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Financial Alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS (and How the IRS Helps Them)

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FINANCIAL ALCHEMY: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS (And How the IRS Helps Them)

Del Wright Jr.*

"[T]here is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate)."†

I. INTRODUCTION

In 2012, taxpayers who participated in the Son of Boss tax shelter received a $1 billion windfall from the government, based on the U.S. Supreme Court ruling in *United States v. Home Concrete & Supply, LLC* ("*Home Concrete*").[1] In the last ten years, by the Internal Revenue Service's ("IRS") own estimate, Son of Boss generated over $6 billion in improper tax benefits.[2] While many taxpayers who participated in the Son of Boss

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†. Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1357 (Fed. Cir. 2006).

1. United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836 (2012); Patrick Temple-West, *Supreme Court Restrains IRS in Tax Shelter Case* (Apr. 25, 2012, 1:03 PM), http://www.reuters.com/article/2012/04/25/us-usa-tax-supreme-court-idUSBRE83O11920120425. *Home Concrete* provided significant clarity in Son of Boss litigations, as it cleared the fog surrounding several decisions at the Court of Appeals level. *Id.*; *see infra* Part III.B (discussing *Home Concrete*).

2. TREASURY INSPECTOR GEN. FOR TAX ADMIN., NO. 2009-30-018, DESPITE THE SUCCESS ACHIEVED, THE SON OF BOSS SETTLEMENT HAD LITTLE IMPACT ON INVESTOR FILING AND PAYMENT COMPLIANCE 1 (2008), *available at* http://www.treasury.gov/tigta/auditreports/2009reports/200930018fr.pdf. Although the IRS settlement generated a significant amount of revenue from previously improper tax benefits, it has failed to ensure future compliance. *See id.* at 3; *see also infra* Part III (describing the BOSS

transaction settled their cases with the IRS, the effect of entering into the transaction was often a net positive for those who settled.[3] Among those who chose not to settle, based on the government's loss in *Home Concrete*, taxpayers were allowed to keep the roughly $1 billion in tax benefits generated from those taxpayers' transactions.

The Son of Boss shelter, at its core, was derived from a financial strategy called a "short against the box,"[4] which, since the 1930s, has allowed taxpayers to avoid paying billions of dollars in capital gains taxes.[5] The government shut down the original form of the short against the box transaction in the mid-1990s and later shut down the Son of Boss transaction in the mid-2000s. Despite those government actions, however, numerous tax shelters derived from the short against the box strategy have robbed the U.S. Treasury of billions of dollars of tax revenue. Those shelters, and the government's response to them, are discussed herein.

Taxpayers and the IRS have long engaged in a battle over tax shelters.[6] After the Internal Revenue Code ("Code")[7] was amended substantially in

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transaction and in turn, the development of the Son of Boss transaction). The government identified just over 1,800 taxpayers who participated in Son of Boss transactions, and, as of March 2005, approximately 1,165 had participated in the settlement initiative. Press Release, IRS, IRS Collects $3.2 Billion from Son of Boss; Final Figure Should Top $3.5 Billion (Mar. 24, 2005), *available at* http://www.irs.gov/uac/IRS-Collects-$3.2-Billion-from-Son-of-Boss;-Final-Figure-Should-Top-$3.5-Billion.

3. *See infra* Part III.B.2 (analyzing the IRS Son of Boss Settlement Initiative).

4. In a "short against the box," also sometimes referred to as a "short sale against the box," a taxpayer owns a long position in a stock and borrows and sells short an equal amount of stock. *See* Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U. L. REV. 431, 437–41 (2005) (providing that "taxpayers entering into a short against the box trade (and several other transactions) are viewed as *constructively* selling their appreciated stock and realizing the built-in gain when they enter into the transaction") (emphasis added).

5. *See* Frances Barton Farr v. Comm'r, 33 B.T.A. 557, 561 (1935); G.C.M. 7451, IX-1 C.B. 81 (1930), *available at* http://www.scribd.com/doc/122379659/Bureau-of-Internal-Revenue-Cumulative-Bulletin-IX-1-1930; *see also* Note, *Federal Taxation of Short Sales of Securities*, 56 HARV. L. REV. 274 (1942) [hereinafter *Federal Taxation*].

6. "Tax shelter," as used herein, refers generally to:

> [A] tax-motivated transaction that relies on a nonobvious (or, in some cases, implausible) interpretation of the Internal Revenue Code that is highly beneficial to the taxpayer (in terms of lowering their taxes) and that has no plausible policy justification—in the sense that one cannot offer an even moderately persuasive story that Congress intended to encourage this particular class of transactions through the tax system.

Kyle D. Logue, *Legal Transitions: Is There an Ideal Way to Deal With the Non-Ideal World of Legal Change?: Legal Transitions, Rational Expectations, and Legal Progress*, 13 J. CONTEMP. LEGAL ISSUES 211, 231 (2003). Alternatively, some use Michael Graetz's famous characterization of a tax shelter as, "a deal done by very smart people that, absent tax considerations, would be very stupid." *E.g.*, Tom Herman, *A Special Summary and Forecast of*

1986, numerous large-scale tax shelters became obsolete.[8] What emerged after the 1986 amendment, however, was a cottage industry of tax professionals creating more targeted tax shelters for corporations and high net worth taxpayers.[9]

Many of these modern tax shelters are structured to take advantage of gaps in the law or regulations, particularly with respect to the taxation of combined financial products. Two of the largest such tax shelters, the Son of Boss and the Contingent Deferred Swap ("CDS") transactions, used combined financial products to turn the Code on its head, generating billions of dollars of tax benefits for transactions largely devoid of substance.[10]

Federal and State Tax Developments, WALL ST. J., Feb. 10, 1999, at A1 (quoting Yale Law Professor Michael Graetz).

7. All references to the Code included herein, unless otherwise indicated, refer to the Internal Revenue Code of 1986, as amended.

8. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) [hereinafter 1986 Act]. The 1986 Act was in part a response to the proliferation of retail tax shelters that gave more and more taxpayers the ability to avoid taxes through transactions designed solely to shelter their income from taxes. *See* Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 TAX L. REV. 401, 426–27 (1989) (describing the effects of the 1986 amendment to the Code). Shaviro provides that:

> Despite the proliferation of antitax shelter statutes and cases, the tax shelter industry continued to grow through at least the early 1980's, and remained in the forefront of public attention through enactment of the Tax Reform Act of 1986. The 1986 Act, however, brought decisive change. By lowering tax rates, creating a flatter rate structure, adding the passive loss rules to the Code, and repealing certain tax preferences, the Act essentially put an end to much of the public tax shelter activity that had taken place over the previous 15 or 20 years.

Id. at 426 (internal footnotes omitted).

9. *See* MINORITY STAFF OF THE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS 18 (2003) (quoting testimony of Michael Brostek before the U.S. Senate Committee on Finance), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-108SPRT90655/pdf/CPRT-108SPRT90655.pdf ("describing 'abusive shelters' as 'very complicated transactions promoted to corporations and wealthy individuals to exploit tax loopholes and provide large, unintended tax benefits.'").

10. The tax benefits discussed herein were created by tax deferral or tax avoidance. Deferral refers to a transaction's ability to delay the obligation to pay taxes until sometime in the future. *See* Lynnley Browning, *Tax Deferral Strategy Gets Closer Look at IRS*, N.Y. TIMES, Feb. 11, 2008, *available at* http://www.nytimes.com/2008/02/11/business/worldbusiness/11iht-tax.1.9920826.html (discussing the IRS' response to one deferral strategy, known as a variable prepaid forward contract (discussed *infra*)). Tax avoidance, as used herein, refers to a transaction's ability to make taxes go away altogether. Often, tax avoidance is achieved by either creating non-economic or phantom losses that offset a taxpayer's other income, or by making a temporary tax deferral permanent. *See, e.g.*, Zoë Prebble & John Prebble, *The Morality of Tax Avoidance*, 43 CREIGHTON L. REV. 693, 698, 700–01 (2010) (arguing that tax avoidance is not only legal, but a moral scheme with a goal of minimizing tax liability). Many

One major reason for the proliferation of these tax shelters has been the difficulty in crafting a comprehensive approach to the tax treatment of combined financial positions. That difficulty has been exacerbated by advances in finance regarding the use and pricing of derivatives. Many tax shelters rely on derivatives and other financial assets to create "synthetic" transactions.[11] While those economic returns may be the same between a particular financial asset and a synthetic financial asset, other aspects such as the tax treatment or the legal or voting rights with respect to the asset are often markedly different. As part of their financial alchemy, sophisticated tax planners have used those differences to conjure the equivalent of tax gold, i.e., helping corporations and high net worth individual taxpayers defer or avoid billions of dollars in tax liability.[12]

The tax shelters described in this Article were structured to exploit, yet purportedly stay within the bounds of, the tax laws. Such shelters are generally described as "technical" tax shelters.[13] According to the IRS, a "'technical tax shelter' [is distinguishable] from a 'scheme or scam' or

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tax shelters do both. *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-750, FINANCIAL DERIVATIVES: DISPARATE TAX TREATMENT AND INFORMATION GAPS CREATE UNCERTAINTY AND POTENTIAL ABUSE 41 (2011), *available at* http://www.gao.gov/new.items/d11750.pdf (describing the potential for abuse of financial derivatives by the nation's taxpayers).

11. Derivatives securities, or "derivatives," are financial instruments, the value of which is determined by reference to one or more underlying assets. JOHN C. HULL, OPTIONS, FUTURES, & OTHER DERIVATIVES 1 (5th ed. 2003). The use of derivatives blossomed subsequent to the discovery of a more precise method to price derivatives. That discovery is generally credited to Fischer Black, Robert Merton, and Myron Scholes. *See generally* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973), *available at* http://www.cs.princeton.edu/courses/archive/fall00/cs323/resources/blackscholes.pdf. As a general matter, the economic returns available on any particular financial asset (e.g., a stock or a bond) can be replicated using a combination of derivatives to create a synthetic position. The most basic synthetic replication strategy is based on the put-call parity relationship, which holds generally that a "long" call, a "short" put, and owning a bond is economically equivalent to owning stock. *See* HULL, *supra*, at 174–75 (providing an example of how different combinations of derivatives can create different positions and outcomes).

12. In many tax shelters, individual taxpayers often use a partnership and the Byzantine intricacies of Subchapter K of the Code to realize the tax benefits of a particular transaction. *See* I.R.C. §§ 701–77 (2006) (governing partnerships). This Article will only briefly describe the Subchapter K machinations used in tax shelters.

13. The term tax shelter also describes patently illegal schemes, often promoted by tax protestors and others of their ilk, which blatantly misinterpret existing law. *See* U.S. DEP'T OF JUSTICE, CRIMINAL TAX MANUAL § 40.01 (2001), *available at* http://www.justice.gov/tax/readingroom/2001ctm/40ctax.htm (providing that "[i]llegal tax protest schemes range from simply failing to file tax returns to concealing financial transactions and assets in warehouse banks and trusts to filing frivolous liens to interfere with IRS investigations").

outright tax evasion that finds no support in either the law or the facts."[14] A technical tax shelter is also different from a simple exploitation of the Code to create a benefit, such as the use by hedge funds to convert their performance fees into carried interests, allowing those fees to be taxed at the capital gains rates rather than ordinary income rates.[15] One practical definition was provided by former Treasury Assistant Secretary Eric Solomon, who described a technical tax shelter as a "tax-engineered transaction normally with little business purpose except to save taxes with minimal risk or profit potential often designed to create a tax loss without an economic loss or in some cases to make income nontaxable."[16]

The technical tax shelters described herein "appeared to satisfy the technical requirements of the Internal Revenue Code, but not its spirit."[17] However, the promoted tax benefits of those shelters often failed to withstand challenge from either the IRS or the courts. The question this raises is why, if they failed to withstand challenge, did they multiply like the famous *Star Trek* Tribbles?[18]

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14. B. John Williams, Jr., Chief Counsel, IRS, *Resolving Tax Shelters: By Settlement or Litigation* 2 (Feb. 25, 2003) (transcript available at http://www.irs.gov/pub/irs-utl/shelters-feb25.pdf).

15. *See* John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. LEGAL ANALYSIS 591, 618 (2009) (noting that performance fees paid to private fund managers "are taxed more favorably (as carried interest)" than other fees paid by mutual fund); Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071, 1075 (2008) (explaining that fund managers' income is taxed at capital gains rates rather than higher ordinary income rates); *see also* Teresa Tritch, *Two-and-Twenty Tax Dodges*, N.Y. TIMES, Aug. 24, 2012, *available at* http://takingnote.blogs.nytimes.com/2012/08/24/two-and-twenty-tax-dodges/ (explaining that private equity partners avoid taxes through a loophole that enables fees to be taxed as capital gains). In its reporting, the *New York Times* estimated that "four Bain funds in which [2012 Republican nominee for the U.S. Presidency Mitt] Romney family's trusts are invested converted $1.05 billion in management fees—which should be taxed as ordinary income—into capital gains, which are taxed at the much lower rate. The tax savings: $220 million." *Id.*

16. Eric Solomon, Remarks at Tax Policy Center–Tax Analysts Forum on Tax Shelters 11 (Feb. 11, 2005) (transcript available at http://www.docstoc.com/docs/40295145/TAX-POLICY-CENTER----TAX-ANALYSTS-FORUM-ON-TAX-SHELTERS).

17. Eric Solomon, A Short History of Tax Shelters 2 (Dec. 9, 2009) (transcript available at http://www.utcle.org/eLibrary/preview.php?asset_file_id=22933). In his remarks, Solomon noted that, "[t]hese tax shelters are to be contrasted with situations in which taxpayers engage in tax evasion without any technical argument for their position, such as hiding assets and income in offshore accounts." *Id.*; *see also* IRS, ACCURACY-RELATED PENALTIES FOR TAXPAYERS INVOLVED IN TAX SHELTER TRANSACTIONS, AUDIT TECHNIQUE GUIDE (ATG), *available at* http://www.unclefed.com/SurviveIRS/MSSP/penalty_final.pdf (providing a guide for IRS examiners in implementing tax penalties to all taxpayers involved in tax shelter transactions).

18. Tribbles were depicted in the original *Star Trek* television series as small furry creatures with a proclivity for procreation. STAR TREK DATABASE,

The answer lies in the chance of getting caught: even though the transactions likely would not have withstood government scrutiny, that scrutiny would have occurred only if the government discovered the transaction through the auditing process before the relevant statute of limitations had elapsed, which is often three years.[19] Because the incidence of audit is fairly low, rational taxpayers simply looked at the expected value of entering into the shelter, equal to the expected benefits minus the expected costs.[20] The expected benefits are obvious—the money saved by not paying tax. The expected costs are more difficult to determine, as they depend on the likelihood of the IRS detecting the transaction in time, the likelihood of the transaction withstanding IRS scrutiny, the likelihood of settlement, and the taxpayer's time value of money calculation. As discussed in Part IV, sophisticated tax planners have leveraged that expected value calculation to benefit their clients at the government's expense.

Technical tax shelters have proliferated, in part, because neither Congress nor the IRS has developed a comprehensive system of rules for the tax treatment of combined financial positions. Moreover, both Congress and the IRS have unintentionally made it easier for those tax planners by drafting multiple regimes for taxing economically similar, yet structurally distinct, financial positions.[21] Absent changes in both the law and the IRS's

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http://www.startrek.com/database_article/tribble (last visited Feb. 11, 2013). Their first appearance in the series was the 1967 episode of *Star Trek* entitled *The Trouble with Tribbles*, in which the crew of the U.S.S. Enterprise solved their "trouble" with the Tribbles by transporting them to an enemy Klingon ship. STAR TREK DATABASE, http://www.startrek.com/database_article/trouble-with-tribbles-the (last visited Feb. 11, 2013).

19. The IRS cannot assess a tax after the statute of limitations on assessment has expired, even if the taxpayer agrees to the assessment. *See* I.R.C. § 6501(a) (2006); *see also* Rev. Rul. 72-42, 1972-1 C.B. 398. Generally, the IRS must make an assessment three years from the later of (1) the due date of the return, or (2) the date the return is filed. *See* I.R.C. § 6501(a), (b). The three-year rule can be extended by agreement. I.R.C. § 6501(c)(4).

20. *See* IRS, DATA BOOK, 2010, 22 (2010), *available at* http://www.irs.gov/pub/irs-soi/10databk.pdf (providing that as of 2010, the chance of audit for all individual taxpayers was about 1.1%, 2.5% for individuals earning between $200,000 and $1 million, and 8.4% for individuals earning over $1 million); *see also infra* Part IV (illustrating that even with the greater likelihood of audit, participating in a shelter may still be the rational economic choice).

21. *See, e.g.*, Reuven S. Avi-Yonah & Linda Z. Swartz, *U.S. International Tax Treatment of Financial Derivatives*, 97 TAX NOTES TODAY 61-49 (1997) ("To date, [the] Treasury has failed to propose a single, workable set of tax rules to govern the use of derivative products either between domestic parties or domestic and foreign parties."); Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments: A Proposal*, 8 HOUS. BUS. & TAX L.J. 1, 2 (2007) ("The current state of taxation of financial instruments is a mess. The rules are complicated, unfair, inconsistent, and patchwork; there is no underlying policy or vision guiding the development of the rules."). For a discussion of the various possible taxing regimes for one particular financial product, see N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON PREPAID

approach to shelters, the Tribble-like proliferation of tax shelters will continue.[22]

This Article discusses the history of using modern financial techniques to create tax-advantaged transactions and technical tax shelters, and it offers analyses and critiques of the current approach. Part II provides a brief overview of the taxation of financial instruments, to help explain how the tax shelters described in this Article sought to exploit U.S. tax laws.[23] Part III then provides specific examples of technical tax shelters, offering an analysis of the shelters' financial and tax positions and a description of the government's responses to those shelters. Part IV explains the calculus used by tax shelter participants, and how that calculus encourages taxpayers to play the tax shelter game. Part V offers suggested changes to the tax laws and discusses how those changes could affect taxpayer behavior.

II. FINANCIAL INSTRUMENTS AND TAXATION

Tax shelters involve many financial transactions to create their sought-after tax benefits. To understand how financial positions are used to create tax shelters, it is first important to understand the financial building blocks of tax shelters. One key financial transaction used in many tax shelters, and which serves as the backbone of many of the shelters discussed herein, is the short sale.[24]

Short selling is the selling of a stock that the seller does not own. A short sale requires that the short seller borrow shares, sell those shares, and promise to return shares to the lender at some point in the future. Investors often enter into short sales when they believe the price of a financial asset will fall. To illustrate a short sale, assume an investor (the "short seller")

FORWARD CONTRACTS (2008), *available at* http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1159Report.pdf.

22. Unfortunately, a device that could use a *Star Trek*-like transporter beam to send technical tax shelters to Qo'noS (the Klingon homeworld) is, as of the date of this article, undiscovered.

23. Tax laws, as referred to herein, "begin[] with the Internal Revenue Code (IRC), enacted by Congress in Title 26 of the United States Code" and include U.S. Treasury regulations that provide "the official interpretation of the IRC by the U.S. Department of the Treasury." IRS, *Tax Code, Regulations and Official Guidance*, http://www.irs.gov/Tax-Professionals/Tax-Code,-Regulations-and-Official-Guidance (last updated Aug. 2, 2012). In addition, "the IRS publishes a regular series of other forms of official tax guidance, including revenue rulings, revenue procedures, notices, and announcements." *Id.*

24. The Supreme Court has defined a short sale as, "a contract for the sale of shares which the seller does not own or the certificates for which are not within his control so as to be available for delivery at the time when, under the rules of the [stock exchange], delivery must be made." Provost v. United States, 269 U.S. 443, 450–51 (1926).

enters into a short sale of a stock when the price is $100 per share; the investor will borrow the stock from another party and immediately sell the borrowed shares for $100 per share.[25] Because the short seller borrowed the shares, however, she will have an obligation to return the shares to the lender sometime in the future. If the shares fall in value, the short seller can profit because she can then purchase shares at a market price below $100, say $75 per share, and use those newly purchased shares to satisfy her obligation to the lender. The return of borrowed shares to the lender is called "closing out the short," and, in this example, would generate a $25 per share profit for the investor.[26]

Short sales are generally taxed using a "wait-and-see," or "open" treatment, meaning the investor will not have to recognize gain or loss until she closes out the short.[27] In our example, the investor would not be required to recognize income until she closes out the short by returning the borrowed shares back to the lender. At that point, she would be required to recognize $25 per share of income, the difference between the price at which she sold the shares ($100) and the price at which she purchased the shares to return to the lender ($75).[28]

In that example, open treatment makes sense, because even though the investor received $100 at the transaction's initiation, there was nothing to measure that $100 against to determine the investment's profitability. The $100 merely represents the maximum potential profit from the transaction (because the stock cannot have a value below zero). However, as discussed *infra*, tax shelter promoters have exploited open treatment by combining financial positions to create paper losses, defer gains, and make taxable income disappear.[29]

Like short sales, derivatives are also generally taxed using open treatment.[30] A derivative is a financial instrument, the value of which is

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25. That other party is often a broker or a dealer in securities.

