Abstract - This paper provides a narrative of recent government efforts to regain control over tax shelters, while occasionally pointing out how all of the approaches to dealing with tax shelters reflect efforts to answer the same basic, yet fundamental, question—what is a tax shelter? The compulsion to construct the definitive definition of a tax shelter has persisted for decades, and this paper offers some reasons for this persistence, concluding with a bit of speculation on whether the search for that definition ultimately will come to fruition or, rather, result in a permanent campaign against tax shelters.

INTRODUCTION

While perhaps not the most significant evidence in terms of dollars consumed, if ever there was an indication of the economic wastefulness of tax shelters and other tax motivated transactions, it is the countless hours and years that have been spent by a procession of government tax officials trying to address the tax shelter problem in a conclusive way. This is not necessarily news to those in government who have grappled with the problem of tax shelters, as suggested in the following introduction to a discussion of the issue by the staff of the Joint Committee on Taxation, prepared for the Senate Finance Committee in 2002:

Perhaps no single topic in the Federal income tax laws has been as vexing and difficult to address as tax shelters. In 1934, Judge Learned Hand made the statement, often cited since, that a taxpayer “may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.” Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), aff’d 293 U.S. 465 (1935). Since that time, taxpayers and administrators have struggled in determining the line between legitimate “tax planning” and unacceptable “tax shelters.” Even now, more than sixty-five years after Judge Hand’s opinion, there are disagreements on fundamental questions that lie at the heart of the tax shelter debate, such as the magnitude of the problem, why the problem exists, and appropriate responses to the problem. (Joint Committee on Taxation, 2002)
For many years now, the at-risk rules and the passive activity loss rules—which were enacted in 1976 and 1986, respectively, in what appear to have been successful efforts to slay the previous generations of tax shelters—have had a profound effect on the thinking behind strategies to combat the current round of tax shelter transactions (see, e.g., Whitmire and Lemons (2003), proposing modifications to the at-risk rules to apply the rules to recent tax shelters), which generally can be distinguished from their predecessors in that the transactions now are somewhat more customized, involve more large corporations, and entail a much higher degree of sophisticated financial intermediation.1

Much like the mythological goddess Medusa, the seeming triumph of the 1984 and 1986 anti-tax shelter efforts has continued to lure the best and brightest towards seemingly beautiful and elegant solutions that are permanent and self-enforcing. However, upon closer inspection (and public exposure), these solutions inevitably transfigure into a coiffure of serpents.

Although the efforts to comprehensively combat tax shelters—and tax avoidance in general—rival even the most profligate government spending programs in terms of the ratio of resources expended to results achieved, the campaign against tax shelters carries on and those involved in “the good fight” generally are perceived as valiant protectors of the tax base. To some extent, this paper is about what government officials have been trying to achieve in the area of tax shelters and why they keep trying.

In discussing what government officials have been trying to achieve, this paper provides a narrative of some of the recent legislative, regulatory, and administrative efforts to regain control—or at least the appearance of control—over the tax shelter industry. These efforts have been directed primarily at taxpayers, but promoters and other facilitators of tax shelters (including accommodation parties that take part in abusive transactions) increasingly have been the targets of these efforts.

As part of this narrative, this paper occasionally will point out how all of the various approaches to dealing with tax shelters reflect efforts to answer the same basic, yet fundamental, question—what is a tax shelter? A tremendous amount of ink already has been spilled trying to answer this question or explaining why the answer seems so elusive (see, e.g., Pearlman (2002), stating that “[t]he subject of tax shelters is such a difficult topic. We struggle for a definition; we debate whether there is a problem; and we search for a response.”), and it is not the objective of this paper to present yet another flawed definition or to reiterate all the reasons why a useful definition has not been found.2

It seems that there are as many definitions of a tax shelter as there have been efforts at combating them, with each new definition different than the last but equally unhelpful. The definitions have ranged from the amusingly colloquial (Herman (1999), quoting Professor Michael Graetz’s definition of a tax shelter as “a deal done by very smart people that, absent tax

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1 There also are similarities between today’s tax shelters and the tax shelters of yesterday. In both cases, the transactions generally have satisfied the literal requirements of applicable provisions of the Internal Revenue Code, Treasury regulations, and IRS guidance. These transactions often are referred to as “technical” tax shelters because the tax benefits that they provide technically are authorized by the relevant provisions (even if they arguably do not comport to various important judicial doctrines, such as the economic substance, sham transaction, substance over form, and step transaction doctrines).

Parenthetically, the use of terms such as “tax shelter” and “tax avoidance transaction” in this paper are intended to exclude the enjoyment of tax benefits (such as most tax credits, income exemptions, and the like) in a manner that clearly is contemplated by Congress and explicitly provided in the Internal Revenue Code. While the proliferation of these types of tax benefits in the tax law raises its own set of policy concerns, the tax shelters at issue in this paper involve transactions which purport to achieve results that are at variance with the intent of Congress and which most reasonable people would believe to be abusive.

2 Parenthetically, the use of terms such as “tax shelter” and “tax avoidance transaction” in this paper are intended to exclude the enjoyment of tax benefits (such as most tax credits, income exemptions, and the like) in a manner that clearly is contemplated by Congress and explicitly provided in the Internal Revenue Code. While the proliferation of these types of tax benefits in the tax law raises its own set of policy concerns, the tax shelters at issue in this paper involve transactions which purport to achieve results that are at variance with the intent of Congress and which most reasonable people would believe to be abusive.
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considerations, would be very stupid"), to the bureaucratically mundane (Internal Revenue Service (2005), defining an abusive tax shelter as a “tax transaction or scheme that shelters income from normal taxation by taking a tax position that is not supported by tax law or manipulates the law in a manner that is not consistent with the intent of the law”).

While the proffered definitions have changed over the years, the compulsion to construct the definitive definition of a tax shelter has persisted ever since Judge Hand gave the tax world Helvering v. Gregory. Drawing from the experiences of the author while in government,³ this paper offers a few reasons for this persistence and concludes with a bit of speculation on whether the search for that definition ultimately will come to fruition or, rather, result in a permanent campaign against tax shelters.

THE HEART OF THE CAMPAIGN AGAINST TAX SHELTERS—THE TAXPAYER

The primary target of the permanent campaign against tax shelters nearly always has been the taxpayer, although those who promote and supply taxpayers with abusive tax–motivated transactions have come under increasing scrutiny in recent years, as will be discussed in more detail below. In all likelihood, the reason for this stems from a general notion that taxpayers ultimately are responsible for what goes onto their tax returns, regardless of their level of sophistication in tax matters but particularly wealthy and corporate taxpayers who, after all, are the typical users of tax shelters.

While the emphasis of the struggle against tax shelters continues to remain on the taxpayer, what has changed is that the protagonists seem to have largely divided into two camps. One camp supports enhanced disclosure of certain transactions that display notional tax shelter characteristics, while the other camp favors injecting into substantive statutory law a common law anti–abuse principle of general applicability—the economic substance doctrine.

Sunshine as a Disinfectant

Late in the Clinton Administration, the Treasury Department published temporary and proposed regulations that were designed to enhance disclosure by taxpayers (and their advisors) of transactions that have attributes common to tax shelters. Unfortunately, these regulations suffered from two critical problems. First, although not intended by their drafters, the regulations were designed in such a way that it was rather easy for taxpayers and their advisors to avoid the disclosure requirements. Second, taxpayers had little or no incentive in any case to comply with the regulations because there was no statutory monetary penalty for noncompliance. Nevertheless, the regulations were an important advance because, while better disclosure may or may not be a sufficient condition for prevailing in the campaign against tax shelters, it certainly is a necessary one.

