

This is a preliminary draft. There are sections that I have not yet drafted and sections that I cut in order to make it a more manageable length for the presentation. I have tried to indicate omissions. I welcome comments. Please do distribute or quote without permission.

Optimal Deterrence and Corporate Tax Shelters
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Abstract

Over the last decade corporations have increasingly used sophisticated tax shelter techniques to sharply reduce corporate income. While Congress has bemoaned this state of affairs, it has adopted very few provisions that might be effective in shutting them down. The IRS has aggressively sought out shelters, but has been stymied by the difficulty in locating the users and the lack of effective enforcement tools. This paper applies optimal deterrence theory to the tax shelter problem. It uses evidence from cases and press reports to show that corporate tax shelters users are utilizing a cost benefit analysis for decisionmaking. That calculus illustrates that the odds of detection are low and the odds of a penalty are even lower. The tax benefits are so low that they swamp the costs. The paper explores what kind of structure optimal deterrence theory would lead to and whether such a structure is feasible.

I Introduction

The corporate tax shelter problem generally is considered a serious threat to the fisc. The government estimates that abusive tax shelters cost the government approximately \$15 billion annually between 1993 and 1999. As of October 2003 the IRS had identified about 6400 individuals and corporations that had bought abusive tax shelters.¹

Individual shelters were prolific in the 70's and early 80's but they were effectively shut down by substantive changes to the law in the 1986 reform act. These changes did not apply to corporations, however. In place of the earlier shelters, corporate tax shelters have arisen that are quite different and have proven remarkably difficult to shut down. A huge amount of effort has

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¹Senate Finance Report 11/03, par. 57 No one really has a clue what the number is. Suffice it to say it is a big number.

been expended in trying to deter investment in corporate tax shelters but so far the government has not been hugely successful. This paper explores that puzzle and asks how sanctions might differ if optimal deterrence theory were utilized.

II Deterrence and Tax Compliance

Optimal deterrence theory is based on the assumption of a rational actor or decision maker. Applied usually to criminal or tortious conduct, it assumes that the actor is rational and informed and his behavior will be affected by penalties. A second assumption is that social welfare is improved if each dollar spent produces a dollar of value. Thus, the optimal penalty structure is one in which each dollar spent offsets a dollar of harm. These two assumptions lead to a structure that takes into account the actor's knowledge, attitude towards risk, probability of detection and so on.

Risk aversion is a key factor in an economic analysis of optimal penalties. Optimal penalty theory proceeds from the observation that the penalty for a crime should be set at the loss created by the offense adjusted to reflect the probability that the offender will escape detection. The goal is to require offenders to pay the full cost of their activity. So if a specific crime results in social costs of \$1000 and the probability of detection is 100%, the offender bears the social cost of the crime if the penalty is set at \$1000. A fine is economically efficient only if the offender pays the fine every time she engages in the activity. Since full enforcement is expensive, the penalty must vary with the odds of detection. If the probability of detection is 10%, the fine must be \$10,000 and so on, so that each penalty leads to an *expected* penalty of \$1,000. Generally we would choose an enforcement mechanism that has the lowest costs. If the costs of detection are high and the cost of collecting penalties does not vary with the rate of the fine, optimal deterrence would call for few resources devoted to raising the probability of detection and very high penalties.

Many scholars have accepted the usefulness of optimal deterrence theory in setting criminal sanctions and in devising punitive damages in tort actions. It has also been subject to a significant amount of criticism on the grounds that not all actors are rational and that people are unlikely to accept the resulting outcomes.

To date optimal deterrence theory has not been applied to corporate tax avoidance or evasion, a type of regulatory malfeasance that usually is not criminal in nature. Something very like it, however, is common with respect to individual taxpayer compliance, i.e. the decision whether to pay taxes. Economists traditionally have approached individual compliance by assuming the taxpayer is engaging in rational decisionmaking under uncertainty. Generally economists argue that the decision to comply with the tax laws is a rational choice to maximize utility. Evasion will be based on an ex ante analysis of the benefits. It is a gamble that either will produce tax benefits or with some unknown probability will result in penalties. The level of compliance is chosen by weighing compliance, which depends on factors such as the probability of the evasion being detected, the taxes, the interest and penalties, reputational damage if detected, risk aversion, and evasion of taxes. Thus noncompliance should respond to higher probability of detection (and therefore sanction) as well as higher penalties.² Despite this work with respect to individual compliance, there is very little evidence that it has been applied in practice.

That may be because, as in other areas, scholars have generally questioned whether behavioral influences weaken the case for a rational choice model. Some argue that since deterrence relies on a perception of risk rather than the risk itself, the probability of detection is

²See generally Gary Becker, *Crime and Punishment: An Economic Approach*, 76 *J. Pol. Econ.* 169 (1968). The seminal work with respect to taxation is Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 *J. Pub. Econ.* 323 (1972).

often misjudged, skewing the deterrence effect. Much of the literature is also concerned with whether actors actually calculate potential harms and benefits of a particular action. Facts such as personal satisfaction or physical danger would seem to be irrelevant for corporations. With respect to tax compliance specifically, some scholars have used a sociological or psychological perspective to question the narrowness of this approach, and have argued that notions of civic duty, morality, perceptions of fairness, shame, peer pressure, social risk, loss of job or reputation will also be a factor in the calculus.³ Some of these social consequences have been built into the economic models. Others argue that they make the economic model unworkable. Behavioral economists also question whether the decisionmaker understands the uncertainty or the probability.⁴ In the tax arena much of this work is an attempt to explain why anyone pays taxes. For most individual taxpayers, the probability of detection approaches zero and penalties are quite low. Thus, the argument goes, the economics of evasion approach cannot explain everything.

Almost all of the compliance work exploring this concept has been done with individual taxpayers.⁵ These critiques based on these behavioral theories and limited rationality seems to have little application to corporations investing in tax shelter strategies. Optimal deterrence theory seems particularly well-suited, however, to designing sanctions that would deter corporate investments in tax shelters. First, without entering into the debate whether all actors are rational,

³See generally Joel Slemrod, *Why People Pay Taxes: Introduction*, in *Why People Pay Taxes* (Joel Slemrod, ed. 1992).

⁴Tversky and Kahneman 1974

⁵ See Eric M. Rice, *The Corporate Tax Gap: Evidence on Tax Compliance by Small Corporations* 125-126 in *Why People Pay Taxes* (noting the lack of scholarly analysis with respect to corporate tax evasion). Rice's study is limited to small corporations, which are much less likely to use tax shelters of the type discussed here and who also face a different calculus.

it is easy to make the case that corporate officers, particularly those in charge of the tax departments of large corporations, are rational actors. It is also easy to believe that they are well-informed about the outcomes of their actions, including the probabilities of detection and penalties. And finally, there is ample evidence that their behavior is affected by this knowledge. And while it is true that individuals make corporate decisions, it appears that almost none of the sociological limitations have any impact on the decision whether to advise the firm to invest in a corporate tax shelter. While there may be some doubt about the value of the classic rational decision model in other contexts, it appears to work well with respect to corporate tax shelters.

