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Innovation and Constraints on Tax Shelters

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Innovation and Constraints on Tax Shelters

"General Electric, the nation's largest corporation, had a very good year in 2010."[1] They reported $14.2 billion in profits with $5.1 billion coming from its operations in the United States. More important than the massive profits G.E. collected might be the tax implications that are so substantial, they cannot be left out. G.E. ended up paying zero dollars in taxes and actually claimed a tax benefit of $3.2 billion along with the profits they earned in 2010. "While General Electric is one of the most skilled at reducing its tax burden, many other companies have become better at this as well."[2]

A 2011 study, released by the Institute for Policy Studies, revealed that at least 25 top United States companies paid more to their chief executives in 2010 than they paid to the federal government in taxes. The study focused on the regulatory filings of the 100 companies with the best-paid chief executives. According to the study the companies, including Verizon, eBay, and Boeing, averaged $1.9 billion in profits and paid their chief executives more than $16 million per year on average. A variety of shelters, loopholes and tax reduction strategies enabled the companies to evade the 35% corporate tax rate and receive an average of more than $400 million back in tax benefits. For instance, "Verizon, which earned $11.9 billion in pretax United States profits, received a federal tax refund of $705 million. The company's chief executive received $18.1 million in compensation."[3]

While company spokespersons are disputing any non-compliance and insist they are fully paying their fair share of taxes, the findings from the study suggest that the current United States corporate tax policy is more conducive to tax avoidance than innovation. A representative for Verizon claimed that the $18.1 compensation was only a target that will be paid in full contingent on the rise of the company's stock and when his bonus is fully vested in three years. The representative also said that

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[1]David Kocieniewski, *G.E.'s Strategies Let it Avoid Taxes Altogether*, N.Y. TIMES, March 24, 2011 at Business Section.
[2]Id. at 1.
[3]David Kocieniewski, *Where Pay For Chiefs Outstrips U.S. Taxes*, N.Y. TIMES, August 31, 2011, at B1.

the report is misleading because it fails to mention the billions of dollars in deferred taxes that Verizon will pay overtime. A Boeing spokesperson explained that the reason for the decline in the company's taxes in recent years is due to the huge investments it has made to U.S. Manufacturing – it has added 5,000 U.S. manufacturing jobs that were incentivized by tax benefits. The representative further stated that Boeing "has paid hundreds of millions in cash taxes and incurred an additional $1 billion in deferred taxes that it will pay at some date in the future."[4] It is not clear which specific accounting strategies each of these companies utilized to their advantage. It is clear, however, that as the tax shelter industry has grown rapidly over the past several years, the complexities of the Tax Code is a primary impediment that has hindered the ability of the federal government to develop effective responses that will curb corporate tax loopholes. Part I of this article gives an overview of the most frequently-used corporate tax strategies including partnership pass-through principals and carried interest. Part II discusses tax avoidance techniques put to use in a high profile transaction that demonstrates there are few challenges that lie in the way of taking advantage of loopholes. Part III explores various existing penalties for tax-avoidance strategies and analyzes the utility and potential harm each penalty imposes on the current tax system. Part IV considers different propositions that have been introduced as a response to the tax shelter industry. Lastly, Part V evaluates tax arbitrage patterns in hopes of raising awareness and enabling detection of an industry that has escalated far beyond what was intended by Congress.

I. Overview of Frequently-Used Corporate Tax Strategies

A. Partnership Pass-Throughs and Carried Interest

There are several strategies and loopholes that companies can take advantage of to secure high wages for their top executives and reduce the taxes they pay to the government. Partnership pass

[4] Id. at B5.

through principles are one such way that private equity managers can take advantage of the lower capital gains rate and avoid paying the higher ordinary income tax rate on their compensation. This principal allows two people who are setting up a private equity fund to organize it as a partnership with their role being the two managing general partners. General partners are compensated in two ways. For their investment decisions, they receive two percent of the assets as compensation for the services (which is subject ordinary income rates). They also receive 20 percent of the fund's profits, the "carried-interest", that is taxable at the lower capital gains rate.[5]

> Put simply, carried interest is a share of a partnership's profits that is taxed as a capital gain as opposed to ordinary income. It is a good deal: The top rate on gains held longer than a year is 15%, so the tax on carried interest is usually less than half the top 35% rate on ordinary income.[6]

"This is permissible under the current Internal Revenue Code (I.R.C.) rules because the partnership itself receives the profits in the form of capital gains."[7] Because there isn't a layer of corporate taxes, through the partnership pass-through principals, the profits retain their capital gains character when they flow through to the individual partners.

Both positive and negative sides of the current tax treatment of carried interests have been presented during congressional hearings. Private equity professionals, who are in favor of the current tax rules, argue that imposing higher marginal tax rates would prohibit risk taking with respect to funding companies in the United States, thus hampering the United States' economy. In contrast, those arguing for change stress the need to ensure equality and fairness. Critics of the current treatment argue that carried interests are compensation to partners in exchange for their services and therefore should be taxed like employment income. Other individuals in high paying professions, lawyers for

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[5]Shrilaxmi S. Satyanarayana, *Tax Equality: Eliminating the Low Effective Marginal Tax Rates for Private Equity Professionals,* 82 ST. JOHN'S L. REV. 1589 (2008) [hereinafter *Tax Equality*].

[6]Laura Saunders, *Carried Interest' in the Cross Hairs*, WALL STREET JOURNAL ONLINE, (August 6, 2011), http://online.wsj.com/article/SB10001424053111903885604576486541761322496.html

[7]*Tax Equality*, supra note 5 at 1.

example, cannot take advantage of any lower capital gains rate as a result of having their income structured in the form of carried interest.

B. Profits-only Partnerships

Taking advantage of the intricate partnership laws is another way to avoid the corporate tax rate. Partnership laws are so complex and different from tax rules governing other arrangements because there are so many unique ways to form a partnership – i.e. by way of two unsuspecting entrepreneurs, a complicated investment relationship, or a joint venture between multi-national companies. There are three general categories of partnerships: service partnerships, property-services partnerships, and investment partnerships.[8] In a services partnership, the partners each contribute solely services to form the partnership. Property-services partnerships refer to when one partner's property they have contributed is integrated with at least one other person's services. In an investment partnership, one person contributes property and another contributes only limited services. Any type of partnership has the ability to grant its members a profits-only partnership interest. The grantee of this type of interest has no interest in any partnership capital and receives the interest in the profits of the arrangement only for the services provided. The character of such income that the holders of these interests recognize is determined when it flows through from the partnership level. In services and property-services partnerships, it is nearly impossible to trace profits directly from the exact source to a single owner of the source because partners become co-owners of integrated partnership property and services. Therefore, the partners share in the profits as provided by their agreed allocations (i.e. 60%-40%), and they both recognize the income in the character it takes at the partnership level. As a result, a partner can receive capital gain treatment for its services in a relationship where property and services are so intertwined that it is impossible to pinpoint the percentage of services provided and by which partner.

[8]See Bradley T. Borden, *Profits-Only Partnership Interests,* 75 BROOK. L. REV. 1238 (2009).

