analysis of structure).

111. *See* I.R.C. § 103 (2006) (excluding interest on any state or local bond from income).

112. *Id*. Until 1988, many in the tax community believed that Congress did not have the power to tax the interest a state or local government paid on its obligations. The underlying theory was expressed in the maxim that the "power to tax is the power to destroy." In *South Carolina v. Baker*, 485 U.S. 505, 524 (1988), the United States Supreme Court overruled precedents that held that Congress was powerless to tax the interest. Since 1969, interest on state obligations has been taxable if the state arbitraged its yield by using the bond proceeds to invest in higher yielding taxable obligations. Section 601(a) the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, 656, added § 103(c) to the 1954 Code, listing arbitrage bonds as exemptions from the tax-exempt bonds list.

buyer would receive the equivalent of a 16-2/3% return on a market rate instrument in a 10% return market.[113]

Moreover, local governments began to exploit their exempt borrowing power to compete for business investment. The governments provided their exempt borrowing authority for financing private facilities.[114] Since increasing numbers of private projects relied on tax exempt financing, interest rates on exempt debt rose.[115] In order to find sufficient buyers for all the debt, state and local governments had to reach deeper into the taxpayer marginal bracket pool. Since exempt interest rates must advance in inverse proportion to the targeted marginal tax rate of the buyers, tax-exempt rates began to converge on taxable rates. And higher bracket taxpayers gained greater tax avoidance benefit from the purchase of higher rate tax-exempt debt.

On the exempt earnings side of tax avoidance is also the increase in the value of life insurance attributable to earnings on the invested cash value of the policy. Inside build-up in the value of life insurance is not taxable so long as the policy remains in force.[116] Only if the policy owner withdraws the cash value of the policy while the insured individual is alive does the inside value increase become subject to income tax.[117] If, however, the policy pays by reason of the death of the insured, the inside income build-up is permanently excludable from the gross income of the beneficiary.[118]

Historically, such whole life insurance policies imputed a very low interest rate to the cash value of the policy, so that the policies were not particularly attractive investments. In the 1970s, the life insurance industry sought to become more competitive as market interest rates advanced rapidly, rendering

113. In a 10% taxable interest market, the state would pay 5% on tax exempt bonds if the all the bonds would sell to a class consisting of taxpayers in a 50% marginal bracket or higher. A 5% after tax return to a 70% bracket taxpayer yields the equivalent of a 16-2/3% rate on a taxable investment. That is 5% = (1-.7) X, and solving for X, .05/.3 = .167.

114. While documentation was complex, industrial revenue bonds followed one of two models. Either the local government authority would borrow and re-lend to the private user, or own the financed facility during the period during which the exempt bonds were outstanding and lease the facility to the private activity user. *See generally* Daniel H. Skerritt, *Industrial Revenue Bonds*, 4 WILLAMETTE L.J. 517, 517–26 (1967) (discussing the use of and legal challenges to using industrial revenue bonds for non-direct municipal purposes).

115. ROBERT S. MCINTYRE, CITIZENS FOR TAX JUSTICE, TAX EXPENDITURES—THE HIDDEN ENTITLEMENTS 26–27 (2d ed. 1996), *available at* http://www.ctj.org/pdf/hident.pdf.

116. The owner of the life insurance may designate the beneficiary, often borrow against the policy or withdraw funds from the policy. Nevertheless, the tax law does not treat ownership of the policy to be ownership of the interest earnings that the policy issuer credits to the policy. Hence the inside build-up in value is not currently includable in the policy owner's gross income. *See* BORIS I. BITTIKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS 6-1 (2d ed. 2002).

117. I.R.C. § 72(e) (2006).

118. *Id.* § 101.

life insurance products less competitive with other investment products.[119] Universal life insurance policies began to appear.[120] Those policies allowed the insured to select among investment options to enhance the inside policy value while shifting some value risk to the policy owner.[121] The increase in policy value mimicked mutual funds or other investment returns, as universal life policies wrapped mutual funds and invested in parallel portfolios to mutual funds and other investment products.[122] Aggressive insurance marketers for a time even marketed life insurance products which the policy owner could trade, and alter periodically the policies' underlying investment portfolio.[123]

The tax shelter movement did not reach just the income tax. Life insurance products became basic tools of the estate planning industry. The case of *Crummey v. Commissioner* established that an expiring power of appointment qualified for the annual gift tax exclusion.[124] These "Crummey" withdrawal powers facilitated the funding of life insurance premiums through annual gifts from the insured without inclusion of the policy proceeds in the insured's estate at death.[125] "Crummey" trusts that owned insurance on the life of wealthy and moderately wealthy individuals became commonplace as individuals sought to enhance their estates with insurance proceeds that were not subject to estate tax.[126]

Probably as important to the tax side of estate planning as *Crane v. Commissioner*[127] was to income tax sheltering was the Fifth Circuit's decision in *Estate of Bright v. United States.*[128] In *Estate of Bright*, the court determined that decedents' estates may claim substantial discounts on their

119. Zvi Bodie, *Managing Pension and Retirement Assets*: *An International Perspective*, *in* INTERNATIONAL COMPETITIVENESS IN FINANCIAL SERVICES: A SPECIAL ISSUE OF THE JOURNAL OF FINANCIAL SERVICES RESEARCH 162, 188 (Marvin H. Kosters & Allan H. Meltzer eds., reprt. 1991) (1990) (noting that in response to a sharp decline consumer demand for long-term fixed-income because of inflation and subsequent high interest rates, insurance companies introduced universal and variable life insurance policies with higher and more adjustable interest rates).

120. *Id.*

121. William C. Scheel, *The Effects of Risk Reduction Inherent in Universal Life Insurance*, J. RISK & INS., June 1979, at 45, 46, 56 (noting universal life insurance policies enabled lower risk premiums because they contain risk reduction properties of a mortality cost guarantee and investment yield guarantee were combined into a single product).

122. HAROLD D. SKIPPER & W. JEAN KWON, RISK MANAGEMENT AND INSURANCE: PERSPECTIVES IN A GLOBAL ECONOMY 534 (2007).

123. *Id.*

124. Crummey v. Comm'r, 397 F.2d 82, 88 (9th Cir. 1968); *see also* I.R.C. § 2041(b)(2) (2006) (outlining powers of appointment); *Id.* § 2503 (describing the gift tax).

125. I.R.C. § 2042.

126. *See* 1 AM. JUR. LEGAL FORMS 2D *Federal Tax Guide* § 1:86 (2004).

127. Crane v. Comm'r, 331 U.S. 1 (1947).

128. Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981).

minority shareholdings in closely held corporations.[129] Majority ownership by closely related family members of the decedent did not alter the ability to claim the discounts, even if the decedent's shareholdings would pass to those other family members.[130] Planners soon built extensive estate tax shelters based upon minority discounting.[131] Older generation individuals transferred both operating businesses and portfolio assets to family limited partnerships (and later family limited liability companies).[132] Then, over time they would give minority interests to family members, claiming on each occasion appropriate minority discounts for the interests, gradually diminishing their own interest to a minority interest.[133] Ultimately, the interests that the older generation donors held at the time of their death would be a minority interests for which their estates could claim substantial discounts that often, when combined with marketability and other discounts, could be as much as or more than fifty percent.[134] Tax shelter would emanate from the sum of the values of all the interests in the family limited partnership or closely held business being far less than the value of the business's underlying assets.[135] The IRS continues to litigate to prevent discounting in the family limited partnership area but has enjoyed only very limited success.[136]

Demand for tax advantaged investment structures grew rapidly through the 1970s and 1980s as tax avoidance began to displace investment quality as a primary investment goal. Even as Congress sought to limit such activities by imposing risk costs on investors as a price for tax benefits,[137] investors' appetites for such investments did not seem to shrink. Tax avoidance had become a deeply embedded and durable cultural feature of the United States. Tax shelter investing became a measure of one's success and intelligence—one

129. *See id*. at 1002–03, 1006–07.

130. *Id*. at 1005–07. On the income tax side, those family members may have been constructive owners of the shares under I.R.C. § 318, but the constructive ownership rules do not apply to the estate tax. I.R.C. § 318(a)(1) (2006).

131. Carter G. Bishop, *The Ebb and Flow of the Federal Tax Role of Fiduciary Duties in Family Limited Partnerships: From* Byrum *to* Bongard, 35 CAP. U. L. REV. 61, 63 (2006).

132. *Id.* at 63 n.19, 67.

133. Ronald H. Jensen, *The Magic of Disappearing Wealth Revisited: Using Family Limited Partnerships To Reduce Estate and Gift Tax*, 1 PITT. TAX REV. 155, 156–57 (2004).

134. *See id.* at 155.

135. *Id*. at 172. This is a remarkable form of tax magic. For more on discounting through family limited partnerships, see generally Mitchell M. Gans & Jonathan G. Blattmachr, *Family Limited Partnership Formation: Dueling Dicta*, 35 CAP. U. L. REV. 1 (2006).

136. *See, e.g.*, Wendy C. Gerzog, Kelley*: A Green Light for FLPs*, 109 TAX NOTES 1467, 1468–69 (2005); Wendy C. Gerzog, *Return to* Senda: *Order Determinative for FLP Discounts*, 110 TAX NOTES 791, 791–92 (2006).

137. *See, e.g.*, *infra* notes 155, 163 and accompanying text discussing the separation of rates for service income and investment income through the maximum tax on earned income and the more immediate economic risk that accompanies the "at risk" rules.

who invested in tax shelters and legally avoided taxes was doing well and was investing wisely—even if the investments were otherwise not economically compelling. Almost unsurprising was the statement attributed to Leona Helmsley a couple of years before she went to jail for tax evasion: "We don't pay taxes. Only the little people pay taxes."[138]

Neither penalties nor substantive changes in the tax law staunched the revenue leakage from tax shelters. With respect to penalties, beginning in 1976 and continuing regularly, Congress added penalty provisions to the Code to address tax sheltering and other practices. Taxpayers became subject to accuracy-related penalties of 20% of the amount underpaid[139] and a special 20% accuracy related penalty on understatements for transactions the IRS had designated as reportable transactions.[140] Taxpayers could avoid the accuracy-related penalty by demonstrating the existence of substantial authority for the position taken or by disclosing the transaction adequately on the return.[141] Failure to disclose in the case of listed or reportable transactions might increase the penalty.[142] For tax practitioners and promoters, Congress added return preparer penalties,[143] promotion of abusive shelter penalties,[144] penalties for aiding and abetting understatement of tax,[145] list maintenance penalties,[146] and reporting requirements for reportable transactions like tax shelters.[147] These penalties caused practitioners to modify their practices[148] but did not stop tax shelters.

Several substantive tax law changes should have slowed the shelter industry's growth but did not. For example, early on, depreciation recapture rules eliminated the conversion opportunity for personal property depreciation shelters.[149] The combination of short useful lives and investment credits[150] for property partnerships used in equipment leasing generated significant short term tax benefits and provided a solid shelter foundation. Unlike real property,

138. Robert Johnson, *Little Dogs Don't Pay Taxes*, N.Y. TIMES, Aug. 1, 2004, at A2.

139. I.R.C. § 6662(a) (2006).

140. *Id.* § 6662A(a).

141. *Id.* § 6662(d)(2)(B).

142. *Id.* § 6662A(c).

143. I.R.C. § 6694(a)–(b) (1976); I.R.C. § 6694(a)–(b) (1994) (reflecting the 1989 amendments to the tax preparer liability provision).

144. I.R.C. § 6700(a) (2006).

145. *Id.* § 6701(a).

146. *Id.* § 6708(a).

147. *Id.* § 6111(a) (imposing a filing requirement); *Id.* §§ 6707(a), 6707A(a) (imposing penalties for failure to report).

148. *See* discussion *infra* note 266 and accompanying text.

149. Revenue Act of 1962, Pub. L. No. 87-834, § 13(a), 76 Stat. 960, 1032 (adding I.R.C. § 1245 to the Code to recapture depreciation allowances on personal property as ordinary income).

150. *Id.* § 2, 76 Stat. at 962 (adding new I.R.C. § 38 to the Code concerning investment in depreciable property).

the value of personal property declined with use, so that depreciation recapture generally was not a barrier to investment in personal property.[151] Loans secured by personal property most often required that the partnership repay the debt as the property declined in value. When it came time to dispose of the personal property, only marginal value and nominal tax gain would have remained to generate depreciation recapture income. However, when the promoter (or another party related to or involved in the deal) was the lender, non-recourse debt may have remained outstanding at the end of the property's real useful life. In those instances where the lender had an intimate connection to the deal, third party financing often was unavailable because the promoter pushed the value of the underlying depreciable property to its limit or beyond in order to enhance the aggregate amount of the depreciation allowances and investment credits.[152] Despite substantial recapture of depreciation, the deferral benefit from the inflated value made the investment sufficiently attractive to tax shelter seeking investors. Also, as a practical matter, investors often may not have included their share of the partnership's income from that recapture in their individual returns.[153]

Congress did not target tax shelters with the depreciation recapture rules, but rather Congress targeted the more general growing disparity between the rate of economic depreciation and the rate of artificially accelerated tax depreciation.[154] In 1969, however, Congress focused on tax shelters and enacted both the minimum tax on tax preference items and the maximum tax on earned income to limit benefits from tax sheltering.[155] The maximum tax on earned income created a schedular-type rate structure separating personal

151. *See* I.R.C. § 1245(e) (1982) (describing when depreciation would be recaptured on certain types of real property).

152. The government occasionally denied depreciation allowances and credits on the basis of overstated value that had no economic substance. Only in fairly egregious cases did the government win value overstatement cases. *See, e.g.*, Estate of Franklin v. Comm'r, 544 F.2d 1045, 1045 (9th Cir. 1976) (holding that non-recourse, seller-financed real estate transaction with inflated value did not transfer an equity interest so as to entitle a depreciation deduction); United States v. Philatelic Leasing, Ltd., 601 F. Supp. 1554, 1554 (S.D.N.Y. 1985) (upholding an injunction against tax shelter promotion involving gross overvaluation of printing plates).

153. Information-matching capability at the time of the change was not equal to the task of matching partnership and individual returns.

154. *See* Cordes et al., *supra* note 2, at 82. Accelerated methods of depreciation created incentives for capital investment but also increased the level of artificiality in the depreciation allowances. *Id.* Accordingly, Congress considered it necessary to prevent the conversion of those artificially rapid deductions into long term capital gain by recapturing the excess deductions as ordinary income. *Id.*

155. Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 301, 804, 83 Stat. 487, 580, 685 (1969) (adding I.R.C. § 56 (minimum tax on tax preferences) and § 1348 (maximum tax on earned income)).

service income from investment income.[156] The maximum rate of tax on personal service income became 50% under the statute, while the maximum rate on investment income remained at 70%.[157] Many high-income, self-employed, and highly-compensated employed individuals nevertheless invested in tax advantaged products to shelter income from services that otherwise would have been subject to the maximum tax.[158] When the deferral reversed so that the investment generated more taxable income than cash flow, the cost of sheltering 50% of earned income might be as high as 70% of investment income. The first tax reductions during the Reagan administration eliminated that schedular-type rate split by decreasing the maximum marginal rate on all income to 50%.[159]

The minimum tax on tax preference items similarly had little if any effect on tax sheltering except that it forced promoters to restructure some products to produce the desired return on invested funds. The minimum tax initially was a 10% add-on tax that imposed a surcharge on certain tax benefits common to many syndicated tax shelters.[160] In 1976, the rate increased to 15%, and the categories of tax preferences expanded.[161] Congress later restructured the minimum tax to the alternative minimum tax, which provides a parallel tax computation to the regular income tax and now reaches far beyond its original tax sheltering targets.[162]

156. I.R.C. § 1348(a) (1970). This is not to say that the United States federal income tax was not somewhat schedular earlier. *See* SYLVAIN R.F. PLASSCHAERT, SCHEDULAR, GLOBAL AND DUALISTIC PATTERNS OF INCOME TAXATION 17–24 (1988) (discussing schedular tax systems); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 49–50 (1996). The Code isolated income and loss from the sale or exchange of capital assets from other income long before the maximum tax. Capital losses were deductible only against capital gains (plus, for individuals, up to an additional $1,000 per year) under I.R.C. § 1211, and 50% or 60% of net capital gain was deductible under I.R.C. § 1201. I.R.C. §§ 1201(b)(1), 1211(b)(1) (1970).

157. I.R.C. § 1348(a); *see supra* note 47 and accompanying text. Earned income for purposes of the statute was the income that was the type of income subject to the Social Security and Self-Employment Tax. *See* I.R.C. § 1348(b)(1).

158. *See* Garrison Grawoig DeLee, Note, *Abusive Tax Shelters: Will the Latest Tools Really Help?*, 57 S. CAL. L. REV. 431, 435 n.23 (1984) (noting that high-income individuals were still sheltering income).

159. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(c)(1), 95 Stat. 172, 178–79.

160. I.R.C. § 56; *see also* DeLee, *supra* note 158, at 435 n.23.

161. Tax Reform Act of 1976, Pub. L. No. 94-455, § 301(a), 90 Stat. 1520, 1549 (amending I.R.C. § 56).

162. I.R.C. § 55 (1982). For a discussion of how the AMT has expanded beyond the original tax-sheltering target, see, for example, Alan J. Auerbach et al., *Budget Blues: The Fiscal Outlook and Options for Reform*, *in* AGENDA FOR THE NATION 109, 120 (Henry J. Aaron et al. eds., 2003) (discussing that presently less than 10% of Alternative Minimum Tax revenue is due to original anti-sheltering provisions); Leonard E. Burman et al., *Policy Watch: The Expanding Reach of the*

Next Congress added the "at risk" rules to the Code.[163] The "at risk" rules seemed a certain bet to stop many of the personal property based abusive tax shelters.[164] Sponsors of the legislation predicted that prospective investors for such shelters would abandon the investment plan rather than exposing themselves to personal liability in order to capture a tax advantage.[165] But the sponsors were wrong. With hardly a moment's hesitation, syndications began to appear that required investors to assume some portion of the partnership's indebtedness in order to claim the tax benefits of the deal.[166] Perhaps because the promoters persuaded investors that the deal had sufficient economic solidity or because promoters reassured investors that they never would have to pay more than their investment capital, tax shelters with limited partner liability for the partnership's indebtedness remained marketable.[167]

But if Congress really sought to limit the incidence of tax sheltering with its changes to the tax law, it did not speak with a clear and consistent voice.

Individual Alternative Minimum Tax, J. ECON. PERSP., Spring 2003, at 173–74 (discussing the growth of Alternative Minimum Tax on originally unintended taxpayers).

163. Tax Reform Act of 1976 § 204(a), 90 Stat. at 1531 (adding I.R.C. § 465 for amount "at risk" deductions); Revenue Act of 1978, Pub. L. No. 95-600, § 201(a), 92 Stat. 2763, 2814 (1978) (extending the § 465(c) "at risk" rules to income-producing activities other than the holding or operation of real estate).

164. Because non-recourse financing was customary in the real estate industry, the "at risk" rules did not apply to real estate originally. I.R.C. § 465(c)(3)(D) (1982). Later, Section 503(a) of the Tax Reform Act of 1986 extended the "at risk" rules to real estate. Tax Reform Act of 1986, Pub. L. No. 99-514, § 503(a), 100 Stat. 2085, 2243 (1986) (striking I.R.C. § 463(c)(3)(D)). However, even after extension to real estate, the "at risk" rules treated commercially reasonable non-recourse financing of real property as an amount at risk so that the change in the law targeted only artificial lending arrangements that facilitated inflating the value of the underlying property. *Id.* § 503(b), 90 Stat. at 2243. The Tax Reform Act of 1986 was the first re-codification of the Internal Revenue Code since 1954, but unlike the 1954 Code, this re-codification preserved the structure and numbering of its predecessor.

165. Olivia S. Byrne, *The At-Risk Rules Under the Tax Reform Act of 1986: The Door Closes on Tax-Motivated Investments*, 17 U. BALT. L. REV. 364, 366 (1988).

166. Partnerships generally solved the problem of making limited partners—who by classification enjoyed limited liability for partnership debt—liable for part of their debt by having them enter into a separate assumption agreement with the lender. The assumption agreement relieved the partnership from personal liability and the investor assumed personal liability. *See* Michael H. Hoeflich, *Tax Shelter Partnerships and the Proposed At-Risk Regulations: Deferred Payment Financing*, 58 TAXES 475, 479 (1980) (discussing implications of the new law and proposed regulations); Philip F. Postlewaite & Tammy Jo Bialosky, *Liabilities in the Partnership Context—Policy Concerns and the Forthcoming Regulations*, 33 UCLA L. REV. 733, 753–54 (1986) (arguing that guarantees would not work because they were secondary in nature and the limited partners would have recourse on the guarantee to the partnership and thus to the general partner).

167. Any agreement by promoters to protect investors against loss, however, would have prevented those investors from being at risk, so the reassurance would have had to be non-specific and non-binding. *See* I.R.C. § 465(b)(4) (2006).

New or improved opportunities to shelter emerged from Congress itself as it continued to use the taxation system to deliver economic stimuli and industry subsidies. The line between Congressional intent in providing tax-based incentives and abusive tax sheltering remained blurry. For example, along with eliminating the maximum tax on earned income, Congress also shortened the useful lives of all tangible property, eliminated the concept of salvage value as a limitation on depreciable basis, and simplified and standardized depreciation rules.[168] The standard for personal property became the five-year-life,[169] half-year convention,[170] and double declining balance method,[171] so that the taxpayer generally recovered twenty percent of the cost of personal property the first year placed into service and an additional 32% the second year.[172] As originally enacted, real property had a fifteen-year-life,[173] a mid-month convention[174] and double declining balance depreciation was available[175] at a cost of recapture as ordinary income on exit.[176] A straight line election under the fifteen-year-life would prevent recapture.[177] Deferral/conversion shelters had to make the fifteen-year straight-line election in order to secure the conversion part of the formula. In addition, historic and rehabilitation tax credits[178] to preserve existing commercial and residential property, as well as low income housing credits,[179] that Congress made

168. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(a), 95 Stat. 172, 203–13 (adding I.R.C. § 168, which laid out an accelerated cost recovery system).