One other critique seems inapposite. A standard argument against optimal deterrence theory is that punishment is not based on any moral evaluation of the actor's conduct. The claim is that a system of punishment that is divorced from the morality of the crime is unjust because any offense is tolerated so long as the offender can pay the price. This leads to an alternative retributive theory of penalties. Such a theory seems to have no place in the discussion of sanctions for investments in tax shelters. A determination of the offender's intent—intentional or negligent—and assessing a penalty commensurate with the offense has never had a role in the corporate tax shelter discussion. There is no desire to punish the corporation; the only interest is in deterrence. Thus, while there may be some doubt about the value of the classic rational decision model in other contexts, it works very well with respect to corporate tax shelters.

III The Tax Shelter Story: Cost Benefit Analysis

It is helpful in designing optimal deterrence enforcement schemes to have a clear insight into the offender's rational decision making. In the case of tax shelter investors, we need not speculate what that process involves. In the last several years various enforcement efforts,

journalistic investigations, commentary by practitioners, congressional investigations and litigation by angry clients have given us a fairly good picture of the decision making process with respect to tax shelters.⁶ The general agreement is that the corporation is doing a risk-reward analysis; all descriptions and comments support the view that the corporation is a rational decision maker.⁷ Thus, a focus on risk is appropriate.⁸ Using this data, below I paint a general description of such a process and then use that description to discuss what optimal deterrence would look like

⁶ [The paper includes a lot of fascinating detail that I have omitted here, but to give you a sense. The Senate Finance Committee held hearings last fall in which KPMG was forced to disgorge many examples of internal memoranda, e-mail exchanges and previously confidential promoter material that illustrated exactly how they structure their promoter efforts, including their relationship with leading law firms. The IRS has litigated a number of cases and the opinions in those cases include detailed information not only about the shelters but also about their promotion and the kinds of opinion letters that were used. They also provide numbers from which a risk-reward calculus can be derived. Several disappointed investors have sued promoters and lawyers and the papers in those cases include rich detail about why the investors decided to purchase the strategies that failed. The specialized media (primarily Tax Notes) reveal details about shelters that are slipped to their “shelter correspondent.” The popular media (especially the Times, 60 Minutes and Frontline) have all interviewed investors and these interviews provide additional information. Finally, several practitioners have published articles outlining exactly how a firm should evaluate tax strategies, including the components of a risk-reward calculus.

⁷1 Joint Comm. on Tax’n, Interest and Penalty Study par. 75 (July 22, 1999), 1999 TNT 143-33, available at LEXIS, Tax Analysts File; For a general discussion see James Andreoni, Brian Erard & Jonathan Feinstein, Tax Compliance, 36 J. Econ. Lit. 819 (1998).

For a walk-through of such a cost-benefit analysis with respect to tax shelters, see David C. Garlock, A Tax Executive’s Guide to Evaluating Tax-Oriented Transactions, 39 Tax Management Memorandum S-46 (Feb. 16, 1998). Garlock offsets against the potential tax benefits (taking into account risk of failure) the following: nontax business risks, tax planning and implementation costs, cost of litigating, risk of penalties and interest on underpayments. See also Bankman, at 1778, who does a similar analysis for a specific shelter.

⁸Calvin H. Johnson, Corporate Tax Shelters, 1997 and 1998, 80 Tax Notes 1603 (1998). Unofficial Transcript of Finance Committee Hearing on Revenue-Raisers in President’s Budget (Apr. 27, 1999) (Statement of Harold Handler, chair, Tax Sec. N.Y. St. Bar Ass’n) 1999 TNT 84-141, available in LEXIS, Tax Analysts File (with respect to tax shelters the “possibility for the benefit far exceeds the potential risk”).

with respect to shelters and why it may be difficult to reach that end state.

In most cases, the head of the tax department or the CFO of a large corporation is approached by a representative of a large accounting firm or an investment bank who is promoting a tax shelter. The promoter, offers the corporation a transaction that let's say will produce a \$150 million tax loss, which will produce a \$52.5 million tax benefit (at 35%). This is enticing precisely because the corporation has \$150 million in gains that it would like to shelter. The shelter is a transaction that will produce artificial losses, that is, losses that can be deducted for tax purposes but that are not economic. Ideally, the corporation bears little risk of loss and will not have to show these losses for book purposes. Thus book income will remain high and earnings per share will be high without regard to the shelter.

The promoter also offers a "more-likely-than-not" opinion written by a major law firm so that the odds of a penalty being imposed even if the firm loses on the merits are probably zero. A more-likely-than not opinion is one that opines that the chances of the strategy succeeding on the merits if litigated are more than 50%. Assume the firm believes the economic risk of losing is 49%. Let's also assume there is only a 30% chance of detection by the IRS. There are two economic costs. The first is the risk of losing (49%) multiplied by the risk of detection (30%) or 15% of \$52.5 million=\$7.9 million. (There is no risk of penalty). The other cost is the transaction costs (including promoter and attorney fees). Let's assume these are \$8 million. But if those costs are deductible at 35%, the net transaction costs are only \$5.2 million. The expected value is therefore \$39.4 million (ignoring the time value of money). This number would decrease if we thought there was a risk of reputational loss or there was the risk of litigation costs or if the corporation was

particular risk adverse for some other reason⁹. And a complete cost-benefit analysis would include management time in reviewing the shelter and the effect on other items if audited, as well as the effect on future items. To err on the conservative side, add another \$4 million costs so that the net expected benefits are \$35 million.

Or assume that despite the more-likely-than not opinion, a dispassionate observer would say that there is only a 20% chance of succeeding on the merits if litigated and the firm uses these odds in the risk reward calculus. In that case the potential loss is \$12.6 million (80% risk of loss x 30% risk of detection and zero risk of penalty). After costs, the expected return is \$34.7 million. Assuming a \$4.7 million discount for risk aversion, management times, litigation, and reputational costs, the expected benefit is \$30 million.

Now assume the worst-case scenario. Assume that the shelter is detected and the IRS asserts that it is invalid. In the worst case, all of the tax benefits are denied. The taxpayer is out the transaction costs and if it chooses to litigate the litigation costs. Assuming the corporation has penalty protection, the only “penalty” if the taxpayer is wrong is the imposition of interest on the deficiency. Clearly this may not even be a penalty—it is a loan from the government, and depending on the interest rate, may even be favorable.¹⁰ But this truly is a worst case scenario because in many cases the IRS will settle. Suppose the IRS were willing to settle for \$6 million (of the \$52.5 million). The taxpayer essentially covers the transaction costs and walks away. [From now on I ignore this possibility, but I could re-run the numbers assuming settlements.] As an

⁹ Corporations should be risk neutral. Polinsky and Shavell

¹⁰The interest rate is equal to the federal short-term rate plus five percentage points, IRC 6621(c), but does not apply until 30 days after the earlier of the date of the deficiency notice or a letter of proposed deficiency triggering administrative review, and the interest is deductible.

economic matter, corporations take on additional risk without subjecting themselves to any additional cost. The business judgement will be to acquire the shelter.

Let's go back and analyze each piece of this cost-benefit scenario to get a better sense of where the government might make changes that would deter behavior.

