Abstract - This article offers a definition and examples of the modern tax shelter and summarizes the anti–tax shelter weapons in the government’s arsenal. Particular attention is given to the economic substance doctrine, which allows the government to attack transactions that comply with the literal language of the law. The battle between taxpayers and the government is described as a multi–player, multi–period game. Recent moves by the government have greatly reduced the payoff to shelters set up by high net–worth individuals. The corporate shelter market is more robust, as taxpayers have been able to exploit flaws in the economic substance doctrine. One attractive policy option is to follow the lead of California and increase the cost of shelters by increasing the penalties.

INTRODUCTION

Tax shelters are in the news and there is a welcome growth in the academic literature on this topic. However, the complexity of the tax law, and of the shelters themselves, makes it difficult for even the readers of this journal to understand how tax shelters work or affect the tax system. This article provides an overview of the tax shelter market and the legal responses to that market.

WHAT IS A TAX SHELTER?

There is no agreed–upon definition of a shelter. That said, I have previously suggested that the term, as used in the tax policy literature, is best defined as a (1) tax motivated; (2) transaction unrelated to a taxpayer’s normal business operations; that (3) under a literal reading of some relevant legal authority; (4) produces a loss for tax purposes in excess of any economic loss; (5) in a manner inconsistent with legislative intent or purpose (Bankman, 2004a).

The fact that, in order to be considered a shelter, a transaction must be inconsistent with legislative purpose or intent suggests, correctly, that there will always be a subjective element in characterizing a transaction as a shelter. It also means that a legislatively blessed, but tax–motivated, transaction

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1 Economic articles on the subject include Slemrod (2004), Desai and Dharmpala (2004), Desai (2003), and Manzon and Plesko (2002). The legal literature on the topic starts earlier and is more extensive. A representative sampling of this literature can be found in the Winter, 2002 symposium issue of the Tax Law Review.
such as putting money in an individual retirement account cannot be a shelter as that term is used in this debate. It means, finally, that the life of a shelter is short. A shelter is an activity that runs counter to the intent of the legislature, so that we may expect that once a shelter becomes public, the legislature will take steps to shut down the shelter. Under longstanding precedent, however, the legislature’s actions will have prospective effect only. Under this definition, a tax motivated transaction that is known to and countenanced by the legislature cannot be a shelter.

The fact that a shelter must be unrelated to a taxpayer’s normal course of business means that a taxpayer who in the course of business takes advantage of a badly worded rule to reduce taxes is not engaged in a tax shelter. The government may challenge the taxpayer’s interpretation of the rule. However, the transaction will not be subject to tax shelter penalties or reporting requirements and cannot be attacked through anti–tax shelter doctrines developed by the courts.

SHELTER EXAMPLES

It will be useful to discuss the shelter problem in the context of a few concrete examples. Consider, first, the following stylized description of the so–called high–basis, low–value shelter used by corporate taxpayers in the early and mid 1990s. This shelter relies upon a foreign party that is not subject to U.S. tax and is located in a jurisdiction that does not tax gain (or allow a deduction for loss) on investment assets. The foreign party holds some assets that have risen in value and some that have fallen in value. Assume the assets that have risen in value have a tax cost, or basis, of 5x and fair market value 100x, and those that have fallen have a basis of 100x and a fair market value of 5x. The mixed portfolio of assets may have been created by a straddle–like investment2 or may be the result of normal business operations. The assets that have risen in value are sold tax–free. The assets that have fallen in value are contributed to the stock of a newly–formed subsidiary of the shelter purchaser in exchange for 15 percent of the stock of that subsidiary. At the same time, the shelter purchaser contributes to its subsidiary in exchange for 85 percent of the stock of that subsidiary. The shelter purchaser takes the position—supported by the literal language of the statute—that its subsidiary inherits the 100x basis for the property contributed by the foreign party. The property is sold for 5x and the subsidiary takes a 95x tax loss (which can be used to offset the parent’s income), but no loss for financial reporting purposes. The foreign party is paid for its role in the deal by receiving stock in excess of the 5x value of property contributed (See Bankman (1999)). A variant of this shelter was used by Enron (Joint Committee on Taxation, 2003).