Because of the unique inability to trace income to its source in partnerships, the IRS generally does not challenge the tax-free grant of a profits-only partnership interest to a service contributor.[9]

There is some recent debate, however, that centers on the tax treatment of profits-only partnership interests that are granted in investment partnerships. In these types of partnerships, the income is substantially derived from property (assets) while only a nominal percentage is derived from services (active trading).[10] Despite being able to trace the partnership income from its source, tax law still allows partners in investment partnerships to allocate partnership tax items in any reasonable matter. Therefore, a pure service provider in an investment partnership is able to receive income at the favorable capital gains rate instead of the ordinary income rate when the income passes through at the partnership level. The broad definition of tax partnership plays a role in being able to take advantage of this loophole.

The Federal tax definition of partnerships can include: partnerships, limited partnerships, LLC's, and arrangements that fail to satisfy the definition of all of those arrangements (i.e. state-law tenancy in common). This "empowers business participants to form partnerships that are equivalent to employment arrangements and use profits-only partnership interests to obtain long-term capital gains. Thus, with no economic consequences, they convert ordinary income (taxed at up to thirty-five percent) to long term capital gain (taxed at fifteen percent)."[11] For example, an investment partnership that consists of two partners, one of which who contributes investment services and the other who contributes capital, falls under the definition of a tax partnership and can use partnership tax accounting and reporting rules in order to qualify for partnership tax treatment. The character of the service-providing partner's gain should really be determined by the extent they contributed investment services and thus be subject to ordinary income treatment. The reason for this is that it is equivalent to someone

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[9] Id.
[10] Id.
[11] Id. at 1.

performing investment services for an employer who would have their compensation taxed at the ordinary income rate. If the partner contributing investment services, however, decides to "select investments that appreciate over time, gain on the disposition of the property will be capital gain and may qualify for long-term capital gain treatment."[12] With few or no hurdles, partners are able to change the form of their arrangements that appear to be a traditional employment contract into an investment partnership to intentionally result in a significant reduction of tax liability.

The different tax treatment that manifests itself in an investment partnership has become a recent topic of debate. Investment partnerships do not appear to require the partnership tax allocation rules like other partnerships do. Professor Borden has incorporated into this debate the suggestion that partnership disregard may be an appropriate way of dealing with the inequities caused by profits-only partnership interests.[13]

> Partnership disregard uses economic concepts to identify the policy-relevant differences between tax partnerships and disregarded arrangements, such as employment arrangements, leases, and loans. Partnership disregard distinguishes between arrangements that should qualify for partnership tax treatment and those that should not. It eliminates inequity while preserving the integrity of partnership tax regime and other areas of the law.[14]

If an arrangement is a tax partnership, this proposal suggests that the focus should be on whether any partners have acted in a non-partner capacity. In addition, close scrutiny should be given to whether the arrangement is not an integrated arrangement such as hired-services or hired-property arrangements, or if it is an integrated arrangement – a tax partnership. If tools existed to help identify arrangements such as an employment arrangement loan, or lease, the taxation of disregarded partnerships would become much clearer. Examining underlying economic concepts, such as the

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[12] Id. at 5.
[13] Id.
[14] Id. at1.

reason for forming the business, will help in the analysis because it can identify the distinction between tax partnerships and disregarded arrangements.[15] As mentioned above, the difference between tax partnerships and disregarded arrangements is integration. The law should apply a test of whether there has been an integration of property and services to determine whether a tax partnership exists. That analysis requires looking at the party's contract or agreement to see if one party retains ultimate control over of either the property or services. If it is discovered that one party does retain a residual claim over either the property or services, then it is a hired-property or services arrangement.[16] Further examination should also focus on if either party holds a current claim of either the property or services contributed. For example, if one person controls the use of the property and can direct the other person's services for the duration of the agreement, the arrangement would be a hired-services arrangement. It is further suggested that the definition of "tax partnership" should be narrowed. By narrowing the definition, arrangements that mirror traditional service arrangements will be deprived of the partnership allocation rules and will ensure that compensation for services is taxed at ordinary rates.[17]

II. Strategy in Action: The Blackstone Example

A high-profile transaction that demonstrates how a company strategized to avoid taxes after taking their firm public is discussed below. The Blackstone Group, formally a private equity firm, went public on June 22, 2007.[18] Blackstone structured itself in a way to retain its status as a partnership and therefore avoid the corporate tax rate of 35%. Congress enacted 26 U.S.C. § 7704 specifically to block entities that functionally resemble corporations from accessing the public equity markets without paying a corporate-level tax. With the exception of subsection (c), § 7704(a) requires that publicly-

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[15] Id.
[16] Id.
[17] Id.
[18] Victor Fleischer, *Taxing Blackstone,* 61 TAX L. REV. 89 (2008).

traded partnerships be taxed as if they were corporations. Section 7704(c) provides an exception for partnerships if at least 90% of their gross income comes from passive type income. Passive type income, as provided by subsection (d) includes but is not limited to dividends, interest, rents, royalties and capital gains.[19] Through strategic tax planning, Blackstone was able to take advantage of the expansive list provided for in § 7704(c) to avoid paying the corporate tax rate.

Private equity firms have attractive tax advantages compared to publicly traded corporations. The firms and funds that are managed are pass-through entities for tax purposes which allow individual partners to take advantage of the capital gains preferential rate of 15%. Private equity fund managers also receive much of their compensation in the form of a profits interest in a partnership, also known as carried interest which is often taxed at the long term capital gains rate.[20] Corporations, on the other hand, cannot take advantage of the capital gains rate and pay taxes on such gains at 35%. Additionally, private equity firms pay no entity-level tax. Blackstone managers engaged in creative tax planning to maintain these benefits.

The complex way Blackstone is structured enables it to avoid the corporate tax rate and the reach of the Investment Act of 1940. Diagram (D1), provides an overview of Blackstone's structure as discussed below. The Blackstone Group, L.P. is the entity that went public, and is governed by The Blackstone Management Group. The parent Management Group has economic rights in Blackstone Holdings, but no economic rights in the public partnership. The Holdings Company generates income by providing services, like management fees and deal advisory fees, to help investors buy portfolio companies. At the bottom of the structure are the portfolio companies that Blackstone buys, restructures, operates, and sells. In the middle of the publicly-traded Blackstone L.P. and Blackstone Holdings exists a corporate blocker entity. This blocker entity, as explained below, allows Blackstone to avoid the corporate level tax.

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[19] Id.
[20] Id.

As mentioned above, § 7704(c) provides an exception to the corporate tax rate if at least 90% of the partnership's income comes from passive income – i.e., dividends, interest, rents, royalties or capital gains. Much of Blackstone's income comes from Blackstone Holdings – including carried-interest distributions which are generated by the sale of the portfolio companies that exist at the bottom of the structure, as well as management fees and deal advisory fees in exchange for its management of investors' capital. "The Code treats carried interest distributions as a return on low-taxed investment capital rather than high-taxed labor income."[21] Therefore, it is classified as passive income. In addition, "Blackstone may periodically waive management fees in favor of increased priority allocations of carried interest, which then are treated as capital gain when received (and thus permissible under § 7704(c))."[22]

Although the income from management fees are characterized as "active" because it results from services provided, Blackstone is able to sidestep that classification for tax purposes. This income is funneled through the entity blocker and is then turned into passive income in the form of dividends and capital gains. The entity blocker allows Blackstone to pay less tax on the blockers income because the blocker-entity is capitalized with inter-company debt (which allows Blackstone to strip income out of the blocker, where it would be subject to the corporate-level tax) into the parent company of the partnership), where it is not. As discussed above, carried interests gets passive income treatment because it's treated as capital gains.[23] "By capitalizing the blocker entity with debt issued by the parent partnership, some of the active business income in the blocker may be stripped out."[24] Through the combination of a blocker-entity and the treatment of carried interests as capital gains, Blackstone qualifies as a passive partnership pursuant to the statute and is not subject to the corporate-level tax.