Tax Benefits: [This section describes the kind of shelter and the benefits to be derived. Generally they rely on a literalist reading of some Code provision that ignores any congressional intent. This part is probably only interesting to the tax cognoscenti.]

Other Benefits: A key element of the ideal tax shelter is that it creates tax benefits without reducing book income. If that happens, earnings will not fall. The combination of decreased tax liability but high earnings sends a two-prong positive signal to investors. It also may provide personal benefits to corporate actors whose stock options or other benefits may be keyed to earnings.

Risk of Detection: In the case of large corporations, the risk is not the risk of audit since most tax shelter buyers would be subject to the coordinated examination program, meaning that they are constantly under audit. Studies that attempt to determine the effect of the probability of an audit on compliance are therefore useless with respect to large corporations. The risk is detection of the shelter itself. If the corporation can succeed in keeping the shelter from the audit agenda agreed to by the agent and the corporation, the fact that it is under audit is irrelevant. Most practitioners believe that there is a "very reasonable prospect" that a shelter will win the audit lottery and go undetected or unchallenged.¹¹ This is attributable to a number of factors. Many

¹¹ For a statement that there is a "very reasonable prospect" that a shelter will win the audit lottery and go undetected or unchallenged, see Revenue Provisions in the President's FY2000 Budget: Hearings Before the Subcomm. on Oversight of the House Ways and Means

shelters are extremely complex, involving many layers of entities and participation by an array of third parties. Almost always they are based on a clearly allowable loss or deduction (in other circumstances) that would not by itself trigger suspicion on the part of the auditor. And most importantly, it is universally agreed that IRS personnel are simply outgunned. Many would not understand the shelter even if it were disclosed.

Nevertheless, Congress and Treasury have adopted a number of rules requiring disclosure of tax shelters on the corporate return. Although intuitively, one would think this has increased the odds of detection, it is not clear whether firms are actually complying with the disclosure rules or whether the IRS is able to use the information provided.

Penalties: The penalty provision is in many ways the most interesting part of this calculus because the current state of affairs is essentially that there is no penalty. Why that is so requires some explanation.

The primary penalty that might apply to the corporation purchasing a tax shelter is the substantial understatement penalty, which is imposed at a rate of 20 percent and applies to an underpayment. [deleted text w/r/t penalties on other players] A corporate taxpayer whose understatement is attributable to a tax shelter is unable to use the normal means of avoiding the penalty (reliance on substantial authority, etc.).¹² The penalty is abated only if the so-called reasonable cause exception applies, that is, that there was reasonable cause for the underpayment

Comm., 106 Cong. 4 (Mar. 10, 1999) (statement of Stefan F. Tucker, Chairman, ABA Tax Sec.).

¹²A noncorporate taxpayer may avoid the penalty if s/he establishes that there is substantial authority for the position an the taxpayer reasonably believed that the treatment was more likely than not the proper treatment. 6662(d)(2)

and the taxpayer acted in good faith.¹³ The regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.”¹⁴ [deleted technical detail on exception] This type of opinion is referred to as a “more-likely-than-not” opinion.

Technically, the reasonable cause exception does not prevent imposition of the substantial understatement penalty,¹⁵ but it is widely viewed as doing so.¹⁶ There are virtually no cases

13 IRC 6664c

¹⁴Reg. 1.6662-4(g)(4)(i)(B); 1.6664-4(c). [check it may be -4 (e) .

¹⁵Quote regs. One possible answer to this problem is simply to apply the regs as they are written. If the transaction does not have a business purpose or has tax benefits that are unreasonable compared to the investment or that involve confidentiality arrangements, it is hard to see how the reasonable cause exception could apply. See *Treas Cor. Tax Shelter Study* at 257 (“one may rhetorically question whether there ever is any reasonable excuse for entering into a corporate tax shelter transaction”).

There is a fair amount of case law applying the reasonable cause exception to individual taxpayers and a reading of it would suggest that it would not apply in tax shelter cases. Courts generally require that the tax adviser had sufficient expertise to justify reliance, the taxpayer provided necessary and accurate information and the taxpayer actually relied in good faith on the the adviser’s judgement. See, e.g., *Ballantyne v. Commissioner*, 83 T.C.M. 1896 (2002). Generally, the taxpayer must make full disclosure of all the relevant facts. See, e.g., *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9 Cir. 1988) (no reliance where accountant knew nothing firsthand about a shelter). In addition the adviser must be disinterested. See, e.g., *Goldman v. Commissioner*, 39 F.3d 402, 408 (2d Cir. 1994); *Chakales v. Commissioner*, 79 F.3d 726 (9 Cir. 1996), cert. denied, 117 S.Ct. 85 (1996). *Neonatology Associates v. Commissioner*, 115 T.C. 43, 98 (2000) (taxpayer cannot reasonably rely on the advice of a tax shelter promoter).

¹⁶ See *Treas. Corp. Tax Shelter Study* at 240 (“many commentators note that the ... penalty is not ... effective ... because the reasonable cause exception ...has become an almost fool-proof escape hatch from the penalty regime.”); *ABA Testimony*, 3/10/99 at 4 (“existence of a favorable opinion is generally thought to insulate the taxpayer from penalties for attempting to understate its tax liability”); *Bankman* at p. 1779 (“in practice, any run-of-the-mill opinion letter is thought to

where the penalty has been applied¹⁷ and it is not clear why the penalty has not been imposed more often.¹⁸ But the IRS generally waives the imposition of this penalty whenever a corporate taxpayer produces a favorable opinion letter from a professional tax advisor. Thus, a promoter always supplies an opinion letter issued by a large law firm as part of its sales pitch. The letter indicates that the tax shelter “more likely than not” will succeed and that the client will not face

insulate the taxpayer from the substantial understatement penalty.”). The IRS and the courts apparently are disinclined to impose penalties. See Treas. Corp Tax Shelter Study at 250; JCT Tax Shelter Study 11/99 at n. 130 (regulations are not being enforced due to uncertainties regarding their application) ; Lee A. Sheppard, *Corporate Tax Shelters: Red Herrings and Real Solutions*, 91 Tax Notes 2075 (June 18, 2001) (stating that the government should issue a ruling saying taxpayers cannot rely on third-party opinions as penalty protection). Apparently we have to make it more transparent.

¹⁷ Ethan’s case; See *Leema Enterprises v. Commissioner*, 77 T.C.M. (CCH) 1261 (1999) (corporate); *Sheldon v. Commissione*, 94 T.C. 738, 769-70 (1990). Courts are reluctant to imposed the penalty particularly where various judicial doctrines are in doubt. See, e.g., *Peerless Indus. v. United States*, 94-1 USTC 50,043 (E.D. Pa. 1994). [Lower court in *Compaq*, 113 t.c. In *Compaq*, the penalty was based on negligence and there was no opinion. and *UPS*, TCM 268 (1999) there were apparently penalties. Those were overturned. IN *ACM* and *Winn-Dixie*, there is no reference to penalties. Check cases where IRS won.