Consider, now, a class of related shelters sold to individuals in the period between 1997 and 2000. One of the first of these shelters was marketed by Price–WaterhouseCoopers under the name of Bond and Option Strategy, or BOSS; the class of shelters is sometimes referred to as BOSS and son–of–BOSS shelters. A typical purchaser of this class of shelter was an entrepreneur who had recently

2 For example, the taxpayer might have bought two stocks that predictably move in opposite directions (e.g., oil–company stocks and airline stocks). The position that appreciates in value may then be sold tax–free, while the position that has fallen in value can be contributed to the subsidiary of the domestic corporation. The taxpayer may have used derivatives to assure itself of the right mix of assets. For example, the taxpayer may have bought a call and a put on the same stock and, shortly before the options are about to expire, sold the position that had appreciated and contributed the position that had fallen in value to the subsidiary of the domestic corporation. However, the use of precisely offsetting investments would, if known, increase the risk that the shelter would be successfully challenged in court.
sold a company and had between $10 million and $250 million in gain to offset. Thousands of taxpayers purchased these shelters, claiming tax losses in the many billions of dollars. The son–of–BOSS shelter marketed by Ernst & Young went by the name of Currency Options Bring Rewards, or COBRA. In the Cobra shelter, the taxpayer writes a call option for, say, 5x and uses the premium to purchase a nearly identical call option for 5x. For example, the purchased call might give the taxpayer the right to purchase euros at $1.22 in a year and the taxpayer might write a call giving the other party the right to purchase euros at $1.21–1/2 in a year. The taxpayer contributes the long–option position (purchased call) and the short–option position (written call) to a wholly–owned company. The net fair market value of the property contributed is zero. The long option position has a fair market value of 5x but the short position, shorn of premium, is a contingent liability of 5x. The taxpayer’s net out–of–pocket cost is also zero, since the 5x premium received in exchange for writing the call is used to purchase the nearly identical call. However, the taxpayer takes the position that her basis in the wholly–owned company is increased by the 5x basis of the long–option position but not decreased by the 5x contingent liability inherent in the short–option position. The company is ultimately liquidated for zero and the taxpayer takes a 5x loss (See Stratton (2002)).

It is important to note the potential cost to the fisc from these somewhat typical shelters. The high–basis, low–value shelter relied on a set of appreciated and depreciated assets that could be costlessly produced in straddle–like transactions and a foreign party. If the shelter worked, it could have reduced the corporate tax to near zero. The COBRA shelter required only the expense of purchasing offsetting options, setting up a business entity, and, of course, compensating the promoter for the idea. If this shelter worked, it could in theory have reduced the tax on high–income individuals to near zero. Indeed, the mechanics of the shelter would work as well for corporations as individuals. While the shelter was not marketed to corporations, if it worked and was so marketed, it could have also reduced the corporate tax to near zero.

The high–basis, low–value and COBRA shelters were only two of a large number of marketed shelters. Dozens of other classes of shelters have been marketed, some with acronyms for names (e.g., CINs, COLIs, CARDS, LILOs), some named after relevant code sections (e.g., 357(c)), some with more descriptive names (e.g., basis–shift, contingent liability, fast–pay preferred). Each of these shelters was used by scores of taxpayers and produced losses estimated in the billions.

**WEAPONS IN THE GOVERNMENT’S ARSENAL**

The government can be expected to respond to a shelter by amending the statute, regulation or other authority upon which the shelter is based. However, longstanding legislative practice is to give that amendment (and all other laws as well) only prospective effect.

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5 The IRS recently estimated that about 1,900 taxpayers purchased son–of–Boss shelters. More recent evidence suggests that the actual number of purchasers is considerably higher. See Gary (2004).