26. Closing out the short is sometimes referred to as covering the short.

27. The rules for taxation of short sales are set forth in I.R.C. § 1233, and the U.S. Treasury Regulations issues thereunder. Those regulations provide that, for "income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale." Treas. Reg. § 1.1233–1(a) (2006); *see also* Rev. Rul. 72-478, 1972-2 C.B. 487; Rev. Rul. 78-182, 1978-1 C.B. 265; *Federal Taxation*, *supra* note 5, at 274.

28. This example excludes any borrowing costs.

29. "Promoter," as used herein, denotes a tax shelter promoter.

30. *See* Alvin C. Warren Jr., *U.S. Income Taxation of New Financial Products*, 88 J. PUB. ECON. 899, 901 (2004) ("This wait-and-see approach applies generally to assets with contingent, rather than fixed, returns, including forward contracts and options."); *see generally* JOINT COMM. ON TAXATION, JCX-21-08, PRESENT LAW AND ANALYSIS RELATING TO THE TAX TREATMENT OF DERIVATIVES 15–23 (2008), *available at*

determined by reference to some other underlying asset.[31] Open tax treatment for derivatives works well when the derivatives' economic returns are contingent, i.e., uncertain and subject to risks. Yet that same open treatment becomes subject to exploitation when a derivative is coupled with another financial position in such a way that the combined positions have, for all practical purposes, allowed the investor to profit from the position while eliminating any additional risk and without subjecting those profits to taxation. Absent any real transactional risk, little justification exists for open treatment. Yet tax shelter promoters have often structured derivatives to achieve just that result, with the only loser being the fisc.

Many types of derivative securities exist, with forwards and options being the most common. Forwards and options also often serve as the basic building blocks for more complex derivative securities.[32] Of those more complex derivatives, the most common is a swap, which is "[a]n agreement to exchange cash flows in the future according to a prearranged formula."[33] A swap is often structured to be economically equivalent to a series of forward contracts.[34] The derivatives in the tax shelters described in this Article were structured using forwards, options, swaps, or some combination of the three.

A. Understanding Forwards

A forward contract is an executory contract to buy or sell an asset at a certain time in the future for a certain price.[35] Forward contracts are defined for U.S. tax purposes as privately negotiated contracts that provide for the sale and purchase of property for a specified price on a specified date.[36] Forward contracts, as derivative securities, have open treatment. Thus, "until the forward contract is sold, exchanged, settled or allowed to lapse [hereinafter known as being complete], the transaction is treated as open, and any gain or loss to the parties is deferred."[37]

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https://www.jct.gov/publications.html?func=startdown&id=1319 (providing a general overview of the taxation of derivatives).

31. HULL, *supra* note 11.

32. *See Id.*, at 594–99; SALIH N. NEFTCI, AN INTRODUCTION TO THE MATHEMATICS OF FINANCIAL DERIVATIVES 2 (2d ed. 2000).

33. HULL, *supra* note 11, at 712.

34. *See Id.*, at 125 ("[a] forward contract can be viewed as a simple example of a swap. . . . Whereas a forward contract leads to the exchange of cash flows on just one future date, swaps typically lead to cash flow exchanges taking place on several future dates.").

35. HULL, *supra* note 11, at 2.

36. Glass v. Comm'r, 87 T.C. 1087, 1101 (1986); HULL, *supra* note 11, at 2.

37. Yoram Keinan, *The Case for Residency-Based Taxation of Financial Transactions in Developing Countries*, 9 FLA. TAX REV. 1, 39 (2008).

An example of a simple forward contract would be as follows: Party A agrees to buy 100 barrels of oil from Party B in 90 days at a price of $115 per barrel. In this example, Party A has assumed a "long" position in the forward contract.[38] Generally, Party A's long position will benefit from rising prices of oil over the next 90 days because Party A has the right to purchase oil at $115 no matter the market (spot) price of oil in 90 days.[39] Alternatively, Party B has assumed a "short" position, because she has agreed to sell the oil and will generally be in a better position if the price of oil falls in the next 90 days.[40]

In a typical forward contract, neither party to the contract makes a payment at the time the contract is executed, although arrangements for collateral may be made.[41] However, a forward contract could call for payment up front, and that transaction is generally described as a prepaid forward. In a typical prepaid forward contract, using the forward contract example above, Party A would pay for the price of 100 barrels of oil up front to Party B. However, the price would not be $115 per barrel; it would be the amount that, if invested at a specific market rate (i.e., the forward rate),[42] would be worth $115 in 90 days (in other words, the discounted value or present value of $115).[43]

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38. A "long" position denotes ownership of a security or derivative. Informally, one who owns 100 shares of a stock is said to be "long 100 of the stock." Likewise, an investor who has purchased (or holds) an option is said to be "long the option" because he or she has the right to exercise the option at a later date. The party with a "long" position will generally be in a better position if the price of the underlying asset rises. While this is generally true for most assets, a long position need not increase in value as the price of the underlying asset increases. For example, if an investor were long a put option, that investor's put option would increase in value as the value of the underlying stock decreased.

39. The current price of a security is called its spot price. Similarly, an agreement to buy or sell an asset today is a spot contract. HULL, *supra* note 11, at 2.

40. For derivative securities, a "short" position is an investment position in which the investor either has written an option or has sold a commodity contract, with the obligation remaining outstanding. For stocks and bonds and other physical securities, a "short" position is a net investment position in a security in which the security has been borrowed and sold, but not yet replaced.

41. *Treatment of Prepaid Derivative Contracts*, Attached to Congressman Richard Neal, Chairman of Subcommittee on Select Revenue Measures, Remarks to the U.S. House of Representatives (Dec. 19, 2007), http://neal.house.gov/images/pdf/background_on_neal_prepaid_derivatives_bill.pdf.

42. A rate applicable to a financial transaction that will take place in the future. *See* HULL, *supra* note 11, at 98–100. The forward rate is often based on the cost of carry, or the cost of holding a position for a period of time.

43. Party A would only agree to pay the present value of $115 because he is advancing money to Party B, yet delivery will not occur for 90 days. Party A thus needs to be compensated for paying for a product for which delivery is delayed. Party B would still have the obligation to deliver 100 barrels of oil in 90 days, but Party B now has the option to either purchase the oil up

B. Understanding Options

Options are financial contracts that give their holders the right, but not the obligation, to buy or sell some asset in the future for a certain price.[44] Generally, there are two broad categories of options—call options and put options.

1. Call Options

Call options give the holder the right to buy an underlying asset on or before a certain date (the exercise date) for a certain price (the exercise price).[45] An example of an equity call option is a contract giving the holder the right to buy 100 shares of Google stock (ticker: GOOG) for $600 per share (the strike price) on or before January 18, 2013 (the exercise date). As of August 15, 2012, when GOOG was trading at approximately $667 per share, a call option with a strike price of $600 and an exercise date of January 18, 2013, was priced at $82.60.[46]

2. Put Options

Put options give the holder of the option the right to sell the underlying asset on or before an exercise date at a certain strike price.[47] An example of a put option is a contract giving the holder the right to sell 100 shares of GOOG for $600 per share (the strike price) on or before January 18, 2013 (the exercise date). As of August 15, 2012, a Google put option with a $600 strike price and a January 18, 2013 exercise date was priced at $17.22.[48]

3. Options and Firm Value

Modern finance has long understood that a firm's equity value, at its core, can be thought of as an option.[49] From a theoretical perspective, a

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front with the amount paid by Party A, or wait until later to purchase the oil, usually with the hope that the price of oil will fall.

44. HULL, *supra* note 11, at 151.

45. "American" options can be exercised at any time up to the expiration date. Alternatively, "European" options can only be exercised on the expiration date. *Id.*

46. The prices quoted herein were intraday prices.

47. HULL, *supra* note 11, at 6.

48. *See supra* note 46.

49. "Long" meaning at least since 1973, when Fischer Black and Myron Scholes published their groundbreaking paper, "The Pricing of Options and Corporate Liabilities," in *The Journal of Political Economy*. Black & Scholes, *supra* note 11. In 1997, Robert Merton and Myron Scholes (who expanded the mathematical understanding of Black and Scholes' work)

firm's equity is equivalent to a call option on the value of the firm's assets, with the value of the liabilities as the strike price of the option.[50] For example, if Company A was established with $100X contributed as equity and then borrowed $50X, it would have assets of $150X, debt of $50X, and equity of $100X. The value of that equity, $100X, is also the price of an immediately exercisable call option on the entire Company with a strike price of $50X. While such a theoretical construct has limited applicability for public companies, the concept has been used by tax planners, as discussed *infra*, to create tax shelters for their clients.

4. Swaps

A swap is an agreement between two counterparties to exchange cash flows related to one or more underlying assets over some period in the future.[51] From a financial market perspective, a swap is merely a series of forward contracts bundled into one contract.[52] The IRS has determined that swaps should be categorized as a type of notional principal contract ("NPC").[53] The tax treatment of NPCs is governed primarily by regulations issued pursuant to Section 446 of the Code. Treasury regulations define an NPC as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a

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were awarded a Nobel Prize for their work (Fischer Black was mentioned as a contributor to the prize, but was ineligible to receive the prize because he died in 1995). Press Release, The Royal Swed. Acad. of Scis., 1997 Nobel Prize in Economic Sciences (Oct. 14, 1997), http://www.nobelprize.org/nobel_prizes/economics/laureates/1997/press.html.

50. *See, e.g.*, Eric Falkenstein & Andrew Boral, *Some Empirical Results on the Merton Model*, *in* RISK PROF. (2001), *available at* http://www.efalken.com/papers/Mertonmodel.htm; Aswath Damodaran, *Applications of Option Pricing Theory to Equity Valuation*, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/lectures/opt.html (last visited Feb. 13, 2013); Aswath Damodaran, *Option Pricing Applications in Valuation*, http://people.stern.nyu.edu/adamodar/pdfiles/eqnotes/optequity.pdf (last visited Feb. 13, 2013).

51. *See* HULL, *supra* note 11, at 125.

52. *See* CLIFFORD W. SMITH, JR. ET AL., MANAGING FINANCIAL RISK 45, 48–49 (1990) (stating that "a swap contract is in essence nothing more complicated than a series of forward contracts strung together"); David F. Levy, *Towards Equal Tax Treatment of Economically Equivalent Financial Instruments: Proposals for Taxing Prepaid Forward Contracts, Equity Swaps, and Certain Contingent Debt Instruments*, 3 FLA. TAX REV. 471, 494 (1997) (providing that long equity swaps are "economically equivalent to a cash-settled, prepaid forward contract" on the underlying property).

53. An NPC is sometimes referred to simply as a swap, although a swap is more narrow because the definition of an NPC includes other financial products such as caps and floors. The Treasury regulations define NPCs to include "interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements." Treas. Reg. § 1.446-3(c)(1)(i) (2006).

specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts."[54]

One of the more common types of swaps is the total return swap, which is typically a financial contract in which one party agrees to make payments based on a set rate (either fixed or floating), and the other party agrees to make payments based on the total economic return of one or more underlying financial assets.[55] A total return swap can be used to replicate the returns on any individual or group of financial assets. Total return swaps are often structured to replicate a secured borrowing (i.e., borrowing money to purchase an asset and using the asset as security for the borrowing), but with significantly different risks.[56]

For example, if a foreign party wanted to invest in a particular stock, such as stock in a U.S. defense contractor, but was prohibited from owning the stock because of either U.S. or its own country's laws, it could enter into a total return swap with a U.S. bank (Bank) to replicate the returns on that stock. The transaction could be structured as follows:

1) The foreign party (FP) determines the cost of the stock it wants to acquire, say $100 million of defense contractor stock (DC Stock);

2) FP enters into a five-year total return swap with Bank on a $100 million notional amount, wherein Bank agrees to pay any positive financial returns on a basket of $100 million of DC Stock to FP, and FP agrees to make periodic interest-like payments on the $100 million notional amount to Bank, and further agrees to pay any negative financial returns (i.e., losses) on the DC Stock to Bank at the end of the period.[57]

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54. *Id.* A specified index is a fixed rate, price or amount (which may vary by period), an index that is based on objective financial information, or an interest rate index that is regularly used in normal lending transactions. *Id.* § 1.446-3(c)(2). "[A] notional principal amount is any specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the [NPC], but is not borrowed or loaned between the parties as part of the [NPC]." *Id.* § 1.446-3(c)(3).

55. Total return swaps have caused problems for the IRS in areas outside the tax shelter arena. For example, the IRS has drafted an industry directive alerting its agents that some taxpayers have used total return swaps to avoid tax with respect to certain U.S. source income. IRS, *Industry Directive on Total Return Swaps ("TRSs") Used to Avoid Dividend Withholding Tax*, LMSB-4-1209-044 (2010) [hereinafter *Industry Directive*].

56. For example, borrowing $100,000 to purchase a house, and using the house as security for the $100,000 loan.

57. Banks will often reduce or hedge their risk by purchasing the underlying stock. Because banks can generally borrow at lower rates than their customers, banks often borrow funds to purchase the underlying stock and profit from the difference between the amount they pay on their borrowings and the amount they charge their customers.

In this example, FP is in a similar position to an owner of the stock, but with some important legal and financial differences. One such difference is that FP does not own the stock, which means it is not deemed a shareholder, thus not running afoul of any ownership restrictions.[58] Other key differences are that (i) FP only has a five-year position in DC stock (though FP could extend the contract if both it and Bank agreed), and (ii) FP has also incurred the risk that Bank will be unable to perform under the contract, deemed "counterparty risk."[59] Absent a Bank failure, however, those differences will have little to no impact on FP's economic return over the five-year period.[60]

From a tax perspective however, FP is in a markedly different position than had it owned the underlying stock. Ignoring for the moment the restrictions on ownership, had FP owned the DC Stock, FP would have been subject to U.S. withholding tax on any dividends it received on the DC Stock.[61] NPCs, however, had a different sourcing rule for dividend payments.[62] That rule had the effect of creating an unintentional tax shelter.

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58. *See* Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 124 (2010).

59. While usually insubstantial, the market crisis of 2008 demonstrates that such risks are potentially significant. *See* Brian J.M. Quinn, *The Failure of Private Ordering and the Financial Crisis of 2008*, 5 N.Y.U. J.L. & BUS. 549, 583–85 (2009). That risk can be hedged with a credit default swap on Bank.

60. However, such differences may play a large role in the market for equities. *See* Jordan M. Barry, John William Hatfield & Scott Duke Kominers, *On Derivatives Markets and Social Welfare: A Theory of Empty Voting and Hidden Ownership* (Becker Friedman Inst. Research Econ., Working Paper No. 2011-011, 2012), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2134458. Barry, Hatfield, and Kominers present an analysis contrasting the "prevailing view among many economists . . . that derivatives markets simply enable [financial markets] to incorporate information better and faster" and arguing that the separation of economic interests and corresponding voting rights brought on by derivatives "can render financial markets unpredictable, unstable, and inefficient." *Id.* at 7.

61. *See* I.R.C. §§ 871, 881 (2012). U.S. withholding tax is generally imposed on certain types of U.S. source income, including dividends paid to foreign persons. The tax rate could be as high as 30% of such U.S. source income. *Id.*; *see also* STAFF OF U.S. S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 110TH CONG., REP. ON DIVIDEND TAX ABUSE: HOW OFFSHORE ENTITIES DODGE TAXES ON U.S. STOCK DIVIDENDS 3 (Comm. Print 2008) [hereinafter STAFF REPORT], *available at* http://www.hsgac.senate.gov//imo/media/doc/091108DividendTaxAbuse.pdf; Lynnley Browning, *Banks' Derivatives Activity Falls Under I.R.S Scrutiny*, N.Y. TIMES (Jan. 20, 2010), http://www.nytimes.com/2010/01/21/business/21tax.html?_r=1&partner=rss&emc=rss. Browning notes that "[t]he instruments known as equity swaps, mimic ordinary shares and give investors like hedge funds the benefits of stock ownership, including payments similar to dividends, without actually owning the shares." *Id.* In addition to other benefits, Browning points to the fact that "[b]ig banks also benefit from the swaps because, under federal tax rules, the banks may avoid paying a 30 percent tax that is normally levied on stock trades." *Id.*

62. *See* Warren, *supra* note 30, at 912.

Foreign taxpayers contemplating ownership of U.S. stocks were faced with a choice: purchase the stock directly and face withholding tax obligations or enter into a total return swap on the stock and escape such obligations.[63] Absent a compelling reason to actually own the stock, many foreign investors utilized the total return swap method described above. Thus, foreign investors were able to replicate the economic returns of ownership without incurring substantial withholding tax obligations. However, in 2008, Congress noted the abuses in such actions[64] and, in 2010, the IRS told its agents to examine such transactions as potentially abusive.[65] Finally, on January 19, 2012, the Treasury and the IRS released temporary and proposed regulations subjecting certain swap payments to U.S. withholding tax.[66]

While the actions of the foreign parties using total return swaps for legitimate investment purposes may not be tantamount to a shelter, those actions nevertheless demonstrate how certain tax rules create legitimate opportunities for taxpayers to avoid tax using derivatives. The tax shelters described below have no such legitimacy.

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63. Foreign parties were able to avoid withholding obligations based on a 1991 Treasury Regulation that provided that the source of any payment made pursuant to an NPC was sourced according to the residence of the person receiving the payment. Thus, the foreign party receiving U.S. stock dividends, according to the Treasury Regulations, was able to claim that those U.S. stock dividends were foreign source, because the foreign party was receiving the payment. As foreign source payments, no U.S. withholding obligations arose. *See* Treas. Reg. § 1.863-7 (1991); *see also Industry Directive*, *supra* note 55.

64. *See* STAFF REPORT, *supra* note 61.

65. On January 14, 2010, the IRS issued an industry directive to identify and pursue certain total return swap transactions that avoided U.S. withholding tax. *See Industry Directive*, *supra* note 55.

66. On January 19, 2012, the IRS released temporary and proposed regulations addressing the treatment of dividend equivalents, and requiring those dividend equivalent payments to be treated as U.S. source income subject to withholding. T.D. 9572, 2012-11 I.R.B. 471–75, *available at* http://www.irs.gov/pub/irs-irbs/irb12-11.pdf. Under the temporary regulations, swap payments made after March 18, 2012, but prior to January 1, 2013, will continue to be subject to the existing sourcing rules contained in § 871(m). Beginning January 1, 2013, however, payments contingent on or determined by reference to dividends on U.S. equities made under swaps and certain other financial instruments that fall within any one of seven categories of "specified notional principal contracts" set forth in the proposed regulations would generally be treated as U.S. source income under § 871(m) and thus potentially subject to U.S. withholding tax. *Id.*

III. TAX SHELTERS USING DERIVATIVES

Before 1986, tax shelters were a dime a dozen.[67] Under pre-1986 law, taxpayers were able to offset ordinary income (like wages) with passive losses (like depreciation). In 1986, Congress ended those shelters by passing the Tax Reform Act of 1986 ("1986 Act"), which included limitations on taxpayers' ability to shelter ordinary income with passive losses.[68] The 1986 Act effectively shut down those pre-1986 shelters.[69] Today's shelters, however, are not as easy to attack.

After the 1986 Act, one of the first tax-advantaged transactions to gain widespread notoriety was a transaction structured for the Estée Lauder family in 1994–95 (the "Lauder Family Transaction"). The Lauder Family Transaction was based on the short against the box transaction. In a short sale against the box,

> an owner of publicly traded equity borrows the same number of identical shares from his broker and sells them short in the market. Usually the borrower pledges the shares he owns as collateral for the loan of the shares used in the short sale. Thus an equity owner can dispose of his economic risk without having to recognize gain in the shares until the short sale is closed. A short sale against the box is a tax deferral transaction, nothing more; yet the tax

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67. Farms, particularly cattle farms, were (and still are) a popular source for tax shelters. *See, e.g.*, Yasha Levine, *This Tax Day, 'Farms' Owned by the Rich Provide Massive Tax Shelter*, NATION (Apr. 14, 2011), http://www.thenation.com/article/159943/tax-day-farms-owned-rich-provide-massive-tax-shelter.

68. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). I.R.C. § 469 applies to passive activity losses. The 1986 Act was a grand compromise between strange and hostile bedfellows. On one side, there was a tax-reform, anti-loophole, base-broadening approach, traditionally a Democratic approach. On the other side, there was a cut-the-tax-rate approach, traditionally Republican. The 1986 Act plopped them together and cut both tax rates and tax loopholes, broadening the base and cutting rates. *See generally* Calvin H. Johnson, *What's a Tax Shelter?*, 68 TAX NOTES 879 (1995). Such a compromise could arguably work well in today's tax shelter environment, but the two parties are much farther apart and any such grand compromise seems unlikely. *See, e.g.*, Martin Feldstein, *The Tax Reform Evidence from 1986*, WALL ST. J. (Oct. 24, 2011), http://online.wsj.com/article/SB10001424052970204002304576629481571778262.html (noting that "[e]xperience implies that the combination of base broadening and rate reduction would raise revenue equal to about 4% of existing tax revenue").

69. Andrew A. Samwick, *Tax Shelters and Passive Losses After the Tax Reform Act of 1986*, at 1 (Nat'l Bureau of Econ. Research, Working Paper No. 5171, 1995) (noting that the act resulted in a "precipitous decline in tax sheltered investments"), *available at* http://www.nber.org/papers/w5171.pdf?new_window=1.

administrator and the courts have permitted it for decades because of the identification rule.[70]

To illustrate the benefits of a short against the box (using pre-1997 law), assume an investor owns 1,000 shares of GOOG (trading at $667 per share) and had a zero basis in those shares. If the investor sold those shares, then she would have to recognize $667,000 of gain.[71] But if the investor borrowed 1,000 shares and sold short those shares, the investor would have $667,000 cash but no gain until he closed out the short.[72] At that point, the investor has $667,000 cash and two open positions for tax purposes: the long position in GOOG stock and the short position in GOOG stock. Since those two positions perfectly offset each other (all gains on the long position offset losses on the short position, and vice versa), the investor has also eliminated all risk with respect to the positions.[73] Generally, the only way to monetize a position, and eliminate risk with respect thereto, would be selling the position. The short against the box achieved the same result as a sale, yet without those pesky taxes.

The Lauder Family Transaction allowed Estée Lauder, the founder of the Estée Lauder Company ("Lauder Company") (as well as her son, Ronald Lauder) to use a short against the box technique to, for all intents and purposes, sell approximately 15 million shares in the Lauder Company and avoid the tax liability generated by the sale.[74] In the transaction, instead of

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70. Lee A. Sheppard, *Equity Swaps as an Executive Tax Shelter*, TAX NOTES TODAY, Oct. 24, 1994, at 266.

71. I.R.C. § 1001 (2012).

72. I.R.C. § 1233 (2012). Importantly, the lender of the shares also has no risk, because the lender would generally require the investor to post the long position as collateral. *See* Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 TAXES 783, 788 (1993) [hereinafter Kleinbard, *Risky and Riskless*]. Kleinbard notes that, "[a] securities borrower must collateralize its obligation to return the borrowed securities to the lender; in a short-against-the-box, this obligation often is satisfied by the borrower/short seller posting its 'long' position as collateral." *Id.*

73. For every dollar increase in GOOG, the value of the investor's long position rises, but the value of the short position falls by the exact same amount. Alternatively, for every dollar decrease in GOOG stock, the value of the investor's stock position falls, but the value of the short position rises by the exact same amount. *See* Kleinbard, *Risky and Riskless*, *supra* note 72, at 789 ("[G]ain (or loss) on the investor's long position is perfectly offset by loss (or gain) on its short position.").

74. The media reported that members of the Lauder family had large positions in Lauder Company stock, but had a very low basis in that stock. *See, e.g.*, Floyd Norris, *New Tax Law Takes Aim at Estée Lauder*, N.Y. TIMES (Aug. 6, 1997), http://www.nytimes.com/1997/08/06/business/new-tax-law-takes-aim-at-estee-lauder.html; Allan Sloan, *Lauder Family's Stock Maneuvers Could Make a Tax Accountant Blush*, WASH. POST, Nov. 28, 1995, at D3. Therefore, if the family members sold their stock, such sales would have generated large capital gains. In 1995, the Lauder family would have been subjected to a 28% capital gains tax. I.R.C. § 1(h) (1995).

selling their own appreciated shares in the Lauder Company, they borrowed shares from family members and sold those shares (i.e., they sold short the borrowed shares).[75]

According to media reports at the time, the Lauders' short against the box transactions allowed them to defer paying between $95 and $125 million in taxes.[76] However, deferral was only one goal: the transaction was structured in such a manner that the borrowed shares would not be returned (i.e., the short would not be closed out) until after the death of the taxpayer. Death, being the most tax-favored event (for all except the decedent), would allow Ms. Lauder's (and her son's) own shares to be revalued for tax purposes to their fair market value at the time of their death.[77]

Tax shelter promoters, drunk with clients seeking to avoid taxes based on notoriety of the Lauder Family Transaction, began aggressively using such transactions to aid their clients in sheltering income. Congress responded to the negative publicity surrounding the Lauder Family Transaction, as well as the threat to the fisc, in 1997, enacting I.R.C. § 1259 as part of the Taxpayer Relief Act of 1997.[78] Section 1259's purpose was to end the short against the box and similar transactions.[79] In enacting section 1259, Congress required taxpayers to recognize gain (but not loss) when they entered into a short against the box transaction (or a similar transaction)[80]

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75. *See* Sloan, *supra* note 74.

76. *See, e.g.*, Norris, *supra* note 74; Sloan, *supra* note 74.

77. *See* I.R.C. § 1014(a)(1) (1994) (providing "the basis of property in the hands of a person acquiring the property from a decedent . . . shall . . . be (1) the fair market value of the property at the date of the decedent's death").

78. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788; *see also* Susan M. Stone, *Deferring the Ultimate Makeover: Estee Lauder's IPO Makes Capitol Hill Look Twice at Short Sales Against the Box*, 14 J. TAX'N INVESTMENTS 356 (1997).

79. In the section 1259 legislative history, Congress acknowledged that under the then-current law (i.e., pre-section 1259):

> [A] taxpayer may lock in gain on securities by entering into a 'short sale against the box,' i.e., when the taxpayer owns securities that are the same as, or substantially identical to, the securities borrowed and sold short. The form of the transaction is respected for income tax purposes and gain on the substantially identical property is not recognized at the time of the short sale.

JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, JCS-23-97, at 173 (Comm. Print 1997).

80. I.R.C. § 1259(c)(1) treats a taxpayer as having made a constructive sale of an appreciated stock position:

> [I]f the taxpayer (or a related person)—
> (A) enters into a short sale of the same or substantially identical property,
> (B) enters into an offsetting notional principal contract with respect to the same or substantially identical property,
> (C) enters into a futures or forward contract to deliver the same or substantially identical property,

with respect to an appreciated stock position.[81] Congress also included section 1259(c)(1)(E), which gave the Treasury the authority to issue regulations if a taxpayer "enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as" other prescribed transactions.[82] To date, the Treasury has not issued any such regulations.[83]

In the section 1259 legislative history, Congress acknowledged:

> [T]axpayers may engage in other arrangements, such as "futures contracts," "forward contracts," "equity swaps" and other "notional principal contracts" where the risk of loss and opportunity for gain with respect to property are shifted to another party. . . . These arrangements do not result in the recognition of gain by the taxpayer.[84]

> (D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any property, acquires the same or substantially identical property, or
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> (E) to the extent prescribed by the Secretary in regulations, enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

I.R.C. §1259(c) (2012); *see also* David M. Schizer, *Financial Instruments: Special Rules*, BNA TAX MGM'T PORTFOLIOS, at pt. III-A Constructive Sales Under § 1259 (noting that "substitutes for short sales against the box have become more widely available in the over-the-counter derivatives market, which matured during the 1980s and 1990s. [Options, forwards and swaps] can be used as hedges, for instance, when a short sale violates the securities laws.") (last updated Feb. 13, 2013).

81. I.R.C. § 1259(b)(1) defines an appreciated position in stock as "any position with respect to any stock . . . if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value." I.R.C. § 1259(b)(1) (2012).

82. I.R.C. § 1259(c)(1)(E) (2012). It was well understood at the time that other transactions could be used that would have the same effect of a short against the box. *See* Edward Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1358–59 (1991).

83. Despite Treasury inaction, a general rule of thumb has emerged in the tax bar that a hedge using options must allow for a spread of at least 20% on the price of a stock (e.g., an in-the-money put struck at 120% of the purchase price or a collar struck at 95% and 115% of the purchase price) to avoid the constructive sales rules of I.R.C. § 1259. *See, e.g.*, Eric D. Chason, *Naked and Covered in Monte Carlo: A Reappraisal of Option Taxation*, 27 VA. TAX REV. 135, 186–191 (2007); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1343 (2001) [hereinafter Schizer, *Frictions*]; Richard O. Loengard, Jr., *NYSBA Reports on Proposed Constructive Sale Legislation*, 97 TAX NOTES TODAY 103-11 (1997).

84. The I.R.C. § 1259 legislator also suggested approaches the Treasury might take in crafting such regulations, noting:

> [It is] anticipated that the Treasury regulations, when issued, will provide specific standards for determining whether several common transactions will be treated as constructive sales. . . .

That legislative history also suggested that section 1259(c)(1)(E) was aimed at transactions that eliminated "*substantially all* of the taxpayer's risk of loss and opportunity for income or gain with respect to [an] appreciated financial position."[85] The gap between "all" and "substantially all" has been a boon for the tax shelter industry. Into that gap stepped the tax promoters with the variable prepaid forward.

A. The Variable Prepaid Forward

On the heels of the Lauder Family Transaction (and Congress' reaction to it), many wealthy taxpayers sought other more-or-less legitimate ways to avoid tax on their appreciated stock positions. One of the more popular methods has been the variable prepaid forward contract, which is nothing more than a less (but still remarkably) efficient short against the box. As reported by the *New York Times* in 2008, the variable prepaid forward

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> In order to determine whether collars have substantially the same effect as the transactions specified in the provision, the Congress anticipated that Treasury regulations will provide specific standards that take into account various factors with respect to the appreciated financial position, including its volatility. It is expected that several aspects of the collar transaction will be relevant, including the spread between the put and call prices, the period of the transaction, and the extent to which the taxpayer retains the right to periodic payments on the appreciated financial position (e.g., the dividends on collared stock). The Congress intended that the Treasury regulations with respect to collars will be applied prospectively, except in cases to prevent abuse.

JOINT COMM. ON TAXATION, *supra* note 79, at 177–78. The committee also noted:

> For collars, options and some other transactions, one approach that Treasury might take in issuing regulations is to rely on option prices and option pricing models . . . Thus, option pricing offers one model for quantifying both the total risk of loss and opportunity for gain with respect to an appreciated financial position, as well as the proportions of these total amounts that the taxpayer has retained. In addition to setting specific standards for treatment of these and other transactions, it may be appropriate for Treasury regulations to establish 'safe harbor' rules for common financial transactions that do not result in constructive sale treatment.

Id. at 178.

85. H.R. REP. NO. 105-148, at 442 (1997) (emphasis added); *see also* JOINT COMM. ON TAXATION, *supra* note 79, at 177. This language appears to be adopted from Treasury's initial constructive sale proposal. This proposal targeted hedges that "substantially eliminate[d] risk of loss and opportunity for gain." *See* U.S. Dep't of Treasury, *Treasury's General Explanation of Administration Revenue Proposals*, 96 TAX NOTES TODAY 56-9 (1996). Congress ultimately enacted an alternative proposal offered by Representative Kennelly that lists the four specific categories and a catch-all. *See* H.R. 846, 105th Cong. (1997).

contract is "one of the most widely used in corporate America. The unpaid taxes associated with it are likely to total billions of dollars a year."[86]

The variable prepaid forward is attractive to taxpayers holding large appreciated stock positions. A quick review of PNC Bank's website shows the ubiquity of the product. For example, PNC Financial Service's website states:

> Use a prepaid forward contract to receive from 75 to 85% of your stock's value in cash. If you'd like to realize the value of your concentrated stock holding and generate cash without selling your stock, making interest payments on a loan or subjecting yourself to borrowing restrictions based on how you plan to use the funds, a prepaid forward contract may be the solution you need.[87]

Here is how the variable prepaid forward works. The taxpayer agrees to sell some variable amount (usually from 80% to 100%) of his appreciated stock position to a financial institution at some time in the future. The financial institution pays a portion of the sales price up front to the taxpayer but has no real risk in the transaction because the taxpayer agrees to post the stock as collateral.[88] In entering the prepaid forward, the taxpayer has monetized and eliminated the risk of loss with respect to at least 80% of the appreciated stock position. So why does the taxpayer not have to recognize income on that 80%? Because in "2003, apparently unaware that an increasing number of the prepaid forward contracts involved share lending, the IRS declared them valid."[89]

In Revenue Ruling 2003-7, the IRS ruled that as long as the taxpayer was permitted to deliver either cash or shares at settlement, and the exact

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86. Lynnley Browning, *U.S. Wonders if Stock Deal Is Tax Abuse*, N.Y. TIMES (Feb. 11, 2008), http://www.nytimes.com/2008/02/11/business/11tax.html; *see also* Jesse Drucker, *How to Pay No Taxes: 10 Strategies Used by the Rich*, BLOOMBERG BUSINESSWEEK (Apr. 17, 2012), http://www.businessweek.com/articles/2012-04-17/how-to-pay-no-taxes-10-strategies-used-by-the-rich [hereinafter Drucker, *No Taxes*].

87. *Prepaid Forward Contract*, PNC, https://www.pnc.com/webapp/unsec/ProductsAndService.do?siteArea=/PNC/Home/Personal/Investments+and+Wealth+Management/Wealth+Management+and+Advice/Asset+Management/Strategies+for+Concentrated+Equity+Positions/Prepaid+Forward+Contract (last visited Feb. 25, 2013).

88. The financial institution often borrows the shares from the taxpayer and immediately sells them short. In doing so, the financial institution accomplished two complementary goals: it generates the cash needed to pay the taxpayer (by selling the borrowed shares short) and eliminates any risk with respect to the transaction. That risk is eliminated because any loss on the prepaid forward contract (because the shares lose value) is offset by its short sale.

89. Browning, *supra* note 86. A 2003 IRS revenue ruling provided that if the taxpayer was permitted to substitute cash for delivery of shares at settlement, the prepaid forward contract would not require the taxpayer to recognize income up front, but would only recognize income when the prepaid forward contract closed. *See* Rev. Rul. 2003-7, 2003-1 C.B. 363.

amount of shares to be delivered at settlement could not be determined, the variable prepaid forward contract would not require the taxpayer to recognize income up front, but would only recognize income when the prepaid forward contract closed.[90] Belatedly, in 2006, the IRS sought to un-ring the bell by issuing a Technical Advice Memorandum declaring particular types of variable prepaid forward contracts invalid.[91]

The IRS has enjoyed recent success attacking the more aggressive variable prepaid forward contracts.[92] While there is little publicly available information about individual IRS settlements, one case for which there is public information is instructive. In 2011, Clear Channel Communications, Inc.'s co-founder, Billy Joe McCombs, settled his $45 million potential tax liability for $23 million, based on his use of variable prepaid forward contracts he entered in 2002 and 2003.[93] From McCombs' perspective, the strategy was successful: even in defeat, he deferred paying $23 million in taxes for nine years, and escaped paying taxes altogether for the remaining $22 million asserted by the IRS. While he was required to pay interest on the underpayment, those interest payments are hardly a deterrent for many taxpayers.[94]

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90. *See* Rev. Rul. 2003-7, 2003-1 C.B. 363.

91. I.R.S. Tech. Adv. Mem. 200604033 (Jan. 27, 2006) (concluding that "when Taxpayer has loaned shares to Counterparty that were originally pledged to the Counterparty, and the Counterparty disposed of the shares, the cumulative effects of the agreement result in a current sale of shares for tax purposes, notwithstanding Rev. Rul. 2003–7, 2003–1 C.B. 363").

92. *See* Jeremiah Coder, *More Taxpayers Settling Their Variable Prepaid Forward Contract Cases*, TAX NOTES TODAY, Jan. 4, 2012, at 66.

93. *See* Janet Novack, *IRS Demands $45 Million from Billionaire McCombs*, FORBES (July 27, 2010, 1:45 PM), http://www.forbes.com/2010/07/27/billy-mccombs-anschutz-capital-gains-personal-finance-billionaire-mccombs-fights-irs.html. According to the article, the IRS asserted:

> [McCombes] should have reported $213.4 million in long-term capital gains in 2002 from the sale of 11.3 million shares of Clear Channel Communications Inc., the company he cofounded in 1972. He's also disputing an additional $3.3 million in 2003 capital gains in connection with the same purported sale. In all, the IRS asserts, McCombs had $245 million in taxable income for 2002 and 2003, rather than the $18 million he reported and owed $53 million in income tax, not the $8 million he paid.

Id.; *see also* Jeremiah Coder, *Practitioners Seek Clarity on Stock Lending After* Anschutz, TAX NOTES TODAY, July 25, 2011, at 342, 345; Drucker, *No Taxes*, *supra* note 86; Jesse Drucker, *Billionaires Can Avoid Reporting Gains on Stocks*, USA TODAY (Nov. 24, 2011, 4:13 AM), http://usatoday30.usatoday.com/USCP/PNI/NEWS/2011-11-24-bcbillionairetaxes_ST_U.htm; Robert Frank, *The Billionaire's Tax Loophole*, WALL ST. J. (Nov. 22, 2011, 4:24 PM), http://blogs.wsj.com/wealth/2011/11/22/the-billionaires-tax-loophole/.

94. Under the Code, the interest rate on underpayments, late payments, or nonpayments of tax equals the federal short-term rate plus three percentage points. I.R.C. § 6621(a)(2) (2012). The federal short-term rate is determined by the Secretary of the Treasury in accordance with I.R.C. § 1274(d). I.R.C. § 1274(d)(1)(C)(i) directs the Secretary to set the short-term rate based on the market yield of U.S. obligations with less than three years remaining before maturity.

The similarity between the variable prepaid forward contract and the short against the box should be obvious: in both cases, taxpayers monetized a significant portion of an appreciated stock position, eliminated much of the risk with respect to that position, and avoided income tax. While the government has stepped up its efforts in combating variations of the prepaid forward transaction, taxpayers have pressed on, using even more complex transactions to create what, at their core, are derivatives-based versions of short against the box transactions.

B. More Sophisticated Structures

"It's simple ain't it, but quite clever."[95]

Variable prepaid forwards presented a challenge to the IRS because the investor had at least some "skin in the game," i.e., the investor retained some meaningful opportunity for gain or loss when the variable prepaid forward contract terminated. In the wake of the IRS's difficulty in challenging those transactions, and the government's limited *ad hoc* steps toward changing the law and closing the transaction down, tax shelter promoters created one of the first large-scale tax shelters using short against the box principles, known as the Bond Option Sales Strategy ("BOSS") Transaction.[96] Unlike the variable prepaid forward transaction, BOSS was a tax shelter, because its main purpose, rather than sheltering gains on stock, was to create phantom losses that could be used to shelter various other kinds of income.

The BOSS Transaction purportedly allowed taxpayers to claim phantom losses based on a contribution to, and distribution from, a newly created

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Such interest, however, often fails to act as a deterrent, because for many taxpayers entering into tax shelters, their ability to generate economic returns on the money they do not pay the government far exceeds the interest cost they have to pay to the government. *See, e.g.*, George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 686 (1985) (noting that then-current interest rates on underpayments were "so low that taxpayers were tempted to take risky positions with the assurance that even if they lost in the long run they could profit immensely from temporarily investing the government's money").

95. ERIC B. & RAKIM, *Move the Crowd*, *on* PAID IN FULL (4th & B'way Records 1987).

96. *See* Press Release, U.S. Senate Comm. Fin., *Grassley, Baucus Release Details of Plans to Ensure Continued Son of Boss Enforcement* (July 23, 2004) (noting that the IRS and Treasury Department were aware of the BOSS transaction, and that the "transaction that was being marketed to taxpayers for the purpose of generating articialtax losses"), *available at* http://www.finance.senate.gov/newsroom/chairman/release/?id=c1706ce6-0955-4528-9d88-32a943317179.

foreign company.[97] The IRS effectively shut down the BOSS Transaction in 1999 by publishing Notice 99-59, and later Notice 2000-44, which designated the BOSS Transaction as a "Listed Transaction."[98] As a Listed Transaction, the BOSS Transaction was also a "Reportable Transaction," which forced taxpayers to report their participation in any Listed Transactions or face penalties.[99] The Treasury estimated that BOSS Transactions would have contributed to a loss to the Treasury of up to $80 billion over a ten-year period.[100] A simplified version of the BOSS Transaction operated as follows:[101]

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97. *See* I.R.S. Notice 99-59, 1999-2 C.B. 761.