Another way that Blackstone was able to maximize on the preferential tax rate was by taking

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[21] Id. at 8.
[22] Id. at 6.
[23] Id.
[24] Id. at 10.

the service-providing management company that generates active income public rather than any individual fund that it manages. By doing this, it did not fall within the parameters of the Investment Company Act of 1940. This act regulates the operation of mutual funds and other investment vehicles. The Act "clearly sets out the limits regarding filings, service charges, financial disclosure, and fiduciary duties of open-ended mutual, exchange-traded and closed-end funds."[25] Since Blackstone's managers and directors are used to enjoying a wide latitude of control in managing the business, being subject to tighter regulations the Investment Act imposes was not an attractive consequence of going public. Blackstone accepted the disclosure and accounting requirements (required of publicly-traded companies), but by means of the partnership structure they strategically retained, it allowed them to avoid many other restrictions associated with major stock exchanges.

Due to Blackstone's involvement in investment activities, which includes managing private investment funds, hedge funds, distressed debt funds, one would easily view their role as buying and selling securities, or an investment vehicle. They have also expanded into investment banking, providing finance advisory and restructuring and reorganization services among others – as run by the Holdings Company. By taking the management company going public, Blackstone took the position that they were not an investment company and their primary source of income is earned in exchange of services provided through their more recent expansion into investment banking sector.

> Section 3 of the Act uses two tests to determine whether an issuer is subject to the act. Section 3(a) (1) (A), the orthodox investment company test, looks to whether a company holds itself out as an investment company. Section 3(a)(1)(C), the inadvertent investment company test, looks to whether the company is engaged in the business of investing, reinvesting, owning, holding, or trading in securities and owns investment securities of excess of 40% of the company's total assets.[26]

The SEC accepted Blackstone's position finding that a majority of their assets came from them providing asset management and financial advisory services. They further determined that they were

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[25]http://www.investopedia.com/terms/i/investmentcompany.asp#axzz1h1ibQO3O
[26]*Taxing Blackstone*, supra note 24, at 6.

not primarily in the business of investing in securities with their own assets. This seems like a direct contradiction of the determination that over 90% of their income qualified as passive for purposes of § 7704. The key issue for the inadvertent test is whether the general partnership interests that Blackstone held in its various funds were investment securities for purposes of the Act. "Because the profits related to general partnership interests depend on the efforts of the general partners, as opposed to the efforts of others, the SEC concluded that the general partner interests were not investment securities."[27] Since the 1940 Act exists to regulate investment vehicles, it actually does not have a bearing on Blackstone's public partnership.

So on one side of the structure is an "active" operating service business that allowed them to avoid being subject to government regulation. On the other side, it is a "passive" investment entity that exempts them from § 7704 taxes. Thus Blackstone was able to plan to qualify as an active service provider under the 1940 Act as well as remain passive for tax purpose. Although the Blackstone deal did not literally qualify as an abusive tax shelter, the end result that allowed Blackstone to go public was contrary to congressional intent. Given that § 7704 was enacted to prevent entities, like Blackstone, from taking advantage of a lower tax rate when they operate as corporations, Congress surely could not have desired for a company to poke holes in § 7704 to achieve these results. It is not in line with the principals of horizontal equity that strive to ensure equal tax treatment of taxpayers who have the same income. It is also creates incentive for more gamesmanship and threatens the integrity of the tax system. Lastly, the partnership structure that Blackstone has adopted, enables them to avoid many governance restrictions and substantially limit their fiduciary duties that otherwise would apply under Delaware law.[28]

A. The Blackstone Aftermath: The Blackstone Bill

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[27] Id. at 6.
[28] Id.

In response to Blackstone's gamesmanship, Congress proposed 'the Blackstone Bill', which would treat Blackstone and other companies with similar plans and structures as a corporation for tax purposes. The bill isolates the firms that it views as generating income from active services and ensures that those firms cannot try to take advantage of the passive income exception. A new sub-section would be added to § 7704 stating that "the passive income exception does not apply to any partnership that derives income from services provided as an investment adviser (as defined by the 1940 Act, without regard to whether one is required to register as an adviser)."[29]

It's important to highlight some draw-backs to the bill that have been recognized. The bill narrowly targets only publicly traded private equity firms and fails to address the broader problems that carried interests raise. For instance, the advantages that result from carried interests treats the performance of services for a private equity firm more favorably than other jobs, thus drawing talent away from other sectors of the economy. By not targeting private equity firms that take advantage of the tax treatment, the Bill is unlikely to increase the rates of most private equity firms. The managing directors of Blackstone are not even directly affected by the Bill because they continue to hold interests in Blackstone Holdings, not the public partnership. Therefore, they continue to benefit from the low tax rate on carried interests even as the public partnership is subject to the higher corporate rate.[30]

The bill would raise Blackstone's taxes by an estimated $525 million annually. The bill's tax penalty will possibly create an incentive for firms to remain privately held. By many firms remaining private, the Treasury will lose out on capital gains revenue it could have received from sale of the partnership units. If the Blackstone bill is not added, however, firms will more than likely continue to go public using the Blackstone structure and avoid the corporate-level taxes that the Treasury would have otherwise received. Furthermore, investment and merchant banking and businesses that are similar to Blackstone will be at a competitive disadvantage, which may encourage them to spin-off

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[29] Id. at 11.
[30] Id.

their banking and management activities into separate entities.

III. Penalty Provisions

Apart from Blackstone, several suggestions have been introduced as to how to eliminate the inequities of the current tax rules. The Economic Substance Doctrine, for instance, is the latest and toughest penalty provision that Congress has implemented.

> It provides for a 20 percent penalty for disclosed transactions that violate the economic substance doctrine, and a 40 percent penalty for undisclosed transactions. It also provides a strict liability provision that does not allow for any reasonable cause or other defenses that are available to taxpayers under the other penalty provisions.[31]

A. Accuracy-related Penalties

It has been argued that the current accuracy-related penalties – the Valuation Misstatement Penalty, the Substantial Understatement Penalty with Tax Shelter Carve Out, and the Reportable Transaction Understatement Penalty – cover every conceivable tax shelter transaction and that adding a fourth penalty to the mix, would create an unnecessary complexity and unfairness to the tax penalty system.