4 Some of these shelters are described in Bankman (1999 and 2004a). Information on other shelters can be obtained though an electronic or index–based search of *Tax Notes Weekly*.

5 Shelters affect state income taxes as well as the federal income tax. For the most part, though, it is the federal government that takes the lead in fighting shelters and, unless noted otherwise, the references to government in this section refer to the federal government.

6 Legislation with retroactive effect is inconsistent with reliance interests and, for that and other reasons, is thought of as bad policy; retroactive legislation with criminal or severe civil penalties may be challenged under the due process clause of the United States Constitution.
The amendment will make the shelter uneconomic for new purchasers, but will not affect the validity of transactions entered into prior to the enactment of the amendment. The government can also be expected to challenge the legitimacy of a shelter adopted before the effective date of the amendment. The government will argue, first, that the taxpayer has misread the literal language of the authority on which it is relying and, second, that the taxpayer has ignored authority to the contrary. The government will also attack the shelter under the so-called economic substance doctrine. That common-law (i.e., judge-made) doctrine holds that even a transaction that otherwise complies with a governing statute can be disregarded for tax purposes if it lacks significant non-tax motive or effect.

The economic substance doctrine is a blunt instrument that works best on the most egregious shelters (Bankman, 2000 and 2004a). The doctrine does not specify how much substance a transaction must have. It is unclear, for example, whether a transaction must return a profit equal to the riskless rate of return, the risk adjusted rate of return on a non-tax-favored asset, the return on the alternative investment the particular taxpayer would have undertaken, and so on. The application of the doctrine to transactions with non-tax motives that do not immediately translate into profit (e.g., protecting a company from a hostile takeover) raises similar questions.

The doctrine must be interpreted to exclude transactions in assets that are explicitly tax favored by Congress. These assets (such as low income housing or machinery subject to very favorable depreciation rules) may be expected to offer low or even negative before-tax rates of returns. At the margin, all investments in these assets will be tax motivated. This, of course, is the purpose of the legislatively blessed tax break (to motivate investment) and, thus, cannot be the basis under the doctrine for denying the benefits to investors. More broadly, the doctrine must in all cases give way to clearly expressed legislative preference. Litigation under the doctrine often turns on issues of legislative intent, as taxpayers argue that the transaction qualifies under a bright-line rule knowingly made by Congress.

Finally, the doctrine does not (and cannot) specify the scope of the transaction that must have non-tax purpose. Taxpayers can be expected to argue that the transaction should be defined broadly, to include related transactions that have non-tax motive or effect. For example, in the high-basis, low-value shelter, taxpayers would argue that the transaction has economic effect because the contributed property, when sold for a tax loss, generated funds that the subsidiary used in its business operation.

The economic substance doctrine is closely entwined with the definition of the term tax shelter, as that latter term is used in policy debates. As stated above, a tax shelter is defined in part as a tax-motivated transaction unconnected to ordinary business operations, and the economic substance doctrine applies to tax-motivated transactions not tied to ordinary business operations. The economic substance doctrine does not prevent a taxpayer from taking advantage of the literal language of a statute or other authority, so long as the opportunity prevents itself in the course of a profit-making activity. As one scholar has noted, “you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it” (Gergen, 2001).

There are good reasons for placing tax-motivated transactions unconnected to profit-making enterprises in a special disfavored category (that of tax shelters) and subjecting only those transactions to the full panoply of anti-tax-shelter provisions, including the economic substance doctrine. In general, it may be both efficient and politically desirable to allow tax-
payers to interpret the law literally when operating in the normal course of business. Providing taxpayers with greater tax certitude in planning bona fide business transactions is a clear benefit. On the cost side, the loss to the fisc when tax laws are read to produce unintended consequences is limited to transactions carried out by those taxpayers who bump into that law in the course of business. If badly written provisions can be exploited in transactions not connected to ordinary business operations, the cost to the fisc rises enormously. Now all taxpayers can take advantage of the poorly drafted law.7

However, given that the economic substance doctrine is, and probably must be, limited to shelters unconnected to any business, its continued utility depends on taxpayers not being able to tie shelter transaction into existing business, or build a new business around a poorly drafted provision.