98. *Id.* The Notice advised taxpayers that the BOSS structure, the described variations, and substantially similar transactions would be considered as abusive tax shelters that would be challenged by the IRS in court. *See* Treas. Reg. § 1.6011-4(b)(2) (2010) (defining a listed transaction as "a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction").

99. *See* Treas. Reg. § 1.6011-4(b)(1) (2010). The regulation defined transactions as including all the factual elements for the expected tax treatment of any investment, entity, plan, or arrangement, and any steps needed to execute a plan. *Id.* The regulation went on to add that there are six categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference, and transactions involving a brief asset holding period. *Id.* § 1.6011-4(b); *see also* I.R.C. § 6707A (2012) (noting that "[a]ny person who fails to include on any return or statement any information with respect to a reportable transaction which is required under section 6011 to be included with such return or statement shall pay a penalty in the amount determined under subsection (b)"). I.R.C. § 6707A(c)(1) defines reportable transactions.

According to the Treasury Inspector General for Tax Administration ("TIGTA"), the penalty was enacted for failure to disclose a reportable transaction, with the intent of helping to detect, deter, and shut down abusive tax shelter activity. However, the procedures for documenting and assessing the penalty were not sufficient or formalized, and cases are not fully developed. These conditions increase the risk that taxpayers will not receive consistent and fair treatment. *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., PENALTY CASES FOR FAILURE TO DISCLOSE REPORTABLE TRANSACTIONS WERE NOT ALWAYS FULLY DEVELOPED, No. 2011-30-004 (2010), *available at* http://www.treasury.gov/tigta/auditreports/2011reports/201130004fr.pdf.

100. Christopher Bergin, *Corporate Shelters Are Serious Threat to System, Summers Says*, TAX NOTES TODAY, Feb. 29, 2000 (quoting Lawrence H. Summers, Treasury Secretary). At the annual Section of Taxation of the Federal Bar Association conference on February 28, 2000, Secretary Summers announced new disclosure regulations to combat the growing corporate tax shelter problem. *Id.* Summers further noted that there was little doubt as to the strong increase in abusive tax shelters. *Id.* He reported that the cessation of lease-in and lease-out transactions and liquidating REIT transactions along with BOSS transactions combined to save taxpayers almost $80 billion over 10 years. *Id.*

101. *See* I.R.S. Notice 99-59, 1999-52 C.B. 761, *available at* http://www.irs.gov/pub/irs-utl/notice_1999-59.pdf; *see also* Michael S. Powlen & Raj Tanden, *Corporate Tax Shelters or Plus ça Change, Plus C'est la Meme Chose*, *in* PRACTISING LAW INST., TAX STRATEGIES FOR

> Step 1
>
> A U.S. taxpayer formed a partnership (TP) that contributed $100X to a foreign corporation (FC) formed for the purpose of carrying out the deal. In return, TP received the FC common stock, valued at $100X. Another party, generally an entity formed by the promoter (Promoter), then contributed additional capital ($40X) to FC in exchange for FC preferred stock. FC then borrows an additional $100X from a bank and secures the loan with $100X of securities purchased with the funds contributed by TP and Promoter. At that point, from an accounting perspective, FC had:
>
> (i) $240X of assets, consisting of the securities purchased with the $100X contributed by TP and the $40X contributed by Promoter (collectively worth $140X) and the $100X borrowed from the bank;
>
> (ii) $100X of liabilities, consisting of the $100X of debt owed to bank; and
>
> (iii) $140X of equity, consisting of $100X FC common stock plus $40X FC preferred stock.
>
> Step 2
>
> Thereafter, FC distributes the $100X of securities to TP with an implicit agreement that FC will pay off the $100X of debt that encumbered the securities. At that point, from an accounting perspective, FC had:
>
> (i) $140X of assets, consisting of $100X of cash and $40X of securities;
>
> (ii) $100X of liabilities; and
>
> (iii) $40X of equity.

To create the intended tax benefits, the taxpayer takes two inconsistent positions with respect to how the transaction should be treated for tax purposes. First, that the $100X of securities distributed by FC to TP were worthless because those securities were subject to $100X of bank debt—even though all parties anticipated and expected FC would pay the $100X of bank debt. The second position is a bit more involved: in the second position, TP claimed that the $100X of FC common stock it owned became worthless once it received the $100X of securities that was distributed by FC. After that distribution, as noted in Step 2 above, FC was left with assets

CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 9, 19 (2001).

of $140X, equal to $100X borrowed from the bank and $40X of securities, liabilities of $100X, resulting in an equity value of only $40X. Because the preferred stock had priority over the common stock, the taxpayer argued that there was no value left to assign to the common stock, making that stock—at least from an accounting perspective—worthless.

In essence, TP claimed in position one that the distributed securities were worthless because the value of those securities *was* offset by the debt; but in position two claimed the distributed securities were worth $100X when distributed because the value of those securities *was not* offset by the debt, making the FC common stock worthless. Based on the second position (that the FC common stock was worthless), TP took the position that it could be treated as having disposed of the stock, pursuant to certain IRS elections.[102] Since TP initially had a $100X basis in the FC stock, based on TP's initial contribution of $100X for the stock, when it took the position that the stock was worthless, TP claimed a $100X loss on the disposition of the FC stock, which was the entire purpose of the transaction. TP would then use that loss to offset other income.

Though far from obvious, BOSS was based on short against the box principles. In BOSS, the promoters created a company that only had simple assets and liabilities and used the tax laws to create different treatments for combined positions. In the short against the box transaction, the promoters were creating optionality by combining borrowed shares with shares sold short to create an effective sale for an economic purpose (monetizing the position and eliminating risk, i.e., the same things accomplished by a sale) but not for tax purposes (no gain recognition). In BOSS, the optionality was created by combining stock with debt to set the value of the stock to zero for one purpose (deeming the stock worthless and generating a tax loss) but full value for another (not requiring the taxpayer to include gain).

While the contrary positions taken by taxpayers in the BOSS Transaction appear illogical, the tax treatment of those positions was arguably mandated by the Code.[103] The IRS attacked the BOSS Transaction in Notice 99-59,

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102. I.R.S. Notice 99-59, 1999-52 C.B. 761. In the Notice, the IRS stated:

> The deemed disposition of the stock may be based upon an election under § 301.7701–3(c) of the [U.S. Treasury Regulations] to change the federal income tax classification of the foreign corporation from a corporation to a partnership, giving rise to a deemed liquidation of the foreign corporation, or by treating the partnership as a trader in securities which elects under § 475(f) to treat the securities that it holds, including the stock of the foreign corporation, as having been sold for their fair market value on the last business day of the taxable year.

Id.

103. In I.R.S. Notice 99-59, the IRS discussed the taxpayer's position in BOSS, noting that:

arguing that the taxpayers' claimed losses lacked economic substance and thus would not be allowable.[104] In Announcement 2005-80, the IRS permitted taxpayers who had participated in the BOSS Transaction (as well as a number of other tax shelters) to settle their cases and pay all of the taxes owed, interest, and a 10% underpayment penalty.[105] While the IRS effectively shut down the BOSS Transaction, relying on the economic substance doctrine, it failed to offer an explicit technical analysis of the financial tax positions.[106] Tax shelter promoters took that failure as an invitation, signaling to them that so long as they could add a fig leaf of an

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> [T]he parties take the position, pursuant to § 301(b)(2) of the Internal Revenue Code, that the amount of the distribution is zero for purposes of § 301. On that theory, no part of the distribution is treated either as a dividend or as a reduction of stock basis under § 301(c). The partnership is treated as having subsequently disposed of the stock of the foreign corporation, giving rise to a tax loss equal to the excess of the partnership's original basis in the stock ($100x in the example) over the fair market value of the common stock after the distribution of securities (zero). The deemed disposition of the stock may be based upon an election under § 301.7701–3(c) of the regulations to change the federal income tax classification of the foreign corporation from a corporation to a partnership, giving rise to a deemed liquidation of the foreign corporation, or by treating the partnership as a trader in securities which elects under § 475(f) to treat the securities that it holds, including the stock of the foreign corporation, as having been sold for their fair market value on the last business day of the taxable year.

Id.

104. *See id.* In the Notice, the IRS explained that only bona fide and actual economic consequence constitutes an allowable loss deduction. *Id.* at 761–62. However, the losses taxpayers claim for capital expenditures they already recovered lack economic substance to be an allowable deduction for federal income tax purposes. *Id.* The common law economic substance doctrine originated with *Gregory v. Helvering*, 293 U.S. 465 (1935), and continued to evolve through cases too numerous to cite. The common law doctrine held that if a transaction lacked economic substance, then its tax consequences would not be upheld. While what constituted "economic substance" was often hard to define precisely, "[f]rom a financial economic perspective, economic substance is commonly regarded as transactions that present the prospect of a reasonable degree of risk and reward absent tax considerations." Alan L. Tucker, *Son of BOSS*, 15 J. DERIVATIVES 74, 75 (2008). In the Notice, the IRS also indicated that the transaction may be subject to challenge under a litany of other Code provisions, "including but not limited to §§ 269, 301, 331, 446, 475, 482, 752, and 1001." I.R.S. Notice 99-59, 1999-52 C.B. 761, 762.

105. I.R.S. Announcement 2005-80, 2005-46 I.R.B. 967. For a discussion of the penalty, see *id.* § 4(E)(1), at 969, referencing *id.* § 3(6), at 968.

106. The IRS only noted that "[t]he purported tax benefits from these transactions may also be subject to challenge under other provisions of the Code and regulations, including but not limited to [I.R.C.] §§ 269, 301, 331, 446, 475, 482, 752, and 1001 of the Code." I.R.S. Notice 99-59, 1999-52 C.B. 761, 762.

economic justification or a profit motive, the transaction would "work." Into that gap stepped even more sophisticated structures.[107]

The BOSS Transaction exploited how combined financial positions (in BOSS, a stock position and a loan) were valued for tax purposes to generate tax losses. The IRS was successful in attacking the transaction because the positions taken by the taxpayer, and the entire transaction itself, were so clearly devoid of substance. However, the lesson of combining financial positions to make tax mischief was not lost on tax shelter promoters.

Fresh off the heels of the BOSS Transaction and the IRS attack thereon, creative tax attorneys and financial professionals devised a more sophisticated offspring of the BOSS Transaction using derivatives. That transaction, aptly entitled "Son of Boss" became arguably the costliest tax shelter in U.S. history.[108]

The IRS characterized the Son of Boss as "a highly sophisticated, technically complex, no-risk scheme designed to generate tax losses without corresponding economic risks that was promoted by some prominent firms in the financial services industry to investors seeking to shelter large gains from the sale of a business or capital asset."[109] A quick review of Lexis reveals over 84 reported Son of Boss cases, one of which, *United States v. Home Concrete*,[110] was recently decided in the taxpayer's favor by the U.S. Supreme Court.[111] In addition, the Republican presidential candidate in the

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107. The structures described herein were complex, not only for the financial machinations, but also to make it more difficult for the IRS to discover such transactions. *See, e.g.*, Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 87–88 (2006). Rostain states:

> It was also difficult for the Service to discover tax shelters in connection with the returns it did audit. Corporate tax returns typically run into the thousands of pages. Tax shelters, moreover, are complex transactions usually involving types of deductions or credits that can be claimed legitimately. Tax shelter purchasers had strong incentives not to signal their participation on their returns since, before 2004, the failure to disclose did not affect whether the penalty for substantial understatement of tax liabilities applied.

Id. (internal citations omitted).

108. *See, e.g.*, Peter C. Canellos & Edward D. Kleinbard, *Did Romney Enable a Company's Abusive Tax Shelter?*, CNN OPINION (Aug. 9, 2012, 6:24 PM), http://www.cnn.com/2012/08/08/opinion/canellos-kleinbard-romney-taxes/ ("Son of Boss and its related shelters represented perhaps the largest tax avoidance scheme in history, costing the U.S. many billions in lost corporate tax revenues.").

109. *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., *supra* note 2.

110. United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836 (2012).

111. The taxpayer in *Home Concrete* did not win on the merits of the Son of Boss shelter, but rather on a tortured interpretation of the statute of limitations the IRS sought to impose on the taxpayer. *Id.* at 1839. The primary issue before the Supreme Court in *Home Concrete* is whether the IRS was correct in extending the statute of limitations for Son of Boss transactions. In addition, "[t]here are about 30 docketed cases awaiting the outcome of [*Home Concrete*] with

2012 presidential election approved a Son of Boss transaction while serving as chair of the audit committee of a Fortune 500 company's board of directors.[112]

Below is a brief explanation of how the option variant form of the Son of Boss shelter was structured for a hypothetical taxpayer ("Taxpayer X") who had $100 million of capital gains to shelter.[113] In a highly simplified example, the Son of Boss shelter worked as follows:

Taxpayer X entered into seemingly offsetting transactions purchasing $100 million of call options on ABC stock ("Position 1") and simultaneously selling $99.9 million of nearly (but not quite) identical call options on the same ABC stock ("Position 2"). The total economic cost to Taxpayer X of Position 1 and Position 2 is $100,000 ($100 million cost of Position 1 minus $99.9 million proceeds from Position 2). Taxpayer X then transfers both Position 1 and Position 2 (collectively, the "Positions") to a partnership (the "SOB Partnership") in exchange for an SOB Partnership interest.[114] Soon after contributing the Positions to the SOB Partnership,

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the government aiming to recover $1 billion in taxes, interest and penalties, according to court documents." *See* Patrick Temple-West, *"Son of Boss" Crackdown Lands in Supreme Court*, REUTERS (Jan. 13, 2012, 1:36 PM), http://www.reuters.com/article/2012/01/13/us-usa-tax-court-idUSTRE80C1UC20120113.

112. *See* Marriott Int'l Resorts, L.P. v. United States, 83 Fed. Cl. 291 (2008); Lee A. Sheppard, *Your Mitt Romney Tax Issues Cheat Sheet*, 136 TAX NOTES 754 (2012) ("Marriott tax shelter. Issue: Was it proper? No. Marriott International entered into a son-of-BOSS deal while Romney was chair of the audit committee of its board. The company lost a court case challenging the shelter on a motion for summary judgment.")..

113. The Son of Boss tax shelter was structured in various ways. In its Notice discussing the Son of Boss transaction, the IRS acknowledges that the transaction has different variations. *See* I.R.S. Notice 2000-44, 2000-36 C.B. 255. One group of investors who were targeted by Son of Boss promoters were hedge fund investors, who, through what many describe as a tax loophole, structure their earnings from managing hedge funds into carried interest, which, under current law, are treated as capital gains. *See* Randall Dodd, *Tax Breaks for Billionaires: Loophole for Hedge Fund Managers Costs Billions in Tax Revenue*, ECON. POL'Y INST. (July 24, 2007), http://www.epi.org/publication/pm120/.

114. This Article purposefully ignores the non-derivative aspects of the shelters discussed herein, unless otherwise noted. This analysis simplifies the mechanism by which the taxpayer is able to claim the loss. *See, e.g.*, Tucker, *supra* note 104, at 75. Tucker states:

> In the Son of BOSS strategy the "transfer" of the manufactured capital loss to the taxpayer was itself a bit of ingenious financial engineering. The taxpayer first formed a single-member limited liability company (LLC) before buying and writing the options. It was the LLC that became a partner in the aforementioned newly created general partnership vehicle. An S corporation was then created. The LLC contributed its interest in the general partnership to the S corporation in exchange for stock. The partnership terminated, the options expired, the S corporation's assets were then sold (technically the triggering event that occasioned the capital loss), and the loss passed to the investor, i.e., the stock was deemed worthless.

Taxpayer X sells his partnership interest for its true economic value, approximately $100,000.

1. Tax Benefits

As described by the promoters of the transaction, upon contributing the Positions to the SOB Partnership, Taxpayer X could claim a basis in his partnership interest of $100 million, not $100,000. The Promoter relied on an interpretation of section 752 for that position, which purportedly allowed Taxpayer X to claim that his basis in the SOB Partnership should be increased by the cost of the purchased call options (Position 1) but not reduced by the sold call options (Position 2) due to the SOB Partnership's assumption of the taxpayer's obligation with respect to the written call options.[115] In that respect, Son of Boss clearly mirrored BOSS in treating one position differently for tax purposes than economic reality would suggest is the correct treatment. As a result, when Taxpayer X sells the partnership interest for $100,000 (its true economic value), he claims a $99.9 million loss, the difference between his $100 million tax basis and his $100,000 of proceeds from the sale of his SOB Partnership interest.[116] By entering into the Son of Boss shelter, Taxpayer X generated a $99.9 million loss to offset his pre-existing $100 million of capital gains income, and, instead of reporting $100 million in capital gains income (and paying $15

Id.; *see also* Paul Braverman, *Helter Shelter*, LAW.COM (Dec. 5, 2003), www.law.com/jsp/article.jsp?id=1069170446899; Paul Braverman, *The COBRA Uncoiled*, LAW.COM (Dec. 5, 2003), http://www.law.com/jsp/article.jsp?id=900005537317. COBRA stands for "Currency Options Bring Reward Alternatives," which is a nominal variant of the Son of BOSS strategy.

115. *See* I.R.S. Notice 2000-44, 2000-36 C.B. 255; *see also*Tucker, *supra* note 104, at 74. Tucker explains:

> Key to the Son of BOSS strategy was its utilization of what was then Section 752 of the Internal Revenue Code (IRC). A technical interpretation of I.R.C. § 752 permitted a partnership to assume a taxpayer's previously established positions in option trades, with long positions being treated as assets and short positions being treated as contingent liabilities. Within the partnership, the contingent liabilities were ascribed a zero value under section 752, which in turn created for the taxpayer an artificially high basis in the partnership.

Id. Son of Boss also relied on a U.S. Tax Court case, Helmer v. Comm'r, 35 T.C.M. (CCH) 727 (T.C. 1975), which held that liabilities created by short option positions are too contingent to affect a partner's basis in a partnership. As a result, the taxpayer's basis in its partnership interest is equal to the value of the long options position and not offset by the short options position.

116. There are myriad other tax issues involved in the Son of Boss shelter. This example seeks only to highlight the primary tax issue involved.

million in capital gains taxes), Taxpayer X would report only $100,000 in capital gains income and pay $15,000 in capital gains taxes.[117]

The Son of Boss shelter, with its use of offsetting positions to create tax benefits, hews closely to the lessons of not only the BOSS transaction, but also the short against the box transactions. Son of Boss used the phantom loss concept of the BOSS transaction and the offsetting position from the short against the box transactions to become one of the most "successful" tax shelters in history.

2. IRS Response

In Notice 2000-44, the IRS announced that it would deny taxpayers the purported losses resulting from the Son of Boss Shelter.[118] The IRS argued that the losses generated by the shelter did not "represent bona fide losses reflecting actual economic consequences as required for the purposes of § 165."[119] Notice 2000-44 also informed taxpayers and promoters that appropriate penalties may be imposed on participants in such transactions and warned that taxpayers and promoters who participated in these transactions and willfully concealed their efforts on tax returns may be subject to criminal penalties.[120]

On May 5, 2004, in Announcement 2004-46 (the "SOB Settlement Initiative") the IRS announced that it would allow taxpayers who participated in Son of Boss shelters to settle with the IRS. Pursuant to the SOB Settlement Initiative, taxpayers electing to settle would concede all claimed tax benefits and attributes of the transaction but would be allowed to treat (i) their net out-of-pocket costs and fees as a long-term capital loss, or (ii) one-half of their net out-of-pocket costs and fees as an ordinary loss, in the year those costs and fees were paid or accrued. In addition, the IRS provided penalty relief for shelter participants.

Particularly, taxpayers who voluntarily disclosed their participation in Son of Boss shelters pursuant to Announcement 2002-2 were not required to pay any penalties upon settlement. However, those who failed to come forward pursuant to Announcement 2002-2 were required to pay a mandatory penalty of either (i) 10% of the underpayment of tax attributable to the Son of Boss shelter for those for whom the Son of Boss shelter was their first and only abusive tax shelter investment; or (ii) 20% of the

117. Tax rate for capital gains during the period was 15%. I.R.C. § 1(h) (2008).
118. *See* I.R.S. Notice 2000-44, 2000-36 I.R.B. 255.
119. *Id.*
120. *See id*.

underpayment for those who have participated in other abusive transactions listed by the IRS.[121]

So why did the IRS offer such a generous settlement? Possibly because it believed it faced the risk of loss for a transaction that had, as one author noted, put "lipstick on [the] pig."[122] It is certainly plausible that the government did not ask for all of the tax (and offered penalty relief) because

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121. I.R.S. Announcement 2002-2, 2002-2 I.R.B. 304. Pursuant to Announcement 2002–2, the IRS sought to:

> encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. If a taxpayer discloses any item in accordance with the provisions of this announcement before April 23, 2002, the IRS will waive the accuracy related penalty under § 6662(b)(1), (2), (3), and (4) for any underpayment of tax.