The regulations featured a disclosure regime that required corporate taxpayers to disclose to the IRS transactions in which they participated if the transactions fell into either of two categories (“reportable transactions”). The first category included transactions that were (1) the same as or substantially similar to transactions that the IRS determined in published guidance to be tax avoidance transactions (“listed transactions”), and (2) expected to reduce

³ From 2001 through 2005, the author served the United States Congress as legislation counsel for the Joint Committee on Taxation. During that time, the author was intimately involved in various legislative efforts directed at tax shelters and tax avoidance transactions.
the corporation’s Federal income tax liability by more than $1 million in a single tax year, or more than $2 million for any combination of tax years.

The second category included transactions that (1) were expected to reduce the corporation’s Federal income tax liability by more than $5 million in a single tax year, or more than $10 million for any combination of tax years, and (2) displayed at least two of six characteristics that are known to be common to tax shelters. These characteristics included: (1) participation in the transaction under conditions of confidentiality; (2) contractual protection obtained by the taxpayer (e.g., contingent fees, rescission rights or indemnities) that the intended tax benefits from the transaction will be sustained; (3) participation in the transaction as the result of promotion, solicitation or recommendation by persons who received or were expected to receive fees in excess of $100,000 because of the taxpayer’s participation; (4) a difference of more than $5 million between the financial accounting and tax reporting treatment of the transaction; (5) participation in the transaction by a party that is indifferent to its own tax consequences of the transaction (i.e., a tax–indifferent party); and (6) cross–border tax arbitrage.

Subsequent modifications to the regulations altered the second category, but the general framework of the category largely remained unchanged.

In order to avoid ensnaring legitimate business transactions in the disclosure regime, the regulations exempted several types of transactions from the disclosure requirements, such as those carried out in the ordinary course of business consistent with customary commercial practice where the corporation would have entered into the transaction without regard to tax benefits or where there was a longstanding and generally accepted understanding of the expected tax treatment in the public domain. Another exception exempted transactions from disclosure if the taxpayer reasonably determined that there was no reasonable basis under Federal tax law for the denial of any significant portion of the expected Federal income tax benefits from the transaction.

Combined with the absence of a penalty for noncompliance, the highly subjective “eye of the beholder” flavor of the exceptions to disclosure proved to be the undoing of the regulations. For the 2000 tax year, only 272 transactions were disclosed, with these disclosures coming from 99 taxpayers. Of these disclosures, 64 were listed transactions and 159 were attributable to only two types of transactions (Senate Committee on Finance (2002), statement of Mark A. Weinberger, Assistant Secretary of the Treasury for Tax Policy).

Responding to growing concern about the spread of tax shelters, particularly among corporations as the corporate governance crisis began to surface, the Treasury Department in 2002 announced a package of administrative actions and legislative proposals designed to shore up disclosure of transactions with tax avoidance features. During the intervening period between the publication of the original regulations and the 2002 announcement, public (or at least media) outrage about tax shelters—along with the corresponding pressure on politicians and government officials to respond to this outrage—increased dramatically, and the Federal budget went from black to red. The administrative actions announced in 2002 included a significant rewrite of the disclosure regulations that reflected the changed enforcement environment since the original temporary and proposed regulations were published.

The revised regulations, which have become final, extended the disclosure requirements to include non–corporate taxpayers (e.g., individuals, partnerships, S–corporations, and trusts) in addition to corporations and, most notably, completely reworked and greatly expanded the circumstances in which a taxpayer
must disclose to the IRS participation in a transaction. Under the revised regulations, the definition of a reportable transaction—meaning, a transaction that must be specifically disclosed to the IRS—includes the following general categories, some of which are carried over from the original temporary and proposed regulations (although without regard to general minimum monetary tax benefit thresholds) but any of which will cause a transaction to be a reportable transaction (rather than two of six, as under the original regulations in the case of transactions other than listed transactions): (1) any listed transaction; (2) any transaction offered under conditions of confidentiality; (3) any transaction offered with contractual protection to the taxpayer; (4) any transaction resulting in a significant tax loss (with significance determined based upon specified single-year and multiple-year dollar thresholds depending upon the type of taxpayer); (5) any transaction resulting in a difference between the financial accounting and tax reporting treatment of the transaction of more than $5 million; and (6) any transaction resulting in a tax credit in excess of $250,000 if the taxpayer has held the underlying asset for less than 45 days.

In revising the disclosure regulations, the Treasury Department held out the promise of enhanced disclosure by devising a much more expansive and objective framework of transactions that must be disclosed. On paper, this framework indeed appears to be much more straightforward and encompassing than were the original temporary and proposed regulations. In practice, it remains to be seen whether this promise will be fulfilled, although early indications are that the compliance burden imposed by the regulations upon even very conservative taxpayers is significant. The key question to be answered will be whether this increased burden is a worthwhile means of making progress in the campaign against tax shelters.

As mentioned above, one of the fundamental problems with the original temporary and proposed disclosure regulations (and, for that matter, the revised regulations for awhile) was the absence of any penalty for noncompliance. This changed with the enactment of the American Jobs Creation Act of 2004, which instituted severe penalties for failing to comply with the disclosure regulations as part of a package of new provisions designed to confront the resurgence of tax shelters. Examination of this package reveals two distinct patterns that are likely to continue in future tax shelter legislation. The first pattern involves the use of compliance with the taxpayer disclosure requirements to stratify other provisions of the Internal Revenue Code. The other pattern, somewhat similar in nature to the first pattern but also somewhat more troubling, involves the extension of the listed and reportable transaction regulatory framework beyond disclosure and, in the process, the incorporation of the framework into substantive (rather than merely administrative) law.

Assuming that the disclosure regulations and accompanying guidance are written and administered in a thoughtful manner, there seems to be little reason to object to treating compliant taxpayers differently from noncompliant taxpayers, as the first pattern suggests may happen with increasing frequency in forthcoming legislation. On the other hand, the second pattern should give pause to anyone who understands the context in which the listed and reportable transaction classifications were developed. As described above, these classifications evolved as an effort to compel taxpayer disclosure of transactions that may or may not be abusive, but that display one or more very broadly outlined tax shelter characteristics. Based upon the unhappy experience of the original temporary and proposed regulations, the disclosure net was cast very widely in the revised regulations,
which is viewed by many as an effective solution to tax shelters. Whether or not this is the case, it is important to point out that disclosure—no matter how extensive—is an administrative burden on taxpayers that does not affect substantive law, and one lesson to be drawn from recent efforts to enact both administrative and substantive legislation against tax shelters is that the chosen definition of a tax shelter (or potential tax shelter) absolutely must be calibrated to the consequences of falling within the definition, so that administrative consequences can be attached to a very broad definition (as is the case with the disclosure requirements relating to listed and reportable transactions) while substantive consequences must be limited to a more targeted definition.