169. I.R.C. § 168(c) (2006); *see also id.* § 168(e)(1)(3) (describing what is to be classified as five-year property with a five-year recovery period).

170. *Id.* § 168(d)(1).

171. *Id.* § 168(b)(1).

172. Taxpayers who placed more than 40% of their property into service in the last quarter of the year, however, had to use a mid-quarter convention, thereby limiting the first-year allowance to 5%. *Id.* § 168(d)(3).

173. I.R.C. § 168(b)(2) (1982) (superseded by I.R.C. § 168(e)(3)(E) (2006)).

174. I.R.C. § 168(d)(2) (2006).

175. I.R.C. § 168(b)(2) (1982) (superseded by I.R.C. § 168(b)(1) (2006)).

176. I.R.C. § 1245(a)(1) (1982). For real property, other than residential real property, that a taxpayer placed in service between 1981 and 1987, I.R.C. § 1245(a)(1) recaptured the depreciation allowances on the disposition of the property as ordinary income unless the taxpayer elected straight line recovery for the property under I.R.C. § 168. Later, I.R.C. § 1250(a)(1) taxed gain on the disposition of real property as ordinary income to the extent of additional depreciation. I.R.C. § 1250(a)(1) (2006). Under I.R.C. § 1250(b)(1) additional depreciation means depreciation adjustments exceeding those that would have resulted from straight line depreciation. I.R.C. § 1250(b)(1) (2006).

177. I.R.C. § 1245 (a)(5)(C) (1982) (exempting real property from recapture of a straight line election is in effect under I.R.C. § 168 (b)(3) (1982)).

178. *Id.* § 46(b). The credits ranged from 15% to 25%. *Id.*

179. Tax Reform Act of 1986, Pub. L. No. 99-514, § 252(a), 100 Stat. 2085, 2189–90 (1986) (adding I.R.C. § 42 which provided for a 4% or 9% credit on buildings placed into service in

available at the same time as it enacted the passive activity loss limitations,[180] substituted for direct subsidies and lent themselves to tax shelter syndications.

These accelerated recovery periods for durable property succeeded in encouraging capital investment but not necessarily in an economically efficient manner. Responding to ever-increasing demand for tax shelter, the provisions served to promote tax shelter products. Broad availability of investment credits[181] that partnerships could overlay with rapid depreciation made tax shelters based on personal property extremely attractive. For several years, investment in new depreciable property yielded a 10% tax credit without any reduction in the depreciable basis of the property.[182] Hence, the present value signature of the tax shelter for the first year for a 50% marginal bracket taxpayer was a net outlay in the first year of only 80% of the cash investment.[183] The investment tax credits rendered the shelters attractive to even lower bracket taxpayers.[184]

Moreover, for a short time safe harbor leasing enabled corporations to shift their tax benefits freely to other corporations that could utilize them better. Under a safe harbor lease, the user of the property shifts both investment credits and depreciation allowances from its investment in new tangible personal property by means of a simple election that mimics a sale and leaseback transaction.[185] The structure did not have to meet general economic substance principles.[186] Promoters quickly facilitated safe harbor leases by offering interests in investment partnerships that bought the corporate tax

1987 or laterwith the amount of the credit depending upon whether the building was federally subsidized).

180. For a discussion on passive activity loss limitations, see *infra* notes 191–93 and accompanying text.

181. I.R.C. § 38(a) (1982).

182. *See id.* §§ 38, 46.

183. The computation combining the impact of the depreciation allowance and the investment credit is as follows: I – (0.1 x I) – (I x 0.2 x (1 – t)), where "I" is the investment amount and "t" is the investors marginal tax rate.

184. Credits, unlike deductions, do not vary in value depending on the taxpayer-recipient's marginal tax rate. Accordingly, all taxpayers who otherwise would have tax liability would get equal tax savings from a credit, as long as allowance of the credit did not depend on the taxpayer having a certain level of income. One dollar of credit meant one dollar of tax savings to all taxpayers. On the other hand, one dollar of deduction to a 25% bracket taxpayer equals twenty-five cents of tax savings, while the same deduction to a 50% bracket taxpayer is worth fifty cents. DOUGLAS A. KAHN & JEFFREY H. KAHN, FEDERAL INCOME TAX: A STUDENT'S GUIDE TO THE INTERNAL REVENUE CODE 555 (5th ed. 2005).

185. *See* Alvin C. Warren, Jr. & Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752, 1762 (1982).

186. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(a), 95 Stat. 172, 214–216 (adding I.R.C. § 168(f)(8), laying out special depreciation deduction rules for leased property). Section 168(f)(8) was later repealed, subject to various transition rules, by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 209(a), 96 Stat 324, 442.

benefits to corporate investors that had an appetite for those benefits. While safe harbor leasing was not available for individual investment, it helped to legitimize tax sheltering for corporations as well as individuals and made tax shelters more of a cultural mainstay.

B. Shutting Down the Deferral/Conversion Shelters—the Industry Shift to Custom Products

The 1986 tax changes reflected the view that base-broadening along with rate reduction would prevent loss of revenue from rate reductions.[187] Discussion in the contemporaneous literature and in government assumed that high marginal tax rates were responsible for tax sheltering.[188] One hypothesis was that absent high tax rates, incentives to shelter income would disappear, or at least diminish sufficiently to become an insubstantial tax concern.[189] Reliance on that hypothesis proved misplaced.[190]

More important to suppressing taxpayers' appetite for tax shelter products in 1986 was the robust schedular feature that the passive activity loss limitation introduced to the Code.[191] That feature divides individual income and loss into two discrete categories: income and loss from conduct of trades or businesses in which the taxpayer does not participate materially—the taxpayer's passive

187. Tax Reform Act of 1986, Pub. L. No. 99-514, § 101(a), 100 Stat. 2085, 2096 (reducing the maximum rate of tax on individuals to 28%). I.R.C. § 1(c) phased out the 15% marginal rate and the personal exemption for taxpayers with incomes in excess of $43,150 ($71,900 on joint returns), thereby creating a bubble rate of 31% within a specific income range. *See* I.R.C. § 1(c) (2006). At the same time, the Tax Reform Act of 1986 increased the maximum effective rate on net capital gain from 20% to 28% by repealing the 60% net capital gain deduction under I.R.C. § 1202(a). Tax Reform Act of 1986 §§ 301–302, 100 Stat. at 2216–19. Net capital gain under I.R.C. § 1222(11) is the excess of net long term capital gain under I.R.C. § 1222(7) over net short term capital loss under I.R.C. § 1222(6). I.R.C. § 1222 (2006).

188. *See, e.g.*, Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CALIF. L. REV. 1905, 1940–41 (1987) (arguing that high marginal tax rates encourage tax shelter investments and broadening the tax base would "directly reduce the number of tax shelters by eliminating the deductions and credits that make such shelters possible"); Jane Seaberry, *Simplification Doesn't Faze Tax Industry*, WASH. POST, Dec. 10, 1984, at Bus. 1 (discussing issues related to proposed tax law changes, including the fact that lowering the tax rate decreases the incentive to shelter income and would be one of "[t]he biggest blows to the tax shelter business").

189. Tom Petska, *Partnerships, Partners, and Tax Shelters after Tax Reform, 1987–1989*, STAT. INCOME (SOI) BULL., Summer 1992, at 8, 10, 17 (discussing the decrease in the number of partnerships after the Tax Reform Act of 1986 and the increase in profit shown by partnerships).

190. *See* discussion *infra* notes 206–07 and accompanying text.

191. Tax Reform Act of 1986 § 501(a), 100 Stat. at 2243 (adding I.R.C. § 469 to the Code which placed limits on passive activity losses and credits). For a discussion on other schedular features, see *supra* note 156 and accompanying text.

activities[192]—and all other income and loss.[193] Generally, taxpayers could deduct expenses and losses from passive activities only to the extent of their income from passive activities.[194] The statute defines excess expense and loss from passive activities as "passive activity loss."[195] While the statute disallows passive activity loss,[196] the disallowance is not permanent. Rather, the passive activity loss suspends and carries forward to the succeeding tax years[197] until the taxpayer has sufficient income from passive activities to absorb the loss[198] or the taxpayer disposes of his or her interest in the passive activity in a taxable transaction.[199] Allowing the deferred passive activity loss upon disposition matches loss allowance with the taxpayer's underlying economic loss from the activity.[200] Losses from traditional passive investments such as securities[201] and losses from business activities in which the taxpayer participates materially remain deductible from both passive activity income and non-passive activity income.[202] The asymmetry in loss deductibility allowing non-passive activity loss to offset passive activity income, but not allowing passive activity loss to offset non-passive activity income, was intentional and made passive activity losses less usable.

While the passive activity loss limitation rendered deferral/conversion shelters impractical for the traditional shelter market of taxpayers whose income came primarily from personal services, a smaller market remained for those who had sheltered in the past. If those taxpayers' old shelter investments were generating income without cash flow because the investment partnership used the income to repay debt,[203] for example, that phantom income was often

192. I.R.C. § 469(c)(1) (2006). Traditional tax shelters were syndicated interests in limited partnerships that engaged in the conduct of a trade or business.

193. *Id.* § 469(e)(1) (classifying traditional passive income like dividends and interest as not passive activity income).

194. *Id.* §§ 469(a)(1), (d)(1).

195. *Id.* § 469(d)(1).

196. *Id.* § 469(a).

197. I.R.C. § 469(b) (2006).

198. *Id.* § 469(d)(1).

199. *Id.* § 469(g).

200. *Id.* The passive activity loss limitations resemble rules of capitalization requiring taxpayers to capitalize, rather than deduct, net passive activity losses. The capitalization analogy does not describe the concept fully except on a rather macroscopic level, as I.R.C. § 469 combines a broad range of passive activities as a single capital category since taxpayers may deduct passive activity loss from one activity against passive activity gain from another unrelated activity. *See id.* § 469(c) (providing a laundry list definition of what constitutes "passive activity").

201. *Id.* § 469(c)(1)(A) defines a passive activity as the conduct of a trade or business. Passive activity income and loss does not include passive investment income under I.R.C. § 469(e)(1).

202. I.R.C. §§ 469(c)(1)(A), (e)(1) (2006).

203. *See supra* text accompanying note 152 (discussing burnt-out shelters).

passive activity income. The taxpayers might shelter that income with a new passive-activity-loss-generating investment.[204]

Despite tax rate reductions and passive activity loss limitations, the tax sheltering industry adapted and survived—in many respects becoming more robust. Promoters shifted their attention from generic shelter products for highly compensated individuals to custom shelters for corporate taxpayers not subject to the passive activity loss limitations.[205] Corporate managers had come to view the historical support functions of tax planning and reporting as active profit centers.[206] Tax sheltering contributed to the corporation's profit and loss statement by reducing the amount of taxes payable.[207] Even though the government might challenge the corporations' shelter-based tax positions, auditors provided clean certifications of corporate financial statements even if the statements did not disclose and reserve potential tax risk.[208]

Rather than deferral, the promoters of these new corporate products sought permanent elimination of tax liability, and frequently, duplication of losses. Several variations of these structured transactions depended at least in part upon the involvement of partners or other participants that were not subject to

204. This is assuming the taxpayers reported the income at all. *See supra* note 153 and accompanying text.

205. I.R.C. § 469(a)(2) does not limit the deductibility of passive activity losses for corporate taxpayers except S corporations that are tax transparent to their individual shareholders and to closely held regular taxpaying corporations if they are personal service corporations. *See* I.R.C. §§ 469(a)(2), (e)(2).

206. *Compare* Donald L. Korb, *What is the Role of a U.S. Tax Advisor in a Changed Law Enforcement Environment*, *in* 28 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1175, 1176 (Practising Law Instit., Tax Law & Practice Course Handbook Ser. No. J-852, 2008) (arguing that corporate desire to reduce and control costs coupled with the realization that taxes were one of the largest expenses led to viewing the tax department as a possible profit center via tax shelters), *with* Blank, *supra* note 8, at 544 (offering examples of "clever" corporations engaging in transactions that complied with the letter of the law that could make large tax liabilities disappear).

207. Mihir A. Desai & Dhammika Dharmapala, *Earnings Management, Corporate Tax Shelters, and Book-Tax Alignment*, 62 NAT'L TAX J. 169, 175 (2009) (finding that an increase in incentive, stock-based compensation may have encouraged managers to actively use tax planning to enhance profitability in the short term and, concomitantly, their own incentive compensation).

208. FIN. ACCOUNTING STANDARDS BD., FIN. ACCOUNTING FOUND., FASB INTERPRETATION NO. 48, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES: AN INTERPRETATION OF FSAB STATEMENT NO. 109 1, 2 (Fin. Accounting Ser. No. 281-B, 2006) (interpreting FASB Statement Number 109 as prohibiting a reporting entity from claiming a tax benefit on its financial statements unless the position that gives rise to the benefit is more likely than not to withstand government challenge). This may diminish the use of tax shelter structures by corporations because, in many instances, the interpretation will prevent the corporation from capturing an immediate financial statement benefit.

U.S. taxation.[209] Although the tax products had some commonalities, promoters tended to tailor the products to the needs of the specific corporate taxpayer.

In one variant, a corporate taxpayer sought to exploit the ratable basis recovery rule applicable to contingent payments on installment sales.[210] By creating a partnership with a foreign partner initially owning the bulk of the partnership interests, the partnership sold heavily leveraged, high tax basis notes in exchange for contingent payments. The first payment was disproportionately large relative to succeeding payments. The partnership had to take the initial payment into account as soon as it received the payment.[211] Under the ratable basis recovery rule, the payment generated a large gain because the allocation of basis to that payment relative to the ratio of the payment to all other reasonably anticipated payments was a disproportionally small portion of the total basis. The partnership allocated the bulk of the gain to the foreign partner under the terms of the partnership agreement because that partner owned most of the partnership interests. The foreign partner was indifferent to the allocation of gain because the gain was capital from the sale of personal property that was not connected to the foreign partner's conduct of a trade or business in the United States and, accordingly, not taxable in the United States.[212] The foreign partner then withdrew or reduced its interest. The remaining small payments generated capital loss because the bulk of the partnership's basis remained to be recovered. The partnership allocated those capital losses to its U.S. corporate partner that then owned substantially all partnership interests. The U.S. corporate taxpayer had a large capital gain from other sources and intended to deduct the capital loss from that gain. In several cases, the government successfully argued that the transaction was for tax avoidance purposes only because it lacked economic substance and business purpose. The court held that the government could disregard the application of the treasury regulation to the transaction.[213] In another case, the

209. Non-United States corporations that are not engaged in a trade or business in the United States are only taxable in the United States on income deriving from United States sources. I.R.C. §§ 881(a), 882(a)(1) (2006). United States tax exempt organizations are not taxable on investment income but are taxable on income from a trade or business that is unrelated to their exempt functions. *Id.* § 511(b).

210. Temp. Treas. Reg. § 15a.453-1(c)(3)(i) (2010) (requiring ratable recovery of basis in installment sales with contingent payments).

211. Am. Auto. Ass'n v. United States, 367 U.S. 687, 689 (1961) (holding prepaid income includable for current tax year even if burdened by performance obligation and costs in the future).

212. I.R.C. § 865 (a) (sourcing income from the sale of personal property of a non-resident outside the United States; I.R.C. § 881(a) (imposing a withholding tax at the source only on certain periodical payments of interest, dividends, and royalties).

213. Boca Investerings P'ship v. United States, 314 F.3d 625, 632 (D.C. Cir. 2003); ACM P'ship v. Comm'r, 157 F.3d 231, 260 (3d Cir. 1998).

court disregarded the partnership as a separate taxable entity because it had no business purpose other than the transaction involving the contingent installment sale regulation.[214]

In another common shelter variant, promoters built upon the longstanding financing tradition of the sale-leaseback.[215] United States corporate taxpayers acquired property offshore and leased it back to the seller. Frequently the seller was a governmental or quasi-governmental body operating a critical, infrastructure facility such as the mass transit system in a foreign city. The buyer/lessor borrowed the purchase price for the facility from a non-U.S. lender. Under the terms of the sale and leaseback (or lease and leaseback), [216] the seller/lessee deposited most of the sale proceeds with a financial institution related to the buyer's offshore lender under documentation that protected the lender from possible default.[217] The payment from the buyer/lessor exceeded the payment deposited by the seller/lessee to provide a "fee" to the seller for facilitating the transaction. The seller/lessee had an option to repurchase the facility at the end of the lease term so that it would not have to relinquish ownership and control of the facility. The option terms economically compelled the seller/lessee to exercise the option. If respected for U.S. tax purposes, the transaction would generate substantial deductions for the U.S. corporate buyer/lessor in the form of interest deductions and depreciation even though the transaction was substantially risk free to the U.S. corporate participant. Longstanding economic substance precedents on sale-leasebacks made these transactions seem likely to withstand challenge even though the U.S. corporate partner had little opportunity for economic profit from the transaction.[218] Nevertheless, the IRS designated the transactions under its coordinated issues program[219] and has successfully litigated several transactions.[220] Despite the settlement initiative that the IRS offered following

214. ASA Investerings P'ship. v. Comm'r, 201 F.3d 505, 516 (D.C. Cir. 2000).

215. Frank Lyon Co. v. United States, 435 U.S. 561, 569–70, 582–83 (1978) (finding a sale-leaseback of building had sufficient economic substance even though the likelihood of profit for the purchaser/lessor in excess of what a lender would receive was remote). For a short period, safe harbor leasing permitted U.S. corporations unable to effectively use their depreciation allowances and investment credits to sell those tax benefits to other corporations through a safe harbor lease. *See supra* text accompanying note 185.

216. The literature and the IRS refer to the transaction by the acronym "SILO" which stands for Sale In/Lease Out.

217. The arrangement substantially had the effect of defeasing the loan. *See Coordinated Issue—Losses Claimed and Income to be Reported from Sale In/Lease Out (SILO)*, IRS.GOV, http://www.irs.gov/businesses/article/0,,id=140247,00.html (last visited Apr. 12, 2011) [hereinafter *Coordinated Issue—Losses Claimed*].

218. *See, e.g.*, *Frank Lyon Co.*, 435 U.S. at 569–70.

219. *Coordinated Issue—Losses Claimed*, *supra* note 217.

220. The IRS has sought, with some success, to challenge both types of shelters. *See* BB&T Corp. v. United States, 523 F.3d 461, 464 (4th Cir. 2008) (successfully challenging a LILO

those successful cases,[221] the IRS's success in challenging LILO/SILOs has not been complete.[222]

In another structured pattern, a corporation having or anticipating a large capital gain from the sale of a subsidiary (or other capital asset) would create a new subsidiary and capitalize it with an amount of cash approximately equal to the parent corporation's estimated exposure from specific contingent liabilities, such as medical reimbursement claims or unfunded environmental cleanup expenses. The new subsidiary assumed those liabilities so that its net value approached zero. Either because the payment of the liabilities would be deductible when paid[223] or, based upon existing precedents, contingent liabilities were not debt for purposes of the corporate tax rules,[224] the parent corporation's adjusted basis in its subsidiary was the amount of cash the parent contributed, undiminished by the amount of the liability.[225] The parent could

transaction); Altria Grp., Inc. v. United States, 694 F. Supp. 2d 259, 262 (S.D.N.Y. 2010) (concluding that the SILO and LILO transactions lacked economic substance); AWG Leasing Trust v. United States, 592 F. Supp. 2d 953, 960, 998 (N.D. Ohio 2008) (successfully challenging a SILO transaction); Fifth Third Bancorp v. United States, No. 1:05-cv-350, 2008 U.S. Dist. LEXIS 108241 (S.D. Ohio Apr. 18, 2008) (reporting jury finding that LILO transaction lacked any economic substance).

221. *LILO/SILO Initiative Frequently Asked Questions*, IRS.GOV, http://www.irs.gov/businesses/article/0,,id=186294,00.html (last visited Apr. 12, 2011).

222. *See* Consol. Edison Co. of N.Y., Inc. v. United States, 90 Fed. Cl. 228, 340 (2009) (holding a LILO transaction to have economic substance).

223. I.R.C. § 357(c)(3) (2006).

224. *See* Deputy v. DuPont, 308 U.S. 488, 489, 502 (1940) (holding payments for use of borrowed stock pending return of the stock—as in the case of a short sale—not to bear interest on indebtedness because the borrowing of shares is not an obligation to make a payment); Helmer v. Comm'r, 34 T.C.M. (CCH) 727, 731 (1975) (holding that the delivery obligation where partnership granted option, received premium, and distributed proceeds was not a debt and did not increase the partners bases in their partnership interests under IRC § 752).

225. Under I.R.C. § 358(a), a shareholder's basis (in these cases, the parent corporation was the shareholder) in the shares of a controlled corporation (the new subsidiary) is equal to the amount of cash plus the fair market value of the property the shareholder contributed to the corporation less the amount of debt that the controlled corporation assumed or subject to which the controlled corporation received the contributed property because I.R.C. § 358(d) treated that debt as cash that the controlled corporation distributed to its shareholder. I.R.C. § 358(a) (2006). Under I.R.C. § 358(d)(2), however, I.R.C. § 357(c)(3) liabilities were not treated as cash that the controlled corporation distributed to the contributing shareholder because the shareholder had not taken those liabilities into account for tax purposes, as the liabilities would become deductible when they ceased to be contingent or when a cash basis taxpayer paid them. *Id.* §§ 358(d)(2), 357(c)(3). New I.R.C. § 358(h) changed this result as it required a reduction of basis for both contingent and deductible liabilities under I.R.C. § 357(c)(3) where the stock basis exceeded the fair market value of the contributed cash and property. *Id.* § 358(h)(1). Section 309 of the Community Renewal Tax Relief Act of 2000 added I.R.C. § 358(h), retroactive to assumptions of liability after October 18, 1999. Consolidated Appropriations Act of 2001, Pub. L. No. 106-554,

sell the subsidiary for a nominal amount and claim a loss equal to the cash it contributed to the subsidiary. Although the loss was capital,[226] a corporation that recently had a large capital gain from the sale of a subsidiary, as were the facts in the decided cases, could use the capital loss the tax play generated. The new subsidiary, in turn, had the funds available to pay the liabilities and often could claim a deduction for the payments.[227]

While emphasis shifted to corporate shelters for a few years, the passive activity loss limitations did not alter the culture. Individuals continued to seek shelter from taxes, preferring to pay fees to shelter promoters rather than paying taxes. In the estate tax area, family limited partnerships with value discounting[228] and Crummey trusts for life insurance[229] remained powerful estate planning tools. For income taxes, demand for tax exempt bonds increased,[230] the underground economy grew,[231] and foreign financial institutions with bank secrecy protection made increasing inroads into the U.S. investment market.[232] The tax shelter paradigm itself shifted for individuals

app. G § 309, 114 Stat. 2763A-587, 2763A-638 (2000). The change also may have affected "son of boss" transactions. *See infra* text accompanying note 235.