In many cases there is no litigation with respect to the shelter. They are subject to settlement in the course of a routine corporate audit. The taxpayer settles for a percentage of the tax benefits claimed and no penalty is assessed. See *Garlock* at S-53 (“Note that the IRS routinely threatens penalties and offers to waive them in settlements”). The IRS does not have the resources to even engage in settlement offers with all known cases of tax shelters. In that case, nothing will be collected. See David Cay Johnston, *Crackdown on Tax Cheats Not Working*, Panel Says, NY Times at C2 (Oct. 20, 2003) (“About eight of 10 known tax cheats are let go without having to even pay the taxes, interest or penalties.”).

¹⁸ One possibility is there almost always is an opinion and there may be some uncertainty what facts would allow the penalty to be imposed in any event. See *Hearings on Corporate Tax Shelters Before the House Comm. on Ways and Means* (statement of Lindy Paull, chief of Staff, Joint Comm. on Tax’n) (Nov. 10, 1999), 199 TNT 218-20, available in LEXIS, Tax Analysts File (facts and circumstances necessary to satisfy reasonable cause is widely disputed). Paull also states that “the IRS generally waives the imposition of this penalty whenever a corporate taxpayer produces a favorable opinion letter from a professional tax advisor.”

penalties.¹⁹ Current opinions are designed specifically to be penalty protection. They do not provide any real information to the client and are often based on misrepresentations in the opinion letter.²⁰ Most important, they are not client-specific. ²¹[The letter comes as part of part of the

¹⁹ See Amy Hamilton, *Leading Class-Action Law Firm Investigates Shelter Promoters*, *Tax Notes* 567 (Nov. 3, 2003). The accounting firm may enter into an arrangement with a law firm. For example, the tax shelter opinions in transactions marketed by KPMG come from Brown & Wood. The two firms entered into an alliance to develop and market tax products for wealthy individuals and publicly traded corporations. Amy Hamilton, *IRS to Serve More Summonses, Updates Shelter Stats*, *Tax Notes* 567 (Nov. 3, 2003). Court documents (check) indicate that Sidley Austin Brown & Wood provided an estimated 600 opinions and “non-client specific” information on listed transactions.

²⁰In testimony before the Senate Finance Committee, a senior manager for KPMG testified that tax professionals ignored unfavorable facts and law “shifting the responsibility for those false facts to tax shelter clients via the facts and representations in the tax opinion letters.” See *Testimony of Michael Hamersley*, 2003 TNT 204-35. The Senate Finance Committee report indicates that the representation of facts in the opinion letter came from KPMG and not from the client. In some cases they factual representations were false or misleading. See *Senate Report* at par. 37

²¹ There is some question whether it is even ethical for a lawyer to deliver such an opinion. They do not appear to conform to current standards. Lawyers who produce such opinions are theoretically subject to ABA Formal Opinion 346, which lays out standards applicable to lawyers who issue tax shelter opinions, as well as Circular 230,....

ABA 346 holds that a lawyer should make inquiry into the relevant facts and not accept as true that which he should not reasonably believe to be true. On the other hand, the lawyer has no responsibility to audit the client’s affairs or to assume that a client’s statement of facts is not true. The opinion also holds that the lawyer should relate the law to the actual facts and should not fail to analyze the critical facts or discuss purely hypothetical facts. The lawyer should also if possible state his opinion of the probable outcome on the merits of each material tax issue. Most important, however, the opinion requires the lawyer providing an overall evaluation of the shelter the extent to which the tax benefits in the aggregate are likely to be realized. The opinion indicates that the lawyer should state that “the significant tax benefits, in the aggregate, probably will be realized or probably will not be realized, or that the probabilities of realization and non-realization of the significant tax benefits are evenly divided.”

standard package that the promoter markets to potential investors and is sold as “insurance.”²²

The opinion might also be useful in providing cover to the executive who approved the transaction should it go awry. (An attorney at an important firm put in writing that it was more likely than not a successful strategy. How was I to know otherwise?)

The law firm is paid a lucrative fee for each use of the opinion letter. The accounting firm often drafts its own prototype tax opinion letter, which it then sends to clients. It also often arranges for an outside law firm (often the same firm) to provide a second favorable opinion letter (distinguished from the marketing opinion and generally used as the documentation for penalty protection). The accounting firms either direct clients to the firm or in some cases obtain the client’s opinion letter from the law firm without the client ever having any contact with the law firm. The law firm is involved only because it agreed in advance to provide a favorable letter to the accounting firm’s clients. Even if the firm recommended by the promoter is not used, the corporate client seeks a canned more-likely-than-not opinion—there appears to be no interest in the

²² Senate Finance Comm report indicates that KPMG told its tax people to tell clients worried about penalties the following: “The opinion letters that we issue should get you out of any penalties. However, the Service could try to argue that KPMG is the promoter of the strategy and therefore the opinions are biased and try and assert penalties. We believe there is very low risk of this result. If you desire additional assurance, there is at least one outside law firm in NYC that will issue a co-opinion. The cost ranges between \$25k–\$40k.” at par. 167
Much information about the practice comes from a case involving Henry Camferdam, whose litigation against Ernst & Young was featured in a 60 Minutes profile and who testified about his experience before the Senate Finance Committee. Camferdam and his partners sold his company and consulted with EY about the taxes owed. He said that EY approached him with a tax saving strategy to offset the capital gain owed on the sale. As part of the marketing, EY showed (but did not allow them to retain) the partners an opinion letter from Jenkins & Gilchrist, “which the partners were told was ‘insurance’ in the event of an audit. They suggested that the partners obtain a second legal opinion and told them that Brown & Wood could provide the opinion. Amy Hamilton, Opinion Writes Getting Off Scot-Free Former Commissioners Say, Tax Notes 571 (Nov. 3, 2003). [check finance testimony; is there a 60 minutes transcript; look for case]

best or a well-reasoned opinion.²³ There is some evidence that the compensation structure is tied to producing a specific product.²⁴ The promoter shops for a good opinion; there appears to be no interest in the best or a well-reasoned opinion .²⁵ This has dramatically changed the role of the tax lawyer from a “passive provider of advice” to “purveyors of tax ‘products.’”²⁶ Although there is much speculation as to why tax lawyers have allowed themselves to be a key part of the process, the consensus is the greed and competitive pressure are at the root of it.²⁷

²³NYSBA report 4/23/99 notes that the current penalty structure results in only consulting tax professionals who have come to a favorable conclusion about the merits of a transaction. “We are aware of experienced attorneys who counsel clients eager to enter into an aggressive transaction not to consult with them, lest the client lose the protection of the reasonable cause exception.” para. 100

²⁴Minority Staff of the Permanent Subcomm. on Investigations, U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals (Nov. 18, 2003), 2003 TNT 223-20. This report includes fascinating details about KPMG’s tax shelter practice. It includes an e-mail in which a senior tax professional asked “Are we being paid enough to offset the risks of potential litigation . . . My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit.” The report also refers to a document where the firm was paid a fee in each case where a client was told during a sales pitch about the availability of a second opinion letter from a law firm, regardless of whether the client purchased the product. See Finance Report at p. 168 (“Our deal with Brown and Wood is that if their name is used in selling the strategy they will get a fee. We have decided as a firm that B&W opinion should be given in all deals.”)