Inflicting substantive consequences on taxpayers who engage in tax shelters always has been more attractive to lawmakers and government officials than imposing “mere” administrative consequences, but the price that must be paid for doing so is that the substantive consequences can only apply in well-defined circumstances, which necessitates a suitably distinguishing definition of a tax shelter. Understandably vexed by the difficulties in constructing a definition of a tax shelter, some proponents of substantive anti-tax shelter legislation have embraced the listed and reportable transaction classifications in the disclosure regulations and employed them as a definition of a tax shelter in substantive proposals (see, e.g., Joint Committee on Taxation (2005), proposing penalties on tax-exempt entities and entity managers for participation in listed transactions or certain reportable transactions without regard to whether the transaction ultimately is sustained upon administrative or judicial review). However, while the breadth of these classifications may be suitable for the disclosure regulations and perhaps some other administrative purposes, they simply are inappropriate for use in substantive legislation (unless, as discussed above, they are used to distinguish between taxpayers who comply with the disclosure regulations and those who do not). In short, the road to defining a tax shelter does not necessarily run through the disclosure regulations.

A Statutory Reality Check

For those who enjoy overheated controversy, nothing in the area of tax shelters fits the bill better than proposals to codify the economic substance doctrine. The economic substance doctrine is a longstanding judicial construct, generally recognized to have originated from the pen of Judge Hand in Helvering v. Gregory, and is one of several doctrines that can be applied to deny the purported tax benefits of tax-motivated transactions even when such transactions satisfy the literal requirements of the Internal Revenue Code. In its most general terms, the economic substance doctrine can be defined as a doctrine that applies to transactions that do not result in a meaningful change to the taxpayer’s economic position other than an ostensible reduction in taxes.

Codifying the economic substance doctrine may be thought of as a forward-leaning strategy to defeat tax shelters. Aside from the tautological complaint that codifying the economic substance doctrine would “chill” legitimate business transactions, perhaps the most common objection to doing so is that the economic substance doctrine is properly a flexible common law doctrine that should be left to courts to define as they apply the doctrine to individual cases. The corollary to this objection is that codifying the economic substance doctrine would “ossify” the doctrine, turning it into a rigid statutory rule the application of which is likely to be ill-suited to individual cases involving complex fact patterns. The Treasury Department has raised this concern, thus giving it legitimacy among critics of this proposal.
Yet these same critics also protest that specific proposals to codify the economic substance doctrine set forth vague, ill-defined terms and concepts that will be difficult to interpret and apply to individual cases. It is hard to find consistency in the argument that, on the one hand, the economic substance doctrine should be a pliable instrument of common law to be applied as a judge sees fit while, on the other hand, proposals to codify the economic substance doctrine suffer from imprecision in drafting. Presumably, judges would have no more or less difficulty filling in the details of a statutory economic substance doctrine than they do today with respect to the common law doctrine.

The basic idea behind the economic substance doctrine is to inject some measure of common sense into our otherwise objective and “rules-based”, yet highly technical and complex, system of taxation. However, most judicial doctrines are exquisitely amorphous, primarily because they develop through application to specific cases, and the economic substance doctrine is no exception. The economic substance doctrine often is intermingled with other similar doctrines, such as the business purpose doctrine and the sham transaction doctrine, which raises the question of whether it is even useful to think of these doctrines as separate principles in the first instance.

Beyond the ambiguity of the economic substance doctrine and its frequent confusion with other closely related doctrines, the articulation of the economic substance doctrine by different courts over the years has been plagued with inconsistency. Some courts have characterized the doctrine as a conjunctive test that requires a taxpayer to establish the presence of both objective economic substance (i.e., the transaction in question results in a meaningful change in economic position of the taxpayer) and subjective business purpose (i.e., the transaction in question was motivated to some sufficient degree by one or more non-tax business purposes) in order for the claimed tax consequences of the transaction to be sustained by the court. Other courts have described the doctrine as requiring only either objective economic substance or subjective business purpose in order for the transaction in question to survive judicial review. Still other courts have framed the economic substance doctrine as a unitary test, with objective economic substance and subject business purpose being simply more precise factors to consider in assessing whether the tax consequences of a transaction should be respected under the doctrine.

In applying the economic substance doctrine, many courts have focused their attention on analyzing whether the transaction in question carries with it the potential to provide the taxpayer with a profit without taking into account tax benefits (i.e., a pre-tax profit). However, as with the basic elements of the economic substance doctrine (i.e., objective economic substance and subjective business purpose), the courts have been inconsistent with respect to the requisite level—and, indeed, the very necessity—of proven pre-tax profit potential under the doctrine. Some courts have found a lack of economic substance in cases involving transactions that had a potential for pre-tax profit but the potential profit was insignificant in relation to the expected tax benefits of the transaction. In contrast, other courts have held that the economic substance doctrine requires merely a reasonable possibility of profit on a pre-tax basis, even if such profit potential is nominal in relation to the purported tax benefits of the transaction.

Ever since Gregory established that literal compliance with the statutory language of the Internal Revenue Code may not be enough, and that the tax law contains a “rule of reason” overhang, there has been a continual tension in the tax system between technical, objective tax rules that tend to be more self-enforcing—but also
more susceptible to manipulation—and the desire of the government to reserve for itself the right to assert that the expected results of technical compliance with the tax rules are subject to a determination that the rules intend such results. The invocation of the economic substance doctrine is a manifestation of this desire.

As the tax rules have grown ever more complex and interactive, the need for principles to act as a governor over the interpretation and application of the rules by taxpayers has grown concomitantly. This has become readily apparent in tax legislation, which is replete with provisions that grant plenary administrative authority either to deny, when appropriate, tax benefits generally provided by a statute or to ensure that loophole–closing statutes hit their intended targets. Yet, our tax system remains for now predominantly oriented towards objective and mechanical rules, technical compliance with which usually provides sufficient comfort to taxpayers in conducting their daily affairs.

Efforts to enshrine in the Internal Revenue Code a broad–based statutory “rule of reason”—based upon the economic substance doctrine—have been stepped up in recent years. The same confluence of events and trends that brought about the new disclosure rules discussed above also can be attributed to the push to codify the economic substance doctrine. Enhanced disclosure under the new rules and codification of the economic substance doctrine really represent nothing more than two different approaches to dealing with the same problem. Whereas the enhanced disclosure approach might be characterized as one of “if we can see it, then we can stop it,” the approach of codifying the economic substance doctrine (along with a severe penalty for violating the doctrine) is one of deterrence in the womb. Those who support codifying the economic substance doctrine tend to have less faith in the ability of the government to combat tax shelters simply through better disclosure. In part, this lack of faith stems from taxpayer victories in certain court cases that appeared to involve tax–motivated transactions. For some, these cases put into question the utility of enhanced disclosure if the government proves to be ineffective at challenging the disclosed transactions.