226. I.R.C. § 1211(a) limits the deductibility of capital losses in the case of a corporate taxpayer to the amount of the taxpayer's capital gain with excess losses available for temporary carryback and carryforward under I.R.C. § 1212(a). I.R.C. §§ 1211(a), 1212(a)(1) (2006).

227. *But see* Coltec Indus. v. United States, 454 F.3d 1340, 1360 (Fed. Cir. 2006) (holding that the transaction where asbestos liability was transferred to new subsidiary was for tax avoidance purposes and lacked economic substance even though consistent with IRC § 358 basis); Black & Decker Corp. v. United States, 340 F. Supp. 2d 621 (D. Md. 2004), *aff'd in part*, *rev'd in part*, 436 F.3d 431, 433, 443 (4th Cir. 2006) (reversing summary judgment for taxpayer and remanding where medical and dental plan liabilities and cash were transferred to new subsidiary).

228. *See supra* note 135.

229. Crummey v. Comm'r, 397 F.2d 82, 83 (9th Cir. 1968).

230. R. STAFFORD JOHNSON, BOND EVALUATION, SELECTION, AND MANAGEMENT 152 (2004) (discussing how the demand for tax-exempt bonds increases when tax rates also increase, as happened when the tax rates increased in 1993, but demand decreased when tax rates declined as a result of the Tax Reform Act of 1986).

231. The underground or shadow economy refers to payments that do not use the national or international banking system in order to avoid detection and taxation. FRIEDRICH SCHNEIDER & DOMINIK ENSTE, HIDING IN THE SHADOWS: THE GROWTH OF THE UNDERGROUND ECONOMY 1–5 (2002) (explaining the concept of the shadow economy, estimating the underground economy around the world, estimating the underground economy at 10% of gross domestic product in the United States during the 1999–2001 period, and identifying steep growth from 1970–2000).

232. In February 2009, Union Bank Suisse agreed to both pay $780 million in fines, penalties, restitution, and interest to settle Securities Exchange Commission and Department of Justice criminal and civil charges and to provide the United States with identities and information pertaining to clients who may have been using these banks to avoid the IRS (breaking the long-standing secrecy of Swiss bank accounts). *Swiss Bank Settles U.S. Tax Charges, Mounting U.S. Pressure on Swiss Bank Secrecy*, 103 AM. J. INT'L L. 338, 338–40 (John R. Crook ed., 2009). Shortly thereafter, IRS Commissioner Douglas Shulman announced that the IRS generally would

from deferral shelters for personal service income to sheltering of large capital gains from sales of businesses. A leading structure to shelter those gains was the "son of boss" shelter[233] that recently forced the dissolution of at least one major law firm, and materially injured several others.[234]

Rather than the old deferral-based shelters, newer products purportedly enabled individuals to eliminate long-term capital gain permanently. In one variant, taxpayers who anticipated a large long-term capital gain might buy and sell call options equal in amount but with minimally different strike prices and expirations. The option premiums paid and received were substantially equal in amount, so the taxpayers had no net cash outlay. The options offered the taxpayers little or no opportunity for profit since advance in the value of the underlying security would also increase the value of the purchased options, but the taxpayers' obligation under the sold options would increase in a like amount.

Under the tax shelter plan, the taxpayers would contribute the purchased call options to a partnership or new corporation. At the same time, that entity assumed the obligation on the sold call options. The contributing taxpayers claimed a tax basis in the partnership interest or stock equal to the purchase price of the call options.[235] Since the obligation under the sold call options was not a fixed obligation to make a payment, it arguably was not a liability that would reduce that basis under applicable corporate or partnership rules.[236] The

not prosecute taxpayers that voluntarily came forward with information about their sheltering overseas and would reduce the applicable punishment from a penalty of 50% of the highest annual balance for each account for each of the last three years to a penalty of between 5% and 20% applied only once to the highest balance in the accounts over the past six years, paying all applicable taxes and interest. Lynnley Browning, *The I.R.S. Will Lower Penalties for Some Offshore Tax Evaders*, N.Y. TIMES, Mar. 27, 2009, at B3; I.R.S. News Release IR-2009-84 (Sept. 21, 2009) (stating that although the original deadline for voluntary disclosures on foreign accounts was Septempber 23, 2009, the IRS was extending the deadline to October 15, 2009). *See also infra* note 490 and accompanying text.

233. I.R.S. Notice 2000-44, 2000-2 C.B. 255. The IRS referred to the shelter product as "son of boss." BOSS was an acronym for an earlier shelter product marketed by a major investment banking firm as the "Bond Option Sales Strategy." While the "son of boss" strategy was unrelated to the BOSS product, the name caught on without the acronym.

234. Both the IRS and clients proceeded against the Dallas-based firm of Jenkens & Gilchrist on account of the active tax shelter opinion business that tax partners in the Chicago office conducted. *See* Katie Fairbank & Terry Maxon, *How Jenkens Lost Its Way*, DALL. MORNING NEWS, Apr. 1, 2007, at 1A.

235. For basis in corporate shares, see *supra* text accompanying note 225 (discussing I.R.C. § 358(a)). For basis with regard to partnership interests, see I.R.C. § 722 (2006).

236. *See supra* notes 224–25 and accompanying text. I.R.C. § 752(b) governs partnerships and treats a taxpayer who contributes property to a partnership—subject to the partnership assuming a liability that encumbers the property—as receiving a cash distribution under I.R.C. § 731(a) equal to the resulting reduction of the taxpayer's separate liabilities. I.R.C. § 752(b) (2006).

contributing taxpayers then would sell their interests in the partnership or corporation to a third party and recognize a capital loss.[237] Taxpayers could use that non-economic capital loss to offset the capital gain they recognized—or soon would recognize—from sale of their business. The loss is non-economic insofar as the net value of the taxpayer's interest in the new corporation or partnership was zero at the moment of acquisition because the economic value would take the sold call options into account. Following the sale of the business and the new entity, the taxpayers had no further interest in that entity, so the transactions and recognitions of gain and loss were complete. The offsetting capital gain from the sale of the business would never become subject to tax.

In 2000, the IRS notified taxpayers of its intention to challenge those and similar transactions on a variety of grounds.[238] Then in 2004, the IRS offered a settlement initiative on "son of boss" type tax products.[239] Taxpayers who conceded all tax liability would be subject to no more than a ten percent penalty—no penalties if they disclosed their transaction on their return—and would be allowed a capital loss for their out of pocket costs (or an ordinary loss for half those costs).[240] Many taxpayers settled, and many of those have sued their professional advisors for malpractice and other related claims.[241] However, the settlement initiative also denied taxpayers who did not settle access to the Appeals Division of the IRS, making litigation their only opportunity to resist or compromise the government's assessment of a deficiency and its penalties.[242]

237. A variant on this structure exploited the partnership termination rules under I.R.C. § 708 that enabled a shift of the artificial basis to other assets, and enabled taxpayers to increase their shares of closely held businesses or, in other instances, corporations that had acquired their closely held shares for shares of the acquiring corporation in tax deferred reorganizations. Other variants used short sale strategies under which the obligation to return borrowed securities that were used to establish a short sale were not identified as liabilities that reduced share or partnership interest basis.

238. I.R.S. Notice 2000-44, *supra* note 233. The example in the preceding paragraph is from the Notice.

239. I.R.S. Announcement 2004-46, 2004-21 I.R.B. 964.

240. *Id.*

241. *See* Soled, *supra* note 8, at 268–69, 268 n.1.

242. Denying taxpayers access to Appeals was unprecedented and controversial. Then Commissioner of Internal Revenue Mark Everson publicly stated that the settlement initiative did not set any precedent for denial of access to appeals in the future: "We viewed Son of Boss transactions as clearly abusive and, for sound administrative reasons, concluded that the resolution terms should be set with bright-line clarity to facilitate a quick resolution." I.R.S. Fact Sheet FS-2004-13 (May 2004). Potential related criminal investigations of Son of Boss transactions also made conventional Appeals case review problematic. Everson also noted that, "The approach that we followed here should in no way be viewed as having set a precedent for subsequent resolution strategies." *Id.* *See also* Vincent S. Canciello, *Tax Shelter Resolution Initiatives and the Independence of Appeals*, J. TAX PRAC. & PROC., Apr./May 2003, at 15, 18

Cases arising from the settlement initiative currently are working their way through the courts. In those cases, the government relies on two theories: 1) that the transactions lack economic substance[243] and 2) that under recently promulgated and retroactive regulations, the contingent or non-cash liabilities are liabilities for purposes of the partnership and corporate rules.[244] A statutory change to Subchapter C of the Code in late 2000,[245] retroactive to 1999, reduced the adjusted basis of property in some instances by the amount of contingent liabilities that encumbered the property.[246] The legislation authorized the Department of the Treasury to promulgate regulations to prevent taxpayers from the "acceleration or duplication of losses" through the use of partnerships in a similar manner.[247] The Treasury promulgated a temporary regulation in 2003, finalized in 2005,[248] that the government has sought to apply to "son of boss" cases.[249]

Whether those cases will have a meaningful and long-term impact on aggressive planning is doubtful. Textualist judicial decision-making that interprets statutes narrowly and technically empowers the aggressive tax planners. That empowerment exerts negative influences on the tax community

(presenting warning from a past National Director of Appeals that prohibiting taxpayers from using Appeals directly conflicts with Congressional orders and is a deterioration of Appeals independence); David B. Robinson, *Appeals' Role in Tax Shelter Settlement: Independence Affirmed*, 58 TAX EXECUTIVE 94, 94 (2006) (interviewing David B. Robison, former National Director of Appeals, stating that he did not anticipate denying access to appeals in similar settlements again).

243. Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 14 (2007) (disallowing the losses that the taxpayer claimed from trading Euro options, and holding that the objective economic substance test required that the economic profit/loss potential bear a reasonable relationship to the loss the taxpayer claims). However, while the Federal Circuit on affirmed the Claims Court on March 23, 2010 on the economic substance issue, it vacated and remanded with respect to penalties arising from the overstatement of the taxpayer's adjusted basis under I.R.C. § 1011. Jade Trading, LLC v. United States, 598 F.3d 1372, 1380–81 (Fed. Cir. 2010) (following Petaluma FX Partners, LLC v. Comm'r, 591 F.3d 649 (D.C. Cir. 2010)).

244. Taxpayers relied on longstanding precedents that treated contingent and non-cash obligations as something other than indebtedness to which I.R.C. § 752(b), for example, would apply. *See* Helmer v. Comm'r, 34 T.C.M. (CCH) 727, 731 (1975).

245. *See supra* note 225 and accompanying text.

246. Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, app. G § 309(a), 114 Stat. 2763A-587, 2763A-638 (2000) (adding I.R.C. § 358(h)(1) which reduced basis by the amount of any determined liability).

247. *Id.* § 309(c)(1).

248. Temp. Treas. Reg. § 1.752-6T (2003) (superseded by Treas. Reg. § 1.752-7 (2005), a permanent regulation concerning liabilities assumed after June 24, 2003).

249. *Compare* Klamath Strategic Inv. Fund, LLC v. United States, 440 F. Supp. 2d 608, 622–23 (E.D. Tex. 2006) (holding that the retroactive regulation under I.R.C. § 752 was interpretive rather than legislative and invalid as applied to the taxpayers), *with* Cemco Investors, LLC v. United States, 515 F.3d 749, 752 (7th Cir. 2008) (holding the regulations to be valid as applied in the case and criticizing *Klamath*).

and the legislative process. Legislators and taxing agencies find the courts unreliable in combating all but the most egregious tax schemes. While the courts have remained solid against active tax protest,[250] they are far less predictable as stalwarts against tax planning devices that lack all but the most minimal economic substance,[251] or they utilize a statute in a manner inconsistent with its obvious legislative purpose.[252] Accordingly, legislatures seek greater precision and narrower application in taxing statutes to eliminate statutory uncertainty and ambiguity that tax planners might exploit. Given drawn out legislative processes, tightening of statutory language tends to lag planning. Tax planners already have moved on to the next statute's flaws before the legislature has corrected the previous statute's flaws.[253] Moreover, tighter legislation is more complex and intricate and often has its own unanticipated gaps in application because it is precise and narrow. I anticipate that tax sheltering and aggressive tax planning will continue with an ever-renewing variety of products.

II. THE ROLE OF PROFESSIONAL ADVISORS—ADDING VALUE

Until the last few decades of the twentieth century, major law and public accounting firms did not actively market tax shelter products. Rather, the firms served primarily in their traditional advisory roles to their clients.[254]

250. *See* Lovell v. United States, 755 F.2d 517, 519 (7th Cir. 1984) (holding that all individuals must pay taxes on their income whether they are natural citizens or not and regardless of whether they take advantage of government services); United States v. Beale, 574 F.3d 512, 519 (8th Cir. 2009) (reaffirming that disagreement about what tax law should be, when knowing tax-paying obligations, yet failing to follow them, does not remove liability for willful tax evasion).

251. *See, e.g.*, Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978) (holding that for there to be economic substance, the transaction must have a legitimate business purpose, must have been considered independently of tax benefits, and must not be shaped only by tax-avoidance purposes with meaningless labels).

252. *See* Pepcol Mfg. Co. v. Comm'r, 13 F.3d 355, 357 (10th Cir. 1993) (holding that using animal bones for gelatin after processing meat could be considered recycling (if they had not been stipulated to be animal waste), and could entitle the plaintiff to energy property investment tax credit, even though the examples of recycling given by Congress when enacting the statute involved creating an end-product similar to the initial product being recycled, such as making paper from recycled newspapers). This is an example of what I would call "off label" statutory use.

253. The average time to pass a bill is six to seven years. 155 CONG. REC. S9216 (daily ed. Sept. 10, 2009) (statement of Sen. Mike Enzi) ("The average bill takes about six years to pass."); Kristen Bell DeTienne & Richard D. Flint, *The Boss's Eyes and Ears: A Case Study of Electronic Employee Monitoring and the Privacy for Consumers and Workers Act*, 12 LAB. LAW. 93, 97 (1996).

254. *See generally* DWIGHT DRAKE, BUSINESS PLANNING: CLOSELY HELD ENTERPRISES 710–11 (Am. Casebook Ser., 2d ed. 2008) (explaining that tax advice is a common area of advice for many business lawyers); ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS

Firms developed long-term relationships with their clients and billed for their time without negotiating their fees.[255] If some of their clients marketed tax shelters, the professional advisors sought to maintain an aesthetic distance from the products and their marketing. Many tax practices were conservative in their tax recommendations.[256] Although tax practitioners assisted in structuring business transactions for tax efficiency, many tax practitioners considered the aggressive exploitation of tax opportunities in conjunction with syndicated products as an undignified practice.[257]

However, as the twentieth century drew to a close, ever more emphasis fell on business development. Firms had less room for outstanding legal technicians who developed only minimal business. Capturing and retaining clients became ever more important and competitive. Even in the elite practice areas like securities offerings, clients shopped for lawyers and negotiated fees. Clients sought lawyers who would "add value" to the business rather than simply passively evaluating the legality of business structures. In order to add value, tax lawyers became more creative and assertive in tax planning.

Beginning in the late 1960s, and possibly earlier, high-income individuals started to bring marketed tax shelter offerings to their legal and accounting representatives for review. In order to service their regular clients, even the prestigious firms found themselves peripherally engaged with tax shelters in reviewing those offerings. As demand for tax shelters increased, the rapidly growing tax shelter industry provided a steady source of securities and tax

FOR LAW STUDENTS: ESSENTIAL CONCEPTS & APPLICATIONS 116, 209–11 (4th ed. 2006) (describing the rise of tax planning and the tax advisor); Henry Ordower, *Toward a Multiple Party Representation Model: Moderating Power Disparity*, 64 OHIO ST. L.J. 1263, 1274–75 (2003) (discussing the role of the lawyer with regard to multiple clients as advisory rather than adversarial).

255. Corporate clients historically did not change their legal representation or demand bids before committing for legal services. During and after the late 1970s, the nature of legal practice and practice relationships began to change. Competitive bidding for legal work became increasingly common, lawyers no longer routinely spent their whole careers with a single firm, and long-lasting relationships between corporate management and outside legal counsel became less common. Pricing for legal services became increasingly important, as corporate clients shifted ever greater portions of legal work to in-house counsel whenever management thought it economically worthwhile to do so. Referrals from outside vendors like tax product and insurance sales representatives became an important source of legal business.

256. Anecdotally, tax lawyers gained a reputation for squelching deals rather than facilitating them when they could not find a structure that worked for the deal or did not agree with the promoter on how the tax characteristics of the deal should play out.

257. One nonagenarian New York practitioner who began practicing in New York City in the early 1940s relates that the "silk stocking" firms then eschewed even residential real estate practice and much commercial real estate. Those firms ceded the practice to smaller, often Jewish practitioners whom the elite firms did not often hire. When I began practicing in the 1970s, the elite firms that employed the top graduates from major law schools similarly eschewed tax shelter practice and looked askance at aggressive tax planners.

work that tempted even the most traditional firms.[258] Legal memoranda and opinions that accompanied PPMs were consistent with traditional legal practice as a support function to business.[259] Accounting firms prepared projections that anticipated favorable tax outcomes and included detailed tax savings-based rate of return computations.[260] Law firms provided memoranda and, less frequently, opinions that described the anticipated tax effects of the proposed, syndicated offering.[261] Memoranda and opinions tended to be generic and, early in the development of the tax shelter industry, frequently discussed hypothetical facts rather than the specific features of the deal involved in the current offering.[262] Firms addressed those memoranda or opinions to their promoter clients rather than to the investors who relied on the opinions in evaluating the investment. Under that procedure, the investors did not have privity of contract with the firms and might have no recourse against them if the IRS challenged the investor's tax reporting positions from the investment.[263] But later, privity of contract as a limitation on claims fell aside as firms had to address and deliver their opinions to the investor directly. Promoters referred prospective investors to lawyers for opinions on the

258. Syndicated limited partnership tax shelter investments were securities. Although the offerings were private placements and exempt from registration under the Securities Act of 1933, a PPM accompanied most offerings to provide necessary disclosure to the investors. *See supra* text accompanying note 51.

259. Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1, 2 (2005) (describing how legal opinions were common in financial transactions).

260. Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Compliance Norm*, 75 FORDHAM L. REV. 961, 965 (2006) (explaining how accounting firms are consulted regarding the benefits of tax planning proposals).

261. *Id.* at 966.

262. Both the American Bar Association and the IRS later barred this practice. *See* ABA Comm. Ethics & Prof'l Responsibility, Formal Op. 346 (1982) (stating that a lawyer could not disclaim responsibility for accuracy of facts in tax shelter opinion); I.R.S. Requirements for Covered Opinions (Treas. Circular No. 230), 31 C.F.R § 10.35 (2007) (asserting that a lawyer must make reasonable efforts to learn the facts of the investment).

263. To successfully sue for malpractice, one must show: 1) the professional owed a duty of care to the plaintiff (generally shown by an attorney-client or accountant-client relationship between the professional and the plaintiff); 2) the professional breached that duty; 3) the professional's negligence was the proximate cause of injury to the plaintiff; and 4) there are actual damages resulting from the professional's negligence. Bradley E.S. Fogel, *Attorney v. Client—Privity, Malpractice, and the Lack of Respect for the Primacy of the Attorney-Client Relationship in Estate Planning*, 68 TENN. L. REV. 261, 267 (2001); *see also* Sorenson v. Pavlikowski, 581 P.2d 851, 853 (Nev. 1978). Without the privity of contract required under the first element of the test, the plaintiff's case would fall apart. *See* Sav. Bank v. Ward, 100 U.S. 195, 205–06 (1880) (holding that the party that causes an injury to plaintiff will not be held liable in a transaction where there is neither fraud, nor collusion, nor privity of contract).

specific investments in the customized tax shelters that followed enactment of the Tax Reform Act of 1986.[264]

But even elite firms seeking to maintain distance from tax shelter promoters and the marketing of the tax products sometimes referred clients who asked for recommendations on tax shelters to the promoters for whom the firms prepared PPMs. A few aggressive tax firms actively developed and marketed their own tax advantaged investment programs.[265]

As the tax sheltering industry developed, both the American Bar Association,[266] controlled by the prestigious firms,[267] and the IRS[268] developed practice standards that prohibited practitioners from rendering opinions on hypothetical facts. Accordingly, practitioners needed to complete due diligence so that their opinions would be based on the facts of the deal. Later, the standards tightened and forced practitioners to form a closer relationship with promoters so that they could render the necessary opinion based on all the details of the deal.[269] Circular 230 requires that a tax shelter opinion conclude

264. *See supra* note 209 and accompanying text; Soled, *supra* note 8, at 271–72.

