Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of Long Term Capital Holdings v. United States

Yoram Keinan†

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

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

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

–Judge Learned Hand, C. J. (February 20, 1947)

TABLE OF CONTENTS

I. Introduction .................................................................................................. 383
II. The Economics of Penalties ........................................................................ 388
   A. Introduction ............................................................................................. 388
   B. The Utilitarian-Economic Theory .......................................................... 390
   C. Sanctions as Prices ................................................................................. 390
      1. The Strict Approach ............................................................................. 392
      2. The Intermediate Theory .................................................................... 392
      3. The Moral/Ethical Approach ............................................................... 393
   D. Conclusions ............................................................................................. 394
III. Tax Penalty and Deterrence ....................................................................... 394
   A. Cost-Benefit Equation ........................................................................... 394
   B. The Tax Department as a Profit-Maximization Unit ................................ 396
   C. Avoiding Overdeterrence ....................................................................... 397
IV. Tax Accuracy-Related Penalties ................................................................ 398
   A. Overview .................................................................................................. 398

† Yoram Keinan is an Adjunct Professor at the University of Michigan Law School, Georgetown Law Center, and American University Washington College of Law, and a Senior Manager with Ernst & Young's Financial Services Industry Group and the Capital Markets Tax Practice of the National Tax Department in Washington, D.C. As a senior manager at Ernst & Young, he specializes in United States taxation of financial products and institutions. He received his M.P.A. and I.T.P. (International Taxation) from Harvard, LL.M. (Taxation), and S.J.D. from the University of Michigan.

¹ Oliver Wendell Holmes, The Path of the Law, 10 HARV. L. REV. 457, 459 (1897).
B. The Evolution of the Accuracy-Related Provisions ........................................ 399

V. Playing the Audit Lottery: A Cost-Benefit Analysis ........................................ 407
   A. The Cost-Benefit Equation ........................................................................... 407
      1. The Taxpayer’s Prospective Gain (M) ...................................................... 409
      2. The Taxpayer’s Lump Sum Costs (C) ...................................................... 409
      3. The Probability of Being Subject to Penalties (Z) ................................. 409
      4. The Rate of the Penalty (F) .................................................................... 414
   B. Analysis of the Cost-Benefit Equation ....................................................... 415
      1. Assumptions ......................................................................................... 415
      2. Determining What is a Sufficient Level of Deterrence
         According to the Taxpayer’s Cost-Benefit Equation ................................ 415
      3. The Impact of Changes in the Rate of the Penalty ................................... 416
      4. The Impact of Changes in the Probability of Being Subject to the Penalty .... 417
      5. Summary of the Results ....................................................................... 418
   C. Conclusions .............................................................................................. 419

VI. How to Change the Corporate Taxpayer’s Cost-Benefit Equation:
   Recent Developments and a Proposal .......................................................... 419
   A. General .................................................................................................... 419
   B. Increasing Z1 and Z2: Reporting, Listing and Disclosure ....................... 421
      1. General .................................................................................................. 421
      2. Jobs Act’s Revisions ........................................................................... 421
      3. The Impact on the Cost-Benefit Analysis .............................................. 422
   C. Increasing Z3: Codification of the Economic Substance
      Doctrine ..................................................................................................... 423
   D. The Reasonable Cause Exception .............................................................. 427
      1. Jobs Act of 2004 ................................................................................. 427
      2. Long Term Capital Holdings v. United States ....................................... 428
      3. IRS’s Reaction to its Victory ................................................................ 430
      4. Second Circuit’s Decision .................................................................... 430
      5. CMA Consolidated Case-Lease Stripping Transaction ......................... 431
      6. Summary .............................................................................................. 433
   E. Changing the Structure of the Penalty Rates .............................................. 434

VII. Conclusions .............................................................................................. 435
The Role of Penalties in Tax Law After Long Term Capital Holdings

Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of Long Term Capital Holdings v. United States

Yoram Keinan

I. INTRODUCTION

Tax-motivated transactions have become a serious consideration for Congress in recent years. Their concerns include loss of tax revenues, harm to the integrity of the tax system, and equity. The equity concern may be described as follows: hard-working taxpayers, who pay their fair share of taxes, should not be at a disadvantage compared to more sophisticated taxpayers who are able to create tax shelters for themselves. As Commissioner Everson stated more than two years ago:

[The IRS is committed to ensuring everyone pays his or her fair share, including those who have the resources to move money offshore or engage in abusive schemes or shelters. We must focus our efforts on achieving greater corporate accountability and ensure that high-end taxpayers fulfill their responsibilities. Honest taxpayers should not bear the burden of others who skirt their responsibility.]

Although these concerns are understandable, Judge Learned Hand stated many years ago that: "[A]nyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's tax."
Accordingly, a transaction should not be treated as a tax shelter if tax authorities do not specifically prohibit it. It is necessary, as this Article will argue, to balance the taxpayer's right to plan within the tax law and the tax authorities' right to prohibit such transactions.

To date, most legislative attacks on corporate tax shelters have targeted specific transactions and have taken place on an "ad-hoc," after-the-fact basis through legislation, administrative guidelines, and litigation. Since Congress undertook the first comprehensive action against corporate tax shelters in the Tax Reform Act of 1976, Congress has introduced various measures attempting to crack down on tax-motivated transactions. In recent years, legislation has become more comprehensive, important elements of which include enhancement of penalties, stronger disclosure requirements, and changes in substantive law. It would seem that these recent attempts signal legislative dissatisfaction with the existing piecemeal rules. Accuracy-related penalties have played a key role in attempts to crack down on tax-motivated transactions. This Article examines the effectiveness of such penalties on a corporate taxpayer's cost-benefit equation in deciding whether to undertake a transaction, assuming the taxpayer is a "bad man" or a "bad corporation." Pursuant to the "bad man" theory espoused by Justice Holmes more than a hundred years ago, a rational person decides whether to comply with the law by calculating his or her own benefits and costs, including his risk of punishment. The rational person breaks the law whenever his or her potential gain from disobeying the law exceeds his or her risk of punishment.

The same calculus applies to obeying tax law; a taxpayer chooses a level of compliance by weighing the costs and benefits of compliance with those of noncompliance and selecting the level of compliance that will lead to the highest expected level of net benefits. The probability of detection and audit different from its appearance. True, it is always the intent that controls; and we need not for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not the whole, transaction would realize . . . (citations omitted; emphasis added).

8. Id.
9. See Holmes, supra note 1, at 459.
10. Id.
A simple approach to the problem of tax compliance holds that when people decide whether to pay their taxes, they take account only of the cost of the tax and of the expected legal sanction from noncompliance. If the expected sanction exceeds the tax payment, the person will pay; otherwise, he will not.
See also Alfred Blumstein, Models for Structuring Taxpayer Compliance, in INCOME TAX COMPLIANCE, REPORT OF THE ABA SECTION OF TAXATION, INVITATIONAL CONFERENCE ON INCOME TAX (1983). Many commentators, including Posner, have observed that individual taxpayers might have other
combined with the magnitude of the penalties are the major expected costs of underpayment of taxes. Accordingly, underpayment of tax is similar to gambling and is referred to as "playing the audit lottery." Penalties are an additional "price" of engaging in an activity that might be viewed as tax-motivated. Absent sufficient penalties, corporations would always play the audit lottery.

The "bad man" theory can explain tax-motivated transactions of business entities and individuals. However, with individuals, non-economic considerations may also be involved; while in the case of corporations, the decision whether to enter into a tax-motivated transaction will depend solely on quantitative factors. This Article focuses on business entities and assumes that business entities decide whether to enter into a tax-motivated transaction based solely on quantitative economic considerations.

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

This Article discusses these two measures as well as various others taken by Congress and the Treasury in recent years to crack down on tax-motivated transactions. By using cost-benefit analysis, I will evaluate the effectiveness of these measures and show that in order to reduce the taxpayer's incentive to play the audit lottery, Congress must focus on increasing the likelihood that the

considerations in deciding whether to comply with the tax law, such as moral values and guilt. This Article focuses on corporations, and assumes that corporations have no moral duty.

12. *Id.*; see also Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1463 (2003) ("[A] rational taxpayer will evade taxes if the expected value of the punishment is lower than the expected gains from evasion.").
14. *Id.* at 92-93.
15. *See* Yoram Keinan, *Corporate Governance and Professional Responsibility in Tax Law*, 17 J. TAX'N F. INST. 10, 11 (2003) ("Entrepreneurs are assumed to seek maximization of the difference between their total receipts and their total costs, and therefore, tax savings that reduce entrepreneurs' total costs can play a role in this profit maximization." (footnote omitted)).
18. Specifically, as discussed in detail below, the Treasury and the Joint Committee focused on increasing the rate of accuracy-related penalties to 40 percent as a means of deterring taxpayers from entering into tax-motivated transactions.
taxpayer will face audit and detection rather than the penalty rate.¹⁹

The last year saw the occurrence of several important developments in the government's attempts, both judicial and legislative, to crack down on tax-motivated transactions. It began in August 2004, with *Long Term Capital Holdings v. United States,* ²⁰ a case in which a district court in the Second Circuit held that a transaction involving the contribution of stock with a built-in loss to a partnership lacked economic substance and had no business purpose other than tax avoidance. The district court followed previous Second Circuit cases, especially *Goldstein v. Commissioner,* ²¹ and applied both an objective profit potential test and a subjective business purpose test to determine that the transaction had neither reasonable potential for profit nor a legitimate business purpose.²² Most importantly, the court upheld accuracy-related penalties assessed by the IRS despite the taxpayer's argument that the transaction satisfied the reasonable-cause exception by virtue of obtaining and relying on two separate law firms' opinions that the transaction should be in compliance with the law. The Second Circuit affirmed the district court's decision, upheld tax underpayment penalties against Long Term Capital Holdings for a gross valuation misstatement, and found that there was no reasonable cause for the understatement.²³

In *Santa Monica Pictures, LLC v. Commissioner,* ²⁴ another case involving the contribution of high-basis low-value assets to a partnership, the Tax Court held that the transactions lacked economic substance and business purpose and imposed accuracy-related penalties, in spite of the taxpayer's reliance on various opinions from several tax professionals.²⁵

¹⁹. See, e.g., Charles O. Rossotti, *Modernizing America's Tax Agency,* 83 TAX NOTES 1191, 1195 (May 24, 1999): Historically, the IRS placed great emphasis on direct enforcement revenue, in part because it is precisely measurable and in part because it showed an indirect deterrent effect that increases compliance. However, there are many techniques other than direct enforcement that increased compliance at the IRS and elsewhere, such as better and more targeted taxpayer education, better reporting, voluntary agreements, improved regulations, and earlier intervention through notices and phone calls.
²¹. 364 F.2d 734 (2d Cir. 1966).
²². Alternatively, the court held that the transaction could be recast under the step-transaction doctrine as a taxable transfer of the loss stock from the contributing partner to the general partner, followed by a sale of the stock by the general partner.
²⁴. 98 T.C.M. (CCH) 1157 (2005). The facts in this case were arguably more extreme than in *Long Term Capital Holdings,* particularly, as the court pointed out, because three weeks after the formation of the partnership, the original partners that contributed the loss assets to the partnership left that same partnership.
²⁵. The taxpayer attempted to rely on the "reasonable cause" exception under I.R.C. § 6664, emphasizing that it had relied on "outside" professional tax advice. To support its position, the taxpayer presented several different opinions obtained from several tax advisers pertaining to different aspects of the transaction. The Tax Court reviewed each of these opinions and concluded that none of them could provide the basis for the exception, mainly because they did not address the controversial issues of the transaction and/or made unreasonable assumptions, such as that the transaction had a business purpose.
The Role of Penalties in Tax Law After Long Term Capital Holdings

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

The Jobs Act of 2004 (P.L. 108-357), was signed by the President on October 22, 2004. The Act, both in the House version and the Senate version, included provisions designed to curtail the use of tax-motivated transactions; these provisions represent the most significant effort by Congress to crack down on tax-motivated transactions since the Tax Reform Act of 1986. As Senator Charles Grassley pointed out:

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

Under the new standard, taxpayers and their advisors must disclose reportable transactions (as discussed below) or suffer higher penalties. However, the proposal to clarify and codify the economic substance doctrine as proposed by Senate was widely criticized and finally dropped by the House.

27. An in-depth discussion on this case is set forth *infra*, Part VI.D.5.
32. *Id.*
33. An important consequence of the Jobs Act of 2004 is also the consolidation of the reporting, registration, listing, and certain accuracy-related penalty provisions under the statutory "reportable transactions" standard, as opposed to the previous incoherent "tax shelter" standard.
34. For a description of the Senate’s proposal to codify the economic substance doctrine, see S. 1637, supra note 30. Subsequent to the enactment of the Jobs Act, three district courts have held for the taxpayers in cases involving tax-motivated transactions. First, in *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621, 624 (D. Md. 2004), a district court granted Black & Decker’s motion for summary judgment in its refund suit for over $57 million in federal taxes arising from a contingent liability transaction. Most notably, the parties stipulated that the taxpayer had no business purpose in entering into the transaction. Nevertheless, because in the Fourth Circuit the disjunctive test prevails, the district court held for the taxpayer on the grounds that the transaction had economic substance. In *Coltec Industries Inc. v. United States*, 62 Fed. Cl. 716, 756 (2004), a U.S. Court of Federal Claims ordered the IRS to refund to Coltec Industries Inc. $82.8 million in federal taxes arising from a contingent liability transaction, almost similar to the one in *Black & Decker*, on the grounds that the transaction satisfied the statutory language and requirements of the applicable statutory provisions (section 357) and, only as a backstop, applying the economic substance doctrine to conclude that the transaction had both business purpose and economic substance. Finally, in *TIFD III-E Inc. v. United States*, 342 F. Supp. 2d 94, 121-
II. THE ECONOMICS OF PENALTIES

A. Introduction

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

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

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

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

The Bad Man is not a revolutionary nor even a reformer out to change ‘the system.’ The Bad Man’s concern is to secure his personal objectives within the existing order as painlessly as possible; he is not so much alienated from the law as he is indifferent to all aspects which do not affect him personally. Unlike Sartre’s Saint Genet, he is not one who has a problem of identity—who defines his being in terms of the system and who is driven to do acts because they are criminal or antisocial. Nor is he a subscriber to some perverse ethic, which turns conventional morality upon its head. The Bad Man is amoral rather than immoral. He is, like Economic Man and Bentham’s ‘civilized’ actors, a rational, calculating creature. In this and in other respects he does not necessarily reflect in a realistic manner the characteristics of actual deviants. Like Dahrendorf’s homo sociologicus, he ‘can neither love nor hate, laugh nor cry.’ He remains a pale, incomplete, strange, artificial man.