During the Clinton Administration, the Treasury Department produced a lengthy white paper on tax shelters, which included a proposal to codify a version of the economic substance doctrine (Department of the Treasury, 1999). At about the same time, the legislative push to codify the doctrine essentially began with a bill introduced by Representative Lloyd Doggett, a Democrat from Texas and a member of the House Ways and Means Committee. As modified in later versions that were introduced in subsequent Congresses, the Doggett bill provided a two–part definition of economic substance, and provided that a transaction has economic substance only if it satisfies both parts of the definition. Under the bill, a transaction would

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4 To reiterate a point made at the beginning of this paper, the framework for analyzing the economic substance doctrine is confined to the realm of technical tax shelters (i.e., transactions that literally comply with the tax rules but ostensibly provide tax benefits that clearly are unintended by such rules), and has little relevance to outright tax fraud and noncompliance with the tax laws. Nevertheless, it is important to recognize that the proliferation of technical tax shelters has some bearing on the problem of noncompliance generally because it is likely that noncompliance is driven to some extent by the perception that not everyone is paying their “fair share” of taxes due, in part, to the marketing and purchasing of technical tax shelters. This perception tends to become amplified when technical tax shelters attract high–profile media attention, as they have in recent years. Therefore, while technical tax shelters traditionally have been limited to the province of corporations and wealthy individuals, their deleterious impact on compliance has the real potential of permeating throughout the entire tax base.

5 The Doggett bill did not prescribe when the economic substance doctrine would apply to a particular transaction, implicitly leaving that determination in the hands of the courts. Thus, the bill would have permitted
have economic substance only if (1) the transaction changed in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (2) the taxpayer had a substantial non–tax purpose for entering into the transaction and the transaction was a reasonable means of accomplishing such purpose. In addition, the Doggett bill provided that a transaction would not be treated as having economic substance by reason of having a potential for profit unless (1) the present value of the reasonably expected pre–tax profit from the transaction was substantial in relation to the present value of the expected net tax benefits that would be permitted if the transaction were respected, and (2) the reasonably expected pre–tax profit from the transaction exceeded the risk–free rate of return.6 The bill also provided special rules dealing with the treatment of fees and foreign taxes for purposes of the pre–tax profit potential test, as well as special rules concerning leasing transactions and certain transactions with tax–indifferent parties. Under the bill, a transaction that was determined to lack economic substance would be subject to an increased substantial understatement penalty of 40 percent. In addition, the penalty would become a strict liability penalty, meaning that the usual reasonable cause exceptions to substantial understatement penalties would not apply. However, the bill provided that the increased substantial understatement penalty would not apply if the transaction was properly disclosed to the IRS (i.e., the penalty would be reduced from 40 percent to the generally applicable substantial understatement penalty of 20 percent), although the penalty would continue to be applied on a strict liability basis.

As a minority member of the Ways and Means Committee, Rep. Doggett initially did not generate much interest in his bill. However, this changed when Representative William Thomas, a Republican from California and chairman of the Ways and Means Committee, included a similar proposal to codify the economic substance doctrine in what would become the first of several bills to repeal the foreign sales corporation and extraterritorial income regimes following rulings by the World Trade Organization that the regimes did not comply with international trade agreements. The Thomas bill was similar to the Doggett bill in that it included the basic two–part conjunctive definition of economic substance, requiring both a meaningful change in the economic position of the taxpayer and a non–tax purpose for entering into the transaction, and an enhanced penalty (i.e., 40 percent substantial understatement penalty for undisclosed transactions and strict liability regardless of disclosure). The Ways and Means Committee never marked up the Thomas bill and, despite Democratic support for codifying the economic substance doctrine, no provision to codify the economic substance doctrine ever has appeared in a bill reported by the Ways and Means Committee or passed by the House of Representatives.

However, both the Senate Finance Committee and the Senate itself have been more favorably disposed to codifying the economic substance doctrine, at least in concept. While support for codifying the economic substance doctrine generally is stronger among Senate Democrats, several
bills containing a provision to codify the doctrine have been reported by the Senate Finance Committee and passed by the Senate, on a bipartisan basis.

Once provisions to codify the economic substance doctrine appeared in the Thomas bill and repeatedly in Senate bills, this approach to the tax shelter problem began to attract greater widespread attention and generated reams of commentary, almost all of it critical of the approach, and much of it ranging from the hyperbolic to the self-contradictory. One of the chief arguments put forward by opponents of codifying the economic substance doctrine is that doing so would imperil legitimate tax planning techniques that are not viewed as abusive and may even be permitted by specific provisions in the Internal Revenue Code or in Treasury regulations. Examples of such transactions that have been presented include, among other things, tax-free corporate spin-offs, elections to be treated as an S-corporation, tax-motivated asset sales, hedging transactions, so-called “check-the-box” elections out of corporate status, debt financing transactions, and tax-free corporate liquidations. Because these transactions generally are motivated by a purpose to minimize taxes, and because the economic substance doctrine would be codified as a rule of general applicability throughout the Internal Revenue Code, it has been argued that the IRS would be unconstrained from challenging such transactions on economic substance grounds.

However, the arguments that were made along these lines generally ignored two facts. First, the proposals to codify the economic substance doctrine were carefully drafted so that the doctrine would not apply automatically, but only if a court determined that the doctrine was relevant. Second, committee reports accompanying legislation that contained provisions to codify the economic substance doctrine always were clear that the doctrine would not apply to transactions that were clearly contemplated under the Internal Revenue Code and Treasury regulations. Nevertheless, efforts were made in later versions of the proposal to more explicitly indicate that the statutory economic substance doctrine was conditioned upon judicial invocation and to incorporate directly into statutory language the exception for clearly contemplated transactions.

Moreover, in an attempt to respond to concerns that a codified economic substance doctrine of universal application would jeopardize legitimate transactional tax planning, the staff of the Joint Committee on Taxation recently published an alternative proposal that would limit the application of the statutory doctrine to transactions that displayed certain features often found in abusive tax avoidance transactions (e.g., disparities between the basis and fair market value of assets, differing treatment of a transaction for financial accounting and tax reporting purposes, and dispositions of property held for a short period of time) (Joint Committee on Taxation, 2005, proposing to limit application of the statutory economic substance doctrine to specified “applicable transactions”). To the extent that this alternative constitutes a recommendation by the staff of the Joint Committee, publishing a proposal to codify the economic substance doctrine in any form is a significant change in the stated position of the staff with regard to codifying the economic substance doctrine. Previously, the Joint Committee staff had never taken a public position in support of, or opposition against, codifying the economic substance doctrine, stating only in general that the cost-benefit analysis with respect to entering into abusive tax avoidance transactions must change and that penalties imposed upon taxpayers who engage in such transactions must be severe (see, e.g., Joint Committee on Taxation, 2003, stating that “[t]he Joint Committee staff believes that stronger measures are necessary to discourage
transactions that lack a non–tax business purpose or economic substance. Such measures, however designed, must significantly increase the economic risk to taxpayers of entering into tax–motivated transactions.”). Not surprisingly, the reaction to the alternative proposal put forward by the Joint Committee staff generally has been negative.

It should be no surprise that the IRS has a mixed record when it comes to administering the tax laws, and administrability should always be an important consideration when evaluating tax legislation. However, the argument that a codified economic substance doctrine would be categorically more difficult to administer than other areas of the tax law rings hollow, given that the doctrine that would be codified did not materialize out of thin air. As opponents of codifying economic substance are eager to point out in arguing for the status quo, the doctrine has been a part of the common law of taxation for a very long time. Presumably, during all that time of administering the common law doctrine, the IRS could have (and, quite possibly, has) argued for the application of the doctrine to any or all of the innocuous tax planning transactions mentioned above. Why the IRS would not be able to administer the doctrine simply because it appears in substantially the same form in the Internal Revenue Code has never been satisfactorily explained.