265. With just a hint of envy, tax professionals from the traditional elite firms regarded those aggressive but very successful firms as a little seedy. Kanter & Eisenberg, based in Chicago, was among the most innovative and aggressive of those firms. Inv. Research Assocs. v. Comm'r, 78 T.C.M. (CCH) 951, 969 (1999). For decades, Burton Kanter was considered one of the most creative tax lawyers in the United States, and he helped several high-profile clients evade taxes, all the while taking sizeable kick-backs for himself. David Cay Johnston, *Tax Lawyer Called Architect of a Tax-Evasion Scheme*, N.Y. TIMES, Jan. 1, 2000 at C2. Kanter also evaded taxes himself, claiming negative income for twelve straight years from 1978 to 1989. *Id.* Kanter was audited by the IRS in every year except one since 1961, and the audits from tax years 1973 to 1994 were still in dispute when the Tax Court reached its decision in 1999. *Id.* Following the fraud ruling in 1999, Kanter's estate appealed the decision all the way to the Supreme Court where the Court reversed and remanded, stating that it was improper for the trial judge to affirm tax liability without considering a special trial judge's opinion. *See* Ballard v. Comm'r, 544 U.S. 40, 72 (2005). The Tax Court recently ruled as Kanter's estate wished, adopting the findings from the special trial judge's opinion. Estate of Kanter v. Comm'r, No. 712-86 (T.C. Nov. 26, 2010); Sam Young, Kanter *Plaintiffs Appealing Unpublished Final Tax Court Order*, 130 TAX NOTES 996, 996 (2011) (disussing the Tax Court's unpublished order adopting the special trial judge's findings and finding a deficiency and failure to pay penalty).

266. *See* ABA Comm. Ethics & Prof'l Responsibility, Formal Op. 346 (1982); BERNARD WOLFMAN ET AL., ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE 267 (4th ed. 2008); Charles E. McCallum & Bruce C. Young, *Ethics Issues in Opinion Practice*, 62 BUS. LAW. 417, 422 (2007).

267. *See* Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 94–95 (2006) (arguing that, for the period after 1990, the elite bar sought to combat the tax shelter industry in order to reassert its authority in the tax arena).

268. *See* I.R.S. Requirements for Covered Opinions (Treas. Circular No. 230), 31 C.F.R § 10.35 (2007) (establishing best practices for attorneys rendering tax shelter opinions).

269. *Id.* It is possible that the decline of Jenkens & Gilchrist may have been because their tax opinions were generic and lacking a careful review of the suitability of the offering for the specific taxpayer and the details of the offering.

that the tax position that the opinion advances "more likely than not" would prevail if litigated.[270] Demands of clients and the growth of tax shelter representation as a significant revenue source motivated lawyers to render "more likely than not" opinions when earlier they might have shied from that high standard of certainty.[271] Rather than improving the quality of the tax deals, the opinion standard seems to have made lawyers and accountants more like the promoters of the shelters. Even the most reputable law firms that might have eschewed tax shelter promoters as clients early in the tax shelter days became engaged in the shelter practice, as that practice itself became increasingly lucrative.[272] Whatever qualms about shelters such firms historically may have had yielded to the ever more prevalent cultural norm that favored tax sheltering and tax avoidance. Self-regulatory organizations like the American Bar Association did not prevent the development of the tax bar's role in the tax shelter industry.[273]

Providing advice collateral to economically driven transactions and recommending transactional adjustments that might diminish the client's tax liability decreased in importance to tax practice. The historical, key role of direct client servicing yielded its importance to the development and sale of tax products. Gradually, tax professionals brought tax products they and others had developed to existing clients.[274] Tax professionals also began to team with aggressive tax product marketers to sell products to clients with whom the tax professional had no existing relationship.[275] Many of the products were unrelated to the client's economic activities.[276] If the client deployed these unrelated products successfully, the products would reduce the client's tax exposure from economic activity more efficiently than targeted, transaction related planning could. Initially, product design involved the efficient and possibly creative capture of intended tax subsidies, but tax professionals soon turned their attention to ferreting out statutory flaws and indeterminacies around which they might build the products. That the advisors knew the statutory flaws and indeterminacies they discovered were unintentional and

270. *Id.* § 10.35(b)(4).

271. Lily Henning, *Tax Shelter Letters: Proposed IRS Regulations Take Aim at Lawyers*, N.Y. L.J., Jan. 8, 2004, at 5.

272. *Id.*

273. Compare this with the inability of the self-regulatory organizations within the financial services industries to prevent the market failures in those industries in 2008. Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 AM. J. COMP. L. 295, 310–21 (Supp. 2010).

274. Interview by Frontline with Michael Hamersley, Former Senior Tax Manager, KPMG (PBS television broadcast Feb. 19, 2004) (discussing the shift at KPMG from individualized client service to wholesale marketing of general tax shelter products).

275. *Id.*

276. *See id.* (discussing selling tax products rather than tailored tax planning to clients).

that their recommended applications of the statute were inappropriate[277] did not deter the advisors from recommending that their clients aggressively exploit the opportunities the statutory weaknesses offered.

Cynicism developed among tax professionals and contributed to a perception that the IRS was helpless to combat tax avoidance. That cynicism encompassed both the so-called audit lottery[278] and the use of very complex, nearly impenetrable transactions. Both the audit lottery and transactional complexity whetted the appetites of tax professionals and their clients for marginal, but lucrative, aggressive tax planning techniques. The tax administrator's limited auditing resources spared many schemes from detection while other unacceptable tax-driven transactions would escape challenge because their intricate structures cloaked their substance. Even where the tax administrator devoted considerable resources to analyzing and challenging those complex structures, courts became unreliable allies in combating them. Courts increasingly deployed textualist statutory analysis and refused the administrator's invitation to read statutes according to their probable intent.[279]

At the same time, successful aggressive tax planning raised clients' expectations that tax advisors always could find devices to diminish the clients' tax obligations. Clients began to view tax advisors who were unwilling to plan aggressively as simply too timid.[280] Client expectations exerted pressure on the planning limits that many practitioners historically respected and caused practitioners to push the limits in order to protect their practices.[281] Successful aggressive tax planning contributed to the cultural

277. *See* Henry M. Ordower, *Trusting our Partners: An Essay on Resetting the Estate Planning Defaults for an Adult World*, 31 REAL PROP. PROB. & TR. J. 313, 354 (1996) (arguing that estate planning practitioners drive the excessive and inappropriate use of estate planning structures that disempower surviving spouses).

278. The audit lottery refers to the fairly remote risk that the IRS will audit one's federal income tax return since the IRS does not have a sufficiently large staff to audit more than 2% of returns. Rather than reporting one's income accurately, one might underreport and play the lottery that the IRS will not audit the return. *See* Joel S. Newman, *The Audit Lottery: Don't Ask, Don't Tell?*, 86 TAX NOTES 1438, 1438 (2000). Electronic filing and information matching allows automatic checking of more than 2% of returns. The IRS lost some ability to select returns for audit efficiently when it suspended its Taxpayer Compliance Measurement Program (referred to customarily as the TCMP audit) in the mid-1990s. *See* George Gutman, *Citing Budget, IRS Announces Indefinite Suspension of TCMP*, 95 TAX NOTES TODAY 212–25 (1995), *available at* 95 TNT 212-25 (LEXIS).

279. Cunningham & Repetti, *supra* note 7, at 2.

280. *See* WOLFGANG SCHÖN, TAX AND CORPORATE GOVERNANCE 222 (2008) (noting that many clients pressured their tax advisors and that advisors were paid based on the amount of taxes saved).

281. *Id.*

shift in the community at large. As a community standard, tax compliance was "out" and tax avoidance was "in."[282]

The elite bar continues to support more stringent disclosure requirements and standards impacting the professionals who support the tax product industries.[283] Yet, the elite bar was far less supportive of amendments to tax return preparer penalties that required the preparer to apply a "more likely than not to be sustained on its merits" standard for positions the preparer reports or recommends.[284] The tax professional community argued against the enhanced standard ostensibly because of the concern that the standard applicable to preparers was higher than that applicable to taxpayers, thereby creating a potential conflict between the interests of the preparers and their clients.[285] Preparers would wish to enforce a "more likely than not" standard or require disclosure on the return to protect themselves from penalties, while their clients would be safe from penalties as long as there was "substantial authority" for a position even if not disclosed on the return.[286] Outcry concerning the standard resulted in the softening of the standard to "substantial authority" conforming to the taxpayer standard the following year.[287] The elite bar was as concerned about the standard as the accountants who prepared the returns because the Treasury promulgated regulations at the same time that brought many attorneys who rendered advice on a transaction under the tax return preparer definition[288] and subjected them to the tax return preparer penalties.[289] Under those regulations, attorneys who advised on transactions became "non-signing tax return preparers."[290]

282. *See infra* note 440 and accompanying text.

283. *See* Rostain, *supra* note 267, at 98–99 (discussing that investors would not want to participate in tax shelter arrangements that involved significant risk).

284. I.R.C. § 6694(a)(2) (2006), *as amended by* the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007, Pub. L. No. 110-28, § 8246(b), 121 Stat. 112, 203 (codified at 26 U.S.C. § 6694), imposes a penalty on a tax return preparer whose client reports an unreasonable tax position based on the preparer's advice without full disclosure of the position. A position is unreasonable if the preparer "knew (or reasonably should have known) of the position," and "there was not a reasonable belief that the position would more likely than not be sustained on its merits." U.S. Troop Readiness, Veterens' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 § 8246(b), 121 Stat. at 203.

285. Jeremiah Coder, *Final Preparer Penalty Regs Adopt Some Changes*, *New Guidance*, 121 TAX NOTES 1351, 1351 (2008).

286. *Id.*

287. *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 506(a), 122 Stat. 3765, 3880 (codified at 26 U.S.C. § 6694).

288. I.R.C. § 7701(a)(36) (2006); Treas. Reg. § 301.7701-15 (2009).

289. I.R.C. §§ 6694, 6695.

290. Treas. Reg. § 301.7701-15(b)(2).

Perhaps recent developments with KPMG,[291] Jenkens & Gilchrist, and others will make professionals somewhat more reserved. Whether the adverse publicity again will change the culture and render tax shelters and the support functions that legal and accounting professionals provide unacceptable remains doubtful. While professional advisors are likely to become more cautious, client demand for shelter products is a compelling motivation to continue to design new tax products.

III. GENERAL ANTI-AVOIDANCE RULES

Tax avoidance and tax planning, complex transactions exploiting weaknesses in taxing statutes with the assistance of tax professionals, are not, however, uniquely American problems. Outside the United States, legislatures have felt the need to rein in unintended tax minimization strategies by turning to GAARs.[292] Among other countries, New Zealand,[293] Australia,[294] Canada,[295] Germany,[296] Sweden,[297] and, recently, China[298] have statutory GAARs.[299] Some of those jurisdictions have employed GAARs for several decades.[300] The Canadian statute is fairly typical of GAAR structures. It defines an "avoidance transaction" as one:

> (*a*) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or
>
> (*b*) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may

291. Rostain, *supra* note 267, at 99.

292. *See supra* note 20 and accompanying text.

293. Section 99 of the Income Tax Act 1976 (N.Z.); Section BG 1 of the Income Tax Act of 2007 (N.Z.) (incorporating GB 1 and certain definitions in YA 1).

294. *Income Tax Assessment Act 1936* (Cth.) s 177D(b) (Austl.).

295. Income Tax Act, R.S.C. 1985, c. 1, § 245 (Can.).

296. ABGABENORDNUNG [AO] [GENERAL TAX CODE], Mar. 16, 1976, BUNDESGESETZBLATT, Teil I [BGBL. I] at 26, § 42 (Ger.).

297. 15 ch. 2, 3 §§ LAGEN OM SKATTEFLYKT [TAX AVOIDANCE (FLIGHT) LAW] (Svensk författningssamling [SFS] 1995:575) (Swed.), *available at* http://www.notisum.se/rnp/sls/lag/19950575.htm.

298. Lee A. Sheppard, *China Tries a GAAR*, 123 TAX NOTES 523, 524 (2009); Jinyan Li, *Tax Transplants and Local Culture: A Comparative Study of the Chinese and Canadian GAAR*, 11 THEORETICAL INQUIRIES IN LAW 655, 657 (2010), *available at* http://www.bepress.com/til/default/vol11/iss2/art8.

299. *See generally* OROW, *supra* note 20; Cooper, *supra* note 20 (describing the proliferation of statutory GAARs).

300. Canada, Australia, and Sweden each have had a GAAR for twenty years or more. *See supra* notes 293–97.

> reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.[301]

When a tax avoidance transaction is present, the statute permits the revenue authority to deny the tax benefit the taxpayer seeks.[302] Unlike many other GAARs that integrate benefit denial and reallocation according to economic reality, the Canadian statute includes a separate provision that permits re-characterization of amounts and reallocation of income and expense.[303]

Although the United States has had a statutory GAAR for only a very brief time,[304] judicial decisions[305] applied an economic substance doctrine in various

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301. Income Tax Act, R.S.C. 1985, c. 1, § 245(3) (Can.). The Supreme Court of Canada has had a difficult time breaking its old habits of approaching tax avoidance cases with a mind to interpret tax statutes based on strict construction, leaving Parliament to clear up any ambiguities in the statutes. As a result, the GAAR has been largely unenforced in its twenty-two-year existence. Lisa Philipps, *The Supreme Court of Canada's Tax Jurisprudence: What's Wrong with the Rule of Law*, 79 CAN. BAR REV. 120, 138 (2000).

302. Income Tax Act, § 245(2) (Can.).

303. *Id.* § 245(5).

304. Section 1409(a) of the Health Care and Education Reconciliation Act of 2010, added Subsection (o) to IRC § 7701 to read in part as follows:

> (o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE. —
>
> (1) APPLICATION OF DOCTRINE.—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if —
>
> (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
>
> (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.
>
> (2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—
>
> (A) IN GENERAL.—The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.
>
> . . .
>
> (5) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—
>
> (A) ECONOMIC SUBSTANCE DOCTRINE.—The term 'economic substance doctrine' means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067 (codified at 26 U.S.C. § 7701).

Thus, if the transaction lacks economic substance, the taxpayer may not claim the tax benefits of the transaction. In addition, the statute would impose a general 20% penalty under formulations at least since the decision in *Helvering v. Gregory*.[306] In addition, various provisions of the Code reallocate income among taxpayers or re-characterize specific transactions according to their economic substance rather than the form taxpayers have chosen.[307]

Enactment of the statutory economic substance rule followed several years of frequent and intensive discussion of economic substance codification both in Congress and in the professional tax community. Some participants in the planning community who supported a statutory rule envisioned an opportunity to make more outcomes predictable than under a non-specific judicial doctrine. While the discussion of codifying the economic substance doctrine indicated that participants in the tax community perceived that the judiciary had not used existing anti-avoidance doctrines adequately or appropriately,[308] that perception was not universal. IRS representatives questioned whether or not a statutory economic substance provision would improve the ability of the IRS to disregard the taxpayer's chosen transactional structure in favor of one that better comports to economic reality.[309] Debate concerning the benefit of a

I.R.C. § 6662 (the accuracy related penalty) for underpayments of tax attributable to transactions lacking economic substance under the statute and would double the penalty to 40% if the taxpayer did not disclose the transaction on the taxpayer's return. *Id.* § 1409(b)(2), 124 Stat. at 1069 (codified at 26 U.S.C. § 6662) (adding I.R.C. § 6662(i)).

305. On the application of the economic substance doctrine, see *Knetsch v. United States*, 364 U.S. 361, 366 (1960); *Dow Chem. Co. v. United States*, 435 F.3d 594, 605 (6th Cir. 2006); *Estate of Franklin v. Comm'r*, 544 F.2d 1045, 1048 (9th Cir. 1976).

306. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd sub nom.* Gregory v. Helvering, 293 U.S. 465 (1935).

307. *See, e.g.*, I.R.C. § 704(b) (2006) (requiring reallocation of partnership items if the partnership's allocation lacks substantial economic effect); *Id.* § 482 (permitting the Commissioner of Internal Revenue to reallocate income and expense among related taxpayers according to economic substance); *Id.* § 7872 (imputing interest income and expense to transactions with understated interest).

308. *See* Cunningham & Repetti, *supra* note 7, at 4–5 (suggesting that the United States Department of the Treasury should instruct the courts in how to interpret the Code using legislative intent to combat tax shelters that may appear to be legal under a textualist reading of the Code); Richard Lavoie, *Subverting the Rule of Law: The Judiciary's Role in Fostering Unethical Behavior*, 75 U. COLO. L. REV. 115, 118 (2004) (blaming the adherence to strict statutory construction and textualism by some justices of the United States Supreme Court, notably Justice Scalia, for the loosening of morals in accounting and tax law practices, and stating textualism does not allow legal constraints to draw strength from moral constraints). Canada's courts have also had problems enforcing its GAAR, which has been in statutory form since 1988. Philipps, *supra* note 301, at 132. The Supreme Court of Canada still relies on its strict construction interpretation of tax statutes and often finds in favor of taxpayers in legal disputes with the Canada Revenue Agency. *Id.*

309. Donald Korb, the predecessor to the current chief counsel for the IRS, strongly opposed codification of the economic substance doctrine. Korb was concerned that a statutory provision would restrict the range of arguments that the IRS might make rather than improving the frequency of IRS' success in application of economic substance to abusive tax structures. Crystal

statutory economic substance doctrine continued through 2009.[310] The statutory economic substance provision is equivalent, if not identical, to a GAAR. Like a GAAR, the provision seeks to re-characterize transactions according to their economic substance rather than according to the tax outcome of the form that the taxpayer has given the transactions.[311] Congress also views the statutory rule as a revenue raiser.[312]

GAARs are not a panacea for tax administrators. One recurring enforcement concern in countries that have GAARs is that the GAAR violates rule of law principles.[313] The GAAR's very lack of precision that is essential to its flexibility as an anti-avoidance tool renders it vulnerable to rule of law arguments. Rule of law principles require that law be understandable and predictable, so that the person whom the law affects reasonably may conform her behavior so as not to violate the law inadvertently.[314] Law must not be secret.[315] Commentary in both Germany[316] and Sweden,[317] for example, questions whether statutory GAARs fail rule of law analysis. The commentators argue that when transactions comply with the specific

Tandon, *Economic Substance Codification Would Create More Problems Than It Solves, Says Korb*, 118 TAX NOTES 777, 777 (2008).

310. Amy S. Elliott, *Alexander Downplays Effect of Economic Substance Codification*, 126 TAX NOTES 1309, 1309 (2010); Amy S. Elliott, *Practitioners Criticize Economic Substance Codification*, 126 TAX NOTES 589, 589 (2010).

311. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–68 (codified at 26 U.S.C. § 7701).

312. Jeremiah Coder, *News Analysis: Corporate Penalties in House Healthcare Bill Cause Concerns*, 125 TAX NOTES 729, 730 (2009). "A November [2009] Joint Committee on Taxation revenue estimate peg[ged] the total revenue to be raised from codifying economic substance and imposing new penalties for underpayments at $5.7 billion from 2010 to 2019. That figure isn't further broken down between the two provisions." *Id*.

313. *See generally* Rebecca Prebble & John Prebble, *Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law? A Comparative Study*, 55 SAINT LOUIS U. L.J. 21 (2010) (addressing that issue in detail in a paper presented at the Sanford E. Sarasohn Memorial Conference on Critical Issues in International and Comparative Taxation, where this paper was also presented).

314. *Id.*

315. *Id.*

316. *See generally* Drüen, *supra* note 4 (addressing the German rule and questioning whether the generality of the anti-avoidance rule causes the rule to conflict with the constitutional rule of law by preventing taxpayers from being able to predict the tax outcome of their transactions).

317. Motion 2009/2010:Sk387 Avskaffande av skatteflyktslagen [Motion to Repeal Tax Flight Law] (introduced before the Swedish Parliament in October 2009), *available at* http://www.riksdagen.se/Webbnav/index.aspx?nid=410&typ=mot&rm=2009/10&bet=Sk387. Some legislators introduce this or a similar motion annually on the ground that the existing law violates the rule of law principle. The legislature has rejected these motions each time they come before the Parliament. For a more detailed discussion of the conflict between the rule of law and the tax avoidance law in Sweden, see Hultqvist, *supra* note 8, at 302. *See also* ALMENDAL, *supra* note 8, at 56–72; Karlsson, *supra* note 8.

requirements of the governing substantive law and nevertheless violate the GAAR, the GAAR prevents taxpayers from being able to predict the tax outcome of their transactions—disqualifying the transactions through law unknown to and unknowable by the public.[318]

GAARs require that in order to generate a specific tax outcome, transactions must conform to the statutory intent, in addition to meeting the transparent technical requirements of the statute. Swedish commentary observes also that application of the GAAR conflicts with rule of law principles in part because it requires analysis and argumentation by analogy.[319] Swedish basic law probably prohibits argumentation by analogy.[320] Hence, operation of a GAAR suggests that taxing statutes have controlling legislative intent that taxpayers, or rather their advisors, know or reasonably may discover. The GAAR denies taxpayers a desired tax characterization when the taxpayers—or rather the taxpayers' tax advisors—seek to exploit statutory language, its generality, or flaws to enable the taxpayers to capture tax benefits for transactions under statutes that the legislature did not intend to apply to those transactions.

Against the possible conflict between the GAAR and the rule of law stands the rule of equal treatment under the law. Modern constitutions universally guarantee equal treatment under the law.[321] Successful tax avoidance enables

318. Prebble & Prebble, *supra* note 313, at 28–29.

319. Hultqvist, *supra* note 8, at 308.

320. *Id.* at 321.