In addition to the economic substance doctrine, the government has a number of other doctrines with which it can attack shelters. The business purpose doctrine, which is generally viewed as a predecessor to the economic substance doctrine, denies taxpayers benefits claimed from transactions without business purpose. The substance over form doctrine allows a court to look beyond the form of a transaction to its underlying substance, and deny benefits that are inconsistent with that substance. The sham transaction doctrine can be used to deny taxpayer benefits in transactions that never occur (sham in fact) or transactions that as a formal matter occur but have no substance. As is perhaps apparent from these brief descriptions, these doctrines are closely related to, and share the same difficulties of, the economic substance doctrine (Bankman, 2000). A transaction cannot be challenged unless it is uncovered (and understood) on audit. Much of the government’s energy in the past decade has gone into improving the odds of this occurring. The most important step the government has taken is to adopt regulations under Internal Code Sections 6011 and 6112 that require both taxpayers and promoters to disclose certain transaction with shelter–like characteristics or effects. To take but one example, under the regulations, taxpayers are required to disclose transactions that produce a tax loss in a single year in excess of ten million dollars. The set of reportable transactions is much larger than the set of tax shelters; the government’s task will be to find the shelters in the reportable transactions (Bankman, 2004a). Another important step has been to subpoena customer lists from accounting and law firms involved in shelter promotion. Firms have responded by arguing those lists were protected under the doctrine of attorney–client privilege and the government has for the most part successfully rebutted those claims. (Stratton, 2004a).

The government has also increased its shelter–related expertise and changed its tax forms to require the taxpayer to give more information on a class of transactions that involve tax losses in excess of losses taken for financial accounting purposes and that are often associated with shelters (IRS, 2004).

The government does not have significant penalties with which to discourage shelter use. In many shelters, the worst outcome a taxpayer faces is return of tax saved, plus interest and a 20 percent understatement penalty (Bankman, 2004a). Taxpayers have sought to avoid any potential penalty by getting a law firm to opine that the transaction is more likely than not to hold up if challenged in court. The opinion is obtained prior to entering

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7 There also may be an efficiency rationale or justification at work here. It may be cheap to exploit a badly written provision that one stumbles upon in the course of business, but expensive to construct stand–alone transactions solely to take advantage of that provision.
into the shelter. In most cases, that strategy has worked. Indeed, the government has settled many shelter cases for less than the tax owed (Stratton, 2003). The government’s willingness to settle reflects the low penalty structure, the strain on the government of litigating so many cases and, of course, the possibility that the case may be lost.

In recent months, the government has been more aggressive in seeking penalties—in at least one case, asking for and getting a 40 percent penalty (Long–Term Capital Holdings v. United States, 2004). The government has also been less generous in its settlement offers. Still, in the opinion of some tax scholars, including this writer, the penalties are suboptimally low.

THE DYNAMIC NATURE OF THE TAX SHELTER INDUSTRY AND BATTLE

It is useful to think of the tax shelter battle as a multi–player, multi–period game (Slemrod, 2004). The promoter takes the first move, investing resources to develop and market a shelter that is expected to provide a positive return for it and its clients. As discussed above, once a shelter becomes known, the government can be expected to change the specific authority upon which the shelter is based. This will close the shelter to new purchasers but not affect the treatment of those who have already entered into the shelter. The government can also be expected to challenge the legitimacy of the shelter under existing law. The return to the promoter will depend in part on how quickly the government learns of the shelter and enacts legislation or rules to close it down to new purchasers. At some point, the taxpayer invests in the shelter; the investment takes the form of fees and transaction costs amounting to at least