1. The Valuation Misstatement Penalty

The valuation misstatement penalty addresses tax disputes that involve overvaluations of certain kinds of property. This penalty provides for a 20 percent penalty on an underpayment of tax attributable to a substantial valuation misstatement and a 40 percent penalty on the underpayment attributable to a gross valuation misstatement. A substantial valuation results when the basis of property claimed on a return is 150 percent or more of the correct value. A gross valuation

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[31]Kathleen DeLaney Thomas, *The Case Against Strict Liability Economic Substance Penalty,* 13 U. PA. J. BUS. L. 445 (2011) at 2.

misstatement results when a basis of 200 percent or more of the correct value is claimed.[32]

2. The Substantial Understatement Penalty

"The Substantial Understatement Penalty with Tax Shelter Carve Out refers to the excess of the amount of tax required to be shown on the return over the amount of tax actually shown on the return. A substantial understatement exists if the amount exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000."[33] The current penalty is 20 percent of the underpayment. Taxpayers can avoid the penalty by showing they acted with reasonable good cause or good faith. Congress, however, imposed more stringent standards on corporate taxpayers engaged in tax shelters. Under the act, corporate taxpayers can avoid the penalty only through a special, more heightened reasonable cause and good faith requirement which requires substantial authority and a reasonable belief that the treatment claimed was more likely than not correct.[34]

3. The Reportable Transaction Understatement Penalty

The reportable transaction understatement penalty imposes "an accuracy-related penalty on listed transactions and reportable transactions with a significant tax avoidance purpose."[35] A reportable transaction is a specific type of transaction that has the potential for tax avoidance or evasion. A listed transaction is a type of reportable transaction that has been specifically identified by the IRS as a tax avoidance transaction. The penalty is 20 percent of the reportable transaction understatement for a disclosed transaction and 30 percent for an undisclosed transaction. The purpose is to utilize a more meaningful policy that promotes disclosure, which is vital to combatting abusive tax-avoidance transactions without imposing strict liability.

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[32] Id.
[33] Id. at 4.
[34] Id.
[35] Id. at 4.

B. Economic Substance Doctrine

1. General Overview

Economic substance requires a transaction to have economic purpose aside from reduction of tax liability in order to be considered valid. The economic substance doctrine has been developed by courts to address the tax shelter epidemic in addition to the three existing accuracy-related penalties. The doctrine deals with tax shelter transactions by disregarding 'transactions that comply with the literal terms of the tax law but lack economic reality.'[36] The doctrine consists of two components: "(1) an objective prong, requiring a transaction to have an economic substance (generally reflected in a realistic possibility of profit or a change in the taxpayer's financial position); and (2) a subjective prong, requiring a valid business purpose apart from tax avoidance."[37]

Even though tax shelters have become more complex over time, the majority of the federal circuit courts have successfully been able to apply at least one of the three current tax shelter penalties to violations of the economic substance doctrine. Palm Canyon X Investments v. Commissioner for instance, involved the "Son-of-BOSS" tax shelter. This type of shelter has multiple variations all revolving around creating an artificially high basis in a partnership interest and later disposing of that interest as a loss. "At issue was the economic substance of the formation of the Palm Canyon investment partnership and certain market-linked deposit (MLD) foreign currency transactions it engaged in to reduce taxes on earnings. The transactions enabled the taxpayer to offset several million dollars of tax payments."[38] "The taxpayer argued that its basis was only offset by a long option but the short option was too speculative to constitute a "liability" for purposes of I.R.C. Section 752."[39]

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[36]Id. at 5.
[37]Id. at 5.
[38]Palm Canyon Investments, LLC, AH Investment Holdings, Inc., Tax Matters Partner v. Commissioner of Internal Revenue, TAX 98 T.C.M. (CCH) 574 (2009).
[39]*The Case Against Strict Liability Economic Substance Penalty,* supra, note 37 at 14.

> In assessing the business purpose of the creation of the Palm Canyon partnership and its purchase of offsetting foreign currency positions, it was determined that Palm Canyon's MLD options were overpriced and not reflective of what the Court termed "reasonable market prices or rational economic behavior. There was no likelihood that the MLD transaction would have been profitable for the taxpayer.[40]

Concluding that there was no legitimate or tax business purpose, the Tax Court held that the gross valuation misstatement penalty applied. In the alternative, the transaction was subject to the negligence penalty or resulted in a substantial understatement subject to the tax shelter rules because the sole purpose of the transaction was tax avoidance. Additionally, the transaction would have qualified as a reportable transaction on at least two grounds – 1. It is a listed transaction; and 2. It resulted in a claimed loss of approximately $5 million dollars. Any Son-of-BOSS transaction results in a gross valuation misstatement because the tax benefits are derived from the taxpayer's basis in its partnership interest that has been reduced to zero.[41]

Another typical tax shelter transaction involves a taxpayer's sale in/lease out ("SILO"). This type of transaction involves a "taxpayer entering into a purported sale-leaseback transaction with a tax exempt entity, under which the tax exempt entity sells property to the taxpayer and the taxpayer immediately leases the property back to the tax exempt entity."[42] "The lease provides for rental payments, and substantially the entire purchase price is set aside by the tax-exempt entity to fund its lease obligations."[43] The arrangement is set up allowing the taxpayer to make minor equity investments and funding most of the purchase price with non-recourse debt which offsets the interest income by way of deductions. The taxpayer is generally shielded from economic risk by offsetting their rental income with interest deductions on the property in addition to the interest deductions on the non-recourse loan.

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[40] http://www.analysisgroup.com, supra, note 38.
[41] *The Case Against Strict Liability Economic Substance Penalty,* supra, note 39 at 14.
[42] Id. at13.
[43] Id. at13.

Wells Fargo entered into multiple SILO transactions in which it leased depreciable assets from various public transit agencies. In Wells Fargo & Co. v. United States, the company claimed $115 million in deductions for 2002, based on 26 sale-in lease-out (SILO) transactions with the various tax-exempt domestic transit agencies.[44] Even though Wells Fargo owned the assets after the purchases were made, the risk on the depreciable property (buses, rail cars, and telecommunications equipment) made it near certain that the transit agencies were going to exercise the repurchase options and retain possession of the assets. It was determined that Wells Fargo never expected to own or operate the property and the transaction took place solely to take advantage of tax deductions. The court held the transactions lacked objective economic substance and a subjective business purpose and disallowed the tax deductions. The only non-tax benefits Wells Fargo received was a return of its equity investment with interest. Based on the facts alone, all of the current tax-shelter related penalties could have applied in this case.

> Because the transaction was ultimately disregarded under the economic substance doctrine, the IRS could have asserted that correct basis in the assets was zero, resulting in a gross valuation misstatement. Additionally, because the court determined that Wells Fargo lacked a non-tax purpose for entering into the transaction, the transaction likely would satisfy the definition of a tax shelter for purposes of the substantial understatement rules. Further, the reportable transaction understatement penalty could have been asserted because SILO transactions are listed transactions.[45]

2. Why Strict Liability is Needed - Arguments in Favor:

"Justifications for new the strict liability penalty largely focus on taxpayer deterrence and reducing disadvantages to the IRS in enforcing penalties."[46] The minimal resources that the IRS has in comparison to some taxpayers often lead to settlements that are not sufficiently detrimental to deter taxpayers enough from entering into transactions that do not have economic substance. Adding to the

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[44] Id.
[45] Id. at 13.