The IRS further announced that taxpayers not participating in the settlement should expect to receive a statutory notice of deficiency (called a "90-day letter") disallowing all losses and out-of-pocket costs, and asserting the maximum level of penalties. The IRS states that in order to achieve uniformity and enhance overall compliance with the tax laws, taxpayers will not be afforded traditional administrative appeals rights, by and through the IRS Appeals Office. Commissioner Mark W. Everson stated that the IRS is "taking this unusual step because of the severity of the abuse." IRS Chief Counsel Donald Korb added that "(t)axpayers should not expect to settle court cases on terms more favorably than those offered in the IRS settlement initiative." *See IRS Offers Settlement for Son of Boss Tax Shelter*, IR-2004-64, IRS, (May 5, 2004), http://www.irs.gov/uac/IRS-Offers-Settlement-for-Son-of-Boss-Tax-Shelter. One author took a different view of the reason the IRS settlement included penalties. *Cf.* Lee A. Sheppard, *11 Rules for Defending Tax Shelter Cases,*122 TAX NOTES 176, 177 (2009) [hereinafter Sheppard, *11 Rules*]. Sheppard states:

> The son-of-BOSS settlement offer foolishly included penalties, because the IRS was on the warpath. The IRS was operating from the view that the taxpayers owed a 40 percent valuation understatement penalty, and so a 20 percent penalty was a discount. The IRS did not count on well-heeled taxpayers being willing to wait it out.

Id.

122. *See* Sheppard, *11 Rules*, *supra* note 121, at 176–77. Sheppard notes that "Lipstick on [the] pig" refers to a transaction having enough plausible business purpose for a judge to find in favor of a taxpayer in a tax shelter. One such Son of Boss shelter case was Sala v. United States, 552 F. Supp. 2d 1167 (D. Colo. 2008). As one author noted:

> the taxpayer invested in foreign currency options and contributed them to a partnership managed by renowned foreign currency trader, Andrew Krieger. The amount of losses generated by the transactions at issue coincidentally offset a huge slug of income the taxpayer had in 2000 (approximately $60 million). Despite the government's best efforts, the court found for the taxpayer, holding that the transactions possessed economic substance. The court also rejected the government's attempt to retroactively apply regulations that reject the *Helmer* decision.

Miller Chevalier, *Tenth Circuit Engaged in Lengthy Deliberation in Sala*, APPELLATE TAX BLOG (July 23, 2010), http://appellatetax.com/2010/07/23/tenth-circuit-engaged-in-lengthy-deliberation-in-sala/. The government lost the *Sala* case at trial, but eventually won on appeal to the Tenth Circuit. *See* Sala v. United States, 613 F.3d 1249 (10th Cir. 2010).

of the risk that some taxpayer would win a case, thus creating a playbook for how to successfully complete a Son of Boss shelter.As I argue in Part IV, that Settlement Initiative and other similar public tax shelter settlements have resulted in taxpayers generating positive returns based on their participation in the shelter. As a result, rather than discouraging taxpayers' participation in shelters, such settlements have provided taxpayers with a strong economic incentive to play the tax shelter game.

In addition to offering settlement, the government began challenging Son of Boss shelters in audit and in litigation. On the merits, the government won the majority of those cases.[123] The IRS and the Treasury also sought to use their regulatory power to combat the Son of Boss shelters by giving the IRS more time to find participants in the shelter. Here, the government did not fare as well.

Generally, the IRS has only three years to assess back taxes.[124] As a result, unless the taxpayer agreed to waive the statute of limitations, the government had to identify the transaction, determine why it violated the law, and assess taxes on Son of Boss shelters within three years of the taxpayer's first tax return claiming benefits of the shelter. However, the government sought to use a loophole of its own to extend the statute of limitations to six years or longer, relying on a tortured reinterpretation of the law that had been expressly rejected by the Supreme Court in *Colony v. Commissioner*[125] in 1958.[126]

Pursuant to section 6501(e)(1)(A), if a taxpayer *omits* from gross income an amount that exceeds 25% of the amount of gross income stated on the return, the government is permitted to use a longer, six-year statute of limitations to challenge a taxpayer's return.[127] In *Colony*, the Supreme Court reasoned that the words "omits from gross income an amount properly includible therein" refers to situations in which specific items of income are

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123. Jeremiah Coder, *Fifth Circuit Adopts Majority View of Economics Substance Doctrine*, TAX NOTES TODAY, May 26, 2009, at 94-1. In only a few instances did the government lose Son of Boss shelter cases based on the taxpayer convincing a trial court that the Son of Boss shelter had sufficient economic substance, and in many of those cases, the government later won on appeal. *Sala* was one such case. *See supra* note 122.

124. Under I.R.C. § 6501(a), in most cases, the IRS has three years from the later of the date in which a return is due or was filed to assess additional tax. However, in cases in which a taxpayer omits from gross income an amount that exceeds 25% of the amount of gross income stated on the return, the assessment period is extended to six years. *See* I.R.C. § 6501(e)(1) (2012).

125. 357 U.S. 28 (1958).

126. *Id.*

127. I.R.C. § 6501(e)(1)(A) (2012). The *Colony* decision interpreted § 275(c) of the 1939 Code, the predecessor to § 6501(e)(1)(A), the authority for the statute of limitations at issue. *Colony v. Comm'r*, 357 U.S. 28, 32 (1958).

left out of the computation of gross income, and they do not apply to errors in the computation of gross income resulting from a mistaken overstatement of the property's basis.[128] In addition, the *Colony* Court evaluated the legislative history of the statute in question and found the congressional purpose of the extended statute was to give the IRS more time to assess situations in which the IRS is at a special disadvantage in detecting errors because the particular transaction was not reported.[129]

While the law had been relatively clear on that point in the intervening seventy years since *Colony*, on September 24, 2009, the government issued temporary regulations that provided that "an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of [sections 6229(c)(2) and 6501(e)(1)(A)]."[130] In issuing that temporary regulation, the IRS sought, by administrative fiat, to create a new interpretation of the overstatement of the basis rule.[131] On December 14, 2010, the IRS issued

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128. *Colony,* 357 U.S. at 32. The Court noted that "[a]lthough we are inclined to think that the statute on its face lends itself more plausibly to the taxpayer's interpretation [that omit means left out, not understated], it cannot be said that the language is unambiguous." *Id.* at 33.

129. *See id*. at 36 ("Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors.").

130. Alan Horowitz, *Son-of-BOSS Statute of Limitation Issue Inundates the Courts of Appeals*, TAX APPELLATE BLOG (Nov. 30, 2010), http://appellatetax.com/2010/11/30/son-of-boss-statute-of-limitations-issue-inundates-the-courts-of-appeals (citing Temp. Treas. Reg. §§ 301.6229(c)(2)-1T, 301.6501(e)-1T).

131. The IRS argued that its regulatory interpretation should be afforded *Chevron* deference by the courts. *See id.* Horowitz notes:

> The Tax Court was the first tribunal to consider the efficacy of this aggressive (one might say, desperate) effort to use the regulatory process to trump settled precedent, as the IRS moved the Tax Court to reconsider its adverse decision in *Intermountain Ins. Service v. Commissioner*, T.C. Memo. 2009-195, in the wake of the temporary regulations. The reception was underwhelming.The Tax Court denied the motion for reconsideration by a 13–0 vote, generating three different opinions. The majority opinion, joined by seven judges, was the only one to base its ruling on rejecting the substance of the government's argument that courts should defer to the regulations notwithstanding the Supreme Court's *Colony* decision. (Four judges stated simply that the new contention about the temporary regulations should not be entertained on a motion for reconsideration; two judges stated that the temporary regulations are procedurally invalid for failure to submit them for notice and comment.)

Id. The government's deference argument rested on *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967, 982 (2005), which ruled that a "court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." (In a

final regulations stating that an understatement of gross income due to an overstatement of basis constitutes an omission of gross income that can trigger the extended six-year period of limitations for assessing tax liability.[132]

While "a man's reach should exceed his grasp," such should not be the case for federal agencies.[133] The government's new rule, in essence, allowed it to ignore *Colony* and use the six-year statute of limitations against taxpayers who participated in Son of Boss shelters. In litigation, the government took aggressive positions related to the statute of limitations issue, and, at one point, the Justice Department asserted that there were thirty-five to fifty cases pending in the federal courts that raised the same issue, with approximately $1 billion at stake.[134] Although the government lost the overwhelming majority of the Son of Boss shelter cases seeking to use the six-year statute of limitations at trial, it won a few, causing the split in the circuits that led to the Supreme Court accepting the case for review.[135] In *Home Concrete*, the Supreme Court ultimately found for the taxpayer, rejecting the IRS' attempt to rewrite the statute of limitations. Thus, the $1 billion of improper tax benefits at stake was forever lost, at least for the government.

C. Contingent Deferred Swap

Around the time the Son of Boss shelter was creating paper losses to shelter capital gains, another technical tax shelter employing derivatives, the

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concurring opinion, Justice Stevens stated his view that this rule would not apply to a Supreme Court decision, because that would automatically render the statute unambiguous, but that remains an open question. *See id.*at 1003 (Stevens, J., concurring)). The Tax Court majority ruled that the Supreme Court's statement in *Colony* that the statute was ambiguous "was only a preliminary conclusion," but "[a]fter thoroughly reviewing the legislative history, the Supreme Court concluded that Congress' intent was clear and that the statutory provision was unambiguous." *Intermountain Ins. Serv. of Vail, L.L.C. v. Comm'r of Internal Revnue*, 134 T.C. 211, 223 (2010) (citing *Colony, Inc. v. Commissioner*, 357 U.S. 28, 33, 36 (1958)). Accordingly, the majority concluded that *Brand X* did not apply, and "the temporary regulations are either inapplicable, invalid or otherwise not entitled to deference." *Id.* at 215. (The two judges who found the regulations procedurally invalid questioned the majority's reasoning and suggested that the Court should not have reached the substantive issue). *See id.* at 227 (Halpern, J., concurring).

132. T.D. 9511, 2011-6 I.R.B. 455.

133. ROBERT BROWNING,MEN AND WOMEN (Forgotten Books 2012) (1855). The full quote is, "Ah, but a man's reach should exceed his grasp, Or what's a heaven for?"

134. *See* Horowitz, *supra* note 130.

135. *See* Steve R. Johnson, *What's Next in the Section 6501(e) Overstated Basis Controversy?*, ABA SECTION OF TAX'N NEWS QUARTERLY 19 (Fall 2009) (summarizing the cases).

Contingent Deferred Swap ("CDS") shelter, was creating phantom deductions to shelter ordinary income.[136] The CDS shelter used the tax law against itself by combining offsetting positions to allow taxpayers to defer recognizing an unlimited amount of ordinary income.[137] CDS, like Son of Boss, had a dial up feature that allowed the taxpayer to size the transaction to meet a desired amount of tax benefit, with little to no extra risk in the transaction based on the transaction's size.[138] Some CDS clients, unsatisfied with deferral and character benefits of CDS, added another wrinkle, called CDS Add-on, to try to defer indefinitely the tax savings gains generated in the CDS transaction.[139]

The CDS shelter exploited, *inter alia*, the lack of guidance provided by the IRS with respect to total return swaps and the different treatment of

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136. The ordinary deductions were created through the use of a so-called trading partnership. That aspect of CDS is mentioned here for completeness, but is not the focus of this Article. The United States Senate Permanent Subcommittee on Investigations noted:

> The tax shelter involved a transfer to a partnership that generates a level of trading activity designed to enable the partnership to achieve trading partnership status that, in turn, allegedly allows swap payments and other first year expenses of the partnership to be treated as ordinary losses that can offset the client's ordinary income in that year.

U.S. SEN. SUBCOMM. ON INVESTIGATIONS, THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY, S. Rep. No. 109-54, at 79 (2005).

137. CDS was marketed to taxpayers seeking to create a certain amount of loss, usually equal to the amount of ordinary income the taxpayer sought to shelter. In fact, Ernst & Young, in documents that turned over to the Senate Subcommittee, had a sample CDS engagement letter that stated explicitly: "Our fee for providing the professional services referred to above will be $[Insert amount at 1.25% of losses to be generated. If size of transaction is not certain at the time this letter is signed, add 'based on your investing $million in the Partnership']." (emphasis in original). *See id.* at 85.

138. *See id.*at 84 ("Essentially, CDS was a conversion strategy, converting ordinary income to capital gains income, with the additional benefit of deferral.").

139. *See* Indictment, United States v. Coplan, 703 F.3d 46 (2d Cir. 2012), *available at* http://lawprofessors.typepad.com/whitecollarcrime_blog/files/us_v.%20Coplan%20E&Y%20Tax%20Shelter%20Indictment%20May%2030%202007.pdf.

> The objective of CDS Add-On was for the client to defer indefinitely the income tax liability on the capital gains generated in the second year of the CDS transaction. In most cases, CDS Add-On consisted of two parts: 1) a two-year CDS transaction that would result in capital gains to the CDS "trading partnership"; and 2) a COBRA-like strategy that would generate artificial losses for the "trading partnership," and thus offset those capital gains.

Id. The "COBRA-like strategy" referred to another tax shelter, the Currency Options Bring Reward Alternatives ("COBRA"). For a thorough analysis of COBRA, see Karen C. Burke & Grayson M. P. McCouch, *COBRA Strikes Back: Anatomy of a Tax Shelter*, THE TAX LAWYER, Aug. 7, 2008, at 62, *available at* http://ssrn.com/abstract=1148371.

fixed versus contingent returns.[140] Simply stated, returns from fixed income investments generally require taxpayers to accrue interest income, meaning the taxpayer is treated, for tax purposes, as if he had earned interest during each taxable year the investment was ongoing, whether he received that interest or not.[141] For example, if a taxpayer purchased a five-year zero coupon bond, the taxpayer would have to recognize the interest earned on that bond each year, even though the investor would not receive any payments for five years. Contrast that with returns from a contingent investment, like equity. For tax purposes, the taxes on a contingent return are taxed using open treatment, meaning the taxpayer will not recognize gain or loss until the asset is sold or otherwise disposed of.[142]

In a simplified example of a CDS shelter, a taxpayer would enter into an eighteen-month total return swap ("CDS swap") with a financial institution with the reference asset being the equity of a special purpose entity ("SPE") created solely for the transaction and the notional amount of the CDS swap equal to the value of the SPE's equity.[143] As part of the CDS swap, the taxpayer would make quarterly interest-type periodic payments, usually based on a fixed or floating interest rate (usually some form of LIBOR[144]) and would receive at termination the SPE's equity return. The taxpayer's

140. *See, e.g.*, Lee A. Sheppard, *We're Not in Kansas Anymore: The IRS Struggles with Contingent Swap*, TAX NOTES TODAY, Aug. 2, 2002, at 150–54 [hereinafter Sheppard, *Kansas*]. I.R.S. Notice 2006-16 provides that if the taxpayer takes the contingent nonperiodic payment into account over the life of the contract under a reasonable amortization method and properly accounts for the NPC, such a transaction would not be deemed substantially similar to mis-typed to which auto-corrects to taxpayer the transaction described in Notice 2002-35. *See, e.g.*, Crystal Tandon, *IRS Attempts to Limit Scope of Contingent Swaps Notice*, TAX NOTES TODAY, Feb. 14, 2006, at 30–33. *See also* Geoffrey Lanning, *Notice 2006-16: IRS Clarifies Prior Guidance on Notional Principal Contracts with Contingent Nonperiodic Payments,* DERIVATIVES—FIN. PRODS. REPORT, May 2006, at 1, *available at*http://www.whitecase.com/files/Publication/b416d841-a20e-41c8-97c3-1476b00883b1/Presentation/PublicationAttachment/204275cb-845b-4a5c-9a7e-15f7f4fd2f16/article_Lanning_Financial%20Products%20Report.pdf.

141. *See* I.R.C. § 163 (2012).

142. *See* I.R.C. § 1001 (2012).

143. The CDS shelter often used partnerships, and had an ongoing trading element, purportedly to enable the client to be able to actually use the deductions at issue. This example ignores the elements of the transaction not dealing with the derivatives. For a thorough analysis of the CDS Shelter, see the *Appeals Settlement Guidelines for Notional Principal Contracts (Contingent Deferred Swaps)*, IRS (Feb. 8, 2006), www.irs.gov/pub/irs-utl/asg_npc__2005-04-20_redacted.pdf [hereinafter *Settlement Guidelines*].

144. "LIBOR" refers to the London Interbank Offer Rate. The LIBOR rate is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year. *See, e.g.*, *London Interbank Offered Rate*, INVESTOPEDIA, www.investopedia.com/terms/l/libor.asp#ixzz28XrqJDg9 (last visited Feb. 12, 2013).

periodic payment obligation was calculated with reference to the notional amount multiplied by the periodic payment rate (with appropriate adjustments for payment frequency). The taxpayer's return was any positive returns on the equity value of the SPE, and its losses would be any negative returns on the SPE, meaning the taxpayer would have to pay additional funds to the counterparty if the SPE lost money.

The tax trick in the transaction was the composition of the SPE. In CDS, the SPE was filled with mostly fixed income assets—assets whose returns would offset the overwhelming majority of the taxpayer's periodic payment obligations.[145] However, because the SPE had some equity assets, the taxpayer took the position that its entire SPE return was an equity return, meaning that any gain (or loss) should be deferred until the CDS swap's termination.[146] The CDS shelter's primary tax benefit was that the taxpayer would claim large current deductions for the CDS swap periodic payments that would be used to offset the taxpayer's ordinary income. Yet those deductions were effectively paid for by the return on the SPE's assets. Another tax benefit was that the income received at termination would be treated as a capital gain, which was taxed at a lower rate.

In essence, the CDS shelter used the tax accounting of swaps, the lack of IRS guidance, and the time value of money to pick a desired deduction with little economic reality and then generate timing (current deductions, deferral of income) and character (ordinary deductions and capital gain income) tax benefits without any significant risk. The following example illustrates how taxpayers used CDS to shelter ordinary income:

On January 1, Taxpayer enters into an eighteen-month CDS swap with a bank with a $3 billion notional amount.[147] Pursuant to the CDS swap, taxpayer agrees to make annual periodic payments of 5% of the notional amount (i.e., $150 million annually).[148] In return, the taxpayer will receive

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145. Often, the financial institution itself would use its own fixed income assets to fund the special purpose entity, making the funding of the special purpose entity nothing more than a bookkeeping entry for the financial institution.

146. *See* Warren, *supra* note 30, at 900 (noting that "income taxation has traditionally relied on a distinction between fixed and contingent returns to determine when income is taxed, (b) financial theory demonstrates that this distinction may not be tenable in practice, and (c) the U.S. income tax relies on other distinctions that may also be undermined by innovative financial contracts").

147. The swaps were structured with a nominal end date, but, often with a wink and a nod, taxpayers understood that if they terminated the swap early, they would be entitled to claim capital gains treatment. *See, e.g.*, Press Release, Justice Department, Promoter of Ernest & Young Tax Shelters Pleads Guilty (Jan. 22, 2009), *available at* www.justice.gov/usao/nys/pressreleases/January09/boltoncharlespleapr.pdf.

148. An obvious question is, where does the taxpayer get the $150 million to pay the counterparty? The answer in many transactions was the counterparty financial institution loaned

the return on an SPE whose only assets consists of (1) $2.99 billion of fixed income assets (assets generating a return of 5% annually), and (2) $10 million of stock. From a purely economic perspective, the taxpayer has entered into two swaps:

> (1) a $2.99 billion swap where the payment obligations are offset by the economic returns of the reference assets, here the $2.99 billion of fixed income assets; and
>
> (2) a $10 million total return swap on the stock.

The taxpayer's payment obligation on the swap, $150 million annually, is almost fully offset by the 5% return on the $2.99 billion of fixed income assets in the SPE, equal to $149.5 million. The only real risk the taxpayer faces is based on whether the $10 million of stock generates a 5% return.

The CDS tax benefits do not follow the economics, however. For tax purposes, the taxpayer claims that he entered into a $3 billion total return swap on a contingent pool of assets because the return on SPE is "contingent," i.e., a part of the SPE's return was equity. Thus, the taxpayer claims a year-one deduction of $150 million periodic payments on the swap; the offsetting $149.5 million (plus the stock return) in income is recognized as capital gain income in year two. In addition, the transaction allowed the taxpayer to size the transaction to reach a desired deduction amount with no discernible additional risk.[149]

The mischief created by the CDS shelter was arguably encouraged by the IRS and the Treasury. In 1993, the Treasury finalized regulations relating to

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the taxpayer the $150 million, secured by the return of the SPE. Because the counterparty was fully secured (and because the entire purpose of the transaction was tax deductions), everyone was happy. *See, e.g.*, *Settlement Guidelines*, *supra* note 143, noting:

> The [CDS participant] typically borrows funds from [the financial institution] for a period of eighteen months pursuant to a Loan Agreement. The Loan Agreement provides for an early payment date that coincides with the early termination date . . . the loan is guaranteed to always be fully collateralized since the amount on deposit with [financial institution] will never be less than the loan amount at the termination of the transaction. [The financial institution's] own credit documents indicate that the loan is never at risk for this very reason.