Much (if not most) of the negative reaction to proposals to codify the economic substance doctrine also has featured the assertion that the courts over the years have developed and applied the doctrine in a flexible manner based upon the individual facts of specific cases, and that codifying the doctrine would handcuff the courts by removing their latitude in applying the doctrine however they see fit on a case–by–case basis. Senior officials of both the Treasury Department and the IRS frequently have expressed their opposition to codifying the economic substance doctrine, which presumably represents the official position of the Bush Administration—as opposed to the official position reflected in the Treasury white paper and budget proposals produced under the Clinton Administration that would have codified a version of the economic substance doctrine. On its own, this argument is an entirely reasonable one, although it does not explain why it is a satisfactory state of affairs when courts that do apply the economic substance doctrine as a two–pronged test do not at least uniformly apply the two prongs either disjunctively (requiring a transaction to satisfy either prong) or conjunctively (requiring a transaction to satisfy both prongs).

However, the potency of this argument seems to fade dramatically when coupled—as it almost always is—with apparently contradictory complaints about the ambiguity and subjectivity inherent in some of the statutory language employed in the codification proposals. It would seem that those who have a favorable view towards the flexibility of the doctrine as common law also should view with favor ambiguous and subjective language in a statutory doctrine that presumably leaves courts with the latitude to interpret such language in a flexible manner. Evidently, though, a malleable common law economic substance doctrine is for some reason preferable to a malleable statutory economic substance doctrine.

Regardless of what might or might not occur in a world in which the economic substance doctrine is statutory law, the key to understanding the proposals to codify the economic substance doctrine is to realize that the success of this approach to tax shelters would be inversely related to how often the doctrine is employed. In other words, this approach to tax shelters is all about deterrence ab initio and discouraging taxpayers from even considering entering into aggressive tax–motivated transactions with the threat of a statutory global anti–abuse rule.
Perhaps the strongest argument against codifying the economic substance doctrine is the one with the most empirical evidence, which is that a statutory economic substance doctrine cannot be the panacea to tax shelters when the government has as much difficulty as it does in demonstrating to a judge the factual elements needed to prove that a particular transaction lacks economic substance. This is not to say that court decisions that are adverse to the government necessarily are the result of ineffective litigation skills, although they sometimes appear to be. Many such decisions give the clear appearance that the judicial branch includes some generalist judges who sincerely believe that taxes are nothing more than a cost of doing business that permissibly can be minimized in any manner short of fraud, provided the means that are employed to minimize taxes comply with the technical requirements of the Internal Revenue Code.

The dispute between those who favor enhanced disclosure and those who favor codifying the economic substance doctrine as the most effective way to combat tax shelters has taken to resembling the ancient rivalry between cats and dogs. Nevertheless, the advocates of the two approaches are in reality trying to accomplish the same thing, which is to define a tax shelter. Whereas the new disclosure rules balance an admittedly over-inclusive definition of a tax shelter against relatively minor (and primarily administrative) consequences, proposals to codify the economic substance doctrine place significant pressure on articulating a very accurate definition of a tax shelter because the proposals generally are accompanied by severe penalties that would be imposed upon taxpayers who undertake transactions that do not have economic substance under the statutory definition. The failure so far to enact proposals to codify the economic substance doctrine (or any variants) represents a failure to devise a universally accepted tax shelter definition that can be employed to alter the ostensible tax consequences of abusive tax avoidance transactions. However, it does not represent the end of efforts to do so. Rather, it simply means that the endeavor will continue.7

A NEW DIRECTION FOR THE CAMPAIGN AGAINST TAX SHELTERS—THE PROMOTER

As indicated above, the focus of efforts to combat tax shelters traditionally has

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7 The recently decided case Coltec Industries, Inc. v. United States, 62 Fed. Cl. 716 (2004), is likely to provide additional impetus to efforts to codify the economic substance doctrine because the opinion appeared to question the validity of the common law economic substance doctrine as a matter of constitutional law, and practically invited Congress to codify the doctrine. Noting that “the current vitality of the ‘economic substance’ doctrine certainly is not clear,” the court in Coltec stated:

Under our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare . . . . Accordingly, the court has determined that where a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the “economic substance” doctrine to trump “mere compliance with the Code” would violate the separation of powers.

As part of its constitutional analysis of the common law economic substance doctrine, the Coltec court also observed that “a few days ago Congress passed a major federal tax bill, but again declined to codify the ‘economic substance doctrine.’ See American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. (2004).” Id. In conjunction with Coltec, another recent case involving the application of the economic substance doctrine to a highly tax-advantaged transaction has been cited as suggesting that Congress should codify the economic substance doctrine if it wants the courts to apply the doctrine with any vigor. TIFD III–E, Inc. v. United States, 342 F. Supp. 2d 94 (D.C. Conn., 2004) (concluding that the transaction in question had economic substance, stating that “the transaction, though it sheltered a great deal of income from taxes, was legally permissible. Under such circumstances, the IRS should address its concerns to those who write the tax laws.”).
been on taxpayers themselves, rather than those who advise them or those who accommodate them by agreeing to participate in shelter transactions for a fee. In part, the emphasis on sanctioning taxpayers has reflected a notion that, no matter how poorly they are advised and no matter who aids and abets them, taxpayers ultimately are responsible for their conduct and what they report on their tax returns. Moreover, it has proven to be exceedingly difficult to develop and draft penalties targeted at tax advisors and accommodation parties that effectively deter them from promoting or participating in lucrative tax shelter transactions while also appropriately distinguishing such conduct from more innocuous behavior.

However, while the emphasis on taxpayers as the central source of the tax shelter problem has never abated, a second front has been opened where tax shelter promoters, transactional accommodation parties, and other taxpayer advisors have come under increasing scrutiny. In part, this development has paralleled the intense examination of the role that various legal, accounting and financial advisors played in the recent spate of corporate scandals. Perhaps the most sensational episode that has occurred so far in this stage of the campaign was the investigation and hearings conducted by the Permanent Subcommittee on Investigations of the Senate Governmental Affairs Committee, which culminated in a minority staff report that documented certain findings and presented remedial legislative proposals (Permanent Subcommittee on Investigations, 2003). Because the subcommittee staff involved in the effort was long on investigative skills but short on expertise and experience in tax matters, many of the findings and recommendations offered in the report lack context and, thus, are flawed and generally overreaching. However, the committee performed a valuable public service overall by drawing much needed attention to an important source of the spread of tax shelters.

**Tightening the Circular Noose**

As part of its 2002 package of anti–tax shelter actions and proposals, the Treasury Department announced that it would be revising the Circular 230 standards and ethics rules for practice before the IRS. With regard to the portions of Circular 230 that relate to tax shelter matters, the Treasury Department proposed its revisions in late 2003 and finalized them in late 2004.

As with the disclosure regulations, this step in the campaign against tax shelters built upon work that began during the Clinton Administration, when the Treasury Department in January 2001 proposed revisions to the Circular 230 rules. The driving force behind the revisions was the entirely legitimate concern that legal opinions written by law and accounting firms were being used to entice taxpayers into undertaking abusive tax avoidance transactions. Because legal opinions often serve as protection against the imposition of penalties on taxpayers for transactions that are not sustained, they have played a crucial role in the resurgence of tax shelters.