[46] Id. at 8.

need for stronger deterrence are the instances where taxpayers can sometimes end up only paying the "tax owed plus interest if the taxpayer obtains an opinion from an advisor that concludes the position is more likely than not to prevail."[47] Therefore, proponents say that a strict liability penalty levels the playing field by having taxpayers and advisors "focus on the potential downside if their position is not sustained on the merits."[48] Strict liability also serves a deterrence function because "it can be applied both to transactions that fall under the current definition of reportable transactions, and to transactions that have not yet been identified as abusive by the IRS."[49] Proponents also argue that due to the increasing complexity of tax transactions where the taxpayer is often the only party with the access to and understanding of the facts, a new stricter penalty needs to be in place than what the current penalties provide.[50]

3. Arguments Against Strict Liability:

There is much ambiguity surrounding the subjective and objective prongs of the economic substance doctrine including when the application is even relevant. The doctrine can apply, for instance, when the substantive provisions of the Internal Revenue Code do not. In her law review article about the economic substance doctrine, Professor Kathleen Delaney Thomas presented important critical views about the penalty that are attributed to its harsh nature. One possible effect is that it may deter taxpayers who are engaging in legitimate transactions, or also discourage taxpayers from disclosing transactions making it more difficult for the IRS to detect tax shelters. "Aggressive taxpayers may determine that the benefit of disclosure, i.e. a reduction in the penalty rate from 40 percent to 20 percent, is too small of a benefit compared to the potential benefit of avoiding detection,

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[47] Id. at 8.
[48] Id. at 8.
[49] Id. at 8.
[50] Id.

and thus a penalty, altogether."[51] The severity of the penalty could lead to an increased amount of litigation, which would in turn burden the IRS and judicial resources. "Since the taxpayer will be subject to a penalty in every case in which it conceded, there is little incentive not to challenge the case on substantive grounds."[52] Professor Thomas also noted opposing ideas such as the possibility that some courts may be reluctant to find that economic substance is lacking because of its severe nature, where it is actually appropriate to apply the doctrine.

An additional tax penalty that is inconsistent with the three prior penalties also makes it difficult for tax payers to predict and understand the consequences of their behavior. Enabling taxpayers to understand potential consequences of their conduct will promote compliance. Furthermore, the strict liability penalty does not seek to remedy any new type of illegal conduct that has not been addressed under the present tax shelter penalties. Proponents of the penalty have failed to provide an explanation as to why taxpayer defenses should not be available for an economic substance penalty. Lastly, it is argued that implementing a strict liability penalty for transactions under the economic substance doctrine will result in treating similarly situated taxpayers differently, leading to unjust and uneven results.[53]

Overall, opponents have expressed their disapproval for a doctrine that is ambiguous and argue that it will over-complicate the current regime. It has been demonstrated that the new doctrine could make it harder for the taxpayers to assess which penalty or penalties they should consider when contemplating the consequences of their conduct. It also becomes more difficult for the IRS to be aware of all the growing number of penalties and to which type of scenario they should be asserting. It seems that there are significant arguments against the new doctrine that includes the IRS' inability to effectively and fairly implement the new penalty, when they lack a clear understanding about when it

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[51] Id. at 9.
[52] Id. at 9.
[53] Id.

should apply. Furthermore, the differing standards among the penalties create an uncertainty as to Congress' intentions. Since it's not clear when the strict liability penalty of the new doctrine will apply or whether the heightened reasonable cause and good faith will be applicable, it's unclear whether Congress is trying to encourage taxpayers to seek the advice of tax professionals, or to deter them from participating in tax shelters. Either way, opponents argue that Congress cannot effectively regulate the behavior of taxpayers through penalties if taxpayers don't know the standards that will apply to their conduct.

IV. Other Approaches

A. Civil Standards and Opinion Letters

The next case, United States v. Stein, demonstrates alternative ways of prosecuting tax shelter schemes and the complexities that arise with it. The government charged KPMG with designing and marketing tax shelters to taxpayers with income or capital gain in excess of $10 million in 1997, and $20 million from 1998 to 2000.

> Taxpayers could choose how much income they wished to shelter, and they paid defendants a fee of five to seven percent of the sheltered income for designing an investment transaction that appeared legitimate but was in substance a phony transaction with no economic benefit. To conceal the nature of the tax shelters, KPMG provided opinion letters that fraudulently stated that the transactions would more likely than not survive the IRS challenge.[54]

KPMG collected $124 million in tax shelter fees as a result of the transactions from 1997-2001 and purportedly caused the government to lose $1.4 billion in tax revenues. This type of conduct had always been charged as civil and ethical violations and "the government had never sought criminal penalties against tax planning professionals for providing opinion letters."[55] In this first attempt to do

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[54]Patricia B. Hsue, *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 (2008) at 7.
[55]Id. at 2.

so, the government relied on civil standards that regulate opinion letters to support the criminal charges they alleged against the defendants. In 2005, KPMG ended up settling with the government by entering into a deferred prosecution agreement (DPA) and agreed to be charged with one count of participating in a conspiracy to defraud the United States and commit tax evasion. KPMG also agreed to pay the government over $700 million in fees it received from its tax shelter business and in restitution to the IRS for actual losses suffered.[56] Ultimately, the criminal conspiracy charges against KPMG were dropped in 2007.

Opinion letters, drafted by tax lawyers, can have the effect of encouraging tax payers to participate in tax shelters. The purpose of these letters serves to put taxpayers on notice of whether a transaction will more-likely-than-not pass legal muster under judicial scrutiny. There used to be a reasonable cause and good faith exception to § 6662 that exempted the taxpayer from penalties if they could demonstrate their reliance on an opinion letter of a professional tax advisor.[57] Essentially, in the past an opinion letter could protect the taxpayer from any tax penalties. Circular 230 has since "added new regulations and imposed heightened due diligence standards and disclosures for covered opinions, as well as increased penalties for violations."[58] Prior to Stein, there was a perceived limited liability associated with opinion letters. This was due to lack of clear opinion letter standards as well as the taxpayer usually falling short of establishing their reliance on the opinion letter. Opinion letters consist of just that – an opinion. The subjective content of the letter, combined with a lack of a clear definition of what a tax shelter is, has allowed players to capitalize on ill-defined areas on tax law while still complying with the literal language of the governing statute.[59] Self-imposed ethical standards were the strongest "deterrent" for tax lawyers. Any ethical standards that may have existed, however, seemed to have little effect on KPMG's activities discussed in Stein.

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[56] Id.
[57] Id.
[58] Id. at 6.
[59] Id.

The heightened standards imposed in Circular 230 along with now charging fraudulently issuing opinion letters as criminal violations suggests the government is taking a new course in response to the growing number of tax shelters that have proved so difficult to constrain. As discussed below, the criminal standards are ambiguous and using them may not lead to developing a clear and effective deterrent when combined with civil standards.