Id.

149. In the above example, the notional amount was set at $3 billion and the periodic payments were 5% of the notional amount, generating a $150 million annual deduction. But since that $150 million payment was effectively offset by the earnings on the fixed income assets in the SPE, the taxpayer had no real risk in the transaction other than the real $10 million total return swap on the equity portion buried inside CDS. Thus, taxpayers were free to adjust the size of the notional amount to achieve a certain amount of deductions, with no real substance or risk.

the timing of NPC income and deductions.[150] While those regulations provided relatively clear guidance with respect to NPCs with non-contingent returns (such as returns on fixed income assets), no guidance was provided for assets upon which the returns were contingent (such as equities). In the absence of Treasury or IRS guidance, most taxpayers accounted for contingent swap payments on a wait-and-see basis, pursuant to which a taxpayer would ignore the contingent payment until it was received (or the contingency was resolved).[151] The wait-and-see approach purportedly created a timing mismatch between deductions and income because the periodic payments the taxpayer made were currently deductible, while the contingent payment at the end of the NPC was deferred. The "wait-and-see" approach, which appeared to be the proper treatment absent Treasury or IRS guidance, encouraged transactions like the CDS shelter because the IRS appeared to have acquiesced on the treatment by failing to issue guidance.[152]

After eight years without guidance, the IRS and Treasury issued Notice 2001-44 to seek to clarify the treatment of contingent swap payments.[153] In Notice 2001-44, four potential accounting methods were outlined, which had the effect of creating more confusion in an already muddled area of law.[154] Three years later, in 2004, the Treasury issued proposed regulations to provide some guidance.[155] During the interim, tax shelter promoters

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150. *See* I.R.C. § 475 (2012).

151. The 1993 NPC regulations contains the following language: "The final regulations do not include any examples of how to treat nonperiodic payments that are not fixed in amount at the inception of the contract. The IRS expects to address contingent payments in future regulations . . . ." T.D. 8491, 1993-2 C.B. 215.

152. The CDS shelter also sought to take advantage of a number of other tax law provisions not discussed herein. However, the focus of this Article is on the derivatives involved in the transaction.

153. I.R.S. Notice 2001-44, 2001-2 C.B. 77. According to the Notice:

> The lack of comprehensive guidance in this area of the law has created significant uncertainty for taxpayers. For some, this uncertainty adds a considerable burden to the tax compliance process, and may discourage certain taxpayers from entering into NPCs. Other taxpayers welcome the ability to pick and choose among various tax law theories as to the character and timing of NPC payments, but this can lead to a whipsaw of the government. Both result in lack of confidence in the tax system, and inefficiencies in the capital markets.

Id.

154. *See id.* The four methods were (1) The Noncontingent Swap Method; (2) the Full Allocation Method; (3) the Modified Full Allocation Method; and (4) the Mark-to-Market Method. A detailed analysis of the four methods is beyond the scope of this Article. *Id.*

155. *See* Prop.Treas. Reg. § 1.446-30, 69 Fed.Reg. 8886 (Feb. 26, 2004). The proposed regulations mandated the Noncontingent Swap Method to account for income and deductions of contingent non-periodic swap payments. Pursuant to the Noncontingent Swap Method, in

stepped into the breach and created the CDS shelter. Given the lack of guidance, the shelter flourished. In 2002, in an attempt to stem the tide, the government issued two not-so-complementary pronouncements, adding confusion to an already confusing area of the law.[156]

The two pronouncements were Revenue Ruling 2002-30 and Notice 2002-35. In Revenue Ruling 2002-30, the IRS required accrual of the noncontingent portion of a contingent swap payment. This approach is commonly termed bifurcation, where a pool of assets is split into a contingent portion (usually equity) and a noncontingent portion (usually fixed income assets).[157] However, the revenue ruling conflicted with existing swap regulations that did not permit bifurcation.[158] In Notice 2002-35, issued after Revenue Ruling 2002-30, the IRS stated that the transaction at issue in the Notice (the CDS shelter) should be recharacterized and treated according to its economic substance.[159] While treating the CDS shelter according to its economic substance may have been correct, such treatment was not, strictly speaking, bifurcation.

In 2006, the IRS began "quietly offering to settle" CDS shelters.[160] Under the settlement offer, the IRS required settling taxpayers to accrue as ordinary income 85% of the noncontingent, nonperiodic payments and

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general terms, taxpayers are required to accrue the contingent leg of an NPC under a method described in the 2004 proposed regulations.

156. *See* David P. Hariton, *Confusion About Swaps and Rev. Rul. 2002-30*, 95 TAX NOTES 1211 (2002); Sheppard, *Kansas*, *supra* note 140; Sheryl Stratton, *Contingent Payment Ruling Creates More Questions*, TAX NOTES TODAY, July 24, 2002, at 142–44.

157. *See* Sheppard, *Kansas*, *supra* note 140.

158. *See, e.g.*, Treas. Reg. § 1.446-3 (2013). For example, Treasury Regulation § 1.446-3(f)(2) prescribes several methods for accrual of a nonperiodic payment under a swap that do not require creation of a deemed loan and the attendant creation of interest expense, and Treasury Regulation § 1.446-3(g)(4) prescribes a method for accrual of a significant nonperiodic payment under a swap. Under this latter method, the swap is to be treated as two separate transactions consisting of an on-market, level payment swap and a loan. According to one commentator, Revenue Ruling 2002-30 sought to treat a swap under both methods at once. *See* Sheppard, *Kansas*, *supra* note 140.

159. *See* Treas. Reg. § 1.446-3(g)(2) (providing that if a taxpayer, either directly or through a related person, reduces risk with respect to an NPC by purchasing, selling, or otherwise entering into other NPCs, futures, forwards, options, or other financial contracts (other than debt instruments), the taxpayer may not use the alternative methods provided in paragraphs (f)(2)(iii) and (v) of § 1.446-3; moreover, where such positions are entered into to avoid the appropriate timing or character of income from the contracts taken together, the Commissioner may require that amounts paid to or received by the taxpayer under the notional principal contract be treated in a manner that is consistent with the economic substance of the transaction as a whole). *See also Settlement Guidelines*, *supra* note 143.

160. *See* Lee A. Sheppard, *IRS Settling Contingent Deferred Swap Shelters,* TAX NOTES TODAY, Feb. 28, 2006, at 39–41.

allowed the remaining 15% to be treated as capital gain.[161] The IRS also allowed taxpayers to deduct their transaction costs.[162]

IV. GOVERNMENT RESPONSES TO SHELTERS

Despite many recent high profile victories, the government tax shelter strategy thus far has been akin to Whac-A-Mole, wherein the government pounds on a particular shelter only to discover new (and often improved) shelters popping up.[163] Historically, once the government identified a new shelter, the government marshaled its forces to stamp out that particular shelter and any similar shelters.[164] Nevertheless, the government has only had limited success in deterring taxpayers from engaging in shelters.

One issue for the government is their lack of resources to fight shelters. Unlike most situations where the government has superior resources, in the tax shelter arena, the government is "[o]ften understaffed and outwitted, [and, as a result,] IRS agents have resorted to using every penalty, sanction, procedural tactic, threat, and common law doctrine available in their arsenal to capture the" lost income from tax shelters.[165] Moreover, because "detection and penalty rates cannot realistically exist at levels that will meaningfully deter wrongdoing,"[166] sophisticated tax planners "press on, tweaking the deal just enough to sidestep reform."[167]

161. *Seeid.*; *see alsoForm Letter is Available on IRS Settlement Offer for Swaps*, TAX NOTES TODAY, Feb. 28, 2006, at 39–42.

162. *See* Sheppard, *supra* note 160.

163. *See, e.g.*, Press Release, Department of Justice, *Justice Department Prevails in Three Tax Shelter Cases on Same Day*(Oct. 4, 2011), *available at* http://www.justice.gov/tax/txdv111314.htm. "Whac-A-Mole" is an arcade game which typically consists of a large, waist-level cabinet with five holes in its top and a large, soft, black mallet. Each hole contains a single plastic mole and the machinery necessary to move it up and down. Once the game starts, the moles will begin to pop up from their holes at random. The object of the game is to force the individual moles back into their holes by hitting them directly on the head with the mallet, thereby adding to the player's score. The more quickly this is done the higher the final score will be. *See, e.g.*, Sara D. Sunderland, *Domain Name Speculation: Are We Playing Whac-A-Mole*, 25 BERKELEY TECH. L.J. 465, 465 n.2 (2010); *Whac-A-Mole*, BOB'S SPACE RACERS, http://www.bobsspaceracers.com/whac-a-mole/html-index.htm (last visited Feb. 13, 2013); *Whac-A-Mole*, WIKIPEDIA, http://en.wikipedia.org/wiki/Whac-A-Mole (last visited Feb. 13, 2013). For example, the government's response to the BOSS led to the development of an arguably better transaction, i.e., Son of Boss.

164. *See, e.g.*, Schizer, *Frictions*, *supra* note 83.

165. *See* Rachelle Y. Holmes, *Forcing Cooperation: A Strategy for Improving Tax Compliance*, 79 U. CIN. L. REV. 1415, 1417–18 (2011) (citing David. M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 335–36 (2006)).

166. *Id.* at 1419.

167. Schizer, *Frictions*, *supra* note 83.

Abusive shelters for large corporations and high-income individuals have cost the U.S. Treasury many billions annually, according to Treasury Department estimates.[168] The weapons in the government's arsenal to fight tax shelters consist of audits, litigation, settlements, and changes in the law. Those weapons have held the line against an explosion of pre-1986 tax shelters but have done little to diminish the marginal growth of the shelter industry or to create disincentives for wealthy taxpayers seeking to game the system. While it is easy to criticize the government's approach, it is equally important to understand that the government is overmatched, as trying to control the spread of tax shelters is like trying to herd cats.

A. Audits, Litigation, and Settlements

Taxpayers, for the most part, are rational and will only undertake an action if the potential benefits outweigh the costs.[169] Using the tax shelters described above, the potential benefits to the taxpayer of the transactions are obvious—the millions of dollars saved in taxes. What are not so obvious are the potential costs to the taxpayers, and having an understanding of those potential costs sheds light on why technical tax shelters have proliferated.

As with all things economic, a few assumptions are necessary before trying to explain any economically-driven behavior. The first assumption is that taxpayers are rational economic actors, and they will not participate in tax shelters if they believe the costs of participation outweigh the benefits. The second assumption is that we can quantify the costs and benefits.

Using a simple expected value calculation of a tax shelter, from a taxpayer's perspective, the taxpayer will enter the transaction if the potential benefits equal to the probability of receiving the benefits multiplied by the benefits' value, exceed the potential costs, equal to the probability of paying such costs multiplied by the total costs.[170] For this

168. *See* TAX DIVISION: U.S. DEP'T OF JUSTICE, FY 2013 CONGRESSIONAL BUDGET 8, *available at* http://www.justice.gov/jmd/2013justification/pdf/fy13-tax-justification.pdf.

169. *See, e.g.*, Logue, *supra* note 6, at 231 (discussing whether the application of the rational expectations assumption to tax law); Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689, 691–92 (2009) (discussing the conditions that will deter individuals with varying levels of rationality).

170. This "simple" expected value calculation is derived from the groundbreaking works of Jeremy Bentham and Nobel Prize winning economist Gary Becker. *See, e.g.*, Gary Becker, *Crime and Punishment: An Economic Approach,*76J. POL. ECON.169 (1968). *See* William A. Drennan, *Strict Liability And Tax Penalties*, 62 OKLA. L. REV. 1, 29–30 (2009). Professor Drennan's article describes a rational taxpayer as "homo economicus" (borrowing from other literature) and notes that "[e]conomics alone motivates homo economicus. He engages in socially harmful behavior unless his total expected cost from behaving badly, including penalties, equals or exceeds his total expected cost of behaving lawfully." *Id. See also* Richard

analysis, the potential benefits are the net tax savings the transaction promises. For example, assume a particular tax shelter purported to generate $100 million of tax loss at a transaction cost of $7 million.[171] The $100 million of tax loss (assuming it can be utilized by the taxpayer—a valid assumption, because there would be no other reason to enter the transaction in the first place) would generate a tax benefit of $35 million. The transaction would thus yield a net benefit (assuming the taxpayer can deduct the fees paid to the promoter) of $30.45 million ($35 million from the transaction, with net fees equal to $4.55 million).[172] The potential costs would include the costs associated with: (i) defending the transaction if the transaction is challenged by the government; (ii) losing the tax benefits; and (iii) any penalties the taxpayer incurs based on the transaction.[173]

Lavoie, *Deputizing the Gunslingers: Co-opting the Tax Bar into Dissuading Corporate Tax Shelters*, 21 VA. TAX REV. 43, 53 (2001) ("[P]romoters often indicate, either explicitly or implicitly, that clients should factor the likelihood of discovery into their appraisal of the transaction; promoters advocate playing the audit lottery."). Other scholars have used more econometric tools to evaluate penalty structures. *See, e.g.*, Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255 (2002) (arguing that the government's current strategy for deterring corporate tax shelters can be effective). Gergen states:

> A rational firm evaluating an illicit over-aggressive tax strategy that considered only the immediate financial implications would weigh the tax savings, t, the cost of executing the strategy, c_e, the probability that the position will be detected by the government, P_d, the probability of an adverse decision upon detection, P_a, and the penalty it would pay on an adverse decision, s, which I treat as a factor of the tax savings. Equation (1) shows the relation among these financial variables. It expresses the expected financial return on execution of the strategy: $t(1 - sP_dP_a) - c_e(1)$.

Id. at 261.

171. The fees charged by promoters for many tax shelters are based on a percentage of the taxpayer's expected tax savings in the transaction. This analysis prices the fee at 20% of the tax benefit, which is not out of line with fees for Son of Boss and CDS shelters. *See, e.g.*, Alpha I, L.P. v. United States, 93 Fed. Cl. 280, 297 (2010) (noting that the charge was 25% of what the taxpayer would have paid); *see also* Ben Wang, *Supplying The Tax Shelter Industry: Contingent Fee Compensation for Accountants Spurs Production*, 76 S. CAL. L. REV. 1237, 1257–76 (2003) (citing Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, FORBES, Dec. 14, 1998, at 198) ("For example, Pricewaterhouse Coopers will charge anywhere from 8–30% depending on the product and its originality.").

172. Calculated as the tax benefit of the loss for a taxpayer in a 35% tax bracket ($35 million, equal to 35% x $100 million) minus the net cost of the fees ($4.55 million, equal to the after tax cost of the $7 million fee, ($7 million minus ($7 million x 35%))). The numbers used in this example are derived from the numbers used in a similar analysis. *See* Lavoie, *supra* note 169, at 52–55.

173. This analysis assumes the only costs are economic costs from participating in the shelter. It ignores social, ethical, or behavioral sanctions that could arise, and also ignores potential criminal liability. I have excluded the potential interest costs the government charges on underpayments of tax (and penalties) because, as discussed *infra*, such costs may not serve as a deterrent.

Before quantifying those costs, the taxpayer would need to assess the likelihood of getting caught, i.e., the chances of the IRS challenging the transaction on audit. In 2011, for individual taxpayers earning over $1 million, the chance of being audited was approximately 13.4%.[174] In addition to individual audits, the IRS also audits flow-through entities taxed as partnerships, and individuals often enter shelters through such entities.[175] The likelihood of audit of flow through entities in 2011 was 0.4%.[176] For the purpose of this analysis of expected value, let us conservatively assume the likelihood of being audited, either individually or through a flow through entity, is 15%.

So, for an individual taxpayer, if the risk of detection is 15%, the taxpayer would have an 85% chance of receiving the $30.45 million tax benefit and a 15% chance of paying some cost. The cost to dissuade a rational taxpayer from undertaking that risk would thus have to exceed approximately $172.6 million, calculated by solving for the expected cost, equating the probability of the expected benefit (85% x $30.45 million) with the probability of the expected cost (15% x $172.6 million).[177]

Scenario	Outcome	Probability	Exp. Return/(Loss)
No Audit	$30.45 million	85%	$25.9 million
Audit	$172 million	15%	($25.9 million)
Expected Benefit/(Cost)			**$0**

However, the potential costs could not conceivably reach $172.6 million. The three components of that cost (defending the transaction, losing the tax benefits, and penalties) fit within a relatively narrow band: the tax benefits

174. *See* INTERNAL REVENUE SERV., 2011 DATA BOOK, *available at* http://www.irs.gov/pub/irs-soi/11databk.pdf. The data is approximate because the IRS does not have an explicit over $1 million category. The audit rate for individuals with adjusted gross incomes between $1 million and $5 million was 11.80%, representing .15% of all returns; the audit rate for individuals with adjusted gross incomes between $5 million and $10 million was 20.75%, representing .01% of all returns, and the audit rate for individuals with adjusted gross incomes over $10 million was 29.93%, representing .01% of all returns. Using a weighted average of the three groups provides a rough estimate of 13.4%.

175. Entities taxed as partnerships were integral to allowing the taxpayers to utilize the tax benefits in both the Son of Boss and CDS tax shelters.

176. *See* INTERNAL REVENUE SERV., *supra* note 173.

177. The calculation uses the expected benefit to determine the expected cost. The expected benefit of the transaction is equal to $25.9 million, the probability of receiving the benefit (85%) multiplied by the total benefit ($30.45 million). Equating the expected benefit to the expected cost, because the likelihood of detection is 15%, the total cost of detection would have to equal $172.9 million to make the expected cost $25.9 million.

of the transaction are $37.45 million ($35 million for the transaction plus $2.45 million benefit based on the deduction for the fees), and the largest potential penalty, for participants who fail to disclose their participation in a Reportable Transaction, amounts to only 75% of the claimed tax benefits of a transaction.[178] Again, using $37.45 million as the tax benefit, the highest penalty, at 75%, would be about $28.1 million. So, for our rational taxpayer, the maximum cost of the lost tax benefit and the penalty is $65.5 million.[179] The only remaining cost is the cost of challenging the IRS, and it is difficult to conceive a taxpayer that is willing to spend over $107.1 million on litigation to bring that potential cost to $172.6 million.[180] If the taxpayer's strategy was to concede as soon as he were audited, thereby avoiding any litigation costs, the taxpayer's expected value calculation would look as follows:

Scenario	Outcome	Probability	Exp. Return/(Loss)
No Audit	$30.45 million	85%	$25.9 million
Audit – Concede All Issues – No Litigation	$65.5 million	15%	($9.8 million)
Expected Benefit/(Cost)			$16.1 million

The above expected value analysis shows why rational taxpayers (with tens or hundreds of millions of dollars to potentially shelter) play the tax shelter game. It fails, however, to provide the entire picture because taxpayers can further reduce their potential costs by playing the game better than the government.

178. The American Jobs Creation Act of 2004 imposed new penalties on taxpayers who fail to adequately disclose "reportable transactions" to the IRS. American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 816, 118 Stat. 1418, 1583 (2004) [hereinafter 2004 Jobs Act]. Before the 2004 Jobs Act, taxpayers were generally only penalized for not disclosing a reportable transaction if the IRS was successful in challenging the transaction. Accordingly, many taxpayers were not overly concerned about disclosing these transactions, especially if the tax benefits of the transaction were clearly legitimate and/or there was little chance of a successful IRS challenge.

179. *See* I.R.C. § 6663(a) (2006). The IRS has the burden of proving fraud by clear and convincing evidence for this penalty to apply; *see id.*, § 6663(b), 7454(a), TAX CT. R. 142(b).

180. While the costs associated with defending a transaction can be substantial, taxpayers are often able to mitigate those costs. For example, taxpayers who participated in Son of Boss shelters often participated in those shelters through partnerships. When the IRS challenged the shelters, many promoters, protecting their own economic interest (i.e., the threat of a lawsuit by suddenly outraged taxpayers), chose to underwrite the defense of the transactions in question.

Many of the individual taxpayers who fought the tax shelters described herein had what one writer artfully described as "boxcar deficiencies."[181] They were also very wealthy and could afford to hire the best legal talent to advise them of their rights once the IRS audit letter arrived. Once that happened, those taxpayers had a myriad of ways to reduce their potential costs: such as responding to often generous IRS settlement initiatives (as described above); using strategic concessions to avoid the imposition of penalties (and minimize the cost of litigation);[182] winning procedural victories against the IRS (such as *Home Concrete*); and suing the promoters for something akin to malpractice.