321. Compare Amendment XIV, Section 1 of the longstanding United States Constitution, with the more general equality guarantee that Article 3 of das Grundgesetz [The German Basic Law] provides without regard to sex, race, language, disability, etc. The German Basic Law, which some literature refers to as the German constitution, serves the function in Germany of the Constitution in the United States, with the material difference being that the procedure for amending the Basic Law is simpler than the emendation procedure for the United States Constitution. Compare Article 79 of the Basic Law, requiring a two-thirds majority in each house of parliament to change the Basic Law, with the United States procedure under Article V of the United States Constitution, requiring ratification by three-fourths of the state legislatures or the electorates of three-fourths of the states. The Swedish Grundlagen [Basic Laws], like the United States Constitution, prohibit laws or regulations that discriminate on the basis of race, religion, national origin, etc., but also sex, subject to a limitation to eliminate historical discrimination except for military service. 2 ch. 12, 13 §§ SKYDD MOT DISKRIMINERING [PROTECTION FROM DISCRIMINATION] (Svensk författningssamling [SFS] 2010:1408) (Swed.), *available at* http://www.riksdagen.se/webbnav/index.aspx?nid=3925#K2 ("12 § Lag eller annan föreskrift får inte innebära att någon missgynnas därför att han eller hon tillhör en minoritet med hänsyn till etniskt ursprung, hudfärg eller annat liknande förhållande eller med hänsyn till sexuell läggning. Lag (2010:1408)." ["No law or regulation may result in disadvantaging any person because he or she belongs to a minority with respect to ethnic origin, skin color or other similar characteristic or because of sexual orientation"]. "13 § Lag eller annan föreskrift får inte innebära att någon missgynnas på grund av sitt kön, om inte föreskriften utgör ett led i strävanden att åstadkomma jämställdhet mellan män och kvinnor eller avser värnplikt eller motsvarande tjänsteplikt. Lag

some taxpayers to pay smaller amounts of tax than other similarly situated taxpayers who are not avoiding tax. The equality principle that such disparate tax treatment violates is just as fundamental to the law as the rule of law itself.

In Germany, the Federal Constitutional Court[322] repeatedly has confirmed that the German Basic Law requires that similarly situated taxpayers receive like tax treatment under some, but not all, German taxes. For example, the court ruled that the wealth tax and the inheritance tax both were unconstitutional because imprecision in valuation of property caused disparate treatment of like taxpayers.[323] More recently, the Constitutional Court held that a two-year limitation on deductibility of the expenses for a second residence for a married taxpayer who worked in a different city from his spouse was unconstitutional.[324] The law treated taxpayers whose employers assigned them to a series of away-from-home assignments more favorably than it treated taxpayers who had single long term away-from-home assignments.[325] And the Court even has held that inadequate means for enforcing the law and collecting the tax in the cases of interest income[326] and capital gains[327] violates the equality principle by favoring dishonest over honest taxpayers.

(2010:1408)." ["A law or other regulation may not disadvantage any citizen on account of sex, unless the regulation is part of the effort to establish equality between men and women or affects mandatory military service or other mandatory service."].

322. GRUNDGESETZ FÜR DIE BUNDESREPUBLIK DEUTSCHLAND [GRUNDGESTZ] [GG] [BASIC LAW], May 23, 1949, BGBL. I, art. 93 (Ger.) (establishing jurisdiction of the Federal Constitutional Court). Das Bundesverfassungsgericht [Federal Constitutional Court] has jurisdiction over any constitutional issue critical to the outcome of a controversy. Other courts must suspend their proceedings once they identify the constitutional issue and refer that issue to the Constitutional Court for resolution.

323. Bundesverfassungsgericht [BVerfGE] (Federal Constitutional Court), June 22, 1995, 93 ENTSCHEIDUNGEN DES BUNDERVERFASSUNGSGERICHTS [BVERFGE] 121 (Ger.) (holding the wealth tax, as applied, to be in violation ofthe equality principle); Bundesverfassungsgericht [BVerfGE] (Federal Constitutional Court), June 22, 1995, 93 ENTSCHEIDUNGEN DES BUNDERVERFASSUNGSGERICHTS [BVERFGE] 165 (Ger.) (similarly holding the inheritance tax to be in violation of the equality principle). *See also* Ordower, *supra* note 2, at 327.

324. Bundesverfassungsgericht [BVerfGE] (Federal Constitutional Court), Dec. 4, 2002, 107 ENTSCHEIDUNGEN DES BUNDERVERFASSUNGSGERICHTS [BVERFGE] 27 (Ger.).

325. *Id.*

326. Bundesverfassungsgericht [BVerfGE] (Federal Constitutional Court), June 27, 1991, 84 ENTSCHEIDUNGEN DES BUNDERVERFASSUNGSGERICHTS [BVERFGE] 239 (Ger.) (holding that in the absence of withholding or another mechanism to collect tax on interest income, taxation of interest income was unconstitutional, but delaying application of the decision to give the tax authorities time to equalize collection of the tax). *See also* Lily Kahng, *Investment Income Withholding in the United States and Germany*, 10 FLA. TAX REV. 315, 316 (2010).

327. Bundesverfassungsgericht [BVerfGE] (Federal Constitutional Court), Mar. 9, 2004, 110 ENTSCHEIDUNGEN DES BUNDERVERFASSUNGSGERICHTS [BVERFGE] 94 (Ger.) (holding taxation of gain from speculation in securities unconstitutional because of lack of an adequate identification and collection mechanism).

The Constitutional Court, however, has observed that overall progressivity in taxation is less important to the equality principle—and its parallel ability to pay principle— than is equal treatment of like taxpayers:

> In the interests of constitutionally mandated equality of tax burden . . . , as a goal, taxpayers who have the same ability to pay[328] should be taxed equally (horizontal tax equity), while (in the vertical direction) taxation of higher incomes should be *measured against* the taxation of lower incomes.[329]

Accordingly, the court has never held the German turnover tax[330] unconstitutional even though it generally taxes lower income taxpayers on a greater percentage of their income or wealth than it does higher income taxpayers.[331]

One commentator explains how the equality principle in taxation validates a GAAR.[332] Despite the GAAR's conflict with the principles of entrepreneurial freedom that emanate from the rule of law, equality in taxation is critical. As the state takes through taxation without giving specific *quid pro quo*, inequality undermines the state's authority to tax. Tax avoidance itself is inefficient. It draws human resources to unproductive tax planning on the taxpayer's side and combating tax planning on the government's side, rather than deploying those resources to economic production that contributes to public welfare.[333]

328. A concept identified in German as "Leistungsfähigkeit."

329. 107 BVERFGE at 27 (46–47) (Ger.) (emphasis added) (author's translation). The German text reads:

> Danach muss im Interesse verfassungsrechtlich gebotener steuerlicher Lastengleichheit (citation omitted) darauf abgezielt werden, Steuerpflichtige bei gleicher Leistungsfähigkeit auch gleich hoch zu besteuern (horizontale Steuergerechtigkeit), während (in vertikaler Richtung) die Besteuerung höherer Einkommen im Vergleich mit der Steuerbelastung niedriger Einkommen angemessen sein muss.

Id. (citations omitted).

330. This is the German version of a value added tax. Umsatzsteuergesetz [UStG] [German turnover tax], Feb. 21, 2005, BUNDESGESETZBLATT, Teil I [BGBL. I] at 386, last amended by Gesetz [G], Apr. 5, 2011, BGBL. I at 554, art. 2 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/ustg_1980/gesamt.pdf.

331. Ordower, *supra* note 2, at 276–78.

332. Drüen, *supra* note 4, at 158.

333. *Id.* In referring to the decisions of the German Constitutional Court requiring the state to enact legislation to fulfill its duty to protect the constitutional rights of its citizens, Drüen writes:

> Bei dieser Fundierung entpuppen sich § 42 AO und andere Vorschriften zur Abwehr von Steuerumgehung als ein Instrument zur Wahrung der Gleichheitsrechte der anderen Steuerbürger. Denn Steuerumgehung revidiert die gesetzliche Belastungsentscheidung . . . . Die Gleichheit ist aber für den Steuerstaat, der nimmt, ohne zu geben, essentiell. Denn die Ungleichheit delegitimiert die Steuer als Gemeinlast. Überdies verzerrt Steuerumgehung volkswirtschaftlich betrachtet den Wett bewerb und führt zur ineffizienten Allokation von Ressourcen, weil beträchtliches Personal in Unternehmen, Steuerberatung und Staat fern von wirtschaftlicher Nutzenmaximierung gebunden wird.

Dr. Drüen is not alone in worrying about inefficient and unproductive tax planning activities.[334] One sees like arguments from commentators in the United States.[335] Generating wealth, while providing neither goods nor services for consumption, does indeed seem an artificial and an inefficient allocation of creative human capital. The resource allocation is artificial in that historically, wealth was a function of ownership of land and agricultural production, while later one derived wealth from active involvement in manufacturing, processing, and distributing goods and agricultural products. Only recently have more ephemeral pursuits like development of and investment in financial and tax avoidance products generated large amounts of wealth for both the product developers and their clients.[336] The resource allocation is inefficient in that it concentrates wealth without providing any tangible benefit except concentration of wealth. This issue affects not only the tax planning industry but also the markets for complex financial products to which governments have shifted their regulatory attention as a result of the widespread economic failures in 2008.[337] While it is possible that the creative individuals who engage in tax planning are suited to that intellectual activity only, that creativity certainly may be transferable to other public welfare producing pursuits were those pursuits equally remunerative. On the other hand, participants in the financial product planning or tax planning industries might argue that their activities make capital available for production by freeing it from taxation or through financial products, thereby releasing capital otherwise locked into less productive activities for more efficient uses.

Whether tax planning is inefficient, and whether GAARs conflict with rule of law principles or buttress distributional equality in taxation, enactment of

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Id. (citations omitted) ["To this contemplation (of the court), § 42 AO (the GAAR) and other regulations to combat tax avoidance emerge as an instrument to protect the equality rights of other tax citizens. Tax avoidance revises the legislative decision on distribution of the tax burden. . . . Equality is critical to the state which taxes without giving back. For inequality delegitimizes taxes as a common burden. More important, from an economic perspective, tax avoidance disrupts competition and leads to inefficient allocation of resources as considerable personnel in business, tax planning industries, and the state is remains far from economic production maximization activity."].

334. *Id.* Professor Drüen distinguishes tax avoidance activity from "wirtschaftliche Nutzenmaximierung" (other activities that maximize economic welfare).

335. Weisbach, *supra* note 3, at 216.

336. *See supra* Part II.

337. U.S. DEP'T. TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 43 (2009), *available at* www.financialstability.gov/docs/regs/FinalReport_web.pdf (discussing financial failures and reforms in the United States); *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC*, at 12, COM (2009) 207 final (Apr. 30, 2009) (discussing financial failures and new regulations in the European Union).

GAARs evidences a common perception among legislatures that tax collectors need additional enforcement tools. Underlying that perception is the observation that taxpayers capture tax advantages through technically correct, but inappropriate or unintended, applications of the tax law. Tax advisors design transactions and recommend structural alternatives for transactions to produce favorable tax outcomes that are inconsistent with the legislative intent underlying the tax law. Those technically compliant transactional designs either 1) lack good economic or business reasons for their use or 2) employ unnecessary or inefficient economic steps toward an objective that becomes economically sound because of the tax advantage those steps may generate. The value of the tax advantage tends to exceed the cost of the unnecessary or inefficient economic steps or the unnecessary transaction as a whole. A GAAR or similar regulation is critical to displace the taxpayer favorable tax outcome, for, if the transactions failed to comply with the technical requirements of the law, the tax collector could prevent an outcome inconsistent with that law. Technical compliance with the law leaves the government either to accept the unanticipated taxpayer favorable outcome or find another means (like a GAAR) of preventing the outcome.

While possibly sound on a theoretical level, I find the secret and uncertain law argument against GAARs[338] to be disingenuous on a practical level. Tax advisors who design tax minimization structures for their clients generally know the purpose of taxing statutes or, at least, know when the legislature did not intend the statute to apply to the structure they proffer. Professional advisors nevertheless exploit statutory weakness and ambiguity to their clients' benefit, thereby serving their clients' economic interests while creating distributional inequalities.[339] In many instances, creative tax planners seek to identify statutory uncertainty where most advisors and their clients would find none.[340] Not infrequently, those difficult to discover statutory flaws mean financial success for the planners as they market tax planning techniques.[341]

338. *See supra* note 313 and accompanying text.

339. *See supra* note 321 and accompanying text.

340. One well-known example of such creativity was the "rabbi" trust for deferral of compensation. I.R.C. § 83 (2006) specifically defined the moment of inclusion in income of property transfers and enabled employees to defer inclusion in income as long as there was a risk that the employee might forfeit the compensation. Rabbi trusts go one step beyond the statute by leaving the compensation that the employer paid into a trust for the employee's benefit subject to the claims of the employer's creditors. The I.R.S. ruled that no transfer had taken place until the property in the trust became free from the creditors' claims. IRS Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980) (giving the "rabbi trust" its name); Rev. Proc. 92-64, 1992-2 C.B. 422 (providing model trust provisions for rabbi trusts). For fiscally solid employers, the risk to the employee of deferring compensation in that manner was slight. *See* Ordower, *supra* note 110, at 316.

341. Over the last decade or so in the United States, tax professionals have applied for and obtained patents on tax strategies. Tax patents would protect the revenue of the patent holder by giving the patent holder control over the use of the strategy to keep it from being deployed

As the techniques find their way into the public domain, however, less meticulous practitioners often use the techniques sloppily or recommend them to inappropriate clients. The techniques lose their value because they become readily visible to the tax administrator who may issue a public statement of intention to challenge the tax characterization and impose penalties,[342] promulgate appropriate regulations, turn to the legislature for statutory change, or use or threaten to use the GAAR.

That a court examining the transaction might not find in favor of the tax collector challenging the advisor's tax characterization does not necessarily mean that the tax structure properly applied the statute. Lack of a clear, unambiguous statutory statement may suffice to secure a taxpayer favorable outcome even where the court doubts that outcome to be correct.[343] In the United States, a statutory GAAR might move the courts away from textualism by giving them a foundation upon which to base a decision unfavorable to the taxpayer despite compliance with the terms of the substantive statute.[344]

IV. TAX PLANNING AND TAX AVOIDANCE: EXAMPLES FROM SWEDEN AND GERMANY

I have not found discussion of a retail tax shelter industry resembling what I describe in Part 2 of this Article in the German or the Swedish literature. Syndicated tax shelter products seem to be a phenomenon of the common law world.[345]

inappropriately and in a manner easy for the tax administrator to challenge. After the Supreme Court's recent decision in *Bilski v. Kappos*, the door is open for business method patents generally, but because the Court did not establish any guidelines for what is and is not a patentable process, the United States Patent Office and future court decisions on the subject may restrict the patentability of tax planning techniques in the future. 130 S. Ct. 3218 (2010); *see also* D.C. Denison, *Relief as Patent Process Left in Tact: High Court Ruling Could Have Altered Software Firms' Rights*, BOS. GLOBE, June 29, 2010, at B5.

342. *See, e.g.*, I.R.S. Notice 2000-44, 2000-2 C.B. 255 (notifying the public that the IRS would challenge Son of Boss type structures).

343. *See generally* Galle, *supra* note 7 (observing the textualist strict interpretation but arguing that an uncodified doctrine may be superior to a statute).

344. Cunningham & Repetti, *supra* note 7, at 38–55 (seeing the partnership anti-avoidance regulation as helping to overcome strict application of the text).

345. *See* Philipps, *supra* note 301, at 138 (noting Canada's courts have struggled with enforcing anti-abuse rules against taxpayers who have structured business deals within the textual letter of the law, but outside of the legislative intent); Wolfgang Schön, *The David R. Tillinghast Lecture, The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111, 118–19 (2005) (referencing the United Kingdom's attempt to crack down on tax accounting discrepancies in corporations).

Nevertheless, tax avoidance (and evasion)[346] and aggressive tax planning certainly are as common in civil law as they are in common law jurisdictions. In Europe, however, tax avoidance often follows rules of income sourcing because, unlike the United States (which taxes its citizens and permanent residents[347] on their worldwide incomes without regard to the source of the income or the taxpayer's residence),[348] European countries do not necessarily tax their citizens on worldwide income. For example, Germany[349] and Sweden[350] tax their residents on their income from all worldwide sources, but tax non-residents, whether or not citizens, generally only on their incomes from German or Swedish sources respectively,[351] including income from services performed or passive income from domestic investment sources.[352]

In order to escape high marginal income tax rates in their home country, individuals who have sufficient resources and a willingness to relinquish their residence in their home country may—and do—relocate themselves and their

346. Tax evasion involves tax planning conduct that is illegal. Tax avoidance, on the other hand, is minimization of taxes through legal means. An often cited quotation from Judge Learned Hand:

> [A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one 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.

Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd sub nom.* Gregory v. Helvering, 293 U.S. 465 (1935) (setting the standard for distinguishing tax avoidance from tax evasion even though it utilizes the term "evasion").

347. I.R.C. § 7701(b)(1) (2006) includes alien individuals who are lawful permanent residents of the United States as residents even if they are living outside the United States.

348. I.R.C. § 61 (2006) includes in the gross income of a United States citizen or resident "all income from whatever source derived." Under I.R.C. §§ 871 and 872 (2006), non-resident aliens are taxable on their income from United States sources and income that is effectively connected with the conduct of a United States trade or business.

349. Einkommensteuergesetz [EStG] [Income Tax Law], Oct. 16, 1934, BUNDESGESETZBLATT, Teil I [BGBL. I] at 3366, 3862 (recodified Oct. 8, 2009) (amended Dec. 22, 2009) (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/estg/gesamt.pdf. The German tax law distinguishes between "unbeschränkte Steuerpflicht" [unlimited tax liability], that is, tax liability from worldwide sources and "beschränkte Steuerpflicht" [limited tax liability].

350. 3 § INKOMSTSKATTELAG [INCOME TAX LAW] (Svensk författningssamling [SFS] 1999:1229) (Swed.), *available at* http://62.95.69.15/cgibin/thw?%24{HTML}=sfst_lst&%24{OOHTML}=sfst_dok&%24{SNHTML}=sfst_err&%24{BASE}=SFST&%24{TRIPSHOW}=format%3DTHW&BET=1999%3A1229%24. Like Germany, Sweden distinguishes between "obegränsad skattskyldighet" (unlimited tax liability) and "begränsad skattskyldighet" (limited tax liability).

351. Income Tax Law § 2(1) (Ger.); 3 ch. 7 § Income Tax Law (Swed.).

352. Income Tax Law § 2(1) (Ger.); 3 ch. 18 § Income Tax Law (Swed.). This statement oversimplifies the point. The rules are more complex but generally follow that pattern.

primary service performance location to low tax jurisdictions to avoid home country taxes.[353] Germany adopted legislation to discourage expatriation to avoid taxes.[354] Under that legislation, individuals who were subject to unlimited German income tax liability for five of the prior ten years before they leave Germany for a low tax jurisdiction such as Switzerland, Liechtenstein, Luxembourg, or an island nation, and who retain significant economic connection with Germany, remain liable for German income tax on most of their worldwide income.[355] With the exception of income from services they perform outside Germany, the liability continues for ten years following their exit from Germany.[356] Similarly, Swedish tax law continues to tax both Swedish citizens and non-citizens who were resident in Sweden for ten years or more and retain significant connections with Sweden on their income from all sources during the five year period following their exit from Sweden.[357] In order to claim exemption from continuing taxation, the taxpayer has to establish the lack of continuing connection with Sweden.[358] Even the United States, which requires relinquishment of citizenship in order to escape worldwide taxation, has had to backstop expatriation with special continuing taxation rules[359] and an exit tax.[360]

Others arrange the business affairs of entities they control to shift their income source to entities located outside the home, high tax rate country.[361] Much of such income-shifting is a function of the planning of transfer pricing between related entities. Transfer pricing remains a broad and general international tax concern. The fundamental issue is the ownership of intellectual property by entities that have their base in low tax jurisdictions. The end user based in a high tax jurisdiction must pay a royalty for use of the intellectual property to the low tax jurisdiction owner. Tax administrators seek to prevent such income shifts but find it difficult to use available statutory tools to reallocate income to the home country.[362]

353. Income Tax Law § 2(1) (Ger.); 3 ch. 18 § Income Tax Law (Swed.).

354. Außensteuergesetz [AStG] [Foreign Tax Law], Sept. 8, 1972, BUNDESGESETZBLATT, Teil I [BGBL. I] at 1713, § 2 (amended 2010) (Ger.).

355. *Id.*

356. *Id.*

357. 3 c. 7 § INKOMSTSKATTELAG [INCOME TAX LAW] (Svensk författningssamling [SFS] 2007:1419) (Swed.).

358. *Id.*

359. I.R.C. § 877 (2006) (continuing to tax in the United States individuals who expatriate for tax avoidance purposes).

360. *Id.* § 877A (imposing a market to market exit tax on expatriation).

361. For some recent estimates on loss of tax revenue in the United States from shifting of income offshore, see Martin A. Sullivan, *Transfer Pricing Costs U.S. at Least $28 Billion*, 126 TAX NOTES 1439 (2010).

362. *See, e.g.*, I.R.C. § 482 (2006) (giving the IRS authority to reallocate excess royalties to the United States user where the user and the intellectual property owner are related).

Such practices of shifting residence and income source have become part of the cultural landscape. A substantial segment of the public at large in many countries views tax evasion and, presumably, avoidance within the law as acceptable conduct.[363] Those without the resources to avoid tax sometimes look upon others' avoidance with envy and occasionally emulate the practice with their own small-scale, but meaningful tax evasion.[364]

While neither Sweden nor Germany may have a marketed tax shelter industry, there is tax planning that includes artificial or unnecessary transactions to achieve favorable tax outcomes. Taxpayers rely on their tax advisors to structure transactions for maximal tax efficiency.

In Sweden, for example, one transaction model enabled a Swedish corporation to sell substantially appreciated property without recognizing gain on the sale.[365] The same structure afforded the buyer an opportunity to recover almost its entire acquisition cost for tax purposes immediately rather than through long term depreciation allowances.[366] In the transaction, the seller formed a foreign entity in which it owned one hundred percent of the ownership interests.[367] Next the seller entered into a tax transparent Swedish "*handelsbolag*"[368] with its controlled foreign entity, retaining only a small interest in the *handelsbolag*.[369] The seller contributed the appreciated property to the *handelsbolag* at the tax basis of the property rather than its current value.[370] This opportunity arose if the property constituted its own trade or business separable from the remainder of the seller's businesses, and the

363. *See* Robert W. McGee & Michael Tyler, Tax Evasion and Ethics: A Demographic Study of 33 Countries 2 (Oct. 2006) (unpublished working paper, Barry University), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=940505 (statistical analysis of attitudes toward tax evasion with a sizable percentage in most demographic groups considering evasion justifiable under some circumstances). I extrapolate that a greater percentage would find avoidance within the law acceptable.