As pursuant to the charges against KPMG, under 26 § 7201, to prove tax evasion, the government was required to demonstrate:

> (1) The tax shelters were illegal, thus causing a tax deficiency, and (2) that each defendant committed an overt act with the intent to commit tax evasion. Under § 7206(1) and (2), the government needed to establish (1) that defendants filed or caused to be filed tax returns that were false as to material matters, and (2) that defendants did not believe that the tax returns were true as to every material fact.[60]

There is uncertainty in the law concerning what is necessary to prove tax evasion. In a prior case, Cheek v. United States, the defendant must have intentionally and willfully violated a known legal duty in addition to willfully committing the act itself in order to be convicted of tax evasion. Because of the complexity and unclear nature of this statute, courts allow a mistake of law defense to charges of willfulness. "This uncertainty in the law defense is rooted in the fundamental principal of due process that a criminal statute must give fair warning of the conduct that it makes a crime."[61] Considering that the legality of the tax shelters in Stein was never actually determined by a court and the uncertainty in the law concerning tax shelters, the government had difficulties in establishing the defendants knew that the transactions they designed were fraudulent. In addition, the IRS had internal trouble determining whether the transactions were reportable. This strengthened the defendants case that they did not know or they could not have anticipated the IRS' position.

Among the criminal charges that were alleged against the defendants, the government charged

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[60] Id. at 8.
[61] Id. at 8-9.

that the advisors willfully issued false opinions in order to insure tax payers against civil penalties, and thus encouraged tax evasion.

> Under the Cheek subjective intent standard, mistake of law is a defense and a court would allow the defendants to introduce evidence that they did not believe that the opinion letters were in violation of the tax evasion standards. Because the standard is subjective, the outcome would not depend on whether their position is legally accurate. Thus, it would be difficult for the government to prove that the defendants intentionally falsified their opinion letters in order to promote tax evasion under the Cheek standard of intent.[62]

Although in Stein, the court didn't require the government to prove that the defendants actually committed tax evasion in order for the conspiracy charge to succeed, the Supreme Court has held that "conspiracy to commit a particular substantive offense cannot exist without at least the degree of criminal intent necessary for the substantive offense itself."[63] Therefore, sometimes a conspiracy to defraud the IRS charge partially depends on the tax evasion charge. So, to convict for conspiracy, the government must prove that the defendants intended to commit the substantive offense. This has two implications - that advisors can still be found criminally liable when they may not have even committed tax evasion and there once again is a gray area in the law that does not lend itself to clear results that taxpayers and the government can rely on.[64] The following example is an attempt to demonstrate this downfall - suppose a tax advisor determined that a transaction had a 49% chance of passing judicial scrutiny instead of the requisite 51% chance needed to qualify for "more likely than not" treatment. However, he was pressured by his firm to change that number to the requisite 51%.[65] The government would argue that the advisor should be held criminally liable, even though the client has not necessarily evaded any taxes. The tax advisor indisputably violated civil and ethical standards. Under the

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[62] Id. at 9.

[63] Id. at 10.
[64] Id.
[65] Id.

government's theory, a defendant with a low level of culpability could be found criminally liable for tax evasion. But the ambiguity surrounding the governing standards for opinion letters when combined with criminal standards do not provide clear guidelines as to what exactly is necessary to prove tax evasion or to remain in the bounds of what is legal.[66]

B. Criminal Sanctions

It seems like the government is always playing catch up to the multiple ways to evade taxes that are created and manipulated as time goes on. Has the imposition of more different types of penalties been helpful in prosecuting defendants for tax evasion, or has it created more confusion? The criminal liability theory in Stein may cloud the already vague definition of criminal activity in the tax shelter context. It can lead to holding opinion letter writers, who are not guilty of tax evasion, criminally liable of conspiracy to defraud. Complexities lead to the creation of more loopholes. It may be valuable to explore different suggestions that call for simplification in response to the perennially growing tax shelter field.

> For example, it has been suggested that Congress could pass legislation imposing criminal sanctions for providing false opinion letters and explicitly state that a tax professional who intentionally provides false opinions, regardless of the type of opinion letter, is subject to criminal penalties. The statute could specify when it would apply by defining what constitutes a false opinion, for example, the falsification of a material fact. This approach would alleviate the current ambiguity of what violations subject a person to criminal liability.[67]

Alternatively, Congress could require tax opinion letter writers to sign the letters under a penalty of perjury, which would bring the letter writers under the sanctions of the tax perjury statute.

Will imposing criminal sanctions create efficiency or confusion? It is unclear from Stein, whether the defendant's actions warrant criminal sanctions. Alternatively, imposing only civil sanctions

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[66] Id.
[67] Id. at 13.

may decrease the confusion that comes along with bringing criminal charges. For example, "if a tax attorney is found to have knowingly violated a legal duty, and the taxpayer was found to have relied on the tax attorney's advice in good faith, the penalties that are normally imposed for an understatement on the taxpayer should be imposed on the attorney instead."[68] This would be cost efficient for courts because it would prevent having the taxpayers from having to bring a malpractice suit against the attorney, and it would force the attorneys to internalize the external costs generated by their misconduct. Since opinion letters serve a social purpose – assisting good faith taxpayers participate in bona-fide tax transactions – imposing civil sanctions would preserve those benefits that the IRS originally envisioned. If the government focuses on heightening civil penalties, they may achieve a more balanced effective regulation of abusive tax shelter practices while still preserving the safeguards that protect the taxpayers from the complexities of the tax code.

C. Loss Disallowance

Another regulatory response that has been suggested in response to the growing amount of tax shelter transactions has been to

> enact a Code provision that will flatly disallow non-economic losses and non-economic deferrals through the use of foreign (and other tax-indifferent) counter-parties. Non-economic losses can be achieved through the manipulation of tax preferences like accelerated depreciations and interest expense deductions that result from a transaction with no economic purpose other than to avoid paying taxes. For example, a transaction will be considered a non-economic loss and be disregarded for tax purposes when the loss does not reflect any actual economic consequences sustained in an economically substantive transaction.[69]

Financial institutions have purposefully entered into transactions with different companies to take advantage of loopholes that result in no substantive change in order to try and take millions of dollars

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[68] Id. at 14.
[69] Marvin A. Chirelstein and Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet,* 105 COLUM. L. REV. 1939 (2005) at 4.

in losses.

The Rule proposed is: "(1) No deduction shall be allowed for losses substantially in excess of any measurable reduction in the taxpayer's net worth, and (2) no deduction or exclusion from gross income shall be allowed through the allocation of non-economic income to a tax-indifferent party (i.e. foreign bank)."[70] The rules would be based on pure mathematical calculations as opposed to basing a decision on subjective criteria such as motive to avoid tax or case law precedent where history shows that the taxpayer has come out successful more times than the Service.

It is noted however, that Congress did not intend to disallow every type of non-economic loss. The authors of the proposed rule above have further suggested that the provision would not apply to non-economic losses clearly contemplated by Congress. In addition, the provision could be accompanied by a list of situations in which non-economic losses are not subject to disallowance. Creating such a list, however, could be difficult as it is likely that lobbyists would try and persuade Congress to include inappropriate items. But this approach would not be as arbitrary as granting a Court or the IRS wide exercise of authority in deciding what does or does not qualify as a tax avoidance transaction based on a case by case basis.