A logical inquiry at this point would be why the IRS provides taxpayers the opportunity to settle, especially if the terms of those settlements (as were the case in both the CDS and Son of Boss settlements) allow any benefit for transactions that would likely lose on the merits. The IRS, however, also has to do a cost-benefit analysis, but with far different criteria.[183] As a primary matter, the IRS must weigh carefully the costs of

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181. *See* Sheppard, *11 Rules*, s*upra* note 121, at 180. "Boxcar deficiencies" are tax deficiencies so large that the cash to pay the deficiency would have to be transported by rail.

182. Taxpayers have used certain concessions to avoid penalties. In the Fifth and Ninth Circuits, taxpayers have successfully argued that when the IRS attacks a transaction on multiple grounds, if the taxpayer concedes on a ground that does not provide penalties, the IRS cannot apply certain penalties to the taxpayer. *See* Keller v. Comm'r., 556 F.3d 1056 (9th Cir. 2009) (IRS unable to assess valuation overstatement penalty after taxpayer conceded to invalid deductions and that a negligene penalty applied); Heasley v. Comm'r., 902 F.2d 380 (5th Cir. 1990) (IRS unable to assess valuation overstatement penalty when taxpayers conceded to taking tax credits for overvalued investments and did not dispute the tax deficiency); Todd v. Comm'r., 862 F.2d 540 (5th Cir. 1988) (IRS unable to assess valuation overstatement penalty after taxpayers conceded items were not placed in service during tax years for which claimed deductions and credits were taken); *see also* Jeremiah Coder, *Self-Serving Concessions and Penalty Avoidance*, TAX NOTES TODAY, Mar. 26, 2012, at 1583–84. The IRS has stated that it disagrees with the decision in *Keller*. Nonacq., 2011-44 I.R.B. 603, *available at* http://www.irs.gov/pub/irs-irbs/irb11-44.pdf.

183. Richard Lavoie explains:

> Even if the Service spots and challenges the transaction, the taxpayer may wind up no worse off for having attempted such an aggressive transaction. After weighing the risk of loss in litigation together with the great expense of litigating a complex tax-shelter transaction, the Service may be willing to settle the matter with the taxpayer by allowing a portion of the tax benefit sufficient to defray the taxpayer's original transaction costs. . . . The settlement would be rational for the Service based on a 10% risk of loss at trial and an expected $2 million in litigation expenses. For the corporate taxpayer, the settlement would largely defray the original payment of the promoter's fee and leave the taxpayer in essentially the same tax position as if the transaction never had occurred. If the promoter agreed to defend the case for free, this agreement would reduce further the potential downside cost for the corporate taxpayer.

losing, a cost far higher than the tax loss in an individual transaction. When the IRS loses a tax shelter case, the record of that loss becomes a "How To" manual for tax shelter promoters, which will multiply the potential tax loss from a particular transaction. Also in determining whether to litigate, the IRS must be convinced it can demonstrate to a court why the transaction should not be respected. As mentioned above, most of these technical tax shelters rely on the Code and Treasury Regulations for their purported tax benefits, so for those shelters, the IRS must show why the taxpayers' reliance on the law was misplaced. But so demonstrating often gives the IRS a difficult choice: state that the technical analysis of the transaction is correct but that some common law principle, such as economic substance, substance over form, step transaction, sham transaction, etc., requires that the transaction not be respected, or show how the technical analysis is incorrect and thus provide some measure of finality to an open tax question. The risk in providing that finality is that it often opens the door to other tax shelters using that same analysis.

Another hurdle the IRS must potentially face is the taxpayer's reasonable cause defense, which mitigates the imposition of penalties. In most circumstances, the Code disallows penalties if it is shown that the taxpayer had reasonable cause for the position taken and that the taxpayer acted in good faith.[184] Taxpayers, especially taxpayers involved in multi-million dollar tax shelters, often claim that they relied on the advice of counsel, giving them a *prima facie* argument for reasonable cause, and thus substantially reducing the likelihood of penalties.

B. Codification

The government has taken a significant step toward changing the expected value calculation by codifying the economic substance doctrine. In 2010, Congress codified the long-standing economic substance doctrine through section 1409 of the Health Care and Education Reconciliation Act of 2010 ("2010 Act").[185] One goal of the 2010 Act was to stop technical tax

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Lavoie, *supra* note 169, at 54 (internal citations omitted).

184. I.R.C. § 6664(c) (2006).

185. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-148, 124 Stat. 1029. The 2010 Act added new § 7701(o) to the Internal Revenue Code. The relevant portions of I.R.C. § 7701(o) state:

> (1) Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—
>
> (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer

shelters, as evidenced by the Technical Explanation's language that "several doctrines [including the economic substance doctrine] . . . can be applied to deny the tax benefits of a tax-motivated transaction, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision."[186]

The 2010 Act added I.R.C. § 7701(o), which provides that for a transaction to have economic substance for income tax purposes, the transaction must (1) meaningfully change a taxpayer's economic position (apart from tax benefits) and (2) have a substantial nonfederal income tax purpose (collectively, the "Codified Economic Substance Test").[187] Prior to

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> has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.
>
> . . . .
>
> (5) Definitions and special rules. For purposes of this subsection—
>
> (A) Economic substance doctrine. The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

I.R.C. § 7701(o) (2006). The 2010 Act also added I.R.C. § 6662(b)(6), which provides that the accuracy-related penalty imposed under § 6662(a) applies to any underpayment attributable to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law" (collectively a § 6662(b)(6) transaction). I.R.C. § 6662(b)(6) (2006). The 2010 Act also added I.R.C § 6662(i), which increases the accuracy-related penalty from 20% to 40% for any portion of an underpayment attributable to one or more I.R.C. § 6662(b)(6) transactions "with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return." I.R.C. § 6662(i)(2) (2006).

186. STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 142 (Comm. Print 2010) [hereinafter TECHNICAL EXPLANATION].

187. *See* I.R.C. § 7701(o) (2006). The term "economic substance" originated with *Am. Sec. & Trust Co. v. Tait*, 5 F. Supp. 337, 340 (D. Md. 1933) (using the term "economic substance" in determining whether a transaction should be respected). The concept of economic substance predates that decision by fifteen years, however. *See S. Pac. Co. v. Lowe*, 247 U.S. 330, 337 (1918) (questioning whether a subsidiary's income was its parent's income or "in truth and in substance" its own). Neither Congress, the Treasury, nor the IRS have provided any guidance that would help taxpayers know what constitutes a "meaningful" change or what is a "substantial" nonfederal income tax purpose for purposes of I.R.C. §§ 7701(o)(1)(A) and (B). On October 4, 2010, the IRS issued Notice 2010-62, which provides limited guidance relating to the application of I.R.C. § 7701(o). Notice 2010-62, 2010-40 I.R.B. 411. The Notice announced that the IRS will not issue any private letter rulings or determination letters on whether economic substance is "relevant." *Id.* at 412. Consequently, there will be no government guidance on when economic substance is "relevant," and taxpayers must make their own determination under the peril of the strict liability penalties.

codification, different courts used different standards to define economic substance.[188]

Codification set forth a uniform standard for how economic substance was defined. Codification provided a small shift in the law[189] in that, prior to codification, a conflict among circuit courts existed with respect to whether the two parts of the economic substance test were disjunctive or conjunctive.[190]

The greater change, at least to the tax bar, was Congress' directives with respect to the applicable penalties. The 2010 Act also adds new section 6662(b)(6), which applies a strict liability penalty for transactions "lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law." No guidance was provided on the meaning of the phrase "any similar rule of law."[191] Thus, if

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188. *See* Arthur Acevedo, *Abusive Tax Practices: The 100-Year Onslaught on the Tax Code*, 17 BARRY L. REV. 179, 198–99 (2012).

189. In fact, I.R.C. § 7701(o) states that "The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." I.R.C. § 7701(o)(5)(C) (2006).

190. Acevedo, *supra* note 187, at 198–99. Acevedo stated:

> [T]he circuits were split concerning how to evaluate and apply the economic substance doctrine. The question was whether the test was to be applied in a conjunctive manner or in a disjunctive manner. The Seventh Circuit, Eighth Circuit, and Eleventh Circuit applied the test in a conjunctive manner. In contrast, the Second Circuit, Fourth Circuit, and the D.C. Circuit applied the test in a disjunctive manner. The Federal Circuit Court of Appeals took a different approach altogether. The remaining circuits considered the two prong test as elements in their analysis of the economic substance of the transaction.

Id. (internal citations omitted).

191. Carol P. Tello, *Dealing with Codified Economic Substance in the Context of International Issues: Self Help, the Only Game in Town*, TAX EXECUTIVES INST., June 7, 2011, at 44, *available at* http://www.tei.org/news/articles/Pages/TTE_SPRING11_dealing_with_codified_economic_substance_in_the_context_of_international_issues.aspx ("There is no 'official' legislative history for section 7701(o), i.e., no House Ways and Means Committee, Senate Finance Committee, or Conference Committee Report except to the extent that the contemporaneous Technical Explanation prepared by the staff of the Joint Committee on Taxation would be so treated. Although the Technical Explanation may not be considered formal 'legislative history,' it does provide some insight and background on section 7701(o)."). Tello explains:

> The Technical Explanation, however, explains that the penalty is intended to apply to a transaction the tax benefits of which are disallowed as a result of the application of factors and analysis similar to that required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine. Presumably, this phrase could include step transaction, substance over form, business purpose, alter ego, and sham doctrines (among others), but there is no limitation on what other rules of law

a court determines that a transaction lacks economic substance, the taxpayer faces a strict liability penalty of either 20%, if the transaction was properly disclosed, or 40%, absent proper disclosure.[192]

While codification clarified the law and expanded the potential cost of penalties, it did little to discourage taxpayer behavior. Most transactions so devoid of substance that the economic substance doctrine is relevant are doomed to fail no matter how the test is constructed. The clarification provided by codification will have almost no effect on determining whether a transaction should be respected. The rule is simply too narrow to capture many technical tax shelters because all the economic substance test amounts to is whether the transaction (or parts of the transaction) contain real risk.

The government could strengthen its attack on shelters by expanding the reach of codification, using the authority Congress gave it to extend the strict liability penalties to one or more of the "any similar rules of law," as set forth in I.R.C. § 6662(b)(6). However, the government thus far has been reluctant to do so.

On October 4, 2010, the IRS issued Notice 2010-62 (Internal Revenue Bulletin 2010-40) ("IRB Notice"). The IRB Notice provides "interim" guidance regarding the codification of the economic substance doctrine under I.R.C. § 7701(o). On September 14, 2010, the IRS issued a directive requiring its examination division to seek substantial review before seeking to impose the codified economic substance doctrine and its related penalties.[193] Later, on July 15, 2011, the IRS provided a directive ("ES Directive") to field examiners and their managers, telling them what information must be developed and analyzed before seeking such a review.[194] Importantly, the ES Directive limited the application of the codified economic substance doctrine, stating that it only applied to application of the "economic substance doctrine" and not to other similar

> may be invoked. The inclusion of this phrase in the penalty provision likely enlarges the reach of section 7701(o).

Id.

192. I.R.C. §§ 6662(a), 6662(i) (2006).

193. Directive from Heather C. Maloy, Comm'r, Large & Mid Size Bus. Div., IRS, to Industry Directors on Codificaton of Economic Substance Doctrine and Related Penalties LMSB–20–0910–024 (Sept. 14, 2010), *available at* http://www.irs.gov/Businesses/Codification-of-Economic-Substance-Doctrine-and-Related-Penalties.

194. Directive from Heather C. Maloy, Comm'r, Large Bus. & Int'l Div., IRS, to LB&I Directive Industry Directors on Guidance for Examiners and Managerson the Codified Economic Substance Doctrine and Related Penalties LB&I–4–0711–015 (July 15, 2011), *available at* http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties [hereinafter ES Directive].

rules of law or judicial doctrines, such as step transaction, substance over form, or sham transaction. The IRS thus de-toothed the tiger.

In the ES Directive, the IRS stated that "until further guidance is issued, the penalties provided in sections 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other 'similar rule of law' or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction)."[195]

The reality of tax shelters is that taxpayers know, for the most part, when they enter a shelter whether the transaction lacks economic substance. Such a transaction often is done solely for tax benefits, with only a fig leaf of expected non-tax benefit or business purpose. While there existed semantic differences to the variations courts have employed in the past, the bottom line is that the most suspect transactions would have failed under any variation of the economic substance test.

As applied by the courts, the economic substance test is little more than a smell test and most technical tax shelters reek. Moreover, a failing transaction would also likely fail some of the other common law judicial doctrines used to attack tax shelters. However, the same is not true in reverse: transactions failing some of the other doctrines would not necessarily fail the economic substance test. That is where the "any similar rule of law" language in the 2010 Act could be relevant.

The reasons for this are several, but the most common is that there are often no legitimate non-tax reasons for most transactions failing the economic substance test. For such transactions, the business purpose was often ginned up by the promoters to provide a patina of legitimacy to what otherwise would be a transfer of tax revenue from the government to the taxpayer. More often than not, the promoter was not relying on a transaction having economic substance, but rather on the transaction not being discovered by the IRS (or being discovered too late for the government to do anything about the transaction).[196]

It is for these reasons that codification will have little impact on changing behaviors, because it does not fundamentally alter a taxpayer's calculus: no matter what variation the economic substance test, the transaction will still likely fail. Thus, the only meaningful impact codification will have is on the expected cost, through the strict liability penalty provisions. However, that cost will not be high enough to change

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195. *Id.*

196. *See, e.g.*, Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 582 (2006) [hereinafter Raskolnikov, *Crime and Punishment*].

behavior for most taxpayers with boxcar deficiencies, because the cost of defending the transaction, even assuming litigation from audit through the U.S. Supreme Court, will rarely be high enough to change a taxpayer's decision to enter the shelter in the first place.

V. CHANGING THE CALCULUS

To change taxpayers' behavior on tax shelters, the government will have to act with stronger measures. Below are four incremental changes that could materially affect taxpayers' expected value calculations with respect to multi-million dollar tax shelters:[197]

A. Expand the Breadth of the Strict Liability Penalty

When Congress codified the economic substance doctrine, it gave the IRS and Treasury the ability to expand the strict liability penalties to "any similar rule of law." There is general agreement that those similar rules of law include sham transactions, substance over form, step transactions (the "common law doctrines"), and possibly some of the myriad anti-abuse provisions in the Code. To date, the IRS has declined Congress' offer to expand those penalties.

The caution the IRS has used in not expanding the "any similar rule of law" language has made sense to date. Transactions lacking in economic substance have few indicia of legitimacy apart from the tax benefits, while transactions violating those "similar rules of law" are far more difficult to categorize, which warrants caution. Moreover, had the IRS stepped prematurely into the breach and sought to apply the "similar rules of law"

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197. These changes in the law should not be across the board, but should be applied only to taxpayers who participate in transactions generating over $1 million in tax benefits. Compared to low or middle-income taxpayers, high-income taxpayers have more incentive to participate in tax shelters. There are a number of reasons for this, including: higher marginal tax rates for high income taxpayers means greater tax savings when that income is sheltered; transaction costs of shelters can be better absorbed when more money is at stake, e.g., a strategy that costs $100,000 to make $1 million of gains disappear means the strategy must generate more than 10% tax savings (based on the $1 million of gains) to make sense, while that same strategy seeking to make $100 million of gains disappear makes sense as long as it generates 1% tax savings. Moreover, from a policy perspective, it makes little sense to implement these changes for smaller transactions because current law adequately covers such transactions, and the costs of an across the board change would add nothing. Those who would argue fairness should remember that there is a tax shelter regime for lower and middle income taxpayers, and it is called employer withholding and reporting. *See, e.g.*, Michael J. Graetz, *Taxes That Work: A Simple American Plan*, 58 FLA. L. REV. 1043 (2006); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1468 n.77 (2003).

strict liability penalties to other transactions, they would have faced a two-front war from taxpayers. On one front, the taxpayers would have more reason to fight, as the cost of the strict liability penalty would be directly compared to the cost of litigation. In addition, because the taxpayer would likely already be in litigation seeking to reduce penalties based on a reasonable cause defense, the added cost to the taxpayer would be minimal.

The other front would be the courts. By not seeking to extend the "similar rules of law" language to other transactions, the IRS has not given taxpayers the ability to challenge any such extension. In addition, the IRS has retained the right, if it so chooses, to wait for a particularly unctuous transaction to seek to extend the doctrine in the future. That future will probably occur when the economy improves, as there will be more taxpayers with boxcar deficiencies willing to play the tax shelter game.

The only fault I assign to the IRS is in disclosing that it was shackling itself with the "any similar rules of law" language. By publishing the ES Directive, the IRS has reduced the uncertainty related to whether it would expand the breadth of the economic substance penalties. That reduction in uncertainty benefits taxpayers, permitting them to make a more informed expected value calculation with respect to particular transactions. By way of example, assume a taxpayer is evaluating a shelter and is fairly certain that the shelter, if discovered, would fail one of the common law doctrines (and potentially incur a 40% penalty) ("Penalty 1") but would have enough economic substance to avoid the economic substance strict liability penalty ("Penalty 2"). That taxpayer is better able to price his risk with respect to the transaction, because whatever the expected cost of Penalty 1, it is lower than the combined cost of Penalty 1 and Penalty 2. By adding certainty on the question of whether Penalty 2 could apply, the IRS has, for all intents and purposes, decreased the potential cost to taxpayers entering into shelter transactions. As a result, the decrease in the taxpayer's expected cost increases the likelihood the taxpayer will enter the shelter.

The IRS has, in the past, used uncertainty to frustrate taxpayer attempts to game the system. One stark example is the synthetic fuel ("synfuel") tax credit from the early 2000s. Under a program created around 1980, taxpayers could get a tax credit for sales of solid synthetic fuels produced from coal.[198] In 1986, the IRS provided guidance on what types of synthetic

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198. *See* I.R.C. § 29 (2000) (current version at I.R.C. § 45 (2006)); Robert Mann, *Another Day Older and Deeper in Debt: How Tax Incentives Encourage Burning Coal and the Consequences for Global Warming*, 20 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 111, 132 (2007).

fuel would qualify for the credit.[199] Based on the tax credit, owners of "approved" synthetic fuel plants could, at that time, sell synthetic fuel for about $19 per ton and collect an additional $25 per ton in tax credits, making the tax credit more valuable than the fuel.[200] The problem, however, was that the synthetic fuel produced had no discernible benefit over regular coal, other than the tax credit.[201]

Those credits attracted the attention of tax shelter promoters, seeking to move the credits away from coal producers to other companies that just wanted to reduce their taxes. For example, in 2001, Marriott Corp. purchased synthetic fuel plants to take advantage of the credit.[202] Marriott Corp. used those credits to cut its effective federal income tax rate to 6.8% in 2002 (corporate taxes were set at 35% at the time),[203] and to a negative tax rate (yes, that means the government paid them) in 2003.[204]

Companies were able to abuse the synthetic fuel tax credit program because the IRS failed to establish guidelines on what types of fuel would qualify for the credits.[205] The IRS regulations established only that coal must undergo a "significant chemical change" to qualify for the credit.[206] Although the credit was intended to encourage the creation of fuel from nonconventional sources, companies found it more profitable to claim the credit for the production of "synthetic" synthetic fuel. Media reports have

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199. *See* Rev. Rul. 86-100, 1986-2 C.B. 3. In that Revenue Ruling, the IRS rules that a particular mixture of coal and water did not qualify for the credit because there was no significant chemical change. *Id.* That Revenue Ruling was the origin of the "significant chemical change" standard that ballooned into the "spray and pray" tax shelter. *See* Mann, note 197, at 132.

200. *See Treasury Department to Review Federal Tax-Credit Program Promoting Synthetic Fuels*, KY. NEW ERA, Oct. 9, 2000, at A7.

201. *See* Martin A. Sullivan, *Economic Analysis: Multibillion Dollar Coal Credit: Lots of Form, Little Substance*, TAX NOTES, Oct. 6, 2003, at 34. ("Marketable coal goes in and marketable coal comes out . . . this type of 'production' does not deserve any federal subsidy.").

202. *See, e.g.*, Jesse Drucker, *Romney as Audit Chair Saw Marriott Son of BOSS Shelter Defy IRS*, BLOOMBERG (Feb. 22, 2012, 10:01 PM), www.bloomberg.com/news/2012-02-22/Romney-as-auditing-chairman-saw-marriott-son-of-boss-tax-shelter-defy-irs.html [hereinafter Drucker, *Romney*] ("In 2004, Marriott's tax planning drew the ire of Senator John McCain. Marriott received hundreds of millions of dollars in federal tax credits meant to promote so-called synthetic fuel through a business purchased by Marriott in 2001 while Romney sat on the board's audit committee.").