²⁵Feinschreiber & Kent at par. 144 (“[T]ax opinions are ‘shopped,’ not to the highest bidder, but the most compliant. As such, tax shelter promoters can force tax professionals to be for ‘services,’ in which these requested services include a mandatory favorable tax opinion”); Bankman at 1782 ([It is] easy for a shelter promoter to obtain a more likely than not opinion: all the promoter has to do is to ‘shop’ the opinion to more than one firm. Eventually, the promoter will find a lawyer who will give the opinion.”).

²⁶NYSBA 4/23/99 report, para 27.

²⁷Bankman, at p. 1782-83. Clients are demanding their participation, if firms opt out, they will not be at the table, large (nonhourly) fees are involved, etc. See Feinschreiber & Kent, at par. 144 (“The race is unlikely to go to the more knowledgeable, to the most competent, or even to the swift, but those practitioners most willing to do the shelter promoter’s bidding, the more unsavory, desperate, or greedy among us.”).

The current penalty structure results in only consulting tax professionals who have come to a favorable conclusion about the merits of a transaction. It is somewhat ironic that the current system actively discourages a lawyer from offering a “true” opinion. If one takes the regulations seriously, the efficacy of the penalty shield is lessened if the lawyer expresses any doubt.²⁸ A taxpayer can hardly claim to have in good faith relied on the lawyer’s opinion that the shelter works if the lawyer expresses any doubt about transaction. The client wants the answer to only two questions: Can you provide a more-likely-than-not opinion ? (yes) Will the transaction result in penalties? (no) Anything more said by the lawyer could jeopardize the answer to the second question. (Clients also have a third question: Will we be caught?—but they are fairly confident they know the answer to that question (no).)

Transaction Costs [deleted text about computation of transaction costs including compensation to lawyers and promoters]

Behavioral Costs: The initial calculation decreased the benefits by a plugged number for risk aversion and reputational concerns but for many corporations this may be of little concern or at least it cuts both ways. Over time, many corporations’ appetite for risk (at least with respect to taxes) seems to have increased. There seems to be a market for shelters that are highly unlikely to be sustained on the merits. On the other hand, corporate managers may not view investment in a tax strategy as very risky—given the frequency of settlements without penalties, there is a very small downside and a very high upside. Reputational concerns also seem to be largely nonexistent for many companies. Fortune 500 companies have been involved in the “outed” shelters and they

²⁸For a similar sort of situation with respect to patent infringement, see Y’Barbo at Section II.A.

have been subject to some press scrutiny but there does not seem to be any evidence that this has altered share price or any other indicator that might be affected by reputation. In fact, a willingness to engage in risky tax strategies to lower the tax burden may be a favorable reputational factor or may send a favorable signal to investors. Corporations may also respond to negative publicity by punishing their agents [Sprint, KPMG] when the shelter goes bad without taking a corporate reputation hit.

IV. Designing Optimal Deterrence

While there seems to be general agreement that this risk reward calculus must be changed,²⁹ there is little understanding of how extremely difficult it will be to design an optimal deterrence strategy.

To start with the conclusions: The cost benefit calculus demonstrates two inter-related points. The first is that there is no one change that is politically viable that will solve the problem. Theoretically, you could shut shelters down by changing the substantive law. But so far no one has come up with a solution where one would be absolutely certain that every shelter does not work. You might also shut down shelters by having 100% detection but the funds that would be required to bring the IRS to the level that it could do a first-class audit on every corporate return are prohibitive. And finally you could shut shelters down if the penalty for engaging in one was high enough to result in optimal deterrence but it is extremely unlikely that Congress would ever

²⁹See, e.g., N.Y. Bar Ass'n, Tax Sec., Report on Corporate Tax Shelters (Apr. 23, 1999), 199 TNT 82-29, available in LEXIS, Tax Analysts File ("concrete steps should be taken to increase the risk associated with entering into corporate tax shelters"); Treas Tax Shelter Study, at par 253 ("Corporate taxpayers themselves must be deterred...This requires ... a real risk of penalty if the transaction ultimately is not upheld"); Unofficial Transcript of Finance Committee Hearing on Revenue-Raisers in President's Budget, (Apr. 27, 1999) (statement of .

adopt such draconian penalties.

The second conclusion is that if no one change is to be taken to the extreme, there will be optimal deterrence only if all pieces are in place. Each piece is essential—the substantive law must be such that in many cases there will be an understatement; there must be some possibility of detection; there must be a high mandatory penalty to curb behavior.

The piece that is currently missing altogether is the penalty. So this paper starts with adding a penalty. It turns out that is a relatively simple thing to do—much simpler than changing the substantive law or increasing detection. In order to see why that is so, it is useful to look at other changes to the risk-reward calculus that would change behavior.

Eliminating the Tax Benefits: Changing the Substantive Law

The risk-reward calculus includes a risk of losing. This is an aspect of the uncertainty under which the decision maker labors. This is because no one can be sure whether the tax shelter will work since in all cases it is based on a technical reading of the law that appears to be supported by statutory authority but may not be within congressional intent. In fact, if it is 100% certain it will work, it is most likely not a tax shelter (tax-exempt bonds). The risk of losing is high for most tax shelters. Many reputable tax lawyers do not believe that most shelters would be sustained if litigated. In fact the term tax shelter itself has come to mean a transaction that was not intended by Congress and is abusive.

Theoretically, one could substantially increase the risk of losing to 100%. Unlike with some other “crimes,” that might actually be the optimal deterrence strategy since it would deter investment with almost no administrative costs. Most corporate managers would be unlikely to enter into a strategy that had a zero percent chance of success. If the law was absolutely clear that

the firm could not deduct payments for x , the firm is not likely to do so. This approach to deterrence will not work with corporate tax shelters, however, because it is impossible to decrease the risk to zero. The reason is that we cannot define x . There are a large number of tax shelter strategies that are based on different provisions of the Code. One possibility is to shut down each one, specifically prohibiting each variation. This has been only marginally effective since promoters move on to new shelters as soon as details of previously peddled strategies become public. Congress is always behind the curve and most of those who previously invested in the shelter do not lose the promised tax benefits. Congress could also consider some global prohibition but has been unable to agree on any proviso for fear of curbing legitimate tax planning. [discussion of this attempt omitted]. But this approach is not optimal because it introduces uncertainty and can never result in increasing the risk of losing to 100%. Returning to the above risk-reward calculus, even if we increased the chance of losing to 90%, the expected return to the strategy would fall only to \$28.4 million. The corporation would still invest.

Increasing the Odds of Detection

Increasing the odds of detection to 100% would come closer to “working” to deter investment in tax shelters.. Re-doing the risk-reward calculus, a 100% odds of detection would increase the costs to \$37 million (70% risk of losing x 100% risk of detection). After factoring in \$5.2 after-tax transaction costs and \$4.7 of risk adversity and reputational costs, the expected benefit would be only \$6 million. If we were to change the substantive law a little to increase the risk of losing or repeal the deduction for the transaction costs, we could virtually eliminate any tax benefit.

There are two reasons why such an approach is not optimal. First it is prohibitively

expensive and second there is no incentive for the firm to comply with disclosure.