364. *See supra* note 231 and accompanying text (discussing the underground, largely cash or barter, economy); *see infra* note 470 and accompanying text.

365. Karlsson, *supra* note 8, at 23. The Swedish Tax Authority announced its intention to litigate based upon multiple arguments including the Swedish GAAR. It also promulgated regulations to reduce tax basis for these transactions prospectively and proposed a statutory change. *See Handelbolaglösningen* [*Partnership solution*], SKATTEVERKET [TAX AUTHORITY], http://www.skatteverket.se/rattsinformation/skatteupplagg/handelsbolagslosningen.4.3dfca4f410f4fc63c8680009678.html (last visited Apr. 25, 2011).

366. *See* Karlsson, *supra* note 8, at 23.

367. *Id.*

368. The Swedish *handelsbolag* is an unincorporated tax-transparent entity and may have a single owner. In the transaction, the Swedish corporation must own a nominal interest in the entity in order to transfer property to it without recognizing gain.

369. *Id.* at 24.

370. *Id.*

transfer facilitated a necessary business restructuring that taxation might impede.[371]

Next the controlled foreign entity and its Swedish parent sell their interests in the *handelsbolag* at the fair market value of the underlying property to a Swedish buyer.[372] Assuming the transaction meets various conditions on income source and treaty rules, the gain is taxable primarily to the controlled foreign entity outside Sweden according to its interest in the *handelsbolag* and is not subject to Swedish taxation.[373] Moreover, the foreign controlled entity may distribute the proceeds to its Swedish parent tax free.[374] As to the buyer, on liquidation of the *handelsbolag*, the buyer recognizes a tax loss equal to the difference between the purchase price for the interests in the *handelsbolag* and the tax basis of the underlying property. That loss is currently deductible.[375]

In Germany, foreign-based *Stiftungen*[376] provide opportunities to distribute investment income among family members and to move the investment income source offshore.[377] The investment income of *Stiftungen* based outside Germany generally is not taxable in Germany until the *Stiftungen* distribute the income to German taxpayers. In this manner, the *Stiftungen* defer taxation in Germany. While high profile Germans have used Liechtenstein *Stiftungen* to evade tax in Germany,[378] *Stiftungen* accomplish their deferral function in many instances as tax planning, not evasion vehicles.

A *Stiftung* in the Liechtenstein context differs from the German entity of the same name. The German term *Stiftung* is generally translated as "foundation."[379] Foundations are either 1) for the common good

371. Karlsson, *supra* note 8, at 25.

372. *Id.* at 24

373. *Id.*

374. *Id*. at 24. *See also* 24 c. Inkommstskattelag (Swed.) (providing rules for distributions from corporations).

375. Karlsson, *supra* note 8, at 24.

376. DAS GROSSE DEUTSCHES WÖRTERBUCH, *supra* note 38, at 3427, defines "Stiftung" as "zweckgebundenes, geschenktes Vermögen" [wealth donated for a specific purpose]. A "Stiftung" (plural "Stiftungen") is similar to a charitable foundation in the United States, and most German-English dictionaries define "Stiftung" as a foundation or endowment. Generally, philanthropic individuals form "Stiftungen" for eleemosynary purposes and contributions are deductible under EStG Section 10(b). Einkommensteuergesetz [EStG] [Income Tax Law], Oct. 16, 1934, BUNDESGESETZBLATT, Teil I [BGBL. I], § 10(b) (recodified Oct. 8, 2009) (amended Dec. 22, 2009) (Ger.). I use the German term in this paper in order to avoid any connotations that the English word carries with it. Special thanks to Gregory Knott for the discussion of *Stiftungen*.

377. The English term "offshore" seems incorrect since Germans often move income to Switzerland with which German has an extended land border or to Liechtenstein adjacent to Switzerland.

378. *See infra* note 491 and accompanying text.

379. *See* Stefan Grundmann, *Trust and Treuhand at the End of the 20th Century. Key Problems and Shift of Interests*, 47 AM. J. COMP. L. 401, 423 (1999) (explaining the way a *Stiftungen* is structured as a base for family wealth).

(*gemeinnützig*) like the charitable *VolkswagenStiftung* [*sic*], 2) holding companies like the one that owns the grocery chain Lidl,[380] or 3) family foundations (for the benefit of self ("eigennützig") or others ("fremdnützig")).[381] The charitable *Stiftung* resembles the American foundation, but other *Stiftungen* have more trust-like characteristics.[382]

Liechtenstein *Stiftungen* (and closely related entities known as *Anstalten*[383]) function similarly to Anglo-American trusts.[384] The *Anstalt* may be "an autonomous fund with its own legal personality which exists to serve the interests of one or more beneficiaries named by the Establishment's founder."[385] Planners frequently use *Anstalten* for family asset protection.[386] A *Stiftung* is "a legally recognized dedication of assets to a particular purpose," such as providing for a particular family.[387] Liechtenstein *Stiftungen* hold property and invest their assets to provide income to beneficiaries. Like a trust, beneficiaries may include the settlors, families of settlors, third parties, and charities.[388] *Stiftungen* invest for their own benefit and at their own risk subject to the terms of the *Stiftung*'s organizational documents.[389] *Stiftungen* and *Anstalten* established in Liechtenstein by foreign non-resident persons pay a capital tax of 0.1% on assets and, to the extent they engage in investment

380. *See, e.g.*, Shirley T. Cheng, Note, *Recent Decision:* Häupl v. Lidl Stiftung & Co. KG, N.Y. INT'L. L. REV., Winter 2008, at 143, 143.

381. Grundmann, *supra* note 379, at 419.

382. *Id.* at 423–25. *Stiftungen* also differ from another similar entity, the *Treuhandgesellschaft*. *Treuhand* is usually translated as "trust," although the concept is not as flexible as trusts in the United States context. *Id.* at 423. Generally speaking, the grantor transfers ownership of property to another party to be used or held for a particular purpose, such as a security interest. For more on *Treuhand*, see generally 1 HANS JOSEF WIELING, SACHENRECHT: SACHEN, BESITZ UND RECHTE AN BEWEGLICHEN SACHEN [PROPERTY, OWNERSHIP, AND LAW OF PERSONAL PROPERTY] 799–825 (1990). *Treuhandgesellschaften* only hold or preserve property for inheritance of other administrative purposes, and *Stiftungen* hold and invest property under more involved, trust-like terms.

383. Although customarily translated as "institution," "institute," or "establishment" (as in research institute), in Liechtenstein an *Anstalt* may also serve a narrow non-public, often investment purpose.

384. *Stiftungen* based in Liechtenstein have even been treated as trusts in courts. *See, e.g.*, William H. Newton, *Structuring Foreign Investment in United States Real Estate*, 50 U. MIAMI L. REV. 517, 529 (1996).

385. Duncan E. Osborne et al., *Asset Protection Trust Planning*, *in* 1 ALI-ABA COURSE OF STUDY MATERIALS: PLANNING TECHNIQUES FOR LARGE ESTATE 543, 625 (2001).

386. *Id.*

387. *Id.*

388. *Id.*

389. Ulrich L. Göres & Jens Kleinert, *Die Liechtensteinische Finanzaffäre—Steuer- und steuerstrafrechtliche Konsequenzen* [*The Liechtenstein Financial Matter—Tax and Tax Crime Consequences*], 19 NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 1353, 1355 (2008).

activity a VAT of 6.5% on their investment returns.[390] Settlors may change the terms of the *Stiftung* or *Anstalt* as the entity's organizational documents may permit.[391]

A grantor may settle a *Familienstiftung*[392] in Liechtenstein with assets of at least 30,000 Swiss Francs.[393] Liechtenstein encourages the establishment of larger *Stiftungen* by halving the 0.1% capital tax for entities with assets of at least 10 million Swiss Francs.[394] Bank secrecy laws in Liechtenstein protect the identities of the grantor and beneficiaries of a *Stiftung* as well as the amount of the *Stiftung*'s assets.[395] Documentation requirements are minimal and the documents need not even name the beneficiaries.[396] About 95% of *Stiftungen* registered in Liechtenstein do not disclose the names of their grantors.[397]

Grantors of Liechtenstein *Stiftungen* who are subject to unlimited tax liability in Germany[398] must include the *Stiftung*'s income in their German gross income if the grantors control the *Stiftung* assets (*kontrollierte Stiftung*).[399] Fairly straightforward tax planning enables grantors to avoid becoming taxable on the *Stiftung*'s income. Formalistic relinquishment of control to others makes the *Stiftung* sufficiently separate from the grantor to cause the *Stiftung* to become an independent entity for German tax purposes. The grantor may establish the *Stiftung* as an *Ermessensstiftung*,[400] operating according to the grantor's stated purposes.[401] While neither the grantor nor the beneficiaries have access to *Stiftung* assets, a dual trustee-management

390. Osborne et al., *supra* note 385, at 624.

391. RAINER DEININGER & ANTON-RUDOLF GÖTZENBERGER, INTERNATIONALE VERMÖGENSNACHFOLGEPLANUNG MIT AUSLANDSSTIFTUNGEN UND TRUSTS [INTERNATIONAL WEALTH TRANSMISSION PLANNING WITH FOREIGN STIFTUNGEN AND TRUSTS] 106 (2006).

392. A family foundation. PETER TERRELL ET AL., COLLINS GERMAN-ENGLISH ENGLISH-GERMAN DICTIONARY UNABRIDGED 236, 634 (2d ed. 1991).

393. DEININGER & GÖTZENBERGER, *supra* note 391, at 105. Liechtenstein uses the Swiss franc as its national currency.

394. Arvid Kaiser, *Alpen-Asyl für flüchtige Millionen* [*Asylum in the Alps for Millions Taking Flight*], SPIEGEL ONLINE (Feb. 14, 2008), http://www.spiegel.de/wirtschaft/0,1518,535409,00.html.

395. DEININGER & GÖTZENBERGER, *supra* note 391, at 106. Note, however, that Liechtenstein has agreed in principle to exchange information with the United States in order to protect its qualified intermediary status. Henry M. Ordower, *United States of America Experience with and Administrative Practice Concerning Mutual Assistance in Tax Affairs* 5 (Saint Louis Univ. Sch. of Law, Legal Studies Research Paper Ser. No. 2010-16, 2009).

396. Ordower, *supra* note 395, at 5.

397. *Id.*

398. That is, generally, residents of Germany. *See supra* note 348 and accompanying text.

399. DEININGER & GÖTZENBERGER, *supra* note 391, at 110–11. The grantors are treated as the owners of the *Stiftung*'s assets in a manner similar to I.R.C. § 671 (2006).

400. A discretionary foundation. TERRELL ET AL., *supra* note 392, at 223, 634.

401. DEININGER & GÖTZENBERGER, *supra* note 391, at 112–16.

structure for the *Stiftung* protects the interests of the grantor and the beneficiaries.[402] Under this dualist system, the *Stiftungsrat* (board) presents spending and investment initiatives, and the *Protektor* (trustee) grants the necessary permission to act as long as the initiatives are consistent with the grantor's intended purposes.[403] The grantor and beneficiaries are only taxable to the extent of distributions they receive from the *Stiftung*.[404]

While the transfer of the assets from the grantor to the *Stiftung* might be subject to a transfer tax in the form of a gift tax, grantors generally may avoid that tax as well by retaining the right to remove and replace the *Stiftungsrat* or alter the terms of the *Stiftung*.[405] For German gift tax purposes that retained power renders the gift incomplete, but the gift is complete for income tax purposes.[406]

A leading German tax treatise identifies other aggressive tax structures that taxpayers have defended successfully, including the warehousing of interest payments to defer tax between an entity and its owner; an interest in the Dublin Docks project; a payment to redeem a term interest in property that the redeeming party granted without consideration; and the payment of penalty interest on unnecessary third party financing.[407] The taxing authorities have challenged other structures successfully: For example, gifts from husband to wife followed by a gift from the wife to child in order to make use of multiple gift tax exemptions and the insertion of entities to intermediate and avoid a tax on an unincorporated business selling land.[408]

In order to alleviate housing shortages, Germany provided significant tax benefits to homeowners who would outfit part of their house as an independent residence with a kitchen and bath. Many homeowners made the conversion in order to capture the tax benefits, but far fewer actually made the residences available for rental.[409] Homeowners tended to be reluctant to actually rent the available space because German landlord-tenant laws were favorable to tenants

402. *Id.* at 112.

403. *Id.* at 114.

404. *See* Osborne et al., *supra* note 385, at 625.

405. *See, e.g.*, Bundesfinanzhof [BFH] [Federal Tax Court], June 28, 2007, SAMMLUNG DER ENTSCHEIDUNGEN UND GUTACHTEN DES BUNDESFINANZHOFS [BFHE] 217, 254 (Ger.), *available at* JURIS (holding that the indirect continuing control through an *Anstalt* of the *Stiftung* distributions prevented completion of the gift for gift tax purposes).

406. *Id.* at 9.

407. KLAUS TIPKE & JOACHIM LANG, STEUERRECHT [TAX LAW] 164–65 (17th ed. 2002).

408. *Id.*

409. *See generally* FRANZ KONZ, KONZ: 1000 GANZ LEGALE STEUERTRICKS [KONZ: 1000 COMPLETELY LEGAL TAX TRICKS] 492–546 (2008) (eBook) (discussing tax savings from home ownership and construction); *id.* at 496 (discussing deductions from buildings).

and made it extremely difficult to evict the tenant and recover the apartment once someone occupied it for six months or more.[410]

V. THE TAX AVOIDANCE CULTURE—LEGITIMIZING TAX EVASION

When I presented an earlier draft of this paper at a workshop several years ago, the commentator for the paper[411] recommended that I define "culture" with some care if I am going to argue that there is a tax avoidance culture. While I take that comment to heart, I find that current usage of the term has rendered a comprehensive definition of "culture" elusive. Dictionary definitions disclose that historical usage of "culture" embraces various beliefs and practices that members of a society have in common and that help to distinguish that society from others. For example, a dictionary I used when I was in college defines culture as "[t]he concepts, habits, skills, arts, instruments, institutions, etc. of a given people in a given period; civilization."[412] Similarly, the unabridged dictionary in the public area at Saint Louis University Law Library defines "culture" as:

> A particular state or stage of advancement in civilization or the characteristic features of such a stage or state; as, primitive Greek, Germanic *culture*. b. The complex of distinctive attainments, beliefs, traditions, etc., constituting the background of a racial, religious, or social group; as a nation with many *cultures*.[413]

And a German language dictionary I have defines the comparable German term "Kultur" as: "Gesamtheit der geistigen u. künstler. Ausdrucksformen eines Volkes (Kunst, Wissenschaft, usw.)."[414]

Those dictionary definitions are consistent with one another, but current usage of the term "culture" has become far less precise and somewhat hackneyed. Any group of human activities may define a culture. Both general and legal literature often refer to a narrow group of related human activities or beliefs as a "culture" consistent with my use of the concept in this paper. There are references to religious cultures, primitive cultures, corporate

410. BURGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Aug. 18, 1896, REICHSGESETZBLATT [RGBL.] 195, as amended, § 549 (special provisions governing residential leases), § 558 (limitations on rental increases to local index), § 573 (limitations on termination), § 573a (special simplified termination where leased premises are in a residence the owner occupies), § 574 (lessee's right to object to termination for hardship) (Ger.).

411. Sarah Lawsky, Comments at the Critical Tax Theory Workshop at Florida State University School of Law (Apr. 4–5, 2008) (schedule for critical tax conference *available at* http://www.law.fsu.edu/law_economics/criticaltaxconference.html).

412. WEBSTER'S NEW WORLD DICTIONARY OF THE AMERICAN LANGUAGE 358 (Coll. Ed. 1960).

413. WEBSTER'S NEW INTERNATIONAL DICTIONARY 643 (2d ed. 1934) (defining "culture").

414. DAS GROSSE DEUTSCHES WÖRTERBUCH, *supra* note 38, at 2187 [the totality of intellectual and artistic forms of expression of a people (art, knowledge, etc.)] (author's trans.).

cultures, and tax cultures[415] that simply describe a set of commonalities in a defined group that distinguish it from other groups. Although historically "culture" was a conceptually neutral term, current usage frequently includes a value judgment that may be pejorative. Negative usages include criminal cultures[416] and cultures of corruption.[417]

While "corporate culture" may simply serve as an identifier, the term also appears with negative connotations in specific contexts, as does the term tax culture when attached to specific tax cultures such as a culture of tax cheating. For example, in *Paramount Communications, Inc. v. Time, Inc.*,[418] the Delaware chancellor identified protection and preservation of corporate culture as a possible legitimate reason to resist a takeover, but in *White v. Panic*,[419] the complaint alleges that there was a "corporate culture that turned a blind eye to violations of employee civil rights, even if it meant violating applicable federal and state laws, rules or regulations."[420] A front page story in a major United States newspaper reported on South Korea's struggle with its "thoroughly male-centered corporate culture, starting with alcohol."[421]

A growing body of tax literature examines tax cultures separately from other cultural elements. Victor Thuronyi sees a tax culture as something that grows out of the legal tradition of a country.[422] Sharon C. Nantell reviews the history of taxation in the United States with a particular eye toward racial and sexual inequalities in the development of U.S. taxation.[423] Ann Mumford compares the tax collection cultures of the United States and Great Britain.[424] Assaf Likhovski examines cultural issues in the tax law in British Palestine in

415. *See infra* notes 421–23 and accompanying text.

416. *See, e.g.*, *Criminal Culture Making Police Work Difficult*, TULSA POLICE DEP'T BLOG (May 1, 2007), http://tpdblog.typepad.com/tpdblog/2007/05/criminal_cultur.html (discussing the effect of criminal culture on the use of informants).

417. The United States Democratic Party recently used this slogan in referring to the political scandals in the Republican Party during the presidency of George W. Bush presidency. *See, e.g.*, Scott Shepard, *Dean Decries GOP's "Culture of Corruption"*, OXFORD PRESS (July 5, 2005), http://www.oxfordpress.com/news/content/shared/news/nation/stories/07/04_DEMS_LOBBY.html.

418. 571 A.2d 1140, 1152 (Del. 1989).

419. 783 A.2d 543, 552 (Del. 2001) (affirming the lower court).

420. *Id.* at 552.

421. Norimitsu Onishi, *As Women Rise, Corporate Korea Corks the Bottle*, N.Y. TIMES, June 10, 2007, at A1.

422. VICTOR THURONYI, COMPARATIVE TAX LAW 3 (2003).

423. Sharon C. Nantell, *A Cultural Perspective on American Tax Policy*, 2 CHAP. L. REV. 33, 64–67 (1999).

424. ANN MUMFORD, TAXING CULTURE: TOWARDS A THEORY OF TAX COLLECTION LAW 1 (2002).

the 1940s.[425] Michael A. Livingston briefly examines and contrasts what he refers to as the tax cultures in Israel, India and Italy.[426] In his article, Livingston deals primarily with the issue of progressive taxation in those countries and then with both public attitudes about compliance and the structure of professional participation in the tax community.[427] In an earlier article, Livingston suggests that tax culture:

> may be defined as the body of beliefs and practices that are shared by tax practitioners and policy-makers in a given society and that provide the background or context in which tax decisions are made, i.e., the noneconomic or at least nonquantifiable side of taxation, which varies between societies even though the underlying economic principles are largely the same.[428]

And Livingston observes further that "[t]ax culture is thus distinct from the general culture or even the legal culture of a given society, although there is of course no clear line between them."[429]

It strikes me that tax avoidance in many developed economies is cultural. It embodies a free-standing set of beliefs, traditions, and practices that constitute a culture and, like any culture, includes a number of features that lack an underlying and compelling logic. That tax avoidance culture may contrast starkly with other elements of the society and yet blend with those other elements as not to appear out of place. Somewhat oddly, but reflecting a view of taxation as separate from the general and contrasting culture, Americans who pride themselves on being charitable, standing up for the oppressed and underprivileged elements of the society, and being meticulously fair in their business dealings might avoid taxes, even knowing that their avoidance must generate unfairness in the distribution of the tax burden.

This paper has argued that tax avoidance through marketed shelter products and aggressive individualized planning has become commonplace.[430]

425. Assaf Likhovski, *Is Tax Law Culturally Specific? Lessons from the History of Income Tax Law in Mandatory Palestine*, 11 THEORETICAL INQUIRIES IN LAW 725, 725–31 (2010).

426. Michael A. Livingston, *From Milan to Mumbai, Changing in Tel Aviv: Reflections on Progressive Taxation and "Progressive" Politics in a Globalized but Still Local World*, 54 AM. J. COMP. L. 555, 556 (2006).

427. *Id.*

428. Michael A. Livingston, *Law, Culture, and Anthropology: On the Hopes and Limits of Comparative Tax*, 18 CAN. J. L. & JURIS. 119, 121 (2005) (arguing generally that cultural matters have an impact on harmonization across borders, so that tax scholarship may need to look beyond economics for development).

429. *Id.*

430. Compare the development of hedge funds in the United States. Hedge funds began as investments for only the wealthiest investors. As their mystique developed and rumors of their vast investment success spread, broader segments of the investing public wanted to get in on the opportunity. Changes in law accompanied changes in investor attitudes and facilitated increased access to fund opportunities. Most recently, a fund manager has had a public offering of its shares. As the government tries to regulate hedge fund activities, demand for the products

Earlier in the paper, I traced the contribution of tax sheltering to this development.[431] Although public opinion once regarded tax sheltering as a morally dubious practice,[432] over a decade or two, that view changed radically.[433] Neither change in the law nor successful tax litigation has made tax sheltering unacceptable conduct.[434]

Similarly, in Europe, public opinion once would have frowned upon expatriation of labor or residence to avoid taxation. While the recent Liechtenstein disclosures generated some public outcry against tax evasion by wealthy and prominent individuals,[435] the public seems to accept and even embrace expatriation decisions.[436] Technological advances facilitate business decisions to relocate to low tax, and often warm weather, jurisdictions.[437]

nevertheless continues to grow. *See* Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 324 (2007); Ordower, *supra* note 254, at 295.