D. Exceptions to Tax Practitioner – Client Privilege

Another response to the growing number of tax shelters was Congress implementing an exception to the privilege that applies to non-lawyers (i.e. accountants, enrolled actuaries, etc.) and their clients regarding tax planning. The exception to the tax-practitioner-client privilege does not apply to "written communications related to the "promotion" of a client's participation in a tax shelter."[71] "Promotion", however, has been interpreted numerous ways and led to inconsistent and

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[70] Id. at 7.
[71] Jared T. Meier, *Understanding the Statutory Tax Practitioner Privilege: What is Tax Shelter "Promotion"?,* 78 U. CHI. L. REV. 671 (2011) at 1.

confusing results. For instance, some courts have interpreted "promotion" to depend on the length and history of the relationship between the tax practitioner and the taxpayer. In Countryside Limited Partnership v. Commissioner of Internal Revenue, the court relied on legislative history, and "held that the tax advice given as part of a close and routine relationship was not promotion and therefore survived the tax shelter exception."[72] But in Valero Energy Corp v. United States, the court held that promotion can include advice given by a taxpayer's "long-time advisors." If practitioners and taxpayers cannot predict if their communication will be protected, then the individuals will most likely withhold the information in fear of it being revealed later on and the goal of the privilege will not be accomplished.

If the definition of "promotion" was read more broadly and "tax shelter" more narrowly, it may help clear up these ambiguities. If the court in Countryside did not interpret the meaning of promotion based on the length and quality of relationships, the people responsible for implementing a transaction that existed purely for tax avoidance would not have escaped liability. It has been suggested that promotion should be read to mean "in furtherance" or "encouragement", and the length or quality of an advising relationship should not be a factor in determining whether the communications should be privileged. The exception in § 7525(b) exempts

> Communications that are in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in § 6662(d) (2) (C) (ii)). Section 6662(d) defines a tax shelter as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.[73]

Because the definition of a "tax shelter" can extend to more than just included on the above list, the tax shelter exception can possibly reach many types of tax planning communications with tax advisers even if it is legitimate tax advice. Therefore, along with broadening the reading of promotion, it is

[72] Id. at 1.
[73] Id. at 4.

proposed that courts should limit the meaning of a "tax shelter."

The Conference Report that accompanied the exception

> suggests that the exception was intended to target abusive tax practices other than routine or individualized tax planning: 'The Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client.' Accordingly, the Conferees do not anticipate that the tax shelter limitation will adversely affect such routine relationships.[74]

The court in Countryside utilized this statement to clarify the meaning of promotion – that a routine adviser-client relationship would exempt any advice given as part of that relationship from the exception to privilege. Another reading lends itself to a different meaning of "routine-relationship" - "if an adviser is promoting tax shelters, then the advising relationship is not 'routine'."[75] This reading is in contrast to the court's interpretation in Countryside. The language of the conference report does not necessarily suggest that tax shelter promotion should be decided based on the length or closeness of the advising relationship. In fact, a past provision § 6111, that has since been amended, defined 'promoter' as "any person who participates in the organization, management, or sale of a tax shelter."[76] Section 6700, entitled "Promoting abusive tax shelters, etc.," reads that a penalty will be imposed on "anyone who organizes or participates in the sale of an abusive tax shelter."[77] These two code provisions indicate that Congress intended the meaning of 'promotion' not to be read narrowly, because tax shelter promotion doesn't have anything to do with the length or closeness of the advising relationship. It should be read to "include organization, management, or sale of tax shelters and cover a wide array of activities necessary to implement a tax shelter – i.e., creating the shelter idea, developing the plan, finding the participants, and coordinating all of the players."[78] This is in contrast to the Countryside holding, because all of those activities can be carried out during a long-term relationship. Therefore, it

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[74] Id. at 4.
[75] Id. at 7.
[76] Id. at 8.
[77] Id. at 8.
[78] Id. at 8.

may make more sense to define 'promotion' in terms of furtherance or encouragement rather than looking at the nature and length of the advising relationship.

If the meaning of 'tax shelter' is not more limited, then courts will most likely only look at whether the taxpayer tried to reduce their tax burden, but fail to consider whether those tax benefits were proper. If that were the case, then most tax planning documents would be subject to the exception and privy to the IRS in discovery. It's possible to limit the scope of what should be included as a tax shelter by focusing on the "significant purpose" phrase of the statute. If, as part of a tax plan, there results tax benefits that are consistent with congressional intent, then the plan is not considered an abusive tax shelter. This safe harbor has been recognized as part of the Regulations when the language "significant purpose" was actually "principal purpose" instead.[79] The statute used to define a tax shelter if the principle purpose was the avoidance or evasion of Federal income tax. Substituting significant purpose for principle purpose certainly reaches more transactions. But this does not mean than there should still not be a safe harbor for tax planning decisions that are perfectly consistent with the Code and congressional purpose.

V. Systematic Approaches

A. The Problem with Arbitrage Generally

As discussed so far, there are a myriad of tax loopholes that have been and can be created due to the complexity of regulatory schemes and legal planning techniques that are used to avoid taxes, accounting rules, and other regulatory costs. The following section discusses different kinds of regulatory arbitrage strategies that have been examined in hopes that a better understanding of arbitrage patterns will raise the government's awareness and in turn, deter people's engagement in illegal tax shelters.

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[79] Id.

Tax lawyers play a big role in structuring deals for corporations in order to reduce regulatory costs. "The government imposes regulatory costs on transactions in the form of taxes, securities-law disclosure requirements, antitrust constraints, environmental-compliance obligations, and so on."[80] The parties to the transaction, the buyer and seller, can have their lawyers plan the form of the transaction to minimize regulatory costs. Any changes the government imposes during the middle of the transaction, has no effect on the deal. "If a formal change reduces regulatory costs—the government's share of the transaction—the new surplus can be divided between the buyer and the seller."[81] Parties re-structure deals frequently in order to avoid or reduce regulatory costs. More well-established corporations can afford elite law firms to employ aggressive deal structures that alleviate regulatory burdens. Because there is lack of any legal definition for many of the underlying economic relationship between the parties, gaps arise very often that create opportunities to produce regulatory-cost savings. The gap between the tax code and the Investment Company Act of 1940 as discussed above enabled Blackstone to retain a "passive" partnership tax status and avoid the reach of the Investment Act because they held themselves out as an "active" company.

The following constraints may be helpful to understand why and how arbitrage occurs and hopefully, how to curb it. Not in any particular order, the list includes legal constraints, transaction costs, professional constraints, ethical constraints, and political costs. The first category of legal constraints is referred to as rifle-shot rules. These involve lawmakers writing restraints into the statute when they can anticipate specific avoidance strategies.[82] Conversely, if the avoidance strategy is not foreseen, Congress will often amend the statute to prevent similar planning. Section 351(a), for example, allows for non-recognition when a shareholder contributes property to a corporation in exchange for solely stock and control of the corporation immediately after the transaction. As per

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[80]Victor Fleischer, *Regulatory Arbitrage,* 89 TEX. L. REV. 227 (2010) at 5.
[81]Id. at 5.
[82]Id.

section 351(b), if a shareholder contributes property and receives cash or debt in addition to the stock, the non-recognition rule does not apply to the cash or debt. One can formulate a strategy, however, to utilize a form of stock that closely resembles debt and thus skim around subsection (b). Section 351(g) was created in response to and provides an anti-planning constraint on the use of redeemable debt-like "non-qualified preferred stock."[83]