As noted above, the problem with increasing detection with respect to large corporations is not the lack of audits but the quality of the audit. It would take a huge infusion of funds to hire and train auditors sophisticated enough to detect and challenge shelters. Even if all shelters were required to be disclosed on the face of the return in exquisite detail, the IRS would be unable to process the information unless the taxpayer simply included a statement that there is an understatement of \$X.

Additionally, unless penalties were changed, the taxpayer has no incentive to comply with the disclosure law. If there is no penalty for not disclosing, the taxpayer would simply play this new form of the audit lottery. And where shelters are used by smaller firms or partnerships, the current audit rate approaches zero, necessitating a prohibitive increase in the IRS budget.

Increasing Penalties

There are two aspects to this piece of the puzzle. The first is taking the step to impose a mandatory penalty; that is the easiest step to take. The second is to set the level of the penalties; that is much more problematic.

a. A Mandatory Penalty

The current penalty, which is not mandatory, in some sense can be thought of as establishing a penalty ex post. The IRS or the court evaluates the conduct and selects a penalty that is appropriate for the rule violation. There are two problems with this approach. An ex post evaluation makes it much more difficult for the actor to determine ex ante whether to engage in the conduct; it is more difficult to do a cost benefit analysis.³⁰ The only reason that a corporation can

³⁰The only reason that a corporation can do that now is essentially because the penalty is zero. For a discussion of the difference between the ex ante and ex post approaches, see William T. Allen, Commentary on the Limits of Compensation and Deterrence in Legal Remedies, 60 Law

do that now is essentially because the penalty is zero. Thus, an ex post penalty may have a much less significant incentive effect. Second, the IRS and the courts are choosing not to impose a penalty (perhaps because they see it as retributive or perhaps because they are not interested in actual deterrence). The solution is a mandatory penalty.

One way to accomplish this is to repeal the reasonable cause exception to accuracy-related penalties; this would eliminate the penalty protection inherent in the lawyer's opinion.³¹ The penalty would become automatic if the shelter was held to be invalid. It could not be waived by the IRS, would apply to the tax shelter understatement viewed in isolation (i.e. it does not matter if overall there is no understatement) and would apply to the first dollar of understatement. This would increase the risk of purchasing the shelter. Whatever justification there might have been for the reasonable cause exception,³² it would not seem to apply to tax shelters. Nevertheless, a

& Contemp. Prob. 67, 78 (1997).

³¹The Clinton administration at one point supported this approach but ultimately backed off. See Administration's Revenue Proposals for the Fiscal Year 2000 Budget. Several months later, Treasury said consideration could be given to providing a "strengthened reasonable cause standard where the penalty could be reduced or eliminated with disclosure. Treasury Dep't, The Problem of Corporate Tax Shelters, Discussion Analysis and Legislative Proposals par. 31 (1999), 1999 TNT 127-12, 1999 TNT 127-13, (July 2, 1999), available at LEXIS, Tax Analysts File. That proposal called for an increase in the penalty to 40% for undisclosed transactions, while those that were disclosed would remain subject to the 20% penalty. The New York State Bar Association has also recommended this approach. 4/23/99 report, para 10. They also recommended varying the amount of the penalty depending upon whether the shelter was disclosed. para. 11

³²Legislative history: enactment of a single reasonable cause exception was intended to permit taxpayers to more readily understand the behavior that is required, to simplify administration of the penalties, to lead the IRS to consider fully whether imposition of the penalty is justified, and to provide greater scope for judicial review. H.R. Rep. 101-247, at 1392-93 (1989). In 1994, Congress eliminated the ability of corporations to avoid the penalty for tax shelter items based on substantial authority and reasonable belief. Could only avoid the penalty for tax shelter items if they established reasonable cause. Check H.R. Rep. No. 103-826, at 198 (1994).

mandatory or a strict liability penalty is not without its detractors. Consider the arguments against.³³

The standard criticism is that a client should be entitled to rely on the advice of its lawyer.³⁴ Firms should not be required to second-guess their tax advisors.³⁵ The assumption behind this rationale is that the tax advisor will act as policeman—if she says that the transaction will not work, the client will not enter into it. There are two problems with this argument. First, it is clear in the tax shelter area, that no one is actually relying on the advice of a lawyer—they are purchasing insurance. As noted above, lawyers are not asked for their opinion and are under pressure to not give their real opinion.³⁶ Second, strict liability in this context would seem to increase the likelihood that taxpayers would rely on the advice of their lawyer; they would seek real advice about the likelihood of the success of the strategy if audited.

Nevertheless theoretically there would be cases in which a lawyer would give real,

³³Some of the opposition is simply a generalized claim that strict liability is unfair. See Unofficial transcript 4/27/99 (statement of Lester D. Ezrati, Int'l Pres., Tax Exec. Inst.), at par 438 (“enactment of a no-fault penalty is wholly inappropriate”); Richard C. Stark, A Principled Approach to Collection and Accuracy-Related Penalties, 91 Tax Notes 115 (Apr. 2, 2001) (“While a no-fault penalty might in some circumstances be a sensible choice, penalizing taxpayers in a significant way purely on the basis of objective criteria can lead to perceptions of unfairness and inconsistent application.”).

³⁴See NYSBA 4/23/99 report at para 96

³⁵Treas Tax Shelter Study at 252.

³⁶The KPMG histories in the Sen. Finance Comm. report indicate that KPMG “did not consult with its client beforehand, even for representations purporting to describe, in a factual way, the client’s intentions, motivations, or understanding of the tax product. KPMG along, apparently without any client input, wrote the client’s representations and then demanded that each client attest to them by returning a signed letter to the accounting firm.” at par. 200 The report also includes an incident in which a client refused to attest to the factual representations because he had no knowledge of the facts and did not understand the transaction. Ultimately, he caved and signed the representation letter with KPMG’s recitation of the facts. at par. 201

thoughtful advice about a transaction that would be labeled as a tax shelter under current law. The lawyer will conclude that it is more likely than not to be sustained on the merits and the lawyer will be wrong. With a mandatory penalty, the firm would be unable to use its reliance on the lawyer's opinion to abate the penalty. Those who criticize this result apparently want to be able to avoid penalties so long as the lawyer says there is some probability that the transaction works. It is not clear why that should be so. It is in the nature of advice that sometimes it will be wrong. The client's recourse should be against a lawyer or promoter who gives bad advice. The government should not be in the position of guaranteeing the lawyer's advice. (Where the lawyer is correct, of course, there is no penalty. Or if the lawyer's advice is that the tax benefits more likely than not will not be sustained and the client does the transaction any way, there is no reason for concern.)

A second criticism of a mandatory penalty that applies only to tax shelters is that the definition of tax shelter will be extremely important.³⁷ Others have expressed concern that any change in penalties is unworkable because the item to which the penalty applies cannot be defined.³⁸ That is already the case. It is not my task here to define tax shelter but I acknowledge that a high strict liability penalty makes it very important to define the situations to which it applies

³⁷NYSBA 4/23/99 report, para. 13. The Bar Assn was also concerned that this would provide additional leverage to IRS agents in audits of transactions that may not be tax shelters but ultimately concluded that this was a lesser risk than not shutting down tax shelters. See also Staff of Jt. Comm. on Tax'n, Description and Analysis of Present-Law Tax Rules and Recent Proposals Relating to Corporate Tax Shelters par. 131 (Nov. 10, 1999, 1999 TNT 218-22 (Nov. 12, 1999) (no fault penalty suffers from "being dependent on the ability to precisely define corporate tax shelters in a way that would distinguish between legitimate business activity and improper tax avoidance").