At least in theory, legal opinions (either in general or involving tax issues in particular) reside squarely within the traditional tenets of sound legal analysis and writing, which call for a complete discussion of the relevant facts (based upon due diligence and reasonable assumptions where necessary), a complete

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8 The author is aware of only a handful of instances in which the subcommittee staff sought the advice and assistance of the staffs of the tax–writing committees while the subcommittee was conducting its investigation and preparing its report.

9 Some of the legislative changes recommended by the subcommittee were included in the Senate–passed version of what became the American Jobs Creation Act of 2004. However, these changes wisely were dropped during conference negotiations of the bill.
discussion of the relevant law (including legal precedents that may be contrary to the conclusion reached in the legal opinion) and an application of the relevant law to the relevant facts. However, legal opinions involving tax issues and transactions gradually evolved from objective legal advice into “get-out-of-jail-free” cards that often serve no other purpose than to facilitate abusive tax avoidance transactions by insulating taxpayers from penalties should the transaction be successfully challenged by the IRS. Two specific trends have made this evolution especially disconcerting.

The first trend has been the increasing reliance by sophisticated (primarily corporate) taxpayers upon opinions purely for insurance against the imposition of penalties, rather than for legal guidance concerning the advisability of entering into a transaction and the likely tax consequences of the transaction. While taxpayers involved in previous generations of tax shelters perhaps could be excused for relying upon the legal advice presented in opinions because of their general lack of sophistication in tax matters, it is a much more difficult proposition to similarly excuse large corporate taxpayers that have engaged in more recent tax shelter transactions when these corporations compete in the same marketplace for legal talent as law and accounting firms and often employ tax departments that rival the firms in size and expertise.

The second—and more pernicious—trend has been the role that opinions have played in the marketing of tax shelters to multiple taxpayers. The main reason that selling tax shelters has become so lucrative is that firms have developed and marketed tax shelters using a business model that can best be compared with that of the pharmaceutical industry. In that industry, although a firm sells each pill for a particular drug generally at the same price, it is often said that the first pill sold cost millions to produce (primarily because of the research and development associated with the pill) but every pill after that cost pennies to produce. Tax shelters have been developed and marketed in much the same way. Once firms recognized the revenue potential for selling essentially the same transaction to many taxpayers, they became willing to invest substantial amounts of money into research and development before the first transaction was even sold. However, knowing that a successful tax shelter means that it can be sold several times, firms have not required the first transaction sold to bear the full price of developing the tax shelter.

As part of the development of a tax shelter transaction, the firm will produce a lengthy legal opinion that supports the ostensible tax consequences of the transaction. Because these opinions are written in a factual vacuum, by definition they violate at least two of the three tenets of sound legal analysis and writing mentioned above—a complete discussion of the relevant facts (which cannot exist without an actual taxpayer to which the opinion is addressed) and an application of the relevant law to the relevant facts (which cannot exist for the same reason). Often, the opinions violate even the third tenet—a complete discussion of the relevant law—because they lack adequate citation and discussion of legal precedents that may be contrary to the conclusion reached in the opinion. Of course, discussing unfavorable legal authorities would detract from the primary objective of the opinion, which is not to provide objective legal advice but, rather, to facilitate the marketing of the transaction. In order to assist in the efficient marketing of the transaction, these opinions literally are drafted as templates, with the name of the taxpayer and the relevant facts to be filled in later. Because of the context in which these opinions are written and the transactions are sold, one fact that usually cannot be filled in—and which typically is assumed away or simply fabricated—is
a business purpose for the taxpayer to engage in the transaction.

The Circular 230 revisions that the Treasury Department issued in final form late in 2004—and that took effect on June 20, 2005—make several significant changes to the standards that tax advisors and their firms must uphold in order to practice before the IRS, particularly in relation to tax advice concerning tax-motivated transactions.\(^{10}\) First, the regulations set forth “best practices” to be followed by tax advisors and firms. These best practices are “aspirational” (i.e., failure to comply with them will not result in disciplinary action under Circular 230) and involve, among other things, clear communication with clients, adequate factual due diligence, and acting fairly and with integrity in practice before the IRS. Other than concern about possible ramifications in malpractice actions taken by clients against their tax advisors, these best practices have not provoked much controversy.

Second, the regulations establish requirements relating to written advice provided by a tax advisor. These requirements provide that a tax advisor cannot render written advice concerning one or more Federal tax issues if the tax advisor (1) bases the written advice on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, (3) does not consider all relevant facts that the practitioner knows or should know, or (4) takes into account the possibility that a tax return will not be audited (or that an issue will not be raised on audit or will be resolved through settlement if raised). In short, the written advice is required to comply with the traditional standards of sound legal analysis and writing. As discussed in more detail below, written advice that meets the definition of a “covered opinion” must comply with some additional requirements.

Third, the regulations require firms that provide tax advice concerning Federal tax issues to put into effect adequate procedures for all members, associates, and employees to comply with the requirements relating to certain written advice referred to as “covered opinions,” which are discussed below. This firm-wide requirement is an acknowledgement that the tax shelter industry no longer is confined to the storefront operations of one or a handful of shady practitioners, but now has come to include more than a few prominent and large law firms, accounting firms, and investment banks. The fact that this requirement has sparked some controversy, largely affirms the unfortunate decline in the importance placed on mentoring junior practitioners generally and, particularly, mentoring on ethics in tax law.

Fourth, the regulations authorize the Director of the Office of Professional Responsibility (which is the office that administers and enforces Circular 230) to establish one or more advisory committees, composed of at least five individuals authorized to practice before the IRS, to review and make general recommendations regarding professional standards or best practices for tax advisors, including whether hypothetical conduct would give rise to a violation of the requirements for written advice. In a rare instance of

\(^{10}\) Section 822 of the American Jobs Creation Act of 2004 amended the statutory authority for the Circular 230 regulations to clarify that the Treasury Department may impose standards for written advice relating to transactions or matters that have the potential for tax avoidance or evasion. Another amendment in section 822 authorizes the Treasury Department and the IRS to impose a monetary penalty against a practitioner who violates any provision of Circular 230. The final Circular 230 revisions do not implement the authority to impose monetary sanctions for violations, and continue to limit the sanctions to censure, suspension and disbarment. However, the preamble to the final Circular 230 revisions states that the Treasury Department and the IRS expect to propose additional revisions to implement the authority to impose monetary sanctions.
preferring government enforcement over self-regulation, practitioners initially complained that these advisory committees could be empowered to weigh in on actual cases involving alleged practitioner misconduct under Circular 230. Once the authority was clarified in the final regulations to provide that the advisory committee would be just that—just another government advisory committee—and would not make recommendations about actual practitioner cases or have access to information pertaining to actual cases, it became uncontroversial.

As mentioned above, the revisions to Circular 230 provide requirements relating to so-called “covered opinions.” With regard to a covered opinion, the revisions require tax advisors to (1) use reasonable efforts to identify and ascertain the facts (which may relate to future events), and not to base the opinion on unreasonable factual assumptions or representations, (2) relate the applicable law to the relevant facts, (3) consider all significant Federal tax issues (with some exceptions that permit limited scope opinions in some circumstances), and (4) provide an overall conclusion as to the likelihood that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion.