Shotgun and general anti-abuse rules are the next two categories. They are broader anti-abuse rules that target a class of transactions or disallow transactions that are motived by regulatory avoidance, instead of focusing on a specific deal structure.[84] The passive-loss rules, for instance, targets transactions that generate phantom tax losses that are used to shelter income. By providing a broad constraint, this rule limits all losses generated from passive activities to the amount of passive income. General anti-abuse rules are the third category. They are designed to curb regulatory arbitrage without any specific strategy in mind. The closest rule that the U.S. has to a general anti-abuse rule exists in the notoriously complex partnership tax rules that targets tax shelters and other transactions which abuse the partnership form. Unfortunately, this regulation is widely viewed as having failed in its goal of curbing tax shelters that use the partnership vehicle. In sum, "rifle-shot approaches are reactive and difficult to draft effectively. Shotgun approaches may be over-inclusive, and broad anti-abuse rules reduce certainty and may deter legitimate business transactions. "While legal constrains are not perfect, further attention to designing effective statutory constraints is a worthy endeavor."[85]

B. Transaction Costs

Transaction costs associated with arbitrage strategies go beyond the fees paid to lawyers and investment bankers who help structure the plan. They include agency costs between managers and

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[83] Id.
[84] Id.
[85] Id. at 14.

shareholders, information costs and counter-party risks, and opacity costs. Recent financial studies show that transaction costs influence whether tax-avoidance strategies will be employed.[86] It may be important to understand the relationship between these costs and when tax arbitrage occurs in order to further constrain tax planning. Regulatory arbitrage increases information costs because

> each party must invest the time and effort to understand the structure and communicate with relevant stakeholders, such as customers, employees, and shareholders. Furthermore, when a structure uses derivatives, a new counter-party credit risk is introduced to the transaction. The parties must assess this risk by acquiring information about the counter-party and monitor the creditworthiness of the counter-party.[87]

Opacity costs, a subset of information costs, generally tend to limit the number of tax arbitrage strategies employed by companies. For many small businesses for example, opacity costs can be a powerful constraint. Even though organizing a venture capital-backed start-up firm like a partnership would minimize tax liability, many small businesses organize as corporations instead. The reason for this is due to the complexity of the tax consequences associated with operating a new business as a partnership.

Empirical work in finance shows that agency costs affect the profitability of tax avoidance. Managers usually capture a large portion of tax savings from a tax avoidance scheme with little going to the shareholders. These strategies, therefore, end up reducing firm value. "Where managers have high-powered, long-term equity incentives, better aligning their interests with shareholders, they tend to engage in fewer tax-avoidance strategies than managers without such incentives."[88] In firms where agency costs are low and where there are strong corporate-governance characteristics, it is more likely that managers will engage in more aggressive tax-avoidance strategies. It is unclear just how much agency costs actually do constrain arbitrage, but it has been shown that privately held firms engage in more tax avoidance than public firms, family owned firms with minority shareholders engage in less

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[86] Id.
[87] Id. at 15.
[88] Id. at 15.

tax avoidance than firms with lower agency costs constraints, and that private firms backed by private equity firms engage in more tax avoidance than management owned firms.

C. Professional, Ethical, and Political Costs

Professional, ethical, and political constraints may all influence lawyers to not execute a strategy that is perfectly legal. Professional constraints, for example, refer to building and maintaining a strong reputation as a tax planning firm that does not just give out answers that clients want to hear, but the right answers that are respected by regulators. As the market for regulatory legal work increases, firms are competing to uphold a strong reputation that clients will continue to pay premium rates for. Maintaining a respected reputation can prevent firms from engaging in overly aggressive planning.[89]

Some lawyers do, however, admit to there being pressure to provide the client with advice favorable to reducing taxes.[90] Additionally, it is rare that clients rely on a single firm to provide them with advice. It is the norm for clients to have used over 100 different firms and to "threaten" to take their business elsewhere if the lawyer does not read the regulations in their favor. Internal pressure also exists from the firm, depending on what type it is, to not focus too much on the IRC and to just close the deal. Some firms provide financial incentive for lawyers to be more aggressive.[91] On the other hand, lawyers in general partnership firms may not engage in very aggressive structures because they're personal assets are at risk. Another interesting angle is that more recent law graduates have been trained to read statutes more aggressively, relying on the plain meaning of the words to justify a favorable result. Many times, transactions fall into a gray area where the Code provides no clear guidance and practitioners must do the best they can. A lawyer not too long out of law school recently

[89] Id. at 17.
[90] Id.
[91] Id.

explained, "Since there's no right answer anyway, I might as well choose the most favorable meaning for my client."[92] It may be interesting to query how much a lawyer balances deeper questions of public policy and congressional intent with the language of the statute in determining the best decision for their client.

Ethical constrains, personal to an individual lawyer, are separate from any institutional pressure. Many question if a moral duty exists among lawyers to produce legal advice that is conservative and mindful of the public interest. As professionals, most lawyers view their ethical obligation as providing their client with all of the relevant legal options with their ethical views thought to be irrelevant.[93] The majority view, that lawyers have an overriding duty to their clients and clients to their shareholders, suggests that regulatory arbitrage will continue to expand. Should lawmakers continue to implement new constraints that may have the effect of further complicating the system? Or, as suggested by many lawyers, will some regulatory arbitrage opportunities become an accepted practice and be legitimized to fit into the system for purposes of simplification? Political constraints largely depend on the firm's long-term involvement with the political process; i.e. a firm's soft-money campaign contributions, issue ads, and lobbying expenditures.[94] These constraints have the ability to reach all of those involved with regulatory arbitrage. If an avoidance strategy goes too far, politicians may respond by enacting new legislation, more attention may be placed on that firm, and customers may take their business elsewhere. There tends to be more risk of exposure in public deals, which are open to more scrutiny, as opposed to private deals. In addition, it is easier for firms with strong existing political relationships to engage in regulatory arbitrage. At the same time, the firms with powerful political relationships may be less inclined to put those relationships in jeopardy.[95]

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[92] Id. at 19.
[93] Id.
[94] Id.
[95] Id.

VI. Conclusion

In sum, the constraints discussed above do not impact firms uniformly. Legal constraints have been effective and it is worthwhile for lawmakers to address obvious forms of avoidance techniques. Because the type of firm affects how they will absorb the regulatory costs, it may be beneficial to consider employing anti-avoidance rules that take these differences among new firms, entrepreneurial firms, and small businesses into account in order to achieve a more proportionate result. Because most lawyers view their ethical duty to their clients, policy makers should not rely on ethical constraints as a guideline. Furthermore, professional constraints do not provide clear parameters for creating efficient anti-avoidance rules. Finally, firms that have strong political relationships with inside players like lobbying legislators, staffers, and agency lawyers can best take advantage of regulatory arbitrage.

Contrary to what some might think would be the simplest route – Congress continuing to make new laws and change the system as new loopholes pop up – might result in even more opportunities to create new loopholes. With that sort of plan, comes increasing costs and complexities, as well diluting agency resources. If regulatory arbitrage is inevitable, it may be worthwhile to think about if it is feasible for the government to accept some of these practices and consider trying to reap their own benefits from the practices. The government should, as much as possible, approach this industry with simple strategies and avoid combining criminal and civil standards that would further create more confusion. While it remains to be seen what will happen, the heightened disclosure requirements and the increased attention that has been given to tax avoidance strategies, will hopefully lead to a greater awareness of corporate tax shelters and ultimately, to their decline.