³⁸Unofficial Transcript of Finance Hearing 4/27/99 (statement of Stefan Tucker, chair ABA Tax Sec.)par. 285-6 ("We do not want strict liability there were you might have a number of circumstances where it ought not apply.").

correctly. If we wanted to say that a penalty should be imposed every time the taxpayer is wrong, this is an easy issue. There is no need for a definition. But here we want to impose a penalty to deter investment in certain (but not all) tax-motivated transactions that result in a *substantial* understatement. Thus, there is no question we need to be able to define the tax-motivated transactions to which the penalties will apply.

There appears to be a concern that a no-fault penalty would apply to legitimate business transactions.³⁹ There is a concern that the fine may not be optimal. A fine that is greater than the optimal fine causes people to avoid behavior that may be worth more than the fine. Excessive fines lead to taking precautions that cost more than they are worth to society. The range of cases where there is a concern is actually quite small. If the tax benefits are granted, there is no understatement and there will be no penalty. The penalty would only apply where the tax benefits are denied—obviously not a legitimate business transaction. What must be worrisome is that the penalty would apply to “legitimate” tax planning that fails—we apparently should not attempt to deter that behavior. (Why?)

A third criticism with no-fault penalties is that the IRS or a judge would be less likely to rule against the taxpayer if there is a pre-commitment to the penalty. The argument is that it is important for IRS to have the flexibility to waive the penalty because if there is no discretion, fewer penalties may be asserted. As the litigated tax shelter cases make clear, these cases are not

³⁹See, e.g., JCT Tax Shelter Report, 11/99 at par. 195 (“[T]o the extent that the ...substantive rule relies on definitions that are too broad, it might apply to disallow what otherwise might be legitimate business deductions...an understatement would result and a penalty would apply ... In some circumstances, this arguably would produce an inequitable result.”) What could this possibly mean? In order for there to be a penalty, there must be an understatement and that must mean that the deductions were not legitimate.

always open and shut. A judge on the fence may be less inclined to find for the government if the result is a substantial penalty for guessing wrong about the law. This is also clearly related to the level of the penalty. The higher the penalty the more likely it would be a factor in a judge's or agent's conclusions on the substantive issue. If the penalty is mandatory, and the law is not certain, there may be no collections on understatements since none may ever be asserted.⁴⁰ In that case, the penalty would not deter behavior.

A fourth criticism, similar to the third, is that there is a need for a safety valve to correct mistakes.⁴¹ A waiver option gives the opportunity for the taxpayer to make a case why the penalty is inappropriately applied in *this* situation. This argument is independent of eliminating reliance on an attorney's opinion but argues for retaining a "reasonable cause" exception to the penalty. That would be a reasonable position to take if we could imagine situations where the taxpayer should have a hearing, where a case could be made. But what would that case be with respect to a tax shelter?⁴² The standard examples, such as missing a filing deadline by a day, a mathematical error or cases of inadvertent noncompliance have no meaning in the tax shelter situation. It seems

⁴⁰Letter from J.A. Glennie, Int'l Pres, Tax Executives Inst. to William M. Thomas, Chairman of House Ways and Means Comm. (Aug. 5, 2003), 2003 TNT 151-21, (Aug. 6, 2003), available in LEXIS, TNT File. (perverse effect of strict liability approach is that it puts not only the penalty imposition at risk, but the underlying tax as well, because field agents may decide not to challenge the underlying return position itself given the harsh and unavoidable consequences.")

⁴¹Stark "When a penalty applies in a broad range of situations, is high in amount, and operates without a showing of fault, a particular need exists for a safety valve that the IRS and the courts can apply to avoid excessively harsh operation.")

⁴²Stark at par. 137 says "[T]he risk heightens that some positions would receive an unwaivable penalty, even though most would view the situation with some leniency. It would take only a few ill-conceived penalties to produce a huge amount of pressure to repeal such a provision."

to me the only possible case is a tax-motivated transaction that does not work (i.e. there is an understatement) that the Service treats as a tax shelter, but which reasonable people would agree is not. (but wouldn't court reverse penalty?)

The final criticism is simply with optimal deterrence approaches. Those who argue that the imposition of penalties without a showing of fault is inconsistent with the concept that a penalty should be proportional to the offense are arguing for gain-based penalties or retributive penalties.⁴³ Furthermore, a mandatory penalty is not really a no-fault penalty. The "showing of fault" is the investment in the tax shelter—that is, the act to be deterred. That is the act to be penalized and the fault lies in the investment.

There is a collateral advantage to eliminating any reasonable cause exception that might offset any potential disadvantages. Since an attorney's opinion would no longer effectively serve as insurance against penalties, presumably it would neither be sought or issued for that purpose. This would return the lawyer to his historical role as advisor. Any opinion sought by the firm would be an opinion that means something and presumably will be relied on by the investor/client. Rather than paying for insurance, the client would be paying for real advice and would ante up only if the opinion was well-reasoned.⁴⁴ The advice would no longer simply be whether an

⁴³ Stark argues that a substantive response and better enforcement are much more important than penalties. He strongly supports retaining the reasonable cause exception even for tax shelters but argues that an advisor's opinion should not be relevant in determining whether the penalty could be waived. Stark has a conceptual objection to eliminating a reasonable cause exception. "[T]he imposition of substantial penalties without a showing of fault is inconsistent with the concept that a penalty should be proportional to the offense, and the broad expanse of the [definition of tax shelter] make it inevitable that the penalty will be inconsistently imposed, as revenue agents and appeals officers excuse a taxpayer's reasonable actions by choosing not to impose or uphold the penalty."

⁴⁴See NYSBA, 4/23/99 report par. 10

opinion *could* be produced, but would be the realistic advice about the strategy (are the tax benefits likely to be sustained? how aggressive is the transaction? if not, will penalties be imposed?) This step should also change the risk-reward calculus. The above calculus was based on an unreasonable prediction of the changes of success. It may be that currently some firms do the calculus with the lawyer's prediction that they are more likely to succeed than not (50% or more) and some use real predictions (30% or less). If the lawyer's opinion removed penalty protection, there would be no reason not to get realistic advice that should result in a lower probability of success being used in the risk-reward calculus. That would put somewhat less pressure on other factors. .^{45]}

b. The size of the penalty

The much more difficult question is the size of the penalty. Simply imposing a mandatory penalty without more would not substantially change the risk-reward calculus. Return to the above example and assume that the firm realistically evaluates the risk of losing at 30%. On those simplistic facts, if the penalty were 20%, the ex ante return would fall from \$30 million by only \$2.5 million (a 24% risk that a penalty of \$10.5 million (20% of 52.5 million)) would apply. Clearly, a 20% penalty would have no deterrent effect. On these facts, in order to wipe out the tax benefits, the penalty would have to be 238% of the understatement.