As with the revisions relating to written advice other than covered opinions, the revisions concerning covered opinions substantively do little more than to mandate that covered opinions meet the longstanding principles of sound legal analysis and writing, albeit in considerably more detail and with more procedural requirements primarily involving additional disclosures and disclaimers that must be included in the written advice. The requirement to provide an overall conclusion concerning the tax treatment of a transaction or matter is a much needed enhancement to these principles because tax opinions too often analyze the tax consequences of each transactional step without ever taking a step back and evaluating the transaction as a whole. Typically, this is a conscious decision of the opinion writer and a rather reliable sign that the transaction is an abusive tax shelter because a big picture analysis of the entire transaction inevitably requires an answer to the question of whether the transaction fundamentally has a business purpose.

Covered opinions generally are defined to include written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues arising from: (1) a listed transaction or a transaction that is substantially similar to a listed transaction; (2) an entity, plan or arrangement the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code; or (3) an entity, plan or arrangement a significant purpose of which is the evasion or avoidance of any tax imposed by the Internal Revenue Code if the written advice is a “reliance opinion,” a “marketed opinion,” subject to conditions of confidentiality, or subject to contractual protection.

A reliance opinion is defined as written advice which concludes that one or more significant Federal tax issues are more likely than not (i.e., a likelihood of greater than 50 percent) to be resolved in the client’s favor, other than advice in which the tax advisor prominently discloses that the advice is not intended to be used for the purpose of avoiding penalties that may be imposed upon the taxpayer. The reliance opinion definition essentially allows taxpayers to decide for themselves whether they desire an opinion that they can rely upon to avoid penalties—an opinion that unquestionably will be more expensive to obtain because it will have to comply with the more stringent requirements of covered opinions (assuming the opinion writer does not want to incur sanctions under the Circular 230 regulations).

A marketed opinion generally is defined as written advice that the tax advisor knows or has reason to know will be used
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or referred to by a person other than the advisor in promoting, marketing or recommending an entity, plan or arrangement to one or more taxpayers.

Without question, the final revisions to the Circular 230 rules are complex and impose some new burdens on practitioners when they provide written advice to clients. In particular, the revisions relating to covered opinions have come under heavy criticism, ranging from the "few bad apples" chestnut to complaints about the added cost to clients of providing written advice that meets covered opinion standards. Much of this criticism has been nothing short of laughable, given that sanctions generally may be imposed only for violations of Circular 230 that are the result of recklessness or gross incompetence, and particularly in light of what has transpired over the past several years with regard to the conduct of many tax advisors. Clearly, there have been many more than a few bad apples when it comes to tax advisors and the facilitative role played by opinions in the marketing of abusive tax avoidance transactions. The dramatic decline in the quality of tax opinions and other written advice relied upon by taxpayers simply has to be reversed, and the final Circular 230 revisions serve as a reminder that the government does have a stake in ensuring that written tax advice meets the general standards of quality legal advice, particularly in circumstances where the client intends to rely upon such advice for protection against the assertion of penalties by the government down the road. Although they do so through rules that govern the behavior of tax advisors, the regulations send an unmistakable message to taxpayers as well—while it still may not be terribly difficult in the future to obtain an opinion validating a questionable transaction, it certainly will be more difficult (and more costly) to obtain such an opinion that the taxpayer can rely upon for protection against penalties.

The final Circular 230 regulations discard the phrase "tax shelter opinion"—which was used in the January 2001 revisions proposed during the Clinton Administration—in favor of the covered opinion terminology. Nevertheless, the revisions hint at an effort to define an abusive tax shelter, or at least written advice that is furnished for such a transaction. However, whereas other efforts to define a tax shelter perhaps place too much of a burden on the definition by making the application of the attendant consequences hinge completely on whether a transaction falls within a singular definition of a tax shelter, the final revisions to Circular 230 appropriately scale up the consequences depending upon the likelihood that the transaction or matter to which the written advice relates involves an abusive tax shelter.

Written advice concerning listed transactions is most likely to involve abusive tax shelters (at least in the view of the government) and, accordingly, is automatically subject to the full range of requirements set forth in the rules with no opportunity to mitigate the application of those requirements. The same holds true for written advice involving transactions the principal purpose of which is the avoidance or evasion of tax. By contrast, written advice concerning transactions a significant (but not the primary) purpose of which is the evasion or avoidance of tax is subject to the full range of requirements set forth in the rules only if there is some further indicia of an abusive tax shelter, such as reliance by the client or (in the case of a marketed opinion) someone else for penalty protection. Moreover, the rules creatively offer some element of tax advisor and client choice with regard to such written advice by lessening the requirements for limited scope opinions or opinions which explicitly state that they cannot be relied upon by the client or (in the case of a marketed opinion) someone else for penalty protection. Finally, written
advice that does not fall within the definition of a covered transaction is least likely to involve an abusive tax shelter and, therefore, is subject to the least burdensome requirements set forth in the rules, which really require little more than adherence to the basic tenets of sound legal analysis and writing.

As discussed above, it is important to calibrate the definition of a tax shelter with the consequences that are attached to falling within the definition. Thus, the disclosure regulations adopt fairly broad categories of questionable transactions (i.e., reportable transactions) because the consequence of falling within one of the categories is purely administrative (i.e., disclosure of the transaction is required). The final Circular 230 regulations borrow the listed transaction category from the disclosure regulations, which is not inappropriate because the consequences of written advice being considered a covered opinion under the regulations are similarly administrative. Likewise, while the purposive categories of covered opinions (i.e., “principle purpose” and “significant purpose”) carry all of the subjectivity, ambiguity and potential breadth that has plagued other attempted definitions of a tax shelter, using these categories in the context of the Circular 230 rules is defensible—grumblings from many in the tax bar notwithstanding—because Circular 230 attaches administrative consequences to the categories and does not impact the substantive tax treatment of the transaction or matter in question. Moreover, the recklessness and gross incompetence standards for imposing sanctions under Circular 230 almost certainly foreclose the imposition of sanctions on close calls where reasonable people can differ. Therefore, while the final Circular 230 regulations do not break any new ground in the quest for the definitive definition of a tax shelter (and do not explicitly purport to do so), the rules demonstrate how even flawed definitions can be creatively and thoughtfully utilized in the campaign against tax shelters.

A Declaration of Auditor Independence

The newest player in the tax shelter discussion is the Public Company Accounting Oversight Board (PCAOB). The PCAOB is an independent quasi–governmental body that was created by Congress as part of the Sarbanes–Oxley Act of 2002. Congress has assigned to the PCAOB the mission of monitoring and regulating public accounting firms to ensure compliance with the Sarbanes–Oxley Act and other securities laws.

The Sarbanes–Oxley Act expressly prohibits the provision of certain non–audit services by public accounting firms to their public company audit clients, on the grounds that these services inherently conflict with the fundamental principle of maintaining the independence of auditors from their audit clients.11 The Sarbanes–Oxley Act permits accounting firms to provide other non–audit services, including tax services (unless such services also constitute one of the proscribed activities), to public company audit clients, provided such services are approved in advance by the audit committee of the client. The decision of whether or not to permit accounting firms to provide tax services to their audit clients was the subject of extensive debate while the Sarbanes–Oxley Act was being considered by Congress, primarily because the climate of outrage over serial business scandals that brought about the Sarbanes–Oxley Act happened

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11 These services include: (1) bookkeeping or other services related to the accounting records or financial statements of the client; (2) design and implementation of financial systems; (3) appraisal or valuation services, fairness opinions, or contribution–in–kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment advisor, or investment banking services; and (8) legal services and expert services unrelated to the audit.
to coincide with increasing scrutiny of abusive tax transactions by corporations. Sensitive to this debate, the Securities and Exchange Commission has cautioned audit committees of public companies against approving questionable transactions “the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported in the Internal Revenue Code and related regulations” (Securities and Exchange Commission, 2003).