431. *See supra* Part I.

432. Dennis J. Ventry Jr., *Raising the Ethical Bar for Tax Lawyers: Why We Need Circular 230*, 111 TAX NOTES 823, 825 (2006) (stating that the older generation of tax lawyers—defined as those between 45 and 65 years old—approach tax planning with an attitude that textualism is insufficient to glean the legislative intent of the tax code and thus the "right" result, while the younger generation of lawyers are more rule-bound and more willing to find a loophole in the text of the statute and to play the audit lottery).

433. *See* Lavoie, *supra* note 308, at 125–26 (stating adherence to morals is often determined by an individual's perception of the consequences of non-compliance). When people decide whether or not to pay their taxes, they consider the cost of compliance and the chance of getting caught; if the cost of compliance exceeds the expected punishment for noncompliance, the taxpayer will not pay his taxes. Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1783–84 (2000). The audit rate is under two percent of returns, and only a small percent of those audited are penalized; civil penalties are generally around twenty percent for underpayment, and criminal penalties are rare. *Id.*

434. Blank, *supra* note 8, at 539. I suspect there is considerable *schadenfreude* (pleasure in the suffering of others) when someone who has sought to avoid taxes with clever schemes gets hit with a large tax liability or criminal prosecution. Anecdotally, I know that many members of the tax professional community did gloat over the travails of Jenkens & Gilchrist, KPMG, and earlier, Kanter and Eisenberg without any sense of conviction that those professionals did anything reprehensible.

435. *See infra* note 492 and accompanying text.

436. Consider the Beatles and their 1966 song "Taxman" that alluded to the 95% maximum income tax rate in Great Britain to which each of them was subject. There was publicity at the time concerning whether the Beatles might expatriate to avoid those confiscatory rates and speculation about whether taxes might have caused the band's dissolution. *See* Tim Andrews, *How High Taxes Broke Up The Beatles*, AMS. FOR TAX REFORM (Sept. 15, 2009, 12:52 PM), http://www.atr.org/index.php?content=091509_Beatles#; Andrew Leonard, *Did the Taxman Break Up the Beatles?*, SALON.COM (Sept. 15, 2009, 9:52 AM), http://mobile.salon.com/technology/how_the_world_works/2009/09/15/the_taxman_and_the_beatles.

437. Many "tax havens" are Caribbean and Pacific islands, as well as the nations of Switzerland and Lichtenstein, although one probably would not view them as warm weather destinations. Similarly, the state of Florida—where many Canadians and Europeans have first or second homes—has no personal income tax. Richard K. Gordon, *On The Use and Abuse of*

Communication depends little upon one's physical location. Transmission of voice, image, and data is substantially instantaneous whether across the room or across the world. Production in developed economies increasingly is service-based, and, at the upper income levels, independent of physical location. Individuals in service industries often can provide their services without physical proximity to the service recipient.[438] Much manufacturing has shifted to less developed economies because of lower production costs. Even in some service industries requiring physical proximity, service recipients have begun to follow the availability of service providers, especially where cost savings are possible.[439]

If people once viewed taxes as "what we pay for civilized society"[440] and as a collective obligation we accept and possibly even embrace, tax aversion has supplanted those views. Despite decline in tax rates over the past fifty years,[441] recent opinion surveys disclose that taxpayers in the United States think tax rates are too high.[442] The "flat tax" movement has many adherents

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Standards for Law: Global Governance and Offshore Financial Centers, 88 N.C. L. REV. 501, 519 (2010).

438. This phenomenon has become problematic as outsourcing of product support to low wage jurisdictions has become common.

439. Joshua Kurlantzick, *Sometimes, Sightseeing is Looking at Your X-Rays*, N.Y. TIMES, May 20, 2007, at 10 (noting Thailand's increasing medical tourism is due to high-quality care and low cost); M.P. McQueen, *Paying Workers to Go Abroad for Health Care*, WALL ST. J., Sept. 30, 2008, at B9 (noting some insurers and employers are realizing the savings possible with medical tourism and are including the option in health care coverage).

440. Compania Gen. de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting) (addressing the power to tax insurance non-uniformly).

441. With limited exceptions, both corporate and individual income tax rates in the United States have declined since 1965. *Compare* I.R.C. §§ 1, 11 (2006), *with* I.R.C. §§ 11, 2001 (1982); *see also* Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 303 (2003). The rate reductions have been more pronounced at the upper end than the lower end with a maximum rate reduction overall from 70% to 35% (with a short period of 28%). I.R.C. § 1 (2006); *see also* Alice Gresham Bullock, *The Tax Code, the Tax Gap, and Income Inequality: The Middle Class Squeeze*, 53 HOW. L.J. 249, 256–57 (2010). The rate on net capital gain and many corporate dividends that low income individuals do not receive regularly, but high income individuals do, is even lower at a general maximum rate of 15%. I.R.C. § 11 (2006). At the same time, there has been a significant increase at the federal level in wage-based taxes that have a disparate negative impact on low and middle class taxpayers rather than high income tax from 10% to 15.6%. Michael J. Graetz, Essay, *Tax Policy at the Beginning of the Clinton Administration*, 10 YALE J. ON REG. 561, 571–72 (1993). Note, however, that new I.R.C. § 1411, as added by the Health Care and Education Reconciliation Act of 2010, Pub. L. 111-152, § 1402, 124 Stat. 1029, 1060–63, imposes a 3.8% Medicare Tax on unearned income over a threshold amount and eliminates part of the regressivity in the employment-based taxes, Medicare and Social Security.

442. Andrew Chamberlain, Tax Found., *What Does America Think about Taxes? The 2007 Survey of U.S. Attitudes on Taxes and Wealth*, SPECIAL REP., Apr. 2007, at 1, *available at* http://www.taxfoundation.org/news/show/22331.html) (finding that 58% of American adults

whose income tax rates already are low but may increase with a true flat rate tax if the tax is to raise the revenue necessary to fund the current level of government services.[443]

Similarly, there has been serious discussion of replacing a progressive income tax with a consumption tax, including a national sales tax and a value added tax. A sales tax would simplify collection by collecting only from vendors and service providers and limiting the opportunities for complex tax planning structures to diminish taxes. A sales or value added tax would not eliminate tax evasion[444] as these taxes substitute a regressive tax model for the progressive one that has dominated U.S. tax policy since World War II. Models of consumption taxes such as the value added taxes prevalent in Europe[445] are regressive relative to income and wealth and, accordingly,

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consider income tax rates too high). *But see* Karlyn Bowman, *What Do Americans Think about Taxes?*, 123 TAX NOTES 99, 99 (2009) (finding 60% of those surveyed thought the amount they would pay in taxes was "fair"); Karlyn Bowman, *What Do Americans Think about Taxes? An Update*, 127 TAX NOTES 917, 917 (2010) (showing survey results demonstrating that Americans think taxes are high but fair, and have little understanding of progressivity).

443. "Flat tax" is a misnomer as a flat tax in fact would be a capitation tax. Proponents of a flat tax refer to a single rate of tax on all taxpaying individuals without regard to their income. The flat rate income tax proposals recommend broadening the base and lowering the rate, but all include a zero rate for some taxpayers. Some current low rate taxpayers probably would move from their current low rates under the United States' mildly progressive rate structure either to the lower zero rate or the higher flat rate. *See generally* LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 100 (2002); John F. Coverdale, Comment, *The Flat Tax is Not a Fair Tax*, 20 SETON HALL LEGIS. J. 285 (1996).

444. For discussion on the vulnerability of the value added tax (VAT) to evasion and fraud, see Richard T. Ainsworth, *Carousel Fraud in the EU: A Digital VAT Solution*, 42 TAX NOTES INT'L 443, 445 (2006); Richard T. Ainsworth, *CO_2 MTIC Fraud—Technologically Exploiting the EU VAT (Again)*, 57 TAX NOTES INT'L 357, 357 (2010); Richard T. Ainsworth, *Tackling VAT Fraud: 13 Ways Forward*, 45 TAX NOTES INT'L 1205, 1207 (2007).

445. Throughout Europe the value added tax accounts for 40% to 60% of tax collections (other than social contributions). Thus, the VAT accounts for approximately the same proportion of revenue as the income and wealth taxes combined, and diminishes the importance of income tax avoidance. ALLESANDRO LUPI, EUROSTAT, TAX REVENUE IN THE EUROPEAN UNION 3 (2010), *available at* http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-10-023/EN/KS-SF-10-023-EN.pdf (noting taxes on production and imports made up 33% of tax revenue in the European Union in 2008); ORG. FOR ECON. CO-OPERATION & DEV., LUCERNE CONFERENCE: COMMUNIQUÉ 2 (2009), *available at* http://www.oecd.org/dataoecd/19/12/43669264.pdf (noting the VAT accounts for 18.6% of total tax revenue across European countries); Ordower, *supra* note 2, at 276 (noting Germany's turnover tax, similar to a VAT, brings in about 50% of its tax revenue). The membership of the European Union formally adopted a Value Added Tax convention to limit VAT competition so that each member state must maintain a VAT rate of at least 15%. Council Directive 2006/112, art. 97, 2006 O.J. (L 347) 1 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0112:20100409 (outlining the common system of value added tax); s*ee also* Walter Hellerstein & Timothy H. Gillis, *The VAT in the European Union*, 127 TAX NOTES 461, 462 (2010).

contrary to the economic interests of the bulk of the taxpaying public. Only relatively well-to-do individuals avoid broad-based consumption taxes by investing substantial portions of their income and wealth rather than consuming to acquire basic goods and services. Consumption-type taxes such as add-on sales taxes, although regressive for the bulk of the consuming public in the United States, are easier to pass at the state level than are increases in the state's progressive or proportional income tax or *ad valorem* property tax. Despite apparent preference for consumption taxes, the public avoids the sales tax. Consumers prefer to purchase from out-of-state, internet-based businesses rather than in-state businesses in order to avoid sales tax.[446] Generally, those consumers evade the state's use tax that complements the sales tax.[447] Most states do not enforce the use tax actively. Smuggling of cigarettes across state lines to evade high consumption taxes on cigarettes also is fairly common.[448]

Also expressing tax views contrary to their personal economic interests are taxpayers in the same survey who consider the steeply progressive estate tax to be the least fair tax. They support estate tax repeal even though it impacts only a narrow band of the wealthiest Americans.[449] While it is possible that the American public sincerely believes it is unfair to tax large estates at death, or that people believe that they will be part of that estate-taxable elite when they

446. A state may compel a vendor to collect a sales tax on sales to its residents if the vendor has a physical presence in the state. If the vendor has no physical presence, the state may not compel it to collect the sales tax. Some states, including New York and New Jersey, have begun to require internet vendors to collect the sales tax so long as they have an associated vendor in the state. Amazon.com LLC v. N.Y. State Dep't. of Taxation & Fin., 887 N.Y.S.2d 842, 845 (N.Y. Sup. Ct. 2009); Drugstore.com, Inc. v. Div. of Taxation, 23 N.J. Tax 624, 644–45 (N.J. Tax Ct. 2008).

447. Purchasers resident in the state must pay, but infrequently do pay, a use tax equal to the sales tax.

448. Matthew McMahan, Note, *The International Effects of Adoption of the Consumption Tax in the United States*, 39 VAND. J. TRANSNAT'L L. 519, 540 (2006) (stating that the consumption tax gives great incentive to smuggle cigarettes on the black market because state taxes vary up to sixty-three point five cents per pack among the states); *see also* Bruce Bartlett, *Cigarette Taxes, Smuggling, and Revenues*, 63 TAX NOTES 1493, 1496 (1994) (citing ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, CIGARETTE BOOTLEGGING: A STATE AND FEDERAL RESPONSIBILITY (1977), a 1977 report from the Advisory Commission on Intergovernmental Relations that concluded states were losing over $391 million per year in revenue due to cigarette smuggling).

449. Chamberlain, *supra* note 442, at 6 (finding that two-thirds of U.S. adults favor estate tax repeal and consider the estate tax to be the most unfair tax). Even if Congress does not modify the estate tax, and its rates and exemptions revert automatically to their 2001 levels after 2010, most Americans' estates never would become subject to the estate tax. *See* I.R.C. § 2010 (2006). Tax legislation at the end of 2010 temporarily changed the maximum estate tax rate to 35% and exempted the first $5 million of estate value from the tax. The change expires at the end of 2012. I.R.C. § 2010(c) (2006), *amended by* 2010 Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act, Pub. L. No. 111-312, §§ 302, 304, 124 Stat. 3296, 3301–04 (2010).

die, a more likely explanation for opposition to the tax—now labeled rhetorically the "death tax"— is a concerted effort to sway public opinion to demonize the tax.[450] That effort has been nearly evangelical.[451]

Taxpayers who work in low-paying service positions such as domestic employment—also contrary to their economic interests—frequently forgo claiming the earned income tax credit[452] and, in the longer term, social security benefits,[453] in order to avoid having to report their wages and enter the system. While many low wage workers are undocumented workers who would not be able to claim the earned income tax credit[454] or participate in Social Security, the urge to remain outside the tax system affects many United States citizens as well and reflects a deep-seated distrust of the tax administrator. The preference not to report income also may arise from failed delivery of useful information concerning the earned income credit and Social Security.[455] At least part of the information failure derives from passive and sometimes active dissemination of misleading information. Employers of low wage employees may prefer to pay cash to evade the employer's share and possibly the need to

450. Expenditures on lobbying efforts to repeal the estate tax were high; one group of eighteen super-wealthy families, having a collective net worth of at least $185.5 billion, spent almost a half-billion dollars of their own money between 1998 and 2006 to advocate for the repeal of the estate tax. CONOR KENNY ET AL., PUB. CITIZEN & UNITED FOR A FAIR ECON., SPENDING MILLIONS TO SAVE BILLIONS: THE CAMPAIGN OF THE SUPER WEALTHY TO KILL THE ESTATE TAX 8–11 (2006) (also found at 2006 TAX NOTES TODAY 80-28).

451. *See* Steve Forbes, *Perspectives on Taxes: Make Them Give Back Our Money*, L.A. TIMES, Aug. 7, 1998, at B9 (suggesting that the government "substantially cut or abolish inheritance or 'death' taxes. . . . Death taxes undermine family businesses and farms and impede growth."); George Lovejoy, *On Taxes, the Choice is Clear Between Bush and Forbes*, THE UNION LEADER (Manchester, NH), Dec. 29, 1999, at A14 (stating that Forbes's proposed flat tax would "immediately abolish . . . the estate tax, which punishes parents trying to pass on their farms and small businesses to their children."). Lovejoy also uses Forbes's famous line, "No taxation without respiration!" *Id.*

452. I.R.C. § 32 (2006).

453. In order to claim Social Security retirement benefits, the claimant must have Social Security credits received when his or her wages became subject to the Social Security tax. *See Number of Credits to be Eligible for Social Security Retirement Benefits*, SOC. SEC. ONLINE (Apr. 29, 2011, 4:28 PM), http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/356.

454. I.R.C. § 32 (2006).

455. Low income tax clinics, many of which received funding from the IRS, have overcome many individuals' reluctance to report their income and persuaded many low income individuals to file income tax returns and claim the credit. *See generally* MARGUERITE CASEY FOUNDATION, THE EARNED INCOME TAX CREDIT: ANALYSIS AND PROPOSALS FOR REFORM 1 (2005), *available at* http://www.caseygrants.org/documents/reports/MCF_EITC_Paper.pdf (also found at 109 TAX NOTES 1669 (2005)) ("There is widespread agreement that the EITC is important and effective. However, even among its supporters, there are three main concerns about its structure and operation. The first concern is the lack of participation by some eligible taxpayers. As many as 25 percent of the taxpayers eligible for the EITC fail to claim it.").

pay higher wages to enable the employee to pay the employee's share of the Social Security and Medicare taxes.[456]

Aversion to both taxation and its administrative accoutrements seems to have grown relentlessly over the latter half of the twentieth century. In the United States, demonization of the IRS has become a commonplace rhetorical device for members of Congress who are seemingly ignorant of their own role in creating the tax laws and the collection system.[457] From time to time, Congress ties the hands of its tax collector. For example, the IRS postponed a proposed round of Taxpayer Compliance Measurement Program (TCMP) audits in the early 1990s following Congressional hearings.[458] Historically, the audits were intrusive to the taxpayers that the IRS selected for the audits but provided critical information to facilitate the audit selection process. Congress's unwillingness to continue to fund the program ultimately led to discontinuation of the program, and the IRS continues to work on other methods to gather essential data.[459]

The IRS Restructuring and Reform Act of 1998 (the "IRRA")[460] probably marks the nadir of respect for the IRS and the height of cynicism about the

456. I.R.C. § 3101 (2006) imposes a 6.2% Social Security tax and a 1.45% Medicare tax on the wages of each employee, and I.R.C. § 3111 (2006) imposes an identical tax on employers on the wages of their employees. Only the first $106,800 of wages (or self-employment income under I.R.C. § 1401) is subject to the Social Security portion of the tax. For household employees, the employer may pay the employee's tax. That payment is includable in the employee's income (in many cases increasing the employee's eligibility for the earned income credit) but is not subject to the Social Security or Medicare tax. *See* I.R.S. Publ'n 926 (2011), *available at* http://www.irs.gov/publications/p926/ar02.html#en_US_publink100086732. Investment income was not subject to either the Social Security or the Medicare tax, so the tax was regressive relative to income and wealth. However, Section 1402(a) of the Health Care and Education Reconciliation Act of 2010, Pub. L. 111-152, 124 Stat. 1029, 1060–63 (adding § 1411 to the Code, effective for taxable years after 2012). This new section imposes a 3.8% Medicare tax on the income from investments and other unearned income of individuals. *Id.* The statute imposes the new tax only on taxpayers whose income exceeds $200,000 ($250,000 for married filing jointly). *Id.*

457. Members of Congress regularly refer to the Code as the IRS Code as if they were innocent of its origins. *See* Steven J. Willis, *Masks, Magic and Games: The Use of Tax Law as a Policy Tool*, 4 AM. J. TAX POL'Y 41, 44 (1985).

458. TCMP is the program under which the IRS selected taxpayers for audits and required them to produce documentation for each entry on their returns. The process was certainly time-consuming for the taxpayers, and often costly, as taxpayers paid for the time their professional advisors devoted to the audits on the taxpayers' behalf. *See* Jonathan S. Feinstein, *Approaches for Estimating Noncompliance: Examples from Federal Taxation in the United States*, 109 ECON. J. F360, F361, F363 (1999).

459. *GAO Reports on IRS Taxpayer Compliance Measurement Program*, 69 TAX NOTES 332, 332 (1995); George Guttman, *Citing Budget, IRS Announces Indefinite Suspension of TCMP*, 69 TAX NOTES 521, 521 (1995).

460. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685.

difficulty of the IRS's job. Congress adopted the IRRA following a period of heated anti-IRS rhetoric and hearings that highlighted purported abuses by IRS employees and featured the testimony of revenue agents who wore masks to hide their identities. The IRRA made tax collection more difficult by adding increased due process rights to appeal the collection process[461] and allowing taxpayers to shift the burden of proof to the government.[462] More significant, however, was the IRRA's "ten deadly sins": a list of ten acts, each of which would result in the immediate separation of an IRS employee from IRS employment.[463] Enactment of the "sins" certainly instilled fear in rank and file IRS employees who depended on the employment for their own livelihood and tended to make them less aggressive in collecting taxes often at the cost of much needed revenue.[464] Unsurprisingly, enactment of the sins into law resulted in a rash of complaints, but internal investigations determined that few complaints had any merit.[465] Numbers of complaints in more recent years have been few.[466]

In both Europe and the United States, the tax avoidance culture has generated extensive tax evasion.[467] The underground economy[468] grew rapidly, more than doubling relative to gross domestic product in the United States from 1970 to 2000,[469] and carried the tax gap along[470]—as both

461. *Id.* § 3401, 112 Stat. at 746–49 (imposing notice and hearing rights by adding I.R.C. §§ 6320, 6330).

462. *Id.* § 3001(a), 112 Stat. at 726–27 (adding I.R.C. § 7491, which enables taxpayers to shift the burden of proof in court proceedings to the government by producing "credible evidence").

463. *Id.* § 1203(b), 112 Stat. at 720–22 (requiring the Commissioner of Internal Revenue to dismiss any employee violating any of ten provisions, including harassing a taxpayer).

464. DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEMS TO BENEFIT THE SUPER RICH—AND CHEAT EVERYBODY ELSE 151–52 (2003).

465. Lee A. Sheppard, *News Analysis: The Sixth Deadly Sin*, 92 TAX NOTES 1018, 1018–19 (2001).

466. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-1039R, IRS' EFFORTS TO EVALUATE THE SECTION 1203 PROCESS FOR EMPLOYEE MISCONDUCT AND MEASURE ITS IMPACTS ON TAX ADMINISTRATION 19 (2004).

467. Of course, there is nothing new about tax evasion. It has existed undoubtedly in almost all cultures that have imposed taxes and has taken many forms from hiding from the tax collector, to concealing property including the proverbial still in the Virginia mountains, to covering windows to evade the window tax in eighteenth century England and Scotland. *See Request for a Window Tax Exemption, 1765*, THE NAT'L ARCHIVES, http://www.nationalarchives.gov.uk/pathways/citizenship/rise_parliament/docs/window_tax.htm (last visited Apr. 12, 2010); *The Cat and the Mouse*, MOONSHINE—BLUE RIDGE STYLE: THE HISTORY AND CULTURE OF UNTAXED LIQUOR IN THE MOUNTAINS OF VIRGINIA, http://www.blueridgeinstitute.org/moonshine/the_cat_and_the_mouse.html (last visited Apr. 12, 2010).