One possible reaction to this number is that the penalty is so draconian that it is politically unviable. If that were true, the conclusion might be that it is impossible to deter investment in

⁴⁵NYSBA 4/23/99 report, par. 100 (“We suspect that many others of us, whether we would acknowledge it to ourselves or not, feel subtle pressures to give favorable opinions in order to be ‘at the table,’ to continue to be involved with our clients’ transactions, and ultimately to generate our fair share of revenues for our firms.”)

corporate tax shelters. So it is worth exploring whether in fact such a high penalty is feasible.

To determine whether people actually believe in optimal deterrence (by which they meant higher penalties in lieu of increased detection), Cass Sunstein, David Schkade and Daniel Kahneman performed two studies. They found that people reject an explicit official decision to vary the degree of punishment with the probability of detection. In one of the studies, students at the University of Chicago Law School (who presumably well understood optimal deterrence theory) were asked whether they agreed with a policy that would increase penalties for tax violations in one state that had a small number of agents and thus a small chance of detection.⁴⁶ Very strong majorities (75%) of respondents rejected this policy and (87%) believed that most people would disagree with the policy. This study is some support for the proposition that efforts to apply optimal deterrence “would encounter significant popular resistance.” But the authors flatly state: “people reject law-enforcement policies that increase or decrease penalties because of the probability of detection.” I do not believe that the study is strong support for popular resistance to *any* optimal deterrence approach by a regulatory agency such as the IRS.

There are a number of other plausible explanations for rejection of the policy offered in the study. The authors acknowledge framing issues with the question. They also acknowledge what

⁴⁶ The actual question was:

Suppose that the Internal Revenue Service (IRS) has a large number of agents per 10,000 people in California, but a small number of agents per 10,000 people in Utah; suppose too that because of practical constraints, the IRS cannot increase the number of agents in Utah. Suppose that you are head of the IRS, and that your second-in-command has sent you a memorandum saying, “To make up for the shortfall of agents in Utah, and ensure the right level of deterrence, we need to impose higher penalties for tax violations in Utah and for tax violations in California. I recommend that you adopt a policy to this effect.” Putting aside purely political considerations, would you agree with this policy?

I would guess is the chief objection by the respondents: “the evident inequality between similarly situated citizens.” My hunch is that most respondents simply did not find the specific proposal to be “fair.” The results might not apply to a more global deterrence policy⁴⁷ or to one targeted differently, such a significant penalty imposed only on corporations investing in abusive tax shelter strategies. ⁴⁸ A draconian penalty on corporate tax shelters is a far different matter than a draconian penalty on double parking.

There are factors that might cut in both directions were high penalties applied only to corporations and only to those who invested in abusive tax shelters. Among those that would lead to a lack of support for optimal deterrence approaches are antipathy towards the government in general or the tax system and the IRS in particular. Clearly some people would not want to give the IRS any more weapons than it already has. Obviously, the target corporations would object and as a special interest group with much political power, they might be able sway Congress if not the public. But there are several factors that make corporate tax shelters a good option for deterrent penalties:

(1) Antipathy towards corporations. A penalty directed at deterring specifically *corporate* behavior might be more acceptable than one directed at individuals. For starters, it could never be levied on individuals (i.e. voters). Despite the reality that economic benefits or detriments accrue to owners, employees or customers, that is not the public perception. (2) Antipathy towards

⁴⁷The authors ask “Would respondents overwhelmingly reject an optimal deterrence policy if it were global—for example, if an administrative agency increased penalties in 2001 because of reduced enforcement resources...?” At p. 247.

⁴⁸The authors flatly state: “people reject law-enforcement policies that increase or decrease penalties because of the probability of detection.”) at p. 250.

stealthy behavior. Corporations try to hide the transactions from both the public and the IRS. People tend to support higher penalties on stealthy behavior.⁴⁹

(3) Conversely, if the behavior becomes known and appears to indicate a rejection of shared norms (paying taxes), the firm's shamelessness may support a higher penalty.

(4) A decrease in corporate tax revenues may result in higher individual rates. To some extent the tax system is a limited zero sum game. If revenues fall from one sector, they must be made up in another. It is not of course a perfect zero sum game because revenue needs are not fixed and at least recently, the pie can be expanded through increasing deficits. But it is very likely that if corporate revenues fell sufficiently, either individual rates would rise or the base would be expanded.

(5) The "fairness" concern might not apply. An especially high tax on corporations who invest in shelters would be "unfair" as compared to whom? In the Sunstein study, taxpayers were distinguished based on characteristics outside their control (the number of agents in the states in which they lived). Corporations control the actions that would trigger the penalty.

(6) Finally, there is some history with variable tax penalties. Some tax penalties have always been based on the probability of detection, and some penalties can be reduced or abated if there is disclosure, thus substantially increasing the odds of detection.

Nevertheless, penalties in the range of 230% would be viewed as extraordinarily draconian and would provide a real test of whether an optimal deterrence approach would work in this extremely favorable setting.

If we conclude that we cannot set a mandatory penalty high enough to change the

⁴⁹Sunstein at 249 ("a stealthy act is more outrageous than one that is out in the open").

cost-benefit analysis sufficiently to eliminate investment in shelters, is there another solution?

This brings me to the second conclusion. The key is that each prong is interdependent on the others. Not only do none of the three steps work alone, none of them works without the other two. Since we are unable to sufficiently change the substantive law such that the probability of losing is 100% (and even if we did, there would still be the likelihood of some evasion), we must impose a penalty where it turns out the taxpayer has violated the law. And since the penalty cannot be so draconian to change the cost-benefit analysis alone, the penalty must be mandatory meaning that there can be no reasonable cause exception, even for relying on an advisor's opinion. And since the mandatory penalty cannot be draconian there must be a risk of detection and imposition since the mere existence or threat of an opinion will not be sufficient to change the calculus.

Return to the risk-reward calculus one final time. Suppose we increase the risk of detection (either through disclosure or by increasing IRS resources) to 50% and everything else remains equal. If that were the case, the penalty needed to wipe out the ex ante benefit would be 102%. Now suppose that we eliminated a deduction for the transaction costs. The transactions costs would now be \$8 million and the penalty would need to be 90%. Obviously, the lower we can get the penalty, the less chance of a political firestorm.

It also be possible that some increase in penalties might change the portion of the risk reward calculus not within the government's control. There is some evidence that firms are quite risk adverse with respect to penalties. As penalties rose, and importantly became mandatory, risk aversion might rise, decreasing the expected benefits. It is also possible that costs to agents may make it less likely that they would engage in the undesirable behavior. For example, if a tax department head or CFO was fired because a significant penalty was imposed on a failed shelter,

she might be less likely to acquire the strategy. Finally, if promoters were required to absorb all the costs of a failed shelter (through litigation by dissatisfied investors), they presumably would need to take that into account in pricing the deals, which should cause transaction costs to rise.

[Loose end: When a corporation is the offender who should pay the penalty? A saction against a corporation ultimately will be borne by those who had no control over the matter –shareholders and consumers. It is also likely that punishment will have little effect on those who actually did the activity we want to deter.⁵⁰ And they certainly could not afford the kind of penalty discussed here.]

⁵⁰ Polinsky and Shavell