On December 14, 2004, the PCAOB voted to propose, and seek public comment on, a set of rules concerning auditor independence and tax services provided by accounting firms to their public company audit clients (Public Company Accounting Oversight Board, 2004). Although many had been advocating a complete prohibition against accounting firms providing any tax planning or advice services to audit clients, the PCAOB chose not to deliver this death blow to what is a substantial source of revenue to most accounting firms (and, indeed, all of the national and international firms).

Among other things, the proposed rules provide that a registered public accounting firm is per se not independent of its audit client if the firm (or any affiliate of the firm) provides either assistance in planning, or tax advice on, certain types of potentially abusive tax transactions. For accounting firms, being declared not independent of an audit client brings serious consequences—specifically, the accounting firm is no longer eligible to continue providing audit services to the client. Therefore, conditioning independence upon whether an accounting firm facilitates aggressive tax behavior of its audit clients effectively obliged the PCAOB to take a crack at defining a tax shelter.

The proposed rules identify three categories of transactions that would cause an accounting firm to lose its independence if the firm assisted an audit client with engaging in such transactions. Two of the three categories are borrowed from the Treasury Department’s definition of a reportable transaction (i.e., a transaction that must be disclosed to the IRS because it displays characteristics of an abusive tax-motivated transaction). The two borrowed categories are listed transactions and confidential transactions. With regard to its use of the listed transaction category for auditor independence purposes, the PCAOB in its release stated that “the Treasury’s regulation on ‘listed transactions’ identifies a class of transactions that, in the Board’s view, carry an unacceptable risk of disallowance by the IRS, which in turn could create an unacceptable risk of establishing a mutuality of interest between the auditor and the audit client if the auditor participated in planning or opining on the transaction that impairs independence” (Public Company Accounting Oversight Board, 2004, at 28). With regard to its use of the confidential transaction category for purposes of the proposed rules, the PCAOB stated that confidentiality restrictions imposed upon purchasers or potential purchasers of tax products is indicative of an intent to market the product to multiple customers, which “contributes to the erosion of public confidence in the ethics and integrity of [accounting] firms” (Public Company Accounting Oversight, Board 2004, at 28).

The reliance by the PCAOB on these categories for purposes of its proposed rules is interesting because the context in which these categories are applied under the proposed rules is far different than the context in which the Treasury Department developed the categories.

12 On July 26, 2005, the PCAOB unanimously adopted these rules with only minor changes. The rules will not take effect until they are approved by the Securities and Exchange Commission.

13 The proposed rules actually would take the confidential transaction category a step further by applying the category without regard to the minimum fee threshold that limits the scope of the category for purposes of the Treasury disclosure regulations.
The Treasury regulations that employ these categories merely impose upon taxpayers administrative consequences (i.e., enhanced disclosure to the IRS) for entering into reportable transactions, including listed and confidential transactions. As discussed above, the reportable transaction categories intentionally were drafted broadly because the risk of including transactions that would not be considered abusive for tax purposes was countered by the fact that the categories were drafted for purposes of an enhanced disclosure regime rather than for purposes of directly affecting the substantive tax treatment of transactions that fall within any of the categories.

By contrast, the proposed rules issued by the PCAOB impose upon accounting firms quite severe substantive consequences (i.e., loss of independence) for assisting audit clients with engaging in listed and confidential transactions. This raises the question of whether the considerations that lead the Treasury Department to develop expansive reportable transaction categories in the name of enhanced disclosure can be so easily imported into other regimes, such as the PCAOB proposed rules, where the stakes are far higher.14 Again, precision in defining a tax shelter must be calibrated with the consequences attached to such definition, with greater consequences necessitating greater precision.

The third circumstance that would cause an accounting firm to lose its independence under the PCAOB proposed rules involves services provided by the firm that promote an interpretation of applicable tax laws for which there is inadequate support. Under the proposed rules, this circumstance exists if a transaction satisfies three criteria: (1) the transaction initially was recommended by the accounting firm or another tax advisor; (2) a significant purpose of the transaction is tax avoidance; and (3) the proposed tax treatment of the transaction is not at least more likely than not to be sustained under the applicable tax laws. While the first criteria appears to be a new entrant into the field of tax shelter indicators, the other two criteria are quite familiar, as is the approach taken by the PCAOB to cobble together a number of faulty tax shelter identifiers in the hope that the assemblage nevertheless combines to provide an appropriate definition of a tax shelter. Fittingly, the PCAOB in its request for comments on the proposed rules asked the question: “Is there a better way to describe aggressive tax transactions, strategies, and products that a registered public accounting firm ought not to sell to an audit client?” (Public Company Accounting Oversight Board, 2004, at 35). While the PCAOB posed this question only in the context of the third circumstance in which an accounting firm could lose its independence under the proposed rules, the question is equally apt with regard to the first two circumstances (involving listed and confidential transac-

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14 To be fair, the proposed rules do not implicate the other categories of reportable transactions under the Treasury regulations, including the categories involving substantial losses or so-called book–tax differences (where the breadth of the categories has been most contentious), although the PCAOB in its release did request comment on whether any of the other categories should be incorporated into the rules. Moreover, the listed transaction category is unique in that it includes specific, discrete transactions rather than generic features of transactions (such as a significant loss or a book–tax difference). However, the category that includes confidential transactions (which also is one of the categories in the PCAOB proposed rules) has been subject to extensive criticism concerning its reach and has been revised multiple times to address such criticisms. In addition, the listed transaction category includes transactions that are “substantially similar” to listed transactions. Combined with the IRS’ discretion in continuing to expand the number of listed transactions, this feature of the listed transaction category means that it also is unique among the reportable transaction categories because it is the only category that is certain to become much more expansive over time.
tions). Drawing from the long experience of trying to define a tax shelter even for tax purposes, the likely answer to the PCAOB’s question is: “Probably not.” Of course, this reply would be offered as a statement about futility, not success.

CONCLUSION

What does this all add up to? While this may not add up to a very clear and usable definition of a tax shelter, the extensive and complex infrastructure of tax shelter measures that has emerged in recent years certainly lays the groundwork for a struggle against tax shelters that sees no apparent end. Much as the beleaguered financial auditing profession ironically has been transformed into a profitable livelihood once again by public companies struggling to comply with the rather onerous financial reporting requirements of the Sarbanes–Oxley Act, there is every indication that a cottage industry is sprouting up to assist taxpayers (and even fellow tax advisors) in complying with the various tax shelter rules and regulations that have been enacted and promulgated. It remains to be seen whether this new framework of tax shelter laws actually will bring about a culture of aversion to abusive tax avoidance transactions and empower the government to effectively pursue the defiant few within such a culture or, instead, merely serve to place compliant taxpayers at a further disadvantage to their noncompliant neighbors and competitors by saddling them with heavy time and paperwork burdens that are likely to come with living under the new rules. If the latter, we can look forward to yet another generation of government officials and staffers continuing the permanent campaign against tax shelters and, in all likelihood, even taking yet another crack at defining a tax shelter. There’s a chance that they may even succeed.

REFERENCES