The same arguments have been made with respect to tax evasion; a taxpayer may have qualitative considerations (such as moral duty) in deciding whether to evade taxes. Eric Posner concludes that:

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

Such non-economic considerations, however, are rarely considered by corporations, which are the subject of this Article. This distinction between individuals and corporations could be explained by Milton Friedman’s 1970 essay in The New York Times magazine section entitled The Social

---

40. Id. This model is generally derived from Gary Becker’s model of criminal enforcement. See Becker, supra note 38, at 172.
41. Id.
43. Joseph Bankman & Thomas Griffith, Social Welfare and the Rate Structure: A New Look At Progressive Taxation, 75 CAL. L. REV. 1905, 1942 n.169 (1987) (arguing that it seems reasonable to attribute some compliance unexplained by the economic model to such things as the moral and social costs of dishonesty and the transaction costs of enduring an audit).
44. Posner, supra note 11, at 1782 (footnote omitted).
Responsibility of Business Is to Increase Its Profits.\textsuperscript{45} As discussed in greater detail below, the elevation of corporate tax departments into profit centers for corporations eliminated most, if not all, qualitative considerations of entering into a tax-motivated transaction.\textsuperscript{46}

B. The Utilitarian-Economic Theory

The utilitarian-economic theory of penalties, according to which penalties should be set at a level that eliminates all potential gain to the offender, was introduced by Jeremy Bentham in the eighteenth century.\textsuperscript{47} Two hundred years later, Gary Becker restated the goal of penalties was the internalization of the social costs of offenses, rather than the elimination of gain.\textsuperscript{48} Polinsky and Shavell then followed Becker’s approach and suggested that offenders generally consider potential punitive damages discounted by the probability of actually being found liable.\textsuperscript{49} Finally, Keith Hylton combined these two approaches by proposing that, if the gains to offenders are less than their victims’ losses, punitive awards should act to eliminate these potential gains to the injurers and not to compensate all of the victims’ losses; conversely, if the offenders’ gains are greater than their victims’ losses, punitive awards should act to compensate the entire amount of the victims’ losses, although the latter would mean that the injurer still gets some gain from the violation.\textsuperscript{50}

C. Sanctions as Prices

A positivist defines “law” as an obligation backed by a sanction.\textsuperscript{51} Under this view, people will comply with the law even if the penalty does not accurately reflect the “price” of behavior.\textsuperscript{52} According to Robert Cooter,
“sanctions” differ from “prices” because

[A] sanction is a detriment imposed for doing what is forbidden, such as failing to perform an obligation. For example, a defendant in a tort dispute may be ordered to pay compensatory damages for an injury caused by his negligence, or a convicted criminal may be sentenced to jail. In contrast, a price is payment of money which is required in order to do what is permitted. For example, a company may buy goods in the marketplace, but it must pay the seller’s price. Similarly, individuals are permitted to earn income, but obliged to pay taxes on their earnings. These definitions of sanction and price are not always consistent with ordinary speech. Tax evasion is forbidden, but in casual speech people often say a fine is the price of tax evasion, when by these definitions it is a sanction.\(^5\)

The “bad man” theory, although viewed as a form of positivism, portrays these sanctions as “prices.”\(^5\) Economic analyses of deterrence are based on applying price theory to activities.\(^5\) From an economic perspective people therefore engage in or refrain from injury-causing behavior depending on how much they may gain or lose from doing so. If the sanctions or “prices” are too high, rational people will refrain from the injury-causing or prohibited conduct.\(^5\) The same rationale applies to tax compliance.

One of Holmes’s most significant and famous arguments is that, in much of private law and, in particular, in torts and contracts law, the “bad man” regards damages and other sanctions as nothing more than a “tax” on the conduct (that is, the breach of contract or negligence).\(^5\) Holmes’s “bad man” theory simply transforms the general structure of liability rules: rather than issuing commands such as “fulfill contracts” or “take due care,” the law in Holmes’s theory instead provides the choice to “fulfill contracts, or pay compensation” and “take due care, or pay compensation for damage that results.”\(^5\)

Naturally, the notion that torts should not be forbidden as long as the injurer pays the price for its actions removes all the moral implications inherent in private law. If a fine is considered to be equivalent to a tax, the bad man’s point of view removes any distinction between wrongful conduct, which should be

---

53. Id. at 1524-25.
55. For a similar argument in the context of copyright violations, see Ann Bartow, Electrifying Copyright Norms and Making Cyberspace More Like a Book, 48 VILL. L. REV. 13, 62 (2003) (“[M]ost consumers are ‘bad but rational men’ who will infringe copyrights at every opportunity unless they are dissuaded from doing so by the fear of punishment.”).
57. See Holmes supra note 1, at 461.
58. David Luban, The Bad Man and the Good Lawyer, in THE PATH OF LAW AND ITS INFLUENCE: THE LEGACY OF OLIVER WENDELL HOLMES, JR., supra note 38, at 33, 39; see Philip Soper, Law’s Normative Claim, in THE AUTONOMY OF LAW 232 (Robert P. George ed., 1996). Thus, sanctions cannot be avoided, but if the state does not claim that people should follow the law because it says to, the state invites people to choose their best alternative and, thus, to view sanctions as merely prices on conduct. According to Soper, such a view is inconsistent with normative language, which distinguishes between taxes and fines.
followed by a sanction and acceptable conduct which is taxed.

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

1. The Strict Approach

In 1982, Frank Easterbrook and Daniel Fischel put forth the strict approach for corporate compliance. This states that corporations (through their officers) do not have an ethical duty to obey laws just because the laws exist; rather, they may act according to the effect of these laws on their individual welfare. Thus, the penalties Congress imposes on disobedience measure how much it thinks firms ought to sacrifice and still adhere to the rules. In turn, the idea of optimal sanctions depends on the supposition that corporations not only may, but also should, violate the rules when it is profitable for them to do so. In the context of tax law, one commentator has indicated that “[s]ome evasion may be efficient because it relates to productive activity that the taxpayer would not have undertaken if he had to pay tax on it.” The concept of law thus relies on an analysis of the likelihood of detection and enforcement, and the probability of enforcement becomes a factor in the rational actor’s calculus as to compliance with the law. Thus, compliance with the standards of behavior set forth in statutes and administrative regulations becomes voluntary; in other words, one has the “right,” although not necessarily a duty, to violate the law, if one is willing to risk the penalties. As a consequence, lawyers have the duty to provide the information necessary for clients to be able to exercise this “right.”

Therefore, the strict approach can be seen as resembling Holmes, whose “bad man” can be used easily to refer to the “bad corporate client.”

2. The Intermediate Theory

The strict approach has been criticized by various commentators as “clearly

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

60. Id. at 1177 n.57.

61. See Lederman, supra note 12, at 1456 n.10.


64. Luban, supra note 58, at 43 (suggesting that under one reading one may view the bad man as the “usual corporate client of Holmes’s day, who ‘treats all legal rules as prices on conduct, risks of sanctions to be discounted by the probability of enforcement, data for cost-benefit analysis’” (quoting Gordon, supra note 38, at 17)).
extreme.” Specifically, Cynthia Williams argues that following the “law-as-price” view of civil regulatory law means that regulatory law is viewed as voluntary, or in other words, as something citizens are free to choose to ignore by accepting or risking the known consequences. According to the intermediate theory of corporate compliance, some laws prohibit actions, such as those generally found in criminal statutes, while some laws put a price on various modes of conduct, such as those generally found in civil law. In this way, regulatory law can be understood as a pricing regime, including even those that include criminal sanctions on violations. Williams summarizes the following elements of the intermediate theory, in accordance with Pepper’s view:

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

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

3. The Moral/Ethical Approach

Other commentators, however, believe that there is a third approach. This approach assumes that, in the corporate decision-making process, social and ethical norms are considered alongside economic factors. For example, the
ALI's Principles of Corporate Governance provide that a corporation "may properly take into account ethical considerations that are generally recognized as relevant to the conduct of business." Thus, rejecting the "sanctions-as-prices" theory, according to the ALI, corporations should consider social norms even if corporate profit and shareholder gain are not thereby enhanced. Many commentators have argued that morality plays an important role in tax compliance as well.

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

D. Conclusions

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

III. Tax Penalty and Deterrence

A. Cost-Benefit Equation

Consistent with the "bad man" theory, a taxpayer's decision whether to comply with tax laws is a rational choice to maximize its expected "utility" or

---

*Corporate Law and Social Norms, 99 COLUM. L. REV. 1253 (1999).*

70. See AMERICAN LAW INSTITUTE, supra note 65. Section 2.01 reads as follows:

The Objective and Conduct of the Corporation

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

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

1. Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
2. May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
3. May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

71. See, e.g., Bankman, supra note 46.

72. See Cooper, supra note 13, at 111-12.
The Role of Penalties in Tax Law After Long Term Capital Holdings

well-being.\textsuperscript{73} Under this theory, the taxpayer chooses a level of compliance by weighing the costs and benefits of compliance with those of noncompliance and then selecting that level of compliance that will lead to the highest expected level of net benefits.\textsuperscript{74} On the cost side, the probability of detection and audit combined with the magnitude of the penalties are the major expected costs of underpayment of taxes.\textsuperscript{75} Several other factors, however, may also be considered part of these expected costs, including the expected level of guilt arising from tax evasion, damage to the taxpayer's reputation if underpayment is detected, and the taxpayer's level of risk aversion.\textsuperscript{76} On the potential gain side, the primary expected benefit from a tax-motivated transaction is the additional after-tax income that results.\textsuperscript{77} As Professor Joel Slemrod indicated:

The standard economic model of an individual's choice about evasion portrays taxpayers as completely amoral, deciding about whether and how much to evade taxes in the same way they would approach any risky decision, such as how to construct a portfolio, how much insurance to buy, or whether to go to Reno to gamble—as a tradeoff between risk and return. Successful tax evasion increases income because it saves on taxes, but detected tax evasion results in a penalty. What to do depends on the chance of getting caught and penalized, what that penalty might be, and how risk-averse one is.\textsuperscript{78}

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

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

\textsuperscript{73} See Allingham & Sandmo, supra note 32 (applying to tax evasion an economic model similar to Becker's model); cf. Richard C. Stark, A Principled Approach To Collection And Accuracy-Related Penalties, 91 TAX NOTES 115, 116 (Apr. 2, 2001) ("Taxpayers choose to comply or not to comply with our tax laws for many reasons, of which monetary sanctions are one. Psychologists, sociologists, economists, legal scholars, and others have identified many reasons for compliant and noncompliant conduct.").

\textsuperscript{74} See Lederman, supra note 12, at 1463 ("[A] rational taxpayer will evade taxes if the expected value of the punishment is lower than the expected gains from evasion.").

\textsuperscript{75} See Blumstein, supra note 11; Lederman, supra note 12, at 1463 n.46.

\textsuperscript{76} See generally JOINT COMMITTEE REPORT, supra note 3. The Report emphasizes that the level of risk aversion is an important element. Taxpayers will vary in their attitudes towards risk taking. Even if the expected costs are lower than the expected gain, a risk-averse taxpayer may choose not to engage in tax evasion under the same scenario; as such, taxpayer gives more weight to the costs than to the benefits.

\textsuperscript{77} For example, in the context of transfer pricing, multinational corporations, which are likely to enter into cross-border transactions, are required to conduct professional research on their pricing policy. This research is required to be available to the inspection of the IRS no later than 30 days after the IRS demand to inspect the company's pricing policy. Conducting this research and formulating the opinion is a big business today, and it imposes significant costs on taxpayers, which might be subject to an audit.

\textsuperscript{78} See Joel Slemrod, Tax Minimization and Corporate Responsibility, 2002 TAX NOTES TODAY 175-20 (Sept. 6, 2002).
additional deterrent effect."79 In many cases, corporate taxpayers offer to agree to all, or a larger portion, of a deficiency in exchange for a concession of the penalties.80 Pursuant to the Government's victory in *Long Term Capital Holdings*,81 the IRS has instructed its attorneys in a Chief Counsel Notice not to be flexible in such negotiations because:

Conceding penalties in such cases also risks undercutting efficient tax administration by reducing the deterrent effect of penalties. Taxpayers and tax practitioners will have less incentive to voluntarily comply if they believe that they can routinely bargain away penalties. In the context of tax shelters (especially listed transactions and potentially abusive transactions), the proper imposition and sustention of penalties in Appeals and in litigation can serve as an effective tool to combat the proliferation of abusive tax shelters.82

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

**B. The Tax Department as a Profit-Maximization Unit**

In recent years, the officers of many companies have come to view their tax liability as a manageable cost that can be reduced like any other ordinary operational cost.83 Treating a corporation's tax liability in this manner leads to the evaluation of the corporate tax department's performance on a quantitative basis.84 This perspective not only increases the corporate motivation to enter into tax-motivated transactions, but also eliminates all the non-quantitative

---


80. Id.


82. See CC-2004-036, supra note 79.


84. See Bankman, supra note 46, at 1784 ("At the same time, perhaps part of a general trend of greater management responsiveness to shareholder concerns and returns, and perhaps due to greater management sophistication, tax departments are now looked at in some companies as profit centers."); text accompanying notes 20-21; see also Urban Institute Testimony on Tax Fraud, Evasion, supra note 3; JOINT COMMITTEE ON TAXATION, REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS (JCS-3-03), Feb. 2003, at 8, available at http://www.gpo.gov/congress/joint/jcs-3-03/vol1/005-011.pdf:

As Enron's management came to realize that tax-motivated transactions could generate financial accounting benefits, Enron looked to its tax department to devise large transactions that would increase its financial accounting income. Enron came to view the role of its tax department as more than managing its Federal income tax liabilities. Rather, Enron's tax department became a source for financial statement earnings, thereby making it a profit center for the company.
The Role of Penalties in Tax Law After Long Term Capital Holdings

aspects of tax evasion. Managers of corporate tax departments today are much less risk-averse and more frequently engage in tax-motivated transactions whenever the potential benefits exceed the expected costs. As one commentator indicated, corporate tax evasion could be viewed as any other typical financing/investment activity of the corporation.

C. Avoiding Overdeterrence

However, the sanction attached to wrongdoing should be in proportion to the gravity of the wrong. Because the government does not wish to discourage corporate activity, overdeterrence created by overly harsh penalties is undesirable; the government is interested in promoting and encouraging business activity in order to stimulate the economy. Therefore, Congress is interested in reducing tax-motivated transactions only with respect to transactions with no economic substance - those that are conducted solely for tax-reduction purposes.

In Long Term Capital Holdings v. United States, the district court asserted that:

The absence of reasonableness sheds light on Long Term’s subjective motivation, particularly given the high level of sophistication possessed by Long Term’s principals in matters economic. Moreover, the construction of an elaborate, time consuming, inefficient and expensive transaction with OTC for the purported purpose of generating fees itself points to Long Term’s true motivation, tax avoidance. Taking fee-generating investments was Long Term’s core business and was regularly executed without either the complex machinations related to OTC’s contributions or the attendant millions in transaction costs. See Boca Investerings P’ship v. United States, 314 F.3d 625, 631-32 (D.C. Cir. 2003). For these and the following reasons, the Court finds that fees, strategic value added by B&B, and increasing Long Term’s principals’ Portfolio investments did not motivate the OTC transaction; rather Long Term possessed no business purpose other than tax avoidance.

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

85. See Slemrod, supra note 78.
86. See Cooper, supra note 13, at 89:
   That is, a corporation that engages in tax evasion can be analyzed as if it had borrowed the unpaid tax from the government and invested the borrowed money in a risky asset. Thus, corporate tax evasion offers the prospect of enhancing the market value of the corporation either because it represents a profitable investment of the corporation’s funds or because of the profitable terms on which the money was borrowed.
87. Cooter, supra note 54, at 915.
88. See Polinsky & Shavell, supra note 49, at 907.
89. 330 F. Supp. 2d 122, 186-87 (D. Conn. 2004).
IV. TAX ACCURACY-RELATED PENALTIES

A. Overview

Accuracy-related penalties apply to the portion of any underpayment that is attributable to (i) negligence,\(^9\) (ii) any substantial understatement of income tax,\(^9\)\(^1\) (iii) any substantial valuation misstatement, (iv) any substantial overstatement of pension liabilities, or (v) any substantial estate or gift tax valuation understatement. The amount of any understatement generally is reduced by any portion attributable to an item if (i) the treatment of the item is or was supported by "substantial authority," or (ii) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.\(^9\)\(^2\) In addition, an accuracy-related penalty will not be imposed with respect to any underpayment if the taxpayer can show that there was a "reasonable cause" for the understatement and that the taxpayer acted in good faith with respect to such understatement.\(^9\)\(^3\) These two exceptions are discussed in greater detail below.

If the transaction constitutes a "tax shelter," special rules apply. Prior to the

---

\(^9\) I.R.C. § 6662(a)(1) imposes a 20-percent accuracy-related penalty on any portion of an underpayment of tax which is attributable to negligence or disregard of rules or regulations. For purposes of section 6662, the term "negligence" includes any failure to make a reasonable attempt to comply with Code provisions. I.R.C. § 6662(c). "Negligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances." Marcello v. Comm'r, 380 F.2d 499, 506 (5th Cir. 1967), aff'g in part and remanding in part 43 T.C. 168 and 43 T.C.M. (CCH) 1847 (1964); see also Neely v. Comm'r, 85 T.C. 934, 947 (1985). For purposes of I.R.C. § 6662, the term "disregard" includes any careless, reckless, or intentional disregard. I.R.C. § 6662(c). A return position that has a reasonable basis is not attributable to negligence. Treas. Reg. § 1.6662-3(a).

\(^9\)\(^1\) A "substantial understatement" exists when the "correct" tax liability exceeds the tax liability actually reported by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations). The rate of penalty is equal to 20 percent of the underpayment. I.R.C. § 6662. For this purpose, the term "understatement" generally means the excess of the amount of the tax required to be shown on the return for the taxable year, over the amount of the tax imposed which is shown on the return. I.R.C. § 6662(d)(2)(A).

\(^9\)\(^2\) The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. Treas. Reg. § 1.6662-4(d)(2). There is substantial authority for a position if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Treas. Reg. § 1.6662-4(d)(3)(i). Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment. Id. Relevant authorities for this purpose are limited to materials such as applicable provisions of the Code, regulations, revenue rulings and revenue procedures, court cases, and legislative history. Treas. Reg. § 1.6662-4(d)(3)(ii); see Santa Monica Pictures, LLC v. Comm'r, 98 T.C.M. (CCH) 1157 (2005).

\(^9\)\(^3\) I.R.C. § 6664(c)(1). The determination whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. 1.6664-4(b)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess his proper tax liability. Id. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. Id.; see Santa Monica Pictures, 98 T.C.M. (CCH) 1157.
Jobs Act of 2004, tax shelter transactions were subject to a special accuracy-related penalty in section 6662(d)(2)(C). Section 812 of the Jobs Act replaced this penalty with a new one that applies to both listed transactions and reportable transactions whose significant purpose is tax avoidance or evasion.


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

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

Originally enacted in 1982, section 6661 introduced a 10% substantial-underpayment penalty, unless the taxpayer had “substantial authority” or the transaction was disclosed. In 1985, the Treasury issued Regulations 1.6661-95. I.R.C. § 6662(d)(2)(C) was repealed and replaced by the Jobs Act § 812(d). Under prior law, a non-corporate taxpayer could reduce the penalty if the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment and there was substantial authority for the position. Both non-corporate and corporate taxpayers could avoid the penalty entirely under I.R.C. § 6664(c), which is also amended by the Jobs Act, by demonstrating that there was reasonable cause for the underpayment and the taxpayer acted in good faith.

I.R.C. § 6653(a) and (b), which were enacted in 1954, imposed a 5 percent penalty for negligence and a 50 percent penalty for fraud.

Blumstein states that increasing the risk of detection and increasing penalties will increase compliance. However, Blumstein also added that a change in the structure of the tax laws might increase compliance as well. The penalty should be based on the multiplier principle and thus, be equal to the underpayment (i.e. the expected gain) divided by the probability of detection.


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

Former I.R.C. § 6661(b)(2)(B). “Substantial authority” is an intermediate-level standard. While less stringent than the “more likely than not” standard, which is a greater than 50 percent likelihood of being upheld in litigation, it is stricter than a “reasonable-basis” standard, the standard which, in general, will prevent imposition of the penalty under I.R.C. § 6653 (a), relating to negligence.
3, defining the term “substantial authority.” Pursuant to these regulations, if substantial authority is established for a questionable transaction other than those viewed as “tax shelters,” it is treated as if the taxpayer had properly reported the transaction on its tax return. Substantial authority exists for any given tax treatment only if the weight of the authorities supporting the treatment is substantial in relation to that of the authorities supporting contrary positions.

Another method to escape the imposition of penalties is the “reasonable-cause” exception. Taxpayers cannot, however, reduce their penalties through production of such evidence if the underlying transaction qualified as a “tax shelter.” They can avoid the penalty by showing a reasonable belief that the transaction was “more likely than not” appropriate. The rationale behind these exceptions is that Congress believed that imposing a penalty was not appropriate where substantial authority existed and where both the taxpayer and the government had different but reasonable interpretations of the law.

In the ensuing years between 1982 and 1988, several other penalty provisions were added to the Code, and most significantly, in 1984, the rate of the penalty for “tax shelters” was raised from 10% to 20%. The Tax Reform Act of 1986 increased the general penalty rate to 20%, and immediately afterward, the Omnibus Reconciliation Act of 1986 increased it yet further to 25%. The many different penalties as well as their potential overlap with one


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

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

105. I.R.C. § 6661(c). Under this exception, if a taxpayer had a “reasonable cause” for the understatement, it could avoid the penalty.

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


110. One result of this flurry of legislative activity in 1986, however, was the creation of several
another created confusion among taxpayers complying with and tax authorities enforcing these new laws.\textsuperscript{111}

In its 1988 Report, the Staff of the Joint Committee on Taxation observed that the penalties should provide taxpayers with economic incentives to comply. The Joint Committee concluded that an increase in the probability of detecting noncompliance or in the rate of the penalty for noncompliance would improve the law’s deterrent effect. Congress also felt the various penalties should provide a more coherent standard. In the Omnibus Reconciliation Act of 1989,\textsuperscript{112} Congress repealed former sections 6659 and 6661 and consolidated the various accuracy-related penalties into the current section 6662, carrying over the same essential language of those sections.\textsuperscript{113} The penalty for fraud remained at 75%,\textsuperscript{114} but section 6662(h) introduced a 40% penalty for certain “substantial valuation misstatements.”\textsuperscript{115} Under section 6662(h)(1)(A), the penalty rate increases from 20% to 40% for substantial misstatements of 400% or more, for 25% or less, for substantial understatements, and for section 482 net transfer-pricing adjustments of $20,000,000 or 20%.\textsuperscript{116}

Another important consolidation in the 1989 Act was the introduction of a single “reasonable cause exception” under section 6664(c).\textsuperscript{117} As indicated in

\textsuperscript{113} The Act of 1989 consolidated the following penalties into a single accuracy-related penalty under I.R.C. § 6662, which applies to five different categories of misconduct: (i) negligence, or disregard of rules or regulations; (ii) substantial understatement of income tax liability; (iii) substantial misstatement of property valuation for income tax purposes; (iv) substantial overstatement of pension liabilities; and (v) substantial misstatement of estate or gift tax liability. I.R.C. § 6662(b)(1)-(5).
\textsuperscript{114} A penalty under I.R.C. § 6663 equal to 75% of the understatement may be imposed. The IRS must establish by clear and convincing evidence that an understatement of tax exists and that an understatement is attributable to fraud. The courts have defined fraud to mean an intentional wrongdoing on the part of a taxpayer motivated by a specific purpose to evade a tax known or believed to be owing.
\textsuperscript{115} Under I.R.C. § 6662(e)(1)(B), there is a “Substantial Valuation Misstatement” if:

(i) The price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

(ii) the net section 482 transfer pricing adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer’s gross receipt.
\textsuperscript{116} A 20-percent accuracy-related penalty applies to the extent that any portion of an underpayment is attributable to any “substantial valuation misstatement.” I.R.C. § 6662(a) & (b)(3). There is a “substantial valuation misstatement” if “the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed... is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).” I.R.C. § 6662(e)(1)(A). In the case of a “gross valuation misstatement,” the penalty increases from 20 to 40 percent. There is a “gross valuation misstatement” if the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed is 400 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be). I.R.C. § 6662(e)(1) & (h)(2) (2000).
\textsuperscript{117} Both the “reasonable-cause” and the “substantial authority” exceptions were revised and reintroduced in the Penalty Administration and Compliance Act of 1989. I.R.C. § 6664(c) was subsequently revised in 2004, as discussed infra, Part VI.
the legislative history, the reasons for the enactment of a single reasonable-cause exception provision were: (i) to allow taxpayers to understand more readily what the law requires and how to comply with the law; (ii) to simplify the administration of penalties by the IRS; (iii) to provide the IRS with better tools to evaluate whether to impose penalties in any given case; and (iv) to provide courts with improved tools for judicial review.\textsuperscript{118}

The most significant change in the substantial authority standard was to increase the requirement to a 50\% likelihood that the transaction satisfies the law.\textsuperscript{119} This change followed the IRS’s February 1989 Task Force Report, in which the IRS proposed significant changes to the definition of “substantial authority.” In particular, the Task Force suggested the possibility raising the substantial authority standard to a 45\%, 50\% or 51\% probability of prevailing in litigation.\textsuperscript{120}

On the other hand, in 1994, during the Uruguay Round Agreement Act,\textsuperscript{121} the “substantial authority” exception for corporations was abolished and replaced by a different exception under section 6664(c). The legislative history indicates Congress was concerned about the substantial-understatement penalty efficacy in deterring corporate tax shelters. The goal of the proposed changes was to tighten the standards applicable to these corporations.\textsuperscript{122} The modified 1994 rules imposed a penalty of 20\% on any understatement of income attributable to corporate “tax-shelter items” unless the taxpayer demonstrates a “reasonable belief” that the shelter is legal.\textsuperscript{123} Relevant “tax shelters” were defined as any partnerships, entities, investment plans, or other plans or arrangements whose “significant purpose” is the avoidance or evasion of tax liability.\textsuperscript{124}

To clarify the operation of the reasonable cause exception, the Treasury

\textsuperscript{118} H.R. REP. NO. 101-247 (1989). The former version of I.R.C. § 6664(c) provided a single reasonable-cause provision applicable to all types of misconduct.
\textsuperscript{119} I.R.C. § 6664(c) exempts taxpayers from accuracy penalties for undisclosed and erroneous tax return positions, including even those positions leading to substantial understatement of tax liability, provided “substantial authority” supported the stance in question.
\textsuperscript{120} Internal Revenue Service, Report on Civil Tax Penalties, released in connection with a Feb. 21, 1989, hearing of the Subcommittee on Oversight of the House Committee on Ways and Means (cited in TEI Submits Proposals for Civil Penalty Tax Reform, 1989 TAX NOTES TODAY 127-26 (July 1989)).
\textsuperscript{121} P.L. No. 103-465, 108 Stat. 4809. Thus, for the first time a clear distinction between individuals and corporations was introduced, such that the latter could no longer use the “substantial authority” or the “reasonable-belief” arguments.
\textsuperscript{122} H.R. REP. NO. 103-826 (1994).
\textsuperscript{123} I.R.C. § 6662(d)(2)(C)(i)(I)-(II). A taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if the taxpayer reasonably relies in good faith on the opinion of a professional tax adviser; and if the opinion is based on the tax adviser’s analysis of the pertinent facts and authorities and unambiguously states that the tax adviser concludes that there is a greater than 50\% likelihood that the tax treatment of the item will be upheld if challenged by the IRS. Treas. Reg. § 1.6662-4(g)(4)(B) (as amended in 2003).
\textsuperscript{124} I.R.C. § 6662(d)(2)(C)(iii) (2000). Recently, the Tax Court has indicated that a transaction with no economic substance would be treated as a “tax shelter” for this purpose. See Santa Monica Pictures, LLC v. Comm’r, 89 T.C.M. (CCH) 1157 (2005).
issued Regulation 1.6664-4, which sets forth the circumstances under which taxpayers can invoke the exception.\textsuperscript{125} Under these regulations, the exception applies only after a determination of all the pertinent facts and circumstances.\textsuperscript{126} Reliance on the advice of a professional tax adviser constitutes reasonable cause and good faith if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith.\textsuperscript{127} The advice must be based on reasonable factual or legal assumptions, including assumptions as to future events and must reasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person.\textsuperscript{128}

Furthermore, the regulations provide that in the case of a “tax shelter,” the taxpayer must satisfy both the substantial authority\textsuperscript{129} and reasonable belief requirements.\textsuperscript{130} Even if these minimum requirements are met, the taxpayer may still be subject to a penalty if the transaction lacks the following: (i) significant business purpose; (ii) economic substance, such that the investment benefits outweigh any potential tax benefits; and (iii) publication of the agreement between the taxpayer and the shelter’s vendor.\textsuperscript{131}

In February 1999 the Clinton Administration proposed several modifications to the substantial-understatement penalty as it applies to corporate tax shelters, including: (i) raising the rate of the penalty to 40% with respect to any tax return item attributable to a corporate tax shelter; (ii) redefining a corporate tax shelter as any entity, plan, or arrangement in which direct or indirect corporate participants attempt to obtain tax benefits from tax-avoidance transactions; (iii) reducing the 40% penalty to 20% if the corporation fulfilled specified disclosure requirements; and (iv) making unavailable the reasonable-cause exception from the substantial-understatement

\textsuperscript{126} Treas. Reg. § 1.6664-4(c)(1). All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on the opinion of a professional tax adviser as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law.
\textsuperscript{127} Treas. Regs. § 1.6664-4(b) & (c)(1)(i). The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. \textit{Id.} In addition, the taxpayer cannot establish reasonable reliance if he fails to disclose a fact that he knows, or should know, to be relevant to the proper tax treatment of an item. \textit{Id.}
\textsuperscript{128} Treas. Reg. § 1.6664-4(c)(1)(ii). For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. \textit{Id.}
\textsuperscript{130} Treas. Reg. § 1.6664-4(f)(2)(i)(B). The “more likely than not” requirement translates into a 50% probability that the treatment would prevail in litigation. The taxpayer must satisfy the belief requirement without taking into account the likelihood being audited or of being able to settle its case. In other words, the taxpayer can meet the reasonable belief requirements only when it did not consider the “audit lottery” in its 50% probability calculation.
\textsuperscript{131} Treas. Reg. § 1.6664-4(f)(4).
penalty for any item attributable to use of a corporate tax shelter.\textsuperscript{132}

Similarly, in its July 1999 Report,\textsuperscript{133} Treasury proposed that:

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

The Treasury suggested the following penalty structure:

<table>
<thead>
<tr>
<th>Disclosure</th>
<th>Defined as a “Tax Shelter”</th>
<th>Not Defined as a “Tax Shelter”</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20% (subject to the</td>
<td>20% (subject to the</td>
</tr>
<tr>
<td></td>
<td>reasonable-belief exception)</td>
<td>reasonable-basis exception)</td>
</tr>
<tr>
<td>No Disclosure</td>
<td>40% (no exception)</td>
<td>20% (subject to the</td>
</tr>
<tr>
<td></td>
<td></td>
<td>substantial authority exception)</td>
</tr>
</tbody>
</table>

The Report stated that not only did the IRS and the Joint Committee think that the exceptions ought to be narrowed, but the ABA\textsuperscript{134} and the NYSBA\textsuperscript{135} also believed that taxpayers escape penalties too easily because of the generous exceptions.\textsuperscript{136}

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

\begin{itemize}
  \item \textsuperscript{132} See also H.R. 2255, 106th Cong. (June 17, 1999). Congressman Doggett introduced H.R 2255 (The Abusive Tax Shelter Shutdown Act (1999)) to curb tax abuses by disallowing tax benefits allegedly arising from transactions without substantial economic justification and by increasing the understatement penalty with respect to such transactions. Similar to the FY 2000 Administration’s proposal, the Act suggested an increase in the rate of the tax shelter penalty to 40% but with reductions when the taxpayer fully discloses the transaction in question.
  \item \textsuperscript{133} See TREASURY REPORT, supra note 3, at 31. The Treasury explained that in spite of the 1994 modification, current laws still provide generous exceptions to the understatement penalty, and taxpayers can easily fit into one of these exceptions.
  \item \textsuperscript{134} Although the ABA did not specifically support an increase in the penalty rate to 40%, it did acknowledge that an expanded penalty regime might be necessary.
  \item \textsuperscript{135} See NYSBA Report, supra note 83, at 894-97. The NYSBA did not specifically support a 40% penalty rate but did suggest revision of the current rates. In particular, the NYSBA proposed a penalty of at least 10% for disclosed tax shelters and a higher penalty for undisclosed transactions. Finally, the NYSBA suggested that the Congress should determine what specific penalty rates would be appropriate. Significantly, the NYSBA supported elimination of the reasonable-cause exception. The NYSBA determined that most tax shelters could obtain a “more likely than not” opinion, and thus, the IRS would find it very hard to impose any penalties. Nevertheless, the NYSBA was concerned about giving the IRS with too much power and encouraged the IRS to formulate guidelines with respect to this issue.
  \item \textsuperscript{136} See TREASURY REPORT, supra note 3, at 4-6 (citing the Statement of Stefan Tucker, on Behalf of the Section of Taxation, American Bar Association, before the Committee on Ways and Means, Mar. 10, 1999); see also id. at 892-93 (citing the Statement of Harold Handler, on behalf of the Tax Section, New York State Bar Association, before the Committee on Finance, Apr. 27, 1999).
\end{itemize}
The Role of Penalties in Tax Law After Long Term Capital Holdings

changes. 137

Based on the above proposals, in May 24, 2000, the Senate Finance Committee’s majority and minority staffs released draft legislation; proposed section 6662A would have increased the penalty on “large corporations,” defined as those with gross receipts over $10 million that engage in the use of corporate tax shelters. 138 In October 2000, 139 the U.S. Senate Finance Committee’s minority and majority staffs released a revised draft that reflected taxpayer submissions following the release of its original proposal on May 24, 2000. 140 Neither of the above two proposals was enacted.

Another draft proposal was released in 2001 by the Senate Finance Committee, which would require greater disclosure of potentially abusive tax shelters. 141 This draft moved away from the strict liability penalty standard proposed under the October 2000 draft and instead would have provided a safe harbor if taxpayers properly disclosed potentially abusive transactions. 142

It took three more years for the penalty provisions to be revised under

137. These included (i) clarification of the corporate tax shelter definition for purposes of the understatement penalty: if a corporation enters into an entity, plan, or arrangement that is described by one or more tax shelter indicators, then a significant purpose of the entity, plan, or arrangement will be considered to be the avoidance or evasion of federal income tax; (ii) abolition of the requirement that the understatement be substantial; and (iii) increase of the penalty rate from 20% to 40% for any understatement attributable to use of a corporate tax shelter. Finally, The Joint Committee of 1999 suggested that the 40% penalty might be abated if the taxpayer satisfies certain requirements, such as a belief that the taxpayer’s tax treatment of the transaction at issue is at least 75% likely to be sustained, and disclosure of certain information. See J OINT COMMITTEE REPORT, supra note 3, at 182.

138. The proposed penalty rate would be set at 40 percent of the understatement “if there is a significant purpose of tax avoidance or evasion.” Proposed I.R.C. §6662A(d)(1). The penalty rate could be reduced to 20 percent if the following requirements are satisfied: (i) the transaction in question actually has a business purpose; (ii) the taxpayer using the transaction discloses it on its tax return; and (iii) the taxpayer reasonably believes when it enters into the transaction that it will more likely than not prevail on the merits if challenged by the IRS. See Senate Finance Committee Anti Shelter Draft Boosts Penalties, Standards of Conduct, 2000 TAX NOTES TODAY 102-9 (May 25, 2000); Finance Releases Comments on Corporate Tax Shelter, 2000 TAX NOTES TODAY 127-4 (June 30, 2000).


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

141. “We remain concerned that taxpayers continue to use abusive tax shelter transactions to avoid paying taxes that they properly owe,” Baucus and Grassley said in a joint statement, and “[w]e are equally concerned, however, that any legislative proposal not be overly broad so as to impede legitimate business transactions.” Baucus and Grassley Crack Down On Abusive Corporate Tax Shelters, 2001 TAX NOTES TODAY 151-1 (Aug. 6, 2001).

142. While the new draft would still increase the penalty for tax understatements attributable to tax shelters from 20 percent to 40 percent, it would provide a safe harbor from the 40 percent rate if: (i) substantial authority supported the taxpayer’s tax treatment of the shelter; (ii) the taxpayer adequately discloses the relevant facts affecting its treatment of the shelter in its tax return; and (iii) the taxpayer reasonably believes it would more likely than not prevail on the merits if the IRS challenged its tax treatment. Under the proposal, a taxpayer would be able to establish “reasonable belief” if it relied on the opinion of a tax adviser independent of the contested tax shelter transaction but would be unable to avoid the 40% percent penalty if it relied on an opinion rendered by a tax adviser with a financial interest in the transaction, with a conflict of interest, or with a lack of independence.
section 6662 of the Jobs Act of 2004. A new penalty was added under section 6662A and the Jobs Act strengthened the accuracy-related penalty under section 6662 by providing a special rule for the calculation of the understatement for corporate taxpayers.\(^\text{143}\) The Jobs Act, however, did not increase the rate of penalty, except for establishing a new 30 percent strict liability penalty for undisclosed listed transactions and reportable avoidance transactions.\(^\text{144}\) The House Report suggests that the previous standard allowed corporations to avoid the penalty.\(^\text{145}\)

New section 6662A established a new accuracy-related penalty that applies to "listed transactions" and "reportable transactions" with a significant purpose of tax avoidance.\(^\text{146}\) The rate is generally 20 percent, but listed transactions or undisclosed transactions might be subject to a 30 percent strict liability penalty.\(^\text{147}\) The taxpayer can avoid the penalty by satisfying the "reasonable cause" and "good faith" standards,\(^\text{148}\) in this case, the section 6662A penalty would not apply.\(^\text{149}\)

In particular, if the taxpayer shows that there was "reasonable cause" and "good faith" with respect to a reportable transaction understatement, no penalty shall be imposed.\(^\text{150}\) However, the exception only applies if (i) the taxpayer adequately disclosed the relevant facts affecting the tax treatment;\(^\text{151}\) (ii) there is or was substantial authority for the claimed tax treatment; and (iii) the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.\(^\text{152}\)

\(^{143}\) The understatement penalty for reportable transactions under I.R.C. § 6662A applies to reportable avoidance transactions and listed transactions. Under the new legislation, a corporate taxpayer will have a substantial understatement of income tax if the amount of the understatement exceeds the lesser of: (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10,000,000. I.R.C. § 6662(d)(1)(B).


\(^{145}\) Id.

\(^{146}\) The terms "reportable transaction" and "listed transaction" under the I.R.C. § 6011 regulations are discussed infra, part VI.B.

\(^{147}\) I.R.C. § 6662A(a) & (c).

\(^{148}\) I.R.C. § 6664(d)(1).

\(^{149}\) Taxpayers who do not adequately disclose the transaction are not eligible for the exception and are subject to the 30 percent penalty. Cf. Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004).

\(^{150}\) I.R.C. § 6664(d)(1).

\(^{151}\) Id.

\(^{152}\) I.R.C. § 6664(d)(2).
V. PLAYING THE AUDIT LOTTERY: A COST-BENEFIT ANALYSIS

A. The Cost-Benefit Equation

As discussed above, the cost-benefit equation is an efficient tool for analyzing the behavior of violators and, more importantly, for analyzing the best ways to deter such behavior. Therefore, cost-benefit analysis is extremely relevant and has been discussed by the Treasury, the Joint Committee, and many commentators. A rational taxpayer uses a cost-benefit comparison in deciding whether to enter into a tax-motivated transaction; therefore the best way to deter the taxpayer from doing so is by influencing his cost-benefit balance.

In recent years corporations have weighed the estimated benefits with the associated costs of a transaction even with respect to tax-motivated transactions. The benefit from such transactions consists of the expected tax savings. The costs associated with the tax-motivated transaction include: (i) direct costs; and (ii) costs associated with the risk of penalties, such as (a) the risk of detection on audit; (b) the risk of losing subsequent appeals to the IRS and to the courts; and (c) the risk of consequent underpayment penalties and interest. As set forth above, all of these constitute "prices" of engaging in the particular activity.

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

\[ M \] – The taxpayer's expected tax savings, or gain.

---

153. See Stark, supra note 73, at 122 ("[T]here are taxpayers, and probably every tax practitioner has encountered them and most of us have represented them, who deliberately take advantage of ambiguities in the code and who carefully do their penalty algebra in evaluating whether to disclose positions and how aggressively they should act.").

154. See JOINT COMMITTEE REPORT, supra note 3.

155. Id.

156. See Cooper, supra note 13, at 93-101; Blumstein, supra note 11; Bankman, supra note 46.

157. See Stark, supra note 73; JOINT COMMITTEE REPORT, supra note 3.


The costs of compliance... consist of the value of the taxes and other expenses paid... The negative consequences on non-compliance arise from the possibility that the taxpayer will be audited and identified as a non-complier, the original tax liability plus interest will have to be paid... The expected benefit to the taxpayers of non-compliance equals the value of failing to pay tax without detection, minus the chance of being caught times the perceived costs, if caught.

159. See JOINT COMMITTEE REPORT, supra note 3, at 25.

160. I.R.C. § 6662 defines the amount of expected gain as "substantial underpayment," that is, the potential gain to the taxpayer equals the gap between the potential tax liability of the taxpayer and its actual tax liability. For the purpose of this Article, I assume that courts' decisions as well as the IRS's reallocation of income in cases which have not arrived in court reflect the best judgment of what should be the true liability.
Z – The probability of being subject to penalties for a given transaction.\textsuperscript{161} This probability is divided into four components:

\[ Z_1 \] – The probability of being audited.

\[ Z_2 \] – The probability that the IRS will detect the transaction on an audit.

\[ Z_3 \] – The probability that the IRS will win its subsequent case against the taxpayer.

\[ Z_4 \] – The probability that the taxpayer will not be able to escape the penalty.

\[ F \] – The rate of the penalty.

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

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

\[ M - C > Z \times (F + M).\textsuperscript{162} \]

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

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

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

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

\textsuperscript{162} F+M consists of the amount of the underreported liability plus the amount of penalty, and is equal to the total amount which the taxpayer has to pay if the IRS wins the case. For purposes of this Article, I ignore the time value of money component, which frequently results from the passage of time between the audit and the conclusion of the case.

\textsuperscript{163} The NYSBA presented the same rationale arguing that as long as the corporate taxpayer has reasonably relied on an opinion, the only downside to the taxpayer will be the payment of interest on the deficiency. When the cost-benefit analysis is done and the chances of auditing, detection, and unfavorable outcome are combined with the low probability that penalties will be imposed, a rational corporate taxpayer can conclude that engaging in a tax shelter is, financially, well worth the risk. See NYSBA Report, supra note 83, at 13; see also Powlen & Tanden, supra note 4, at 1009.

\textsuperscript{164} Based on the equation, four potential changes are applicable: (i) reducing the potential gain (Reducing M); (ii) increasing the lump sum costs (Increasing C); (iii) increasing the probability that the taxpayer will be subject to the penalty (Increasing Z); and (iv) increasing the rate of penalty (Increasing F).
The Role of Penalties in Tax Law After Long Term Capital Holdings

1. The Taxpayer’s Prospective Gain (M)

A taxpayer’s gain in a tax-motivated transaction is generally mirrored by a resulting harm to other parties. Here, the harmful effect is on all of society because the benefit to the individual taxpayer equals the economic harm to society, the social cost of a reduction in tax revenues. However, with the additional non-financial costs to the taxpayer, which always exist to some extent, the basic assumption becomes one in which the expected gain to the individual taxpayer is always less than the costs to society.\(^{165}\) Therefore, as the discussion above suggests, the cost-benefit equation should be used to deprive the taxpayer of its prospective gains rather than to force the taxpayer to internalize the social costs.\(^{166}\)

2. The Taxpayer’s Lump Sum Costs (C)

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

3. The Probability of Being Subject to Penalties (Z)

This factor is subdivided into four different components:

165. See Hylton, supra note 50.
166. Id.
167. Promoter fees are not only the most significant type of costs, but also the clearest type of costs, since the fees are paid upfront, while the other costs may be calculated indirectly. Another significant and clear cost is the cost of opinion formulating by tax lawyers, which are separate from the promoter fees. According to Noback and Saunders, such costs can amount to $500,000. See Janet Noback & Laura Saunders, The Hustling of X Rated Shelters, FORBES, Dec. 14, 1998, at 11. For a thorough discussion of these costs in relation to tax-motivated transactions, see generally Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004).
168. See Noback & Saunders, supra note 167; see also Bankman, supra note 46. In recent years, promoters of tax shelters have tried to “beat” the market and to offer companies fees, which are based on success.
169. Since the costs are presented in a lump sum, smaller companies have a greater burden as a portion of the tax liability under dispute.
The probability of being audited (Z1)\textsuperscript{170}

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

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

The probability that a tax-motivated transaction will be detected on an audit is one of the more significant aspects of the taxpayer’s cost-benefit equation.\textsuperscript{175} This risk is sometimes referred to as “playing the audit lottery.”\textsuperscript{176} Even if a taxpayer made all the appropriate disclosures about its business transactions, many auditors might not be able to distinguish the tax-motivated transaction from other corporate activities.\textsuperscript{177} Detection of tax-motivated transactions

\textsuperscript{170} For a discussion on the role of the probability of being audited and detected in the cost-benefit analysis, see Calvin H. Johnson, Corporate Tax Shelters, 1997 and 1998, 80 TAX NOTES 1603, 1606 (Sept. 28, 1998); see also Joint Committee Report, supra note 3, at 25-26; Treasury Report, supra note 3, at 32; Treasury Report, supra note 3, at 4 (citing the Statement of Stefan Tucker, on Behalf of the Section of Taxation, American Bar Association, before the Committee on Ways and Means, Mar. 10, 1999); James Holden, Dealing with Aggressive Tax Shelters, 52 TAX LAW. 369 (1999).

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

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

\textsuperscript{173} See Noback & Saunders, supra note 167, at 12; see also Treasury Report, supra note 3, at 17.

\textsuperscript{174} See Study Disputes IRS has Turned Corner on Enforcement, 2004 TAX NOTES TODAY 212-2 (Nov. 2, 2004) (describing a study prepared by Syracuse University’s nonpartisan research group, Transactional Records Access Clearinghouse, which indicates that audit rates for fiscal year 2004 are on pace to lag the 2003 audit rate by 25\% and overall corporate audit coverage dropped for the ninth consecutive year in 2003 to 0.87\%).

\textsuperscript{175} See Cooper, supra note 13, at 95-101.

\textsuperscript{176} Joint Committee Report, supra note 3, at 26.

\textsuperscript{177} See Rosenberg, supra note 171, at 189 (“Even if the Service does audit the taxpayer, it may not notice whatever tax evasion the taxpayer may have engaged in. To the extent that it must rely on the taxpayer’s own records to incriminate the taxpayer, the Service is in a difficult position.”). For a similar
The Role of Penalties in Tax Law After *Long Term Capital Holdings*

depends on several elements, including the quantity and quality of auditors, any efforts to hide its tax-motivated transactions, and the nature and complexity of the underlying transaction. As indicated by Cooper:

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

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

Specifically, as observed by the ABA in 1999:

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

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

view in the inside trading context, see Bainbridge, *supra* note 38, at 1262 (footnotes omitted):

By one estimate, fewer than one in five cases of insider trading is successfully prosecuted, and in retrospect that estimate probably is too high by several orders of magnitude. It is often very difficult to tell when insider trading is taking place, and even when insider trading is suspected it is very difficult to identify the responsible party if many people had access to the information. Finally, even when insider trading is detected, it often can be difficult to build a persuasive case against the inside trader.


179. *Id.* at 100.

180. TREASURY REPORT, *supra* note 3, at 6 (citing the Statement of Stefan Tucker, on Behalf of the Section of Taxation, American Bar Association, before the Committee on Ways and Means, Mar. 10, 1999).
implementing this strategy may, in effect, "win the audit lottery" despite losing the gamble of having to be audited.\(^{181}\)

Recent statements by the IRS Commissioner are revealing to the extent they suggest that the IRS’s litigation enforcement strategy has focused on corporations and high-income individuals, not because they constitute the greatest portion of underpaid tax revenue, but rather because it provides the greatest "political resonance" and a "sense of fairness."\(^{182}\) The IRS Strategic Business Plan for 2005-2009 indicates that the "tax gap" is roughly $312 billion per year and less than half of that amount is attributable to large corporations and high-income individuals.\(^{183}\) The tax gap is attributable mostly to the self-employed and small businesses.

The probability that the IRS will win its subsequent case against the taxpayer (\(z_3\))

Even when the IRS audits and detects a tax-motivated transaction, it still may not prevail in court. Recently, taxpayers won clear-cut victories in *Black & Decker*,\(^ {184}\) *Coltec Industries*,\(^{185}\) and *TIFD III-E Inc.*,\(^ {186}\) which followed the government win in *Long Term Capital Holdings*.\(^ {187}\) The IRS, however, has recently won in *CMA Consolidated Inc. v. Commissioner*.\(^ {188}\) Generally, the government’s chances of winning cases depend on the adequacy of substantive tax rules and, as an alternative, anti-abuse rules. This Article focuses on the latter. Current U.S. tax law employs two types of anti-abuse rules: statutory rules\(^ {189}\) and common-law rules. As of today, unlike other countries such as Canada, New Zealand, and Australia,\(^ {190}\) there is no general anti-abuse rule (GAAR) in the United States Internal Revenue Code. Therefore, except for

---

181. JOINT COMMITTEE REPORT, supra note 3, at 26-27.
182. See Everson Defends IRS’s Enforcement Focus on High Earners, Corporations, Practitioners, DAILY TAX REP., Nov. 16, 2004, at G-1 [hereinafter Everson on Enforcement].
183. See IRS Strategic Plan, 2005-2009, Publication 3744 (Rev. 6-2004), at 18 (noting that the tax gap numbers are based on compliance models developed from tax return data for fiscal year 1988 and earlier years); see also Everson on Enforcement, supra note 182 (estimating the tax gap as exceeding a quarter of a trillion dollars per year based on a combination of nonfiling, nonreporting, and nonpayment).
189. Examples of statutory anti-abuse rules include: (i) I.R.C. § 269 (2006), which grants authority to disallow certain benefits; (ii) I.R.C. § 446 (2006), which prescribes a change of method of accounting if necessary to clearly reflect income; (iii) I.R.C. § 482 (2006), which grants authority to reallocate income and deductions between related parties if necessary to prevent evasion or to clearly reflect income; (iv) I.R.C. § 1092 (2006), which grants authority to disallow benefits in the case of a straddle; and (v) I.R.C. § 1259 (2006), which requires recognition of income upon a "constructive sale."
The Role of Penalties in Tax Law After Long Term Capital Holdings

particular statutory and regulatory anti-abuse rules, general anti-abuse rules remain common law doctrines. Since *Gregory v. Helvering*, courts have been applying various anti-abuse common law doctrines to deny the tax benefits of tax-motivated transactions. When a transaction is challenged by the IRS, the court may apply one of these doctrines to determine if the tax benefits associated with the transaction should be allowed.

In its 1999 report, the Treasury agreed that anti-abuse rules could be used to provide more clear-cut answers for tax-motivated transactions and suggested, for the first time, codification of the doctrine. The Joint Committee also supported codification; however, they thought the problem lay not in the current anti-abuse rules but in the fact that the IRS lacked the necessary tools for litigating cases. The Joint Committee saw the glass as half-empty; for every case the IRS won, there were hundreds more that it lost. However, all proposals to clarify and codify the economic substance doctrine were widely criticized.

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

As mentioned above, the accuracy-related penalty provisions contain exceptions that allow taxpayers to avoid the penalties even if the IRS wins a case against the taxpayer. In general, pursuant to the “reasonable-cause exception,” a taxpayer who is found liable for underpayment of taxes is treated as if it had never entered into the tax-motivated transaction in the first place. This reduces the disincentives for entering into tax-motivated transactions, since even if detected and prosecuted, at worst, they would have to make up the underpaid tax plus normal interest, but at best, they might escape the penalties

191. 293 U.S. 465 (1935), aff'g 69 F.2d 809 (2d Cir. 1934).
192. See generally Frank Lyon Co. v. United States, 435 U.S. 561 (1978) (looking at economic substance or reality of sale and leaseback transactions); Knetsch v. United States, 364 U.S. 361 (1960) (disallowing interest expense deductions because only thing of substance to be realized from transaction was tax deduction); Comm'r v. Court Holding Co., 324 U.S. 331 (1945) (recognizing step transaction doctrine, whereby courts must consider all steps of transaction in light of entire transaction, so that substance of transaction will control over form of each step); ACM P'ship v. Comm'r, 157 F.3d 231, 233-43 (3d Cir. 1998), aff'g in part 73 T.C.M. (TCM) 2189, cert. denied, 119 S. Ct. 1251 (1999) (holding that the sophisticated investment partnership were formed solely to generate a capital loss to shelter some of Colgate-Palmolive's capital gains); Kirchman v. Comm'r, 862 F.2d 1486, 1488-89 (11th Cir. 1989) (holding that option straddles were entered into to produce deductions with little risk of real loss); Karr v. Comm'r, 924 F.2d 1018, 1021 (11th Cir. 1991), cert. denied, 112 S. Ct. 992 (1992) (holding that energy enterprise was developed solely to produce deductible losses for investors); Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 96 (4th Cir. 1985) (holding that sale-leaseback of a computer by a car dealership was entered into solely to generate depreciation deductions); Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000); Boris I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOW. L.J. 693, 707 (1978); TREASURY REPORT, supra note 3, at 6.
193. TREASURY REPORT, supra note 3, at 6.
194. See JOINT COMMITTEE REPORT, supra note 3, at 175.
195. See supra text accompanying notes 11-34.
altogether by invoking one of the law's exceptions.\textsuperscript{196}

Despite that, the changes in the Jobs Act of 2004, however, have strengthened the requirements for the reasonable cause exception. Recently, in \textit{Long Term Capital Holdings v. United States},\textsuperscript{197} the court upheld penalties assessed by the IRS despite the taxpayer's argument that it had obtained and relied on two separate law firms. Finally, under section 6662A, the penalty for undisclosed listed transactions or undisclosed "reportable avoidance transactions" is a strict liability penalty.\textsuperscript{198}

\textbf{4. The Rate of the Penalty (F)}

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

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

Instead, under the current accuracy-related penalty regime, the penalty is calculated as a percentage of the underpayment, regardless of the taxpayer's likelihood of being subject to the penalty.\textsuperscript{200} Currently, a forty percent penalty is imposed on a "gross valuation misstatement." A third possibility under section 6662A is a 30 percent strict liability penalty for undisclosed listed "reportable avoidance transactions."\textsuperscript{201} This alternative, however, is not discussed herein.

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

\[ F = 0.2M, \text{ or} \]

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{196} See Lederman, \textit{supra} note 12, at 1458-59.
\item \textsuperscript{197} 330 F. Supp. 2d 122 (D. Conn. 2004).
\item \textsuperscript{198} I.R.C. § 6662A(a) & (c).
\item \textsuperscript{199} See Posner, \textit{supra} note 11, at 1783.
\item \textsuperscript{200} Specifically, I.R.C. § 6662, which was modified in 1989 to include all accuracy-related penalties, imposes a twenty percent penalty on the portion of an underpayment attributable to, among other things, substantial understatement of income and misstatement of valuation.
\item \textsuperscript{201} I.R.C. § 6662A(a) & (c).
\item \textsuperscript{202} As set forth above, an understatement of tax under I.R.C. § 6662 is the excess of the amount of tax required to be shown on the return over the tax imposed reduced by any rebate. I.R.C. § 6662A(b).
\end{enumerate}
\end{footnotesize}
The Role of Penalties in Tax Law After *Long Term Capital Holdings*

\[ F = 0.4M. \]

If the taxpayer is found liable, the taxpayer will have to remit its entire underpayment, \( M \), plus the penalty, \( F \) (such that the taxpayer would have to pay either \( 1.2M \) or \( 1.4M \)). For purposes of this Article, I ignore the effect of interest on the taxpayer’s liability.

**B. Analysis of the Cost-Benefit Equation**

1. **Assumptions**

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

2. **Determining What is a Sufficient Level of Deterrence According to the Taxpayer’s Cost-Benefit Equation**

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

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

As a factual matter, however, even the most expensive tax-motivated transactions do not entail lump-sum costs of more than 30%. In fact, the empirical evidence indicates that in the majority of cases, lump-sum costs constitute only a small fraction of the expected gain. Therefore, the taxpayer in
this first illustration is unlikely to enter into a tax-motivated transaction.

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

Illustration 1: the rate of the penalty is 0% and the probability of being subject to it is 25% \((F = 0 \text{ and } Z = 0.25)\):

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

\[
M - C > Z(F + M) \\
M - C > 0.25M \\
C < 0.75M
\]

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

Illustration 2: the rate of the penalty is 20% and the probability of being subject to it is 25% \((F = 0.2M \text{ and } Z = 0.25)\):

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

\[
M - C > Z(F + M) \\
M - C > 0.25(1.2M) \\
C < 0.7M
\]

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

Illustration 3: the rate of the penalty is 40% and the probability of being subject to it is 25% \((F = 0.4M \text{ and } Z = 0.25)\):

The calculation shows that:

\[
M - C > Z(0.4M + M) \\
M - C > 0.25(1.4M) \\
C < 0.65M
\]

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

Illustration 4: the rate of the penalty is 100%\(^{203}\) and the probability of being

---

203. Even though it is unrealistic that the penalty rate will be raised to 100%, the purpose of this
The Role of Penalties in Tax Law After *Long Term Capital Holdings*

subject to it is 25% \((F = M, Z = 0.25)\):

The calculation shows that:

\[
M - C > Z(M + M)
\]

\[
M - C > 0.25(2M)
\]

\[
C < 0.5M
\]

Conclusion: As long as \(C\) is less than \(0.5M\), the taxpayer will enter into a tax-motivated transaction. Even a 100% rate of penalty is not enough to deter the taxpayer as long as \(Z\) is low!

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

The calculation shows that:

\[
M - C > Z(0.2M + M)
\]

\[
M - C > 0.5(1.2M)
\]

\[
C < 0.4M
\]

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

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

The calculation shows:

\[
M - C > Z(0.4M + M)
\]

\[
M - C > 0.5(1.4M)
\]

\[
C < 0.3M
\]

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

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

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

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

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

See Illustration 2, according to which \(C<0.7M\).

---

section is to demonstrate than even if such a change occurs, the deterrence will still be insignificant.
Illustration 8: the rate of the penalty is 20% and the probability of being subject to it is 50% ($F = 0.2M$ and $Z = 0.5$):

The calculation becomes:

$$M - C > Z(0.2M + M)$$
$$M - C > 0.5(1.2M)$$
$$C < 0.4M$$

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

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

The calculation becomes:

$$M - C > Z(0.2M + M)$$
$$M - C > 0.75(1.2M)$$
$$C < 0.1M$$

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

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

The calculation becomes:

$$M - C > Z(0.4M + M)$$
$$M - C > 0.5(1.4M)$$
$$C < 0.3M$$

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

5. Summary of the Results

<table>
<thead>
<tr>
<th>Rate of the Penalty</th>
<th>$Z = 0.25$</th>
<th>$Z = 0.5$</th>
<th>$Z = 0.75$</th>
</tr>
</thead>
<tbody>
<tr>
<td>0% penalty</td>
<td>$C &lt; 0.75M$</td>
<td>$C &lt; 0.5M$</td>
<td>$C &lt; 0.25M$</td>
</tr>
<tr>
<td>20% penalty</td>
<td>$C &lt; 0.7M$</td>
<td>$C &lt; 0.4M$</td>
<td>$C &lt; 0.1M$</td>
</tr>
<tr>
<td>40% penalty</td>
<td>$C &lt; 0.65M$</td>
<td>$C &lt; 0.3M$</td>
<td>Full deterrence</td>
</tr>
<tr>
<td>100% penalty</td>
<td>$C &lt; 0.5M$</td>
<td>Full deterrence</td>
<td>Full deterrence</td>
</tr>
</tbody>
</table>
C. Conclusions

1. Increasing the rate of the penalty reduces taxpayer’s incentives to enter into a tax-motivated transaction.
2. Increasing the probability of being subject to a penalty also reduces their incentives to enter into a tax-motivated transaction.
3. The most important conclusion from the above illustrations is that increasing the rate of the penalty is less effective than increasing the probability that the taxpayer will be subject to the penalty.  

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

VI. HOW TO CHANGE THE CORPORATE TAXPAYER’S COST-BENEFIT EQUATION: RECENT DEVELOPMENTS AND A PROPOSAL

A. General

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

There are several ways by which $Z$ could be raised. The probability of being subject to a penalty, as mentioned above, consists of four components:

---

204. For similar conclusions, see Allingham & Sandmo, supra note 39, at 330: Summing up the comparative static analysis of our model, we may note that although it does not yield any clear-cut results in the analysis of changes in actual income and in the tax rate, unambiguous results can be derived for the two parameters of the model which are of particular interest for policy purposes in this field, viz. the penalty rate and the probability of detection. The former is a parameter over which the tax authority exercises direct control; the latter it may be assumed to control indirectly through the amount and efficiency of resources spent on detecting tax evasion. The model implies that these two policy tools are substitutes for each other. While the expected tax yield would fall with a decrease of $p$, the loss of tax revenue could be compensated by an increase of $p$.

205. Back then, however, Congress and Treasury thought that a combination of rate increase and disclosure would provide the best answer.
the probability of being audited ($Z_1$); the probability of being detected as a tax shelter participant ($Z_2$); the probability that the IRS will win its case against the taxpayer ($Z_3$); and the probability that the taxpayer will not otherwise escape paying the penalties ($Z_4$). As also demonstrated above, increasing the overall probability ($Z$) most efficiently deters from entering into tax-motivated transactions.

Below is a summary of the four most efficient methods that would reduce taxpayers' incentives to play the audit lottery:

(1) The most effective measure with respect to $Z_1$ and $Z_2$ is to require greater disclosure from taxpayers and registration and listing from promoters and advisors involved in tax-motivated transactions. The Jobs Act of 2004 has improved these rules not only by unifying all three measures under the single standard of “reportable transactions” but also by imposing penalties for non-disclosure. Nevertheless, the most important improvement of these rules has yet to come. The Treasury must provide taxpayers with appropriate guidance on what should be disclosed, and as of today, the confusion among practitioners and the IRS pertaining to these rules is enormous.

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

(3) My proposal with respect to $Z_4$ focuses primarily on the reasonable-cause exception. Many taxpayers have been able to escape penalties either by using the reasonable cause exception or by negotiations with the IRS if a tax-

---

206. The Joint Committee in 1999 specifically mentioned the key role of disclosure in improving the audit and detecting rates. See JOINT COMMITTEE REPORT, supra note 3, at 31.

207. See Hariton, supra note 83, at 241; TREASURY REPORT, supra note 3, at 12, app. C.

208. See, e.g., § 245 of Canada's Income Tax Act, known as the General Anti-Avoidance Rule or "GAAR." Canada Income Tax Act, R.S.C., ch. 1 § 245 (1985). The Canadian GAAR allows an "avoidance transaction" to be recharacterized to deny the "tax benefit" that would otherwise arise as a result of the transaction. § 245(4). An "avoidance transaction" is defined as any transaction that would result in a tax benefit unless the transaction (or series of transactions) may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. § 245(3). "Tax benefit" includes a reduction, avoidance or deferral of tax payable under the Act. Id. Even if a transaction is an avoidance transaction, the GAAR will not apply where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act, read as a whole. See generally Cooper, supra note 190.
The Role of Penalties in Tax Law After Long Term Capital Holdings

motivated transaction is detected. The Jobs Act of 2004 has tightened the rules for the exception, and the decision in Long Term Capital Holdings (discussed below) made it clear that a "should" opinion from a reputable law firm may not suffice. Not any opinion would provide the support for the reasonable cause exception; only ones founded on solid legal grounds.

(4) Finally, the least efficient proposal is to change the rate of accuracy-related penalty ($F$). As the above analysis illustrates, increasing the rate of penalty would be effective only if the rate structure is altered to be based on the multiplier element.

B. Increasing $Z_1$ and $Z_2$: Reporting, Listing and Disclosure

1. General

The Treasury issued regulations regarding the disclosure of "reportable transactions" on February 27, 2003.209 The Regulations require a taxpayer to disclose in its tax return certain information regarding each "reportable transaction" in which the taxpayer participates. The regulations define a reportable transaction as a transaction that satisfies any one of six categories of transactions.210

2. Jobs Act’s Revisions

Section 6707A imposes a penalty on any taxpayer who fails to disclose a "reportable transaction." The amount of the penalty is $10,000 for an individual and $50,000 for all corporations and other entities.211 The Jobs Act also repealed and significantly revamped the rules for the registration of tax shelters

210. Treas. Reg. § 1.6011-4(b)(2)-(7). The six categories include: (i) any transaction that is the same as (or substantially similar to) a transaction that is specified by the Treasury as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (a "listed transaction"); (ii) any transaction that is offered under conditions of confidentiality; (iii) any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained; or (2) the fees are contingent on the intended tax consequences from the transaction being sustained; (iv) any transaction resulting in a taxpayer claiming a loss (under I.R.C. § 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses; (v) any transaction done by certain taxpayers in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year; and (vi) any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.
211. I.R.C. § 6707A(b)(1). For a listed transaction, the penalty is $100,000 for an individual and $200,000 for all corporations and other entities. I.R.C. § 6707A(b)(2).
under section 6111 and the list maintenance requirements under section 6112. These two sections now apply to “reportable transactions” as opposed to “tax shelters.”

The penalty is imposed on a “material advisor” who fails to file an information return or files a false or incomplete information return with respect to any reportable transaction, including a listed transaction. The advisor is required to maintain a list of reportable and listed transactions, regardless of whether it files an information return under section 6111.

3. The Impact on the Cost-Benefit Analysis

The revision of sections 6111 and 6112 signals a shift away from the unclear concept of “tax shelters” to the statutory standard of “reportable transactions.” The definition of a “tax shelter” under section 6111 was uncertain and Congress decided to unify the reporting, registration, and listing rules (to impose a separate accuracy-related penalty) using a single standard, namely the reportable transactions standard.

The revised registration and listing rules, with the help of additional disclosure, may shore up the continuing drop in audit rates. It may reflect a tacit understanding by Congress that the IRS, at least temporarily, concedes the audit process is either too slow or simply incapable of uncovering transactions, leading to the legislation’s enactment. The result would be that the IRS would be able to increase the audit and detection of tax-motivated transactions and, therefore, the cost side of the equation would increase.

Nevertheless, guidance is now necessary. Both taxpayers and the IRS are still unsure of the scope of the rules. On the one hand, many transactions that are not tax-motivated might technically fall under the disclosure, registration and listing requirements, while many abusive transactions might not be subject

---

212. Previously, section 6111(c) defined a “tax shelter” as any investment: (A) with respect to which a reasonable person could infer from representations made, or to be made, in connection with the offer for sale of interests in the investment, that as of the close of any of the first five years after the investment is offered for sale, the tax shelter ratio for any investor may be greater than 2 to 1; and (B) that must be registered under a federal or state law regulating securities or is sold pursuant to a registration exemption that requires instead that a notice be filed with a federal or state agency regulating the offering or sale of securities or substantial investments.

213. Previous section 6112(a) provided that any person who organizes or sells an interest in any “potentially abusive tax shelter” must maintain a list identifying each person who was sold an interest in the shelter and containing such other information as the Secretary may prescribe. If the promoters were required to list the transaction as a tax shelter and failed to do so as prescribed by I.R.C. § 6112 (without reasonable cause), the penalty would be $50 for each person with respect to whom there is such a failure to a maximum of $100,000. See I.R.C. § 6708(a). A “potentially abusive tax shelter” was defined as either: (i) any tax shelter with respect to which registration is required under I.R.C. § 6111; or (ii) any entity, plan, or arrangement of a type that the Secretary determines in regulations to have a potential for tax avoidance. Former I.R.C. § 6112(b).


216. I.R.C. § 6112(a).
to the rules. Thus, to reduce the incentives to play the audit lottery, the Treasury and the IRS must clarify the scope of the rules, provide assistance to the taxpayers in complying with the rules, and devote resources to enforce and implement the rules.

C. Increasing Z3: Codification of the Economic Substance Doctrine

Another way of increasing the likelihood of accurate taxation is providing the IRS with greater tools to win cases, namely increasing Z3. As discussed herein, one of the most significant proposals to provide the IRS with such tools includes the proposal to codify, or clarify, the economic substance doctrine.217 Under the judicial economic substance doctrine, the tax benefits of transactions lacking economic substance may be denied and the transaction would be disregarded.218 Nevertheless, as numerous courts have affirmed, taxpayers are generally free to structure their affairs so as to minimize their tax liability; therefore, a transaction does not lack economic substance merely because it is tax-motivated.219 In general, the economic substance doctrine is based on an


218. See, e.g., Killingsworth v. Comm'r, 864 F.2d 1214, 1216 (5th Cir. 1989) ("Since Gregory was decided, courts have consistently held that although a transaction may, on its face, satisfy applicable Internal Revenue Code criteria, it will nevertheless remain unrecognized for tax purposes if it is lacking in economic substance." (citation omitted)); Karr v. Comm'r, 924 F.2d 1018, 1023 (11th Cir. 1991) ("[E]xpenses incurred in connection with a sham transaction are not deductible."); TREASURY REPORT, supra note 3, at 56:

[T]he third, and final, way the IRS can use non-statutory standards to challenge the tax benefits of a particular tax-advantaged transaction is through the application of the economic substance doctrine. This doctrine allows the IRS to deny tax benefits if the economic substance of a transaction is insignificant relative to the tax benefits obtained. See also Horn v. Comm'r, 968 F.2d 1229, 1236 (D.C. Cir. 1992) ("The economic sham doctrine generally works to prevent taxpayers from claiming the tax benefits of transactions, which, although they may be within the language of the Code, are not the type of transaction Congress intended to favor."); Yoshia v. Comm'r, 861 F.2d 494, 497 (7th Cir. 1988) ("There is a doctrine that a transaction utterly devoid of economic substance will not be allowed to confer [a tax] advantage."); Ferguson v. Comm'r, 29 F.3d 98, 101 (2d Cir. 1994) (per curiam) ("An activity will not provide the basis for deductions if it lacks economic substance."); Boynton v. Comm'r, 649 F.2d 1168, 1172 (5th Cir. 1981), cert. denied, 454 U.S. 1146 (1982) ("Transactions that have no economic effect other than the creation of income tax losses are shams for tax purposes and will not be recognized.").

219. United Parcel Servs. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1019 (11th Cir. 2001) ("A 'business purpose' does not mean a reason for a transaction that is free of tax considerations."); Salina P'ship LP, FPL Group, Inc. v. Comm'r, 80 T.C.M. (CCH) 686 (2000) ("It is well settled that taxpayers generally are free to structure their business transactions as they please, even if motivated by tax avoidance considerations.") (citing Gregory v. Helvering, 293 U.S. 465 (1935)); Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184, 196 (1983), aff'd in part, rev'd in part, remanded, 752 F.2d 89 (4th Cir. 1985); Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury."); Rosenfeld v. Comm'r, 706 F.2d 1277, 1281 (2d Cir. 1983) ("[A] transaction which is otherwise legitimate, is not unlawful merely because an individual seeks to minimize the tax consequences of his activities."); Owens v. Comm'r, 568 F.2d 1233, 1237 (6th Cir. 1977) ("We begin with the principle that a taxpayer, working within the law, may legitimately seek to avoid taxes."); N.
objective and subjective determination of whether a transaction has real, non-tax economic benefit.\textsuperscript{220} Under this general two-prong test, the economic substance doctrine is based on an objective and subjective determination of whether a transaction has real, non-tax economic benefit.\textsuperscript{221}

In recent years, several legislative proposals to "codify" or "clarify" the economic substance doctrine have been made.\textsuperscript{222} In 2004, the codification of

\begin{enumerate}
\item \textit{Ind. Pub. Serv. Co. v. Comm'r}, 115 F.3d 506, 511 (7th Cir. 1997) ("A tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what otherwise would be his taxes."); Yoshia v. Comm'r, 861 F.2d 494, 497 (7th Cir. 1988) ("There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes."); Aiken Indus., Inc. v. Comm'r, 56 T.C. 925, 933 (1971), \textit{acq.}, 1972-2 C.B. 1 ("The fact that the actions taken by the parties in this case were taken to minimize their tax burden may not by itself be utilized to deny a benefit to which the parties are otherwise entitled under the convention."); Bass v. Comm'r, 50 T.C. 595, 600 (1968) ("[A] taxpayer may adopt any form he desires for the conduct of his business, and . . . the chosen form cannot be ignored merely because it results in a tax saving."); cf Saviano v. Comm'r, 765 F.2d 643, 654 (7th Cir. 1985):
\begin{quote}
[T]he freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service will play along.
\end{quote}
The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of the transactions to their economic substance and to apply the tax laws accordingly.

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

\item See supra note 219, and sources cited therein.

\end{enumerate}
The Role of Penalties in Tax Law After Long Term Capital Holdings

the doctrine was rejected by the House of Representatives\textsuperscript{223} and was not included in the Conference Report for The Jobs Act of 2004.\textsuperscript{224} These proposals, however, have been criticized not only by commentators but also by Government officials on various grounds.\textsuperscript{225}

There were two major criticisms of the proposed codification: opposition to the substance of the proposal and opposition to codification at all. The first criticism was that the proposal set forth a new and higher standard that had not been adopted by the courts, rather than "codifying" or "clarifying" a common law doctrine.\textsuperscript{226} The most criticized point pertains to the proposed conjunctive test,\textsuperscript{227} which is consistent only with a minority of circuits.\textsuperscript{228} Another aspect that departs from the majority of case law is the requirement that the taxpayer provide at least a risk-free return on its investment\textsuperscript{229} and a comparison between tax and non-tax benefits in order to prevail on the challenge.\textsuperscript{230}


\textsuperscript{225} Samuel C. Thompson Jr. & Robert Allen Clary II, Coming In From The 'Cold': The Case For ESD Codification, 2003 TAX NOTES TODAY 102-33 (May 23, 2003) (citing Assistant Secretary of the Treasury for Tax Policy Pamela Olson's statement in her nomination hearings before the Senate Finance Committee: "I do not think that codification of the Economic Substance Doctrine will help").

\textsuperscript{226} See Kevin D. Dolan, Notice 98-5 Foreign Tax Credit Arbitrage, 455 PLI/TAX 1029, 1047-50 (1999).

\textsuperscript{227} See proposed I.R.C. § 7701(n)(1)(B)(i)(I) & (II).

\textsuperscript{228} Pasternak v. Comm'r, 990 F.2d 893, 898 (6th Cir. 1993): The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction. . . . If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the second inquiry is never made. Cf. Rice's Toyota World v. Comm'r, 752 F.2d 89, 90 (4th Cir. 1985) ("The purpose of this test is to ascertain both the subjective motivations of the taxpayer and the objective reasonableness of the investment to determine whether the transaction contained economic substance aside from the tax benefits."); Hines v. United States, 912 F.2d 736, 740 (4th Cir. 1990) ("Under the test in Rice's Toyota, however, a transaction with an expected loss may not be a sham if the taxpayer was motivated by some legitimate business reason other than to obtain tax benefits."); Black & Decker v. United States, 340 F. Supp. 2d 621 (N.D. Md. 2004). Black & Decker confirms that the Fourth Circuit applies the disjunctive standard. The district court relied also on Hunt v. Commissioner, 938 F.2d 466, 471 (4th Cir. 1991), and Hines, 912 F.2d at 738-39, for its decision.

\textsuperscript{229} Hilton v. Comm'r, 74 T.C. 305 (1980). Commentators, generally, have disagreed with such a standard. See, e.g., NYSBA Objects To Codification of Economic Substance Provisions, 2003 TAX NOTES TODAY 102-19 (May 28, 2003) ("[T]he economic substance doctrine is fundamentally an anti-abuse rule, and not all transactions that lack either a pre-tax return greater than a risk-free return or a substantial non-tax business purpose are abusive. It depends on the provision under consideration."); Alvin C. Warren Jr., The Requirement of Economic Profit in Tax Motivated Transactions, 59 TAXES 985 (1981) (stating that on the one hand that a "very small economic profit" is insufficient to validate a transaction, but on the other, that a requirement of a full market return is "incoherent").

\textsuperscript{230} Sheldon v. Comm'r, 94 T.C. 738 (1990); see also Bankman, supra note 46, at n.33 (stating that "the court [in Saba] favored an approach that compared tax benefits to pretax profits—an approach consistent with the Treasury Department’s shelter proposals but inconsistent with most case law on
The more general form of criticism relates to the question of whether the doctrine should be codified at all.\textsuperscript{231} As discussed above, codification of the economic substance doctrine was proposed by the Treasury Department during the Clinton Administration as part of its proposals to curb corporate tax shelters,\textsuperscript{232} but was subsequently criticized as being unnecessary and potentially harmful to the overall tax shelter regulatory effort by the Bush Treasury. The Treasury’s rationale for not codifying the doctrine is succinctly described in a conversation between the Chairman of the Senate Committee on Finance, Senator Charles E. Grassley (R-IA), and the then Acting Assistant Secretary of the Treasury for Tax Policy, Pamela F. Olson:

\textit{Senator Grassley:} Let us go back to this committee's effort to crack down on tax shelters . . . . Do you believe that codification of the Economic Substance Doctrine will help or hinder our goal of combating tax shelters?

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

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

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

So I think that it has the potential to slow IRS audits, and anything that slows IRS audits is not a good thing. I think that what we need at this point is more enforcement, and the IRS being able to complete more audits as rapidly as possible.\textsuperscript{233}

In \textit{Coltec Industries}, the court discussed the legislative history of the point\textsuperscript{\textendash}).


\textsuperscript{233} \textit{Hearing on the Nomination of Pamela F. Olson to be Assistant Secretary of the Treasury Before the S. Comm. on Finance}, S. Hrg. 107-742, 107th Cong., at 8-9 (Aug. 1, 2002). For recent comments by the IRS Chief Counsel Donald L. Korb opposing codification, see \textit{Korb Speculates on Codification of Economic Doctrine}, Doc. 2004-21647, 2004 TAX NOTES TODAY 217-2 (Nov. 9, 2004) (reporting IRS Chief Counsel Donald Korb as being opposed to the efforts on Capitol Hill to codify the economic substance doctrine).
proposal to codify the economic substance doctrine.234

In fact, a few days ago Congress passed a major federal tax bill, but again declined to codify the "economic substance doctrine." See American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. (2004). Under our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare. . . . Accordingly, the court has determined that where a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the "economic substance" doctrine to trump "mere compliance with the Code" would violate the separation of powers.235

Thus, codification may be useful for the government in reducing the "audit lottery;" however, it must be consistent with the majority of case law pertaining to the economic substance doctrine. A possible solution, which would be consistent with the majority of circuits, would be to transform the two-prong test into a single, flexible objective standard. Such a standard would, in fact, revive the original substance-over-form analysis conducted by the U.S. Supreme Court in Gregory v. Helvering, and would not seem to contradict the current standard applied by all circuits.

D. The Reasonable Cause Exception

1. Jobs Act of 2004

The effect of revising the substantial understatement penalty in section 6662 and the reasonable cause exception is that the penalty applies to a broader range of transactions for large corporations. The revised "reasonable cause" and "good faith" exceptions are more stringent than the previous standards.

In terms of the cost-benefit equation, the most notable element of the Jobs Act of 2004 was strengthening the reasonable cause exception. This should increase the likelihood that taxpayers who lose their case on the merits would be penalized. In addition, the introduction of the strict liability penalty for undisclosed listed and reportable avoidance transactions signals that a taxpayer may be subject to penalty even after obtaining tax opinions. Certainly, Congress has moved in the right direction by limiting the applicability of the exception and thereby exposing more taxpayers to the potential penalty if the case is won by the IRS. The following two cases illustrate the courts' application of the reasonable cause exception in transactions having no economic substance.


235. Id. at 756; cf. Gitlitz v. Comm'r, 531 U.S. 206, 220 (2000) (refusing to rely on policy arguments in order to look beyond the plain words of the statute and deny tax benefits claimed by the taxpayer).
2. Long Term Capital Holdings v. United States

In this case, the essence of the transaction was to allow loss duplication by a partnership, through the contribution by Onslow Trading & Commercial LLC ("OTC") when it became a partner in 1996. OTC contributed cash and stock with a built-in loss to Long-Term Capital Partners LP ("LTCP"). The cash component of OTC's contribution was borrowed from a UK entity related to Long-Term Capital Management LP ("LTCM"), the general partner of LTCP. In addition, OTC purchased from LTCM a "liquidity put" and a "downside put" with respect to its interest in LTCP. The puts were exercised and, in December 1997, LTCM sold some of the stock. The preferred stock with a basis of $107M was sold for approximately $1M, producing a loss of $106M, which was allocated to LTCM under section 704(c). The taxpayer obtained a "should" level opinion from two law firms: King & Spalding and Shearman & Sterling.

**Economic Substance:** The taxpayer argued that the standard in the Second Circuit is a disjunctive test. The court, however, disagreed and held the prevailing standard in the Second Circuit was the unitary test. Nevertheless, even if the court had accepted the disjunctive test, the taxpayer still would have been liable because the court held that the transaction had neither objective economic substance nor subjective business purpose.

The court rejected the taxpayer's argument that a meaningful change in the parties' economic positions was enough to give economic substance. Applying a cost-benefit analysis similar to the one in Goldstein v. Commissioner, the court held that LTCM had no realistic expectation of economic profit after taking into account fees. The court reviewed the costs incurred by LTCM and held that the taxpayer could not have reasonably expected to generate a pre-tax profit after considering these costs and fees. With respect to the...
The Role of Penalties in Tax Law After *Long Term Capital Holdings*

potential profit, the court held that the maximum reasonably expected gross earnings were estimated at $2M.

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

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

**Accuracy-Related Penalties:** The court found the taxpayers liable for valuation overstatement and substantial understatement penalties.\(^{241}\) The court held that the legal opinions did not allow the taxpayers to qualify for the “reasonable cause/good faith” exception to the penalties because: (i) the King & Spalding written opinion was delivered late, and the record did not establish that Long Term had reasonably relied on King & Spalding’s oral advice; (ii) there was no evidence that any of the Long Term partners other than one actually read the opinion; (iii) the favorable authorities cited in the opinion were based on facts materially different from those found by the court, so could not be relied upon; (iv) the opinion did not adequately address Second Circuit precedent, nor the “end result” variation of the step-transaction doctrine; and (v) Long Term lacked good faith, as evidenced by the steps it took to conceal the preferred stock losses on its tax return.

To conclude, the court’s primary reason for sustaining the penalties asserted by the IRS appeared to be that the transaction lacked economic substance and business purpose. But the court also suggests that the opinion did not protect the taxpayer because it was deficient in its legal analysis and because at most

---

\(^{241}\) *Id.* at 199-200 (citing *Gilman v. Comm'r*, 933 F.2d 143, 151-52 (2d Cir. 1991)). In *Gilman*, the Second Circuit applied the valuation overstatement penalty under former section 6659 to an underpayment of taxes derived from a transaction that was disregarded for lack of economic substance. Because the taxpayer was deemed to have a zero basis, the taxpayer’s claimed basis was infinitely larger than the amount determined to be the correct basis (as would be any amount of claimed basis, compared to zero). Acknowledging that applying the valuation overstatement penalty “somewhat strains the natural reading of the statutory phrase ‘valuation overstatement’”, the court nevertheless held, consistent with other judicial precedents applying the valuation overstatement penalty in the context of tax shelter transactions, that the penalty was applicable. 933 F.2d at 151. The Court of Appeals observed: “application of the section 6659 penalty surely reinforces the Congressional objective of lessening tax shelter abuse.” *Id.* Additionally, former section 6659 might require some nexus with an overvaluation; however, “[a] transaction that lacks economic substance generally reflects an arrangement in which the basis of the property was misvalued in the context of the transaction.” *Id.* at 152. The lack of economic substance in *Gilman* was due in part to a valuation overstatement, based on the absence of any reasonable expectation of profit and the lack of value in the property that the taxpayer purchased. *Id.* at 151.
one of the partners in LTCM had read the opinion.

3. IRS's Reaction to its Victory

Subsequent to the court's decision in *Long Term Capital Holdings*, in a chief counsel notice, the IRS has advised chief counsel attorneys on the role penalties play in tax administration.242 With respect to the reasonable cause exception, the IRS stated that:

One of the most common taxpayer defenses is the claim that the taxpayer reasonably relied in good faith on the advice of a professional tax advisor in taking a return position. I.R.C. section 1.6664(c). While professional tax advice can afford taxpayers a defense to the imposition of penalties, the mere fact that the taxpayer obtained such advice does not necessarily, in and of itself, meet the requisite burden of proof. Circumstances may show that the taxpayer did not rely on the advice in good faith, or that the taxpayer's reliance was not reasonable. The regulations under section 6664 provide a nonexclusive description of circumstances where taxpayers may not rely on the advice of others as a defense to accuracy-related penalties. See Treas. Reg. section 1.6664-4(c); Long-Term Capital Holdings.

Note, however, that this notice was issued prior to the enactment of the Jobs Act of 2004 and the three straight losses in economic substance cases. In light of the Government's losses in *Black & Decker*,243 *Coltec Industries*,244 and *Castle Harbour*,245 it is possible that the government will re-evaluate its position.

4. Second Circuit's Decision

In affirming the district court decision, the Second Circuit upheld the IRS's imposition of penalties.246 The Second Circuit found ample evidence in the record to support the district court's finding that LTCH had made a number of assumptions that it knew to be false and that it was unreasonable for its tax advisors to rely on those assumptions when a reasonably diligent review of the pertinent facts and circumstances would have shown those assumptions to be false.

LTCH argued that the 40% penalty should not be applied because (1) there was not a misstatement of value, only a misstatement of basis; (2) the basis misstatement was the result of a legal dispute, not a factual dispute; and (3) the underpayment was not attributable to the basis misstatement.247 The court found that LTCH's arguments were without merit because (1) section 6662(e)(1)(A) defines a valuation misstatement to include misstatements

247. Id. at 43-44.
The Role of Penalties in Tax Law After *Long Term Capital Holdings*

concerning the correct amount of the valuation or adjusted basis; therefore, valuations misstatement as it appears in section 6662(b)(3) includes both valuation and basis misstatements; (2) section 6662(e)(1)(A) does not differentiate between factual and legal determinations and it is incorrect that "the penalty cannot apply where the transaction is 'recast' for tax purposes using a legal doctrine such as the step transaction or economic substance doctrine"; and (3) the underpayment was directly dependent on the valuation misstatement because the amount of the tax benefit was determined by the amount of the misstatement.248

The Second Circuit's decision highlights the importance of analyzing the objective economic substance and subjective business purpose of any transaction involving tax planning. The case reaffirms the importance of a taxpayer contemporaneously documenting the transactional thought processes as well as preparing to demonstrate its reliance on the reasoned legal analyses of its tax advisor. In upholding the penalties, the decision emphasizes that if a taxpayer wants to rely on an opinion of its tax advisor for penalty protection, that opinion cannot be based on any false or unreasonable assumptions.

The law firm seemed to have assumed away the economic substance and business purpose issues by relying on a representation on those points without making any effort to demonstrate why it was reasonable to rely on them. According to the district court opinion, "a reasonably diligent analysis of all facts and circumstances would have revealed at least some of those assumptions to be unreasonable and unsupportable."249 The case highlights the need for independent analysis by a tax advisor of the reasonableness of a taxpayer's asserted business purpose for a transaction as well as of the transaction's purported economic substance.

5. CMA Consolidated Case-Lease Stripping Transaction

The Tax Court held that deductions claimed by a promoter of lease stripping transactions, who acquired a position in an arrangement that it had tried to market to other investors, should be treated as lacking economic substance.250 In evaluating whether the transaction lacked economic substance, the court applied the two-pronged inquiry: (1) a subjective inquiry into the existence of a valid business purpose, and (2) an objective inquiry concerning the non-tax economic effect of the transaction(s).251

The factual circumstances in this case consisted of a "Byzantine labyrinth

248. *Id.* at 44.
of complex transactions," the Tax Court said. The Tax Court further noted that most of the transactions were undertaken solely to achieve a tax effect. The taxpayer was generally involved in equipment leasing transactions and the structuring of equipment financing. During the early 1990s, the taxpayer began to arrange deals designed to separate equipment rental income from the related rental expenses. The specific lease stripping transaction here involved computer and photo processing equipment which was subject to two existing end-user leases and a prior lease stripping arrangement. The arrangement involved the purchase of the lease by a partnership where 99% of the taxable income resulting from a rent sale to finance the purchase was allocated to a tax-exempt Indian nation. The property was then transferred to the taxpayer in exchange for preferred stock of minor value. As structured, the lease strip interest was intended to generate over $4.2 million of potential tax deductions at an out-of-pocket cost of $40,000.

Economic Substance: With regard to the first prong of this test, the court found that the lease strip deals "are mere tax-avoidance devices or subterfuges mimicking a leasing transaction." The court further noted that the obvious purpose was to obtain unwarranted and substantial tax benefits. The taxpayer could only enjoy a return from the lease rentals after expiration of the user leases and prior to the ultimate equipment return. However, the documents were drafted with incorrect dates that eliminated this period entirely, thus even though the taxpayer argued that this should be corrected, the fact that no attention was paid to the error, is evidence that the taxpayer had no interest in the underlying leasehold interest. Accordingly, the court held that taxpayer had no valid non-tax business purpose for entering into the lease strip deal apart from tax benefits.

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

252. Id. at *65.
253. Id. at *10-23. In those deals, the rental income was allocated to a tax-indifferent or tax-neutral party in order to allow another party to claim a greatly disproportionate share of the related tax benefits.
254. Id. Here, an "upper lease" interest was created between the equipment owner and the existing head lease and user lease.
255. Id. at *83.
256. Id. at *85-86. The court seemed to suggest a ratio type of test, comparing the tax benefits to the pre-tax profit. As set forth above, such a standard was rejected by the vast majority of courts. Note that other than the finding that the tax benefits were overwhelming here and the pre-tax profit was non-existent, the court did not articulate how this balancing might be applied to these or other facts.
corrected, thus there could be no reasonable expectation of a pre-tax return. As such, the court held that the deals lacked economic substance.

**Accuracy-Related Penalties:** The court further imposed penalties on the taxpayer for negligence (20 percent) and gross valuation overstatement (40 percent). The taxpayer argued that it had relied on a tax opinion and appraisal information provided to the original lease strip investors in the equipment but did not receive any such assurance itself. The court determined that this did not rise to reasonable cause or good faith supporting removal of the asserted penalties. With respect to the appraisal and tax opinion, the court observed that they “among other things, had not been furnished by *disinterested, objective advisers* but by advisers involved in marketing the first lease strip deal to [the taxpayer].”\(^{257}\) Thus, the court held that not all opinions would qualify for the exception, especially those issued by the same advisers who marketed the transaction.

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

> Because we have found that the subject transactions are without substance or business purpose and that petitioner and its officers were fully aware of the lack of *bona fides* of the factual underpinnings for the transactions, there could be no substantial authority or reasonable belief or cause on petitioner’s part that would allow it to avoid the application of the section 6662 penalties in this case.\(^{258}\)

**6. Summary**

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

---

257. *Id.* at *154* (emphasis added).

258. *Id.* at *156-57*. Specifically, the Tax Court observed that the taxpayer failed to prove that: (1) The accounting firm’s advice was based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances; (2) petitioner had disclosed all relevant facts to the accounting firm; and (3) the accounting firm’s advice was based on reasonable factual or legal assumptions.

*Id.* at *155* (citation omitted).
give an opinion that satisfies the exception. Finally, in both cases, the courts did not stop short with a 20 percent penalty and imposed the 40 percent gross valuation penalty.

E. Changing the Structure of the Penalty Rates

The least efficient method would be to increase the amount of a penalty, either by raising the penalty rate or by restructuring the way the penalty is calculated. The current method of calculating the penalty as a percentage of the underpayment does not provide sufficient deterrence, so restructuring the system according to the *multiplier principle* may yield greater efficiency. Harsh penalties may be considered unfair, and may create perverse incentives; instead of increasing compliance, overly harsh penalties may spur taxpayers to evade taxes more. Moreover, overly harsh penalties may lead to over-deterrence. A practical problem with respect to the multiplier principle is how to set the probability of being subject to the penalty (Z). One solution may be to introduce several, graduated penalty rates, such as 20%, 40%, 60%, up to 100%.

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

To illustrate: if a tax-motivated transaction has no lump-sum costs, such that C=0, and we set the other variables at the following levels: \( Z = 40\% \) (\( Z_1 + Z_2 = 40\%, \) and \( Z_3, Z_4 \) are 10%),\(^{259}\) the taxpayer’s cost-benefit equation becomes:
\[
M = 0.4(F + M) \\
M - 0.4M = 0.4F \\
F = 1.5M
\]

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

If: \( C = 0.2M \) and \( Z = 0.5 \):

---

\(^{259}\) Note that is example assumes that the IRS wins the case for 100%, and that there is a strict liability.
The Role of Penalties in Tax Law After Long Term Capital Holdings

\[ M - 0.2M = 0.5(F + M) \]
\[ 0.8M = 0.5F + 0.5M \]
\[ F = 0.6M \]

Thus, when \( Z = 0.5 \), and \( C = 0.2M \), we need at least a 60% penalty rate to achieve full deterrence. When \( Z \) falls to 25%, a more realistic assumption, the results are much different, however, assuming \( C = 0.2M \):

\[ M - 0.2M = 0.25(F + M) \]
\[ 0.8M = 0.25F + 0.25M \]
\[ 0.25F = 0.55M \]
\[ F = 2.2M \]

Thus, under the more realistic assumption of \( Z = 0.25 \), the penalty rate should increase to 220%, a practical impossibility. Thus, increasing the penalty rate is not the right answer. The current regime does not even come close to full deterrence when viewed through the lens of the multiplier principle. Congress had a difficult time in attempting to increase the rate to 40% in certain cases. Nevertheless, the penalty regime should be based upon the multiplier principle. Thus, under the assumption that \( Z = 0.5 \) and that \( C \leq 20\% \) of \( M \), the penalty rate should be at least 60%.\(^{260}\)

VII. CONCLUSIONS

As tax shelters, in their abusive form, are becoming ever more aggressive, the IRS is aggressively attacking them with support from congressional hearings. Curbing abusive corporate tax shelters has become a priority for the Internal Revenue Service and Treasury Department. The objective is early identification and effective action on abusive tax shelters.

The Jobs Act of 2004 is not the first occasion, and undoubtedly will not be the last occasion, where there is a widely-held perception that an increasing use of tax-motivated transactions by corporations and individuals is eroding the tax base and fundamentally undermining the general sense of fairness in the tax system.\(^{261}\) Although tax shelters have been studied for decades which resulted in a number of voluminous reports, the term has yet to be fully defined with any specificity.\(^{262}\) Defining the line between what is permissible tax planning and impermissible tax evasion has proved to be extremely difficult for both taxpayers and the government. Perhaps this is because there is a strongly-held belief rooted in well-established case law that one does not, even out of a sense

\(^{260}\) For similar proposals, see Bankman, supra note 46, and James Holden, Buyers Beware of Aggressive Tax Shelters, 82 TAX NOTES 707, 712 (Feb. 1, 1999).


\(^{262}\) See, e.g., TREASURY REPORT, supra note 3.
of patriotic duty, have to maximize the amount due to the tax collector.263

As concluded above, based on a cost-benefit analysis, the current legislation does not adequately deter the use of most types of shelters because the current penalty rates and probability of being subjected to such penalties are too low as compared to the potential gains. Thus, a simple cost-benefit analysis would show that, in most cases, taxpayers would be well advised to take their chances and "play the audit lottery," and the current penalty provisions deter only transactions with relatively small expected gains. To crack down on tax-motivated transactions more efficiently, Congress must find better methods for changing the taxpayers' cost-benefit balance.

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

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

By expanding its enforcement actions on various fronts, the IRS has made it clear that it intends to "win the war" on aggressive tax shelters. However, as long as taxes are imposed, tax shelters will continue to exist in some form. History also instructs that no matter how hard they try, Congress, the Treasury Department, and the IRS almost always will remain at least one step behind promoters of aggressive transactions. As a result, whether or not the economic substance doctrine is codified, courts most likely will continue to play important roles refereeing creative, unanticipated interpretations of even the best-intentioned provisions of the Internal Revenue Code and regulations.

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