203. *Id.* The top U.S. corporate income tax rate at the time was 39%. *See* IRS, CORPORATION INCOME TAX BRACKETS AND RATES, 1909–2002, *available at* http://www.irs.gov/pub/irs-soi/02corate.pdf.

204. Drucker, *Romney*, *supra* note 201.

205. One writer noted that "If there were an award for the worst tax credit ever, the section 29 nonconventional-source fuel tax credit as it applies to chemically modified coal would probably be the winner." Sullivan, *supra* note 200.

206. *Id.*

detailed examples of companies spraying substances such as diesel fuel or pine tar on already marketable coal to receive the credit.[207] The "spray and pray" tax shelter was thus created.[208]

According to one member of Congress, "The companies claiming this tax credit are little more than sorcerers who 'spray and pray' that the government will foolishly continue to pay for their alchemy."[209] "This provision has developed into nothing less than a complete scam, robbing the public treasury of billions of dollars each year."[210]

The synthetic fuel tax credit program was set to expire in 2007.[211] Faced with such a short time horizon, instead of seeking to change the law, the IRS needed to come up with a way to keep the credit from exploding. In 2000, the IRS issued Revenue Procedure 2000-47, which provided that the IRS would no longer issue "advance rulings or determination letters" on whether a certain plant qualified for the tax credit.[212] The IRS announced that it made its decision because "[c]oncern has been raised that taxpayers are also claiming the § 29 credit for processing coal in other ways that may not have been intended by the Congress."[213]

The immediate aftermath of the decision to issue Revenue Procedure 2000-47 was predictable: the industry was outraged, and they went to

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207. In its 2009 annual report, Marriott reported that it was closing its synthetic fuel operations because the tax credits were no longer available. MARRIOTT INT'L, ANNUAL REPORT 18, 38, 65 (2009). In its quarterly report for the quarter ended June 18, 2008, Marriott reported that, "For the first half of 2007, the synthetic fuel operation generated revenue of $156 million. Income from the Synthetic Fuel segment totaled $50 million, net of tax, in the first half of 2007." MARRIOTT INT'L, QUARTERLY REPORT (FORM 10-Q) (July 11, 2008).

208. *See* John Connor & Leila Abboud, *IRS Reviews Validity of Claims For Synthetic-Fuel Tax Credit*, WALL ST. J., June 30, 2003, *available at* http://online.wsj.com/article/SB105681655331371900.html.

209. *See* Lloyd Doggert, *Green Congressman Reintroduces "Synfuel" Bill to Close Corporate Loophole*, AUSTIN SIERRAN, May 2005, at 7, *available at* http://texas.sierraclub.org/austin/May05.pdf.

210. *See* Heidi Glenn, *Doggett, Coleman Would End Synfuel Credit*, TAX NOTES TODAY, Apr. 28, 2004 (quoting Congressman Lloyd Doggett); *see also* Steve Huettel, *Coal-Fueled Savings*, ST. PETERSBURG TIMES, Dec. 10, 2001, *available at* http://www.sptimes.com/News/121001/news_pf/Business/Coal_fueled_savings.shtml ("'It does not enhance the heat content of the coal or cause it to burn more cleanly or efficiently,' Kentucky Gov. Paul Patton wrote the Treasury Department last year, echoing the views of his state's coal producers. 'If the coal were untreated, it would still be burned in a power plant and produce as much electricity. . . . The way this program is being used is an outrage.'").

211. *See* I.R.C. §§ 45K(e)(2), (f)(1)(B) (2006).

212. Rev. Proc. 2000-47, 2000-46 I.R.B. 482.

213. *Id.*

Congress to get the IRS to change its mind.[214] Nevertheless, the IRS tactic worked, in that the number of companies seeking to claim the credit now faced uncertainty about their ability to do so.[215] I propose the IRS introduce some uncertainty surrounding the imposition of the strict liability penalties. That uncertainty should, at a minimum, increase the potential costs, and thereby decrease the perceived benefits, from participating in tax shelters.[216]

B. Increase Likelihood of Detection

"Low detection rates, combined with inadequate penalties, and enormous information asymmetries, leave the IRS at a vast disadvantage in attempts to restrain taxpayers from taking overly aggressive or abusive positions on

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214. *See, e.g.*, Letter from Rick Santorum, U.S. Senator, to Paul O'Neill, Sec'y of the Treasury (Feb. 16, 2001), *in Santorum Wants Advance Rulings for Synthetic Fuel Projects Restarted*, TAX NOTES TODAY, Feb. 16, 2001. Sen. Santorum stated:

> If Treasury and the IRS believe that there are abuses taking place with regard to certain coal synfuels projects, such abuses should be addressed on a case-by-case basis through the Service's ordinary ruling and audit procedures—not by retroactively changing the rules of the game for taxpayers who reasonably relied on the standards established by the federal government for this program.

Id.; *see also* Letter from Mike Doyle, U.S. Representative, to Paul O'Neill, Sec'y of the Treasury (Mar. 30, 2001), *in Doyle Urges Treasury to Reconsider Issuing PLRs for Synthetic Fuel Producers*, TAX NOTES TODAY, May 3, 2001; *Santorum Again Urges Treasury to Reconsider Position on Nonconventional Fuel Credit*, TAX NOTES TODAY, Oct. 12, 2001 (reporting Senator Rick Santorum's second letter to Paul O'Neill dated August 30, 2001). In addition, "on October 3, 2000, House Ways and Means Committee members E. Clay Shaw Jr., R-Fla., Karen Thurman, D-Fla., and Mark Foley, R-Fla., wrote a letter to the Treasury Department expressing their opposition to a suspension 'or even a pause' in the rulings program." Sullivan, *supra* note 200. Also, "[i]n an October 20, 2000, letter, Reps. Spencer Bachus, R-Ala., Bud Cramer, D-Ala., and Robert Aderholt, R-Ala., urged the IRS and Treasury not to suspend action on section 29 ruling requests when reviewing the policy on tax credits for synfuel from coal." *Id.*

215. *See, e.g.*, Donald L. Barlett & James B. Steele, *The Great Energy Scam*, TIME , Oct. 4, 2003, *available at* http://www.time.com/time/magazine/article/0,9171,493241,00.html#ixzz26SmPUc3A ("The IRS review of the synfuel industry has for the time being halted the buying and selling of credits.").

216. *Cf.*, Charles A. Rose, Note, *The Tax Lawyer's Dilemma: Recent Developments Heighten Tax Lawyer Responsibilities and Liabilities*, 2011 COLUM. BUS. L. REV. 258 (2011). In his note, Mr. Rose argues that "the strict liability feature of the codified economic substance doctrine is unfair to the taxpayer and hinders the ability of courts to analyze the facts and circumstances of each case," and further argues that the "idea that strict liability serves as an effective deterrent to tax lawyers engaged in tax shelter promotion is misplaced, as tax lawyers are regulated under standards of professional responsibility, rather than through understatement penalties." *Id.* at 292–93.

their tax returns."[217] Taxpayers are thus encouraged to play the so-called audit lottery.[218]

As noted above, the chance of detection has a great deal of influence on the expected value of a shelter. However, given the sheer number of taxpayers and the limited number of IRS agents (and the fact that the IRS published its audit data), taxpayers have a relatively clear view of their audit likelihood. Two modest changes could change a taxpayer's expected value calculation: (1) require opinion disclosure for penalty protection, and (2) extend the statute of limitations for transactions lacking economic substance or any "similar rules of law" as defined in section 7701(o).

1. Require Opinion Disclosure for Penalty Protection

The IRS could affect taxpayer behavior by requiring taxpayers to disclose any tax opinions with their returns. As a practical matter, one of the main purposes of a tax shelter opinion is, at least for transactions that do not violate the economic substance test, to avoid penalties. As such, the IRS should require taxpayers to disclose any tax opinions if the taxpayer is going to use the opinion for penalty protection. That way, the taxpayer has a choice: disclose the opinion to reduce the likelihood of penalties (but increase the transparency of the transaction to the IRS) or withhold the opinion and lose the penalty protection. Moreover, by giving the taxpayer the choice of whether to disclose the opinion, the government puts the onus on the taxpayer. In either case, the potential cost of the shelter rises from an expected value perspective: either the probability of detection increases because the opinion was disclosed or the cost of getting caught increases because the taxpayer loses its penalty protection ability based on nondisclosure of the opinion.

2. Extend the Statute of Limitations

Another change the government should contemplate is extending the statute of limitations for tax shelter participants. Such a change will increase the likelihood of detection, thereby decreasing a taxpayer's expected value of participation.

Currently, the government has three years to identify and challenge a taxpayer's return. As noted above, the government unsuccessfully sought to extend the three-year statute of limitations in Son of Boss cases, and, had

217. *See* Holmes, *supra* note 165, at 1422.

218. *See* Raskolnikov, *Crime and Punishment*, *supra* note 195, at 582.

they been successful, such extension would have brought in over a billion dollars in taxes. The IRS and Treasury should ask Congress to extend the statute of limitations for 7701(o) transactions from three to six years, a recommendation previously sought with respect to other types of tax shelters.[219] Some lawyers have already opined on how the *Home Concrete* decision can help taxpayers by limiting their risk to three years.[220]

C. Increase the Cost of Failure

The costs of a tax shelter's failure are, for the most part, quantifiable. To change behaviors, those costs need to increase. Three obvious candidates to increase those costs are: (1) add hard to quantify costs; (2) make it easier for taxpayers to sue their advisors; and (3) increase the interest costs to the actual return taxpayers received on the money they saved up front by participating in the shelter.

1. Add Hard to Quantify Costs

The IRS and Department of Justice need to focus more resources on holding tax shelter participants criminally liable. Too often, all taxpayers (not just the wealthy) think of cheating on their taxes as simply a way of doing business. Even when promoters are caught, their tax shelter clients sheepishly claim to have been duped and act outraged that there was tax cheating going on. Arguments for criminalization will often fail, because the line for most taxpayers is not between "tax evasion and tax avoidance" as some suggest.[221] Rather, the line is really between impermissible tax avoidance and permissible tax avoidance, and that line is not a line at all, but a hazy field where tax professionals play. Notwithstanding those pressures, an increased effort to find criminal violations in tax shelters could bear fruit. Having worked in the tax shelter industry for a number of years prior to joining the Department of Justice's Tax Division, and having

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219. *See, e.g.*, U.S. SENATE, PERMANENT SUBCOMM. ON INVESTIGATIONS, STAFF REPORT ON TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 17 (2008), *available at* www.hsgac.senate.gov/public/_files/071708PSIReport.pdf ("Congress should extend from three years to six years the amount of time IRS has after a return is filed to investigate and propose assessments of additional tax if the case involves an offshore tax haven with secrecy laws and practices.").

220. *See* Thomas Jaworski, *Home Concrete Decision Alters Accounting, Reserves for Uncertain Tax Positions*, TAX NOTES TODAY, Aug. 29, 2013 (citing Matthew D. Lerner at Steptoe & Johnson LLP in noting that "Companies should no longer feel obliged to retain their reserves [for uncertain tax positions] beyond the three-year limitations period").

221. *See* Holmes, *supra* note 165, at 1417.

prosecuted tax cheats while there, I can attest to the fact that there were a number of prosecutable crimes hidden in many of the Son of Boss and CDS tax shelters (particularly for prosecutors with experience in the area). Unfortunately, few prosecutors are equipped to unravel a tax shelter, and, for better or worse, the government tends to seek out the low hanging fruit when looking to criminalize tax shelter conduct.[222]

2. Make It Easier for Clients to Sue Their Advisors

While most of the proposals noted herein refer to the demand side of the equation, one supply side proposal is warranted: make it easier for clients to sue the tax shelter promoters. In the past few years, taxpayers have increasingly brought malpractice cases against their advisors for tax shelter transactions.[223] Some have noted the increase in malpractice cases, and argued that the increase, coupled with greater government opprobrium, has

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222. Two relatively recent tax shelter cases against individuals associated with some of the largest tax shelter promoters in the United States bears this out. In one, *U.S. v. Greenstein*, the government prosecuted two tax shelter promoters for a tax scheme based on an offshore fund they claimed had over $9 billion in assets, but, according to the government, in fact had "no assets or employees." *See* Press Release, DOJ, Former Quellos Executives Sentenced in Offshore Tax Shelter Scam Involving More than $9.6 Billion in Phony Stock Sales, Men Fabricated Losses as a Tool to Help Wealthy Avoid Taxes (Jan. 28, 2011), *available at* http://www.justice.gov/usao/waw/press/2011/jan/quellos.html. The indictment filed in that case is available at http://www.justice.gov/usao/waw/press/2011/jan/pdfs/quellos%20second%20sup%20indictment.pdf. In another criminal tax shelter case, KPMG, the accounting firm, admitted to criminal wrongdoing and agreed to pay $456 million in fines, restitution, and penalties as part of an agreement to defer prosecution of the firm. Press Release, IRS, KPMG to Pay $456 Million for Criminal Violations IR–2005–83 (Aug. 29, 2005). As part of the same case, two KPMG partners and a lawyer they worked with were also convicted of tax fraud. The KPMG-related prosecution was part of a larger case, *U.S. v. Stein*, 541 F.3d 130 (2d Cir. 2008). In *Stein*, thirteen codefendants were dismissed because, according to the Second Circuit (and some very talented attorneys), the government improperly forced KPMG to stop paying the defendants' attorneys' fees. *Id.* at 135. The *Stein* court determined that such interference "deliberately or callously" prevented many of the defendants from getting funds for their defense, blocking them from hiring the lawyers of their choice. *See, e.g.*, *Charges Against 13 KPMG Defendants Dropped*, CBSNEWS (Feb. 11, 2009, 4:32 PM), http://www.cbsnews.com/2100-500395_162-3061910.html. I am unaware of any non-white collar defendants having success with the argument that they were prevented from hiring their attorney of choice because the government pressured the criminal enterprise for whom they worked from paying their legal bills.

223. *See, e.g.*, Jay A. Soled, *Tax Shelter Malpractice Cases and Their Implications for Tax Compliance*, 58 AM. U. L. REV. 267 (2008). Professor Soled noted that although it is impossible to determine with accuracy the number of malpractice cases, with so many taxpayers settling tax shelter transactions in the 2000s, it was "reasonable to assume that a significant number of these former shelter investors subsequently sued their tax advisors for . . . , at the very least, fees associated with the failed tax shelter advice." *Id.* at 268 n.1.

caused many tax professionals to stop promoting aggressive, large-scale tax shelters.[224] While possibly true, a better explanation is the economy from 2008 onward. As a practical matter, tax shelters are valuable only to taxpayers with income to shelter, and since 2008, fewer clients have been in the market to shelter hundreds of millions of dollars of gains.

Although the government's efforts and the increase in malpractice cases may have had an impact, it is far too early to determine whether that impact will last through the next bull market. Nevertheless, the government should act to diminish the procedural hurdles to tax malpractice suits, starting with the statute of limitations for taxpayers seeking to institute such suits.

Courts interpreting state law have most often used four different starting points for the statute of limitations, including (1) when the malpractice occurred; (2) when the malpractice was discovered or discoverable; (3) when the injury was suffered; and (4) when the injury was discovered or discoverable.[225] Those four starting points lead to an array of difficult issues for the courts, because using those four starting criteria, the statute of limitations could begin (1) when the advice is rendered; (2) when the tax return is submitted; (3) when the IRS issues a public pronouncement (which has no legal effect) challenging a transaction's tax benefits; (4) when the IRS audits a taxpayer's return; or (5) when the case is finalized, either by settlement or when the taxpayer has completed litigation and appeal opportunities have been exhausted.[226] The problem is worsened by the long lead time of tax shelter cases. The 2012 *Home Concrete* decision was based on a tax shelter transaction for which returns were filed in 1999 and 2000. While the taxpayer prevailed in *Home Concrete*, had the taxpayer lost and decided to institute a tax malpractice case against its advisors, there could be numerous possible starting points for the litigation: (1) when the tax advice was rendered (1999-2000); (2) when the returns were submitted (2000-2001); (3) when the IRS issued its first Son of Boss pronouncement (2002); (4) when the taxpayer's return was audited (2006 in the *Home Concrete* case); or (5) when the Supreme Court decided the *Home Concrete* case (April 25, 2012).[227]

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224. *Id.* at 269–70.

225. *See id.* at 316–17 (citing BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE § 601.2.3 at 461–62 (6th ed. 2004)).

226. Soled, *supra* note 222, at 317, (citing Jacob L. Todres, *Investment in a Bad Tax Shelter: Malpractice Recovery is No Slam-Dunk*, 107 TAX NOTES 217 (2005)).

227. U.S. v. Home Concrete & Supply, LLC, 132 S. Ct. 1836 (2012); Patrick Temple-West, *Supreme Court Restrains IRS in Tax Shelter Case*, REUTERS (Apr. 25, 2012, 1:03 PM), http://www.reuters.com/article/2012/04/25/us-usa-tax-supreme-court-idUSBRE83O11920120425.

A clear problem with providing a longer statute of limitations for these cases is that it provides a benefit to one group (the super-wealthy taxpayers playing the shelter game) against another group (the just plain wealthy who charge fees selling tax shelters to the super wealthy). However bad the optics of such a rule, if the goal is stemming the tide of tax shelters, such a provision could move the needle on a promoter's desire to create, market, and implement new tax shelters, at least those for which the primary goal is to avoid detection because the underlying transaction is meritless.

3. Change the Interest Calculation

The government should re-tool the interest calculator for tax shelter underpayments and associated penalties. When taxpayers are required to repay the taxes avoided from prior years (underpayments) after a determination that those tax benefits were unwarranted, the law requires the taxpayer to pay those taxes back with interest. Section 6621 of the Internal Revenue Code establishes the rates for interest on tax underpayments and penalties,[228] and that rate is equal to the federal short-term rate[229] plus 3% (or 5% for "large corporate" underpayments)[230] (collectively, the "underpayment rate").[231]

That underpayment rate often fails to match the earnings the taxpayer makes on his or her funds in the time period between when the taxpayer realizes the benefits and the time the government is repaid with interest. Those earnings are often a windfall for the taxpayer, rewarding the taxpayer's gambit with a time value of money bonus. From January 2002 through January 2012, the underpayment rate for individual taxpayers has been between 3% and 8%, and for corporate taxpayers has been between 5 and 10% for large corporate underpayments.[232]

Instead of charging a set rate, the government should require taxpayers to provide, under penalties of perjury, a calculation of their earnings since the tax benefits were realized. Once that amount is calculated, the taxpayer should be required to pay the greater of the underpayment rate or the earnings on the tax benefits. As most taxpayers will have provided the

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228. Rev. Rul. 2011-18, 2011-39 I.R.B. 428.

229. The federal short-term rate is determined in accordance with I.R.C. § 1274(d) during January of each year and is published in a Revenue Ruling. For 2012, the rate was published in Revenue Ruling 2012-7, 2012-6 I.R.B. 362, to take effect beginning February 1, 2012.

230. *See* I.R.C. § 6621(c) (2006) and Treas. Reg. § 301.6621–3 (1992) for the definition of a large corporate underpayment.

231. I.R.C. § 6621(c) (2006); Treas. Reg. § 301.6621–3 (1992).

232. Rev. Rul. 2012-8, 2012-13 I.R.B. 563, 571.

government with at least one check to whatever calculation they provide (the tax returns filed in the interim), the government has a natural check to determine the veracity of the taxpayer's calculation. Moreover, by requiring a jurat, the government would also create a not-strictly-economic variable to the expected value calculation: the threat of prison for perjury.

VI. CONCLUSION

The technical tax shelter has not disappeared. What has disappeared is the income that has driven the shelters—the economy of the past few years has not given taxpayers great need to shelter income. In all likelihood, that will change in the future, and taxpayers will be flocking to tax shelters again. While the activity in the area is slow, the government should shore up its defenses, else it will be again overwhelmed by a herd of one-off tax shelters.

As noted above, economic substance is opportunistically easy to structure around and provides little deterrence to sophisticated tax planners. For the better part of my pre-academic life, I worked in the tax shelter area, structuring them, writing opinions for them, attacking them (occasionally) as a federal tax prosecutor, and finally defending the people who participated in them. One clear lesson in that last role is that the biggest determinant of whether the IRS attacked your transaction was the amount of greed built in. That greed was often in the form of a transaction that made no economic sense, but generated outsized tax benefits. After looking at many such transactions over and over, it became clear that the transactions at issue could have been structured to avoid failing the economic substance test at little cost to the taxpayer. However, greed often overwhelmed sensible tax planning, because the benefits outweighed the costs. If the government wants to slow the spread of shelters that will go along with the next boom cycle, it should act now to change the calculus and make the potential costs more of a factor in wealthy taxpayer's calculus.