468. SCHNEIDER & ENSTE, *supra* note 231, at 3–4 (describing the size and growth of transactions outside international banking systems in order to avoid taxation).

469. *Id*.

concepts became part of the American vocabulary. As aggressive tax planning and avoidance became commonplace and neutral behavior, moral suasion to report income accurately carried little force. It no longer was the least bit unseemly to evade taxes in various harmless ways: not paying employment taxes on household employees, not reporting barter transactions, buying goods for delivery from out-of-state to avoid sales tax, making cash payments as part of price negotiation, reporting charitable deductions for purchases at charity auctions, etc.[471] It was not unusual to find designees to high public appointed office who did not pay Social Security taxes on their domestic employees or even on their own wages.[472] Their tax lapses provided political fodder to delay or prevent their appointment, but the same behavior in ordinary citizens seemed far less objectionable.

Recent surveys of attitudes toward tax evasion disclose that in the United States and most European countries, the majority of those surveyed consider tax evasion to be acceptable conduct under some circumstances.[473] Estimates of the size of the underground economy[474] and the tax gap[475] suggest that tax cheating occurs on very large scale. Cash payments and barter for goods and services enables individuals to receive but not report income that taxing authorities have very limited ability to detect. Many factors may contribute to high rates of tax evasion on both sides of the Atlantic Ocean, including high tax rates,[476] complexity of the law, cost of compliance, perceptions that specific groups (especially very high income individuals and businesses) are avoiding or evading taxes, and the incidence of illegal immigration.[477]

470. According to the IRS, the tax gap refers to unreported and uncollected tax revenue attributable to taxpayers failing to report. The IRS estimated a collection rate of approximately 84% and a tax gap of $290 billion in 2005. U.S. DEP'T. TREASURY, UPDATE ON REDUCING THE FEDERAL TAX GAP AND IMPROVING VOLUNTARY COMPLIANCE 2 (2009), *available at* http://www.irs.gov/pub/newsroom/tax_gap_report_-final_version.pdf.

471. Robert W. McGee et al., *The Ethics of Tax Evasion: A Comparative Study of Germany and the United States* (Oct. 2006) (unpublished working paper, Barry University), *available at* http://ssrn.com/abstract=936743.

472. Sydney N. Schanberg, *Contemplating Hypocrisy and Zoë Baird*, NEWSDAY (Nassau, NY), Jan. 26, 1993, at 75 (discussing how Zoë Baird withdrew her nomination for Attorney General under President Clinton after admitting she had hired an illegal immigrant as a housekeeper and did not pay her Social Security taxes); *Geithner's Tax Code*, WALL STREET J., Jan. 22, 2009, at A16 (noting Tim Geithner's nomination as Secretary of the Treasury was delayed when he admitted he had not paid payroll taxes for several years).

473. McGee et al., *supra* note 471, at 25, 27.

474. SCHNEIDER & ENSTE, *supra* note 231, at 3.

475. U.S. DEP'T. TREASURY, *supra* note 470, at 12.

476. Decreasing the rates of tax did not seem to dissuade aggressive tax planning and evasion following the TRA 86, discussion *supra* Part II.B, or avoidance of much lower rate state sales taxes, *supra* note 446 and accompanying text.

477. Since the end of the *Bracero* program in the mid-1960s, which permitted Mexican workers to do seasonal work in the United States, the number of unauthorized workers in the

Undocumented workers frequently are willing to work for lower wages than legal residents.[478] Otherwise law-abiding individuals employ undocumented workers and pay them cash, both because documented workers are not available for certain types of work at reasonable cost and because the undocumented workers often fear that reporting income will expose their presence in the country, subjecting them to deportation. That segment of the cash-based economy has become part of the local culture in both the United States and Europe.

Efforts to limit the opportunities for taxpayers to underreport their income have motivated Congress to increase information reporting in the United States. Information reporting helps to identify recipients of interest[479] and dividends,[480] but significant payment reporting from one's trade or business has gained only limited traction.[481] Despite statutory requirements, most

United States has steadily climbed. The U.S. Census estimated that in 1969 there were around 540,000 undocumented aliens in the United States; that number climbed to 11.5 million in 2006, with nearly two-thirds of the 11.5 million arriving after 1995. ÖRN B. BODVARSSON & HENDRIK VAN DEN BERG, THE ECONOMICS OF IMMIGRATION: THEORY AND POLICY 295, 305 (2009); *Illegal Immigration: Population Estimates of Undocumented Immigrants in the US, 1969–2009*, PROCON.ORG, http://immigration.procon.org/view.resource.php?resourceID=000844 (last visited Apr. 12, 2010).

478. *See* Francisco L. Rivera-Batiz, *Undocumented Workers in the Labor Market: An Analysis of the Earnings of Legal and Illegal Mexican Immigrants in the United States*, 12 J. POPULATION ECON. 91, 92 (1999) (offering anecdotal evidence of illegal immigrants accepting very low wages).

479. *See* I.R.C. § 6049 (2006) (requiring information reporting on payments of interest aggregating $10 or more).

480. *See id.* § 6042 (requiring information reporting on dividend distributions aggregating $10 or more).

481. *See id.* § 6041 (requiring information reporting on payments exceeding $600 or more in one's trade or business). While the IRS cannot determine how many reportable payments go unreported, the GAO determined that only some 8% of 50 million small businesses file Form 1099MISC for payments of $600 or more, suggesting that small businesses do not report many or their trade or business payments as I.R.C. § 6041 requires. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-238, TAX GAP: IRS COULD DO MORE TO PROMOTE COMPLIANCE BY THIRD PARTIES WITH MISCELLANEOUS INCOME REPORTING REQUIREMENTS 17 (2009). Congress extended this reporting requirement to additional transactions in 2010 with Section 210(a) of the Small Business Jobs Act. Small Business Jobs Act of 2010, Pub. L. 111-240, § 210(a), 124 Stat. 2504, 2561. The reporting requirement was projected to raise almost $22 billion in tax revenue. H.R. REP. NO. 112-15, at 7 (2011) (noting the Congressional Budget Office estimated repealing the provision would cost $21.9 billion in tax revenue over ten years). Nevertheless, Congress quickly repealed the extended reporting requirement in response to lobbying against the provision. Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, Pub. L. No. 112-9, 125 Stat. 36 (codified in scattered sections of 26 U.S.C.). *See also* H.R. REP. NO. 112-15, at 2 (2011) (noting that "it is now widely acknowledged" that the burdens of reporting outweigh the potential benefits of improved tax compliance); *NFIB Leads Successful Grassroots Effort to Repeal1099 Reporting Requirements*,

individuals employing household workers like nannies, cleaners, and gardeners, to whom wages payments are not deductible, have an extremely low compliance record for reporting those payments [482] despite high visibility incidents of non-reporting costing the responsible individual a government appointment.[483] Off-economy barter arrangements became significant enough to warrant issuance of guidance from the IRS[484] and a statutory information reporting requirement.[485] Yet, in some cases, Congress has stymied the IRS's efforts to collect taxes, and the IRS was correctly identified as contributing to the underreporting of income.[486]

If lower- and middle-income taxpayers are evading taxes, they have taken their cultural cue from the high net worth end of the population spectrum. Individuals with high income and wealth pay taxes at an increasingly lower rate in the United States.[487] The low rates are partially a product of capital gain and dividend rate preferences,[488] and partially a function of tax shelter investments and other forms of aggressive tax planning.[489] Many wealthy Americans also evade taxes.

Recent events in Europe and the United States concerning offshore accounts and hidden income have disclosed that high net worth individuals

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NFIB, http://www.nfib.com/issues-elections/issues-elections-item?cmsid=56314 (last visited Apr. 15, 2011).

482. Ron Lieber, *Doing the Right Thing by Paying the Nanny Tax*, N.Y. TIMES, Jan. 24, 2009, at B1 (offering various estimates stating that 80% to 95% of those who employ household workers do not comply with required reporting of Social Security taxes for those employees).

483. Schanberg, *supra* note 472, at 75.

484. Rev. Rul. 79-24, 1979-1 CB 60–61 (1979) (holding a bartered services are taxable to all parties).

485. I.R.C. § 6045 (2006) (requiring information reporting by brokers including barter exchanges).

486. For example, in 1978, Congress placed a moratorium on fringe benefit regulations and collection of taxes on fringe benefits. *See* Act of Oct. 7, 1978, Pub. L. No. 95-427, 92 Stat. 996 (codified in scattered sections of 26 U.S.C.). Ultimately, Congress enacted statutory fringe benefit exclusion provisions. Deficit Reduction Act of 1984 (DEFRA), Pub. L. No. 98-369, § 531(a)(1), 98 Stat. 494, 877–88 (adding I.R.C. § 132). Fringe benefit exclusions remain problematic from the perspective of equality principles in that they permit some taxpayers to consume goods and services without paying for them, while taxpayers who pay for comparable goods and services may not deduct the cost in determining their taxable income because the expenditures are personal, living, or family expenses nondeductible under I.R.C. § 262.

487. David Cay Johnston, *Tax Rates for Top 400 Earners Fall as Income Soars*, 126 TAX NOTES TODAY 916, 916 (2010), *available at* 2010 TNT 32-C (LEXIS) (showing a steady reduction in effective tax rates and increase in income for the top 400 earners in the United States from 1992 to 2007); *see* PARISI & STRUDLER, *supra* note 39, at 7, 10.

488. *See* I.R.C. § 1(h) (2006) (providing a general maximum rate on net capital gain as defined in I.R.C. § 1222(11) and a general dividend rate of 15%, with the dividend rate maximum set to expire at the end of 2010).

489. *See supra* Part I.

have evaded taxes of massive proportions in both Germany and the United States. For wealthy individuals, bank secrecy laws facilitate tax evasion. Those individuals frequently deposit large sums in financial institutions in countries that have strong bank secrecy protections.[490] Despite taxation of residents on interest and dividends worldwide in Germany, for example,[491] taxpayers fail to report earnings from those secret deposits.

Recently, the German taxing authorities purchased an electronic database from a Liechtenstein bank employee that disclosed the names of many well-known and wealthy Germans who were evading German taxes with a scheme that involved the use of *Stiftungen*[492] for private benefit.[493] The *Stiftungen* deposited assets in Liechtenstein banks, and the accounts and their underlying ownership were invisible to German taxing authorities until German prosecutors purchased a CD-ROM from a former Liechtenstein bank employee containing the names of German residents with *Stiftungen* in Liechtenstein.[494] Liechtenstein permitted the individuals who established the *Stiftungen* to withdraw funds from the *Stiftung*'s accounts for the private expenses of the individual and his or her family while the individual and family members were outside Germany.[495]

Financial institutions in Switzerland and Liechtenstein have actively facilitated tax evasion in both the United States and Germany by marketing

490. Historically, Luxembourg, Switzerland, Liechtenstein, and the Channel Islands all protected the identities of their depositors, but the Organization for Economic Cooperation and Development began a tax haven project in 1996 to combat unfair tax competition by blacklisting countries that facilitated home country tax avoidance through refusal to share information with home countries on income from and investment in the tax haven. The project identified the countries listed above as tax havens because of their bank secrecy laws. Luxembourg, the Channel Islands and Switzerland all have begun to cooperate with national taxing authorities to provide information to help the authorities identify tax evaders. Liechtenstein has resisted cooperation. *See What is the U.S. Position on Offshore Tax Havens?: Hearing Before the Permanent Subcomm. on Investigations, S. Comm. Governmental Affairs*, 107th Cong. 1–5 (2001) (statement of Sen. Carl Levin); Randall Jackson, *OECD to Update Tax Haven Criteria*, 50 TAX NOTES INT'L 109, 109 (2008).

491. Einkommensteuergesetz [EStG] [Income Tax Law], Oct. 16, 1934, BUNDESGESETZBLATT, Teil I [BGBL. I] at 3366, 3862, §§ 1(1), 2 (recodified Oct. 8, 2009) (amended Dec. 22, 2009) (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/estg/gesamt.pdf.

492. DAS GROSSE DEUTSCHES WORTERBUCH [GERMAN DICTIONARY], *supra* note 38, at 3427.

493. Kaiser, *supra* note 394.

494. Gerson Trüg & Jörg Habetha, Die Liechtensteiner Steueraffäre—Strafverfolgung durch Begehung von Straftaten? [The Liechtenstein Tax Matter—Criminal Pursuit through Commission of Criminal Offenses?], 13 NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 887 (2008). The purchase price was some 4.2 million Euros. *Id.*

495. Carter Dougherty & Mark Landler, *Tax Scandal in Germany Fans Complaints of Inequity*, N.Y. TIMES, Feb. 18, 2008, at C2.

accounts that conceal the identity of the account holder. The financial institutions have accepted and encouraged the use of controlled foreign entities to evade any reporting the institutions might be obliged to make to United States and German tax authorities.[496] Liechtenstein agreed in principle to share information with the United States in order to protect its qualified intermediary status.[497] As the United States has sought to bring U.S. taxpayers into compliance with both foreign account reporting requirements[498] and to collect underpayments of tax, the U.S. government prosecuted agents of a Swiss bank who had marketed secret Swiss accounts to American taxpayers.[499] The United States entered into a deferred prosecution agreement against Swiss financial institutions in exchange for an agreement to provide the U.S. accountholder information.[500] Swiss courts initially rejected all or part of those agreements as violative of Swiss bank secrecy laws, but more recently the Swiss Parliament approved the release of client information for thousands of American bank account holders.[501]

496. STAFF OF PERMANENT S. SUBCOMM. ON INVESTIGATIONS, 111th CONG., TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 3 (Comm. Print. 2008).

497. *See* Ordower, *supra* note 395, at 5.

498. All United States persons who have a financial interest in a foreign account holding $10,000 or more must file a Report of Foreign Bank and Financial Account (FBAR) (Form TD F 90-22.1) annually. *See generally Report of Foreign Bank and Financial Accounts (FBAR)*, IRS.GOV, http://www.irs.gov/businesses/small/article/0,,id=148849,00.html (last visited June 1, 2011) (providing questions and answers concerning the FBAR filing requirement).

499. The United States indicted UBS Bank executive, Raoul Weil, in 2008 for conspiracy to defraud the United States for his role in the cross-border business, and he is now considered a fugitive; former UBS private banker, Bradley Birkenfield, pleaded guilty in 2008 to conspiring to defraud the United States for similar conduct. Press Release, U.S. Dep't of Justice, UBS Enters into Deferred Prosecution Agreement (Feb. 18, 2009), *available at* http://www.justice.gov/tax/txdv09136.htm.

500. *Id.*

501. UBS and the Swiss government have been adamant that Swiss bank privacy laws prevent UBS from revealing the names of some 52,000 Americans depositors. While UBS did agree to hand over the banking information of 4,450 American depositors to the United States government, the Swiss government tried to block this release of information as contrary to Swiss bank secrecy laws. The Swiss Federal Administrative Court ruled in January 2010 that for UBS to hand over customer banking information would be illegal. *All Things Considered: Banking Flap Strains U.S.-Switzerland Relations* (NPR broadcast Aug. 1, 2009), *transcript available at* http://www.npr.org/templates/story/story.php?storyId=111464413; *2nd Swiss Court Ruling Complicates Life for UBS & Swiss Government*, BANKING NEWSLINK (Jan. 26, 2010), *available at* http://www.allbusiness.com/legal/trial-procedure=decisions-rulings/13786899-1.html. On June 17, 2010, though, the Swiss Parliament decided to forgo a national referendum on the matter of bank secrecy law violations and agreed to honor the deferred prosecution agreement, allowing for the disclosure of account information on 4,450 UBS accounts held by American clients. *See* Lynnley Browning, *Swiss Approve Deal for UBS to Reveal U.S. Clients Suspected of Tax Evasion*, N.Y. TIMES, June 18, 2010, at B3.

CONCLUSION: CHANGING THE CULTURE

I do not believe that the current complexity of the tax law necessarily fortifies the disrespect for taxation so characteristic of the tax avoidance culture. Rather, complexity is a by-product of using the tax system to drive social policy and deliver a wide range of economic incentives and disincentives. Taxation law has moved so far from a public perception of fairness and necessity that radical changes are critical to overcoming years of anti-tax rhetoric and activity. I see the following four steps—which require considerable and very unlikely legislative resolve to implement—as essential to promote cultural change:[502]

1. Wean legislatures from using the taxation system to deliver incentives or subsidies.
2. Fund a massive compliance effort.
3. Adopt wide-scale withholding to complement information reporting, and broaden both.
4. Advertise and educate, emphasizing the services that tax revenue provides.

Disincentives are less troubling than incentives. Several countries have used special punitive taxes to discourage certain socially undesirable behaviors including alcoholism, smoking and even unnecessary automobile use.[503] Even in those instances, however, critics have argued that such behavior-based or "sin" taxes impact lower income individuals disproportionally[504] and do not consistently modify behavior.[505]

Delivery of incentives and subsidies through the tax system makes the tax laws complex. Subsidies require complex and detailed rules so that the government does not deliver the subsidy to claimants who fail to engage in the activity that the legislature wishes to promote. Nevertheless, experience with the tax shelter industry teaches that tax subsidies encourage aggressive tax planning to redirect the subsidies to taxpayers who engage in the subsidized activity inefficiently, or even not at all. Tax subsidies enable taxpayers with comparable incomes to pay vastly different amounts of tax. Whether the tax

502. David Cay Johnston, *Tax Favors, IBM, and the Murder of Vernon Hunter*, 126 TAX NOTES 1137, 1137 (2010) (arguing it is critical to end targeted tax benefits in light of the tax protestor who crashed his plane into IRS headquarters).

503. Joel S. Newman, *Slinking Away From Twinkie Taxes*, 113 TAX NOTES 1155, 1156 (2006).

504. Jonathan Gruber, *Taxing Sin to Modify Behavior and Raise Revenue*, EXPERT VOICES, Apr. 2010, at 1 (noting taxes on cigarettes, alcohol, and goods causing obesity disproportionately affect low-income individuals who spend a greater proportion of their income on these goods).

505. *See* Catherine Rampell, *Do Sin Taxes Really Work?*, N.Y. TIMES UPFRONT, Sept. 6, 2010, at 22.

incentives are desirable or their distribution, fair seems to be of little importance to the development of the culture. If one perceives that others who have equal or greater incomes pay less tax, a conclusion that the tax system is not even-handed is self-evident. Simplification of the tax laws by using them to collect revenue for governmental purposes only is critical to cultural change but especially hard to sell to legislatures that have habituated themselves to hiding subsidies in tax incentives.

Tax administration requires funding in order to do its job completely. Statistics show that the average revenue agent collects many times his or her salary and benefits in tax revenue.[506] I am not suggesting that revenue agents should work on commission with salaries being a function of the revenue they generate.[507] Tax collection requires resources so that playing the audit lottery becomes a bad bet. Increase in the audit rate would encourage compliance. Increasing identification of and attention to taxpayers who have the ability to underreport will narrow the tax gap. The compliance effort must begin with high income or wealthy taxpayers to dispel the common perception, whether or not justified, that the wealthy can avoid tax with impunity.

Information reporting is a wonderful idea that provides a wealth of information.[508] Eventually, the IRS will be able to use all the information for matching efficiently and accurately. As good as information reporting may be, withholding at the source would be better.[509] Wage withholding initially was unpopular. Yet, despite many employers' ongoing efforts to define their employees as independent contractors to avoid withholding and the employer's share of the Social Security tax, wage withholding has developed into a commonplace feature of employment payroll. Wage withholding passes almost unnoticed in most cases. Most information reporters equally could withhold taxes as report income. For those who have information, but no control over the funds that change hands, a requirement of advanced and detailed reporting as a condition to accepting appointment is critical to replace withholding where withholding is not practical. Withholding compels compliance.

Done correctly and carefully, massive education and advertising complementing tax simplification and enhanced compliance resources might

506. *See generally Fiscal Year 2009 Enforcement Results*, IRS.GOV, http://www.irs.gov/pub/irs-drop/fy_2009_enforcement_results.pdf (showing enforcement results from fiscal years 2000–2009 and disclosing nearly $3 million in collections for each key full-time equivalent enforcement employee on individual returns with an examination coverage of only about 1%).

507. The George W. Bush Administration attempted this paradigm with mixed success when it contracted with third party debt collectors to collect overdue tax payments. *See* Amy Hamilton, *The "Fight" Over the IRS Hiring Private Debt Collectors*, 101 TAX NOTES 321, 322 (2003).

508. *See supra* notes 479–85 and accompanying text.

509. However, Congress lacks resolve to require more extensive information reporting, so extended withholding seems unlikely. *See supra* note 481.

change attitudes and the culture.[510] In the United States, the IRS has publicized some successes well and with effect. Failure of Jenkens & Gilchrist and the prosecutions, albeit unsuccessful overall, of KPMG parties were discomforting to the tax professional community and may have caused some professionals to rethink the advice they were giving clients. The recent "son of boss," SILO/LILO, and foreign account initiatives met meaningful, but incomplete, success in moving taxpayers away from those behaviors. While a well-funded counter-campaign is likely to emerge, publicity of collection from highly visible, high income and wealthy tax avoiders demonstrates to a wide range of taxpayers at varying levels of income and wealth that the tax system seeks to collect fairly from all. At the same time, I envision an advertising campaign of public service-type announcements reminiscent of the anti-drug advertising. The campaign should balance the positive and negative, emphasizing the great benefits that tax collections fund—education, police, fire and military protection—and the negative of the relative-certainty of negative consequences from failing to report and pay.

510. The Tax Literacy Project, a website hosted by Arizona State University School of Law, incorporates many of the ideas suggested by this paper. *Tax Literacy Project*, ARIZ. STATE UNIV., http://www.law.asu.edu/programs/Programs/TaxLaw/TaxLiteracyProject.aspx (last visited May 31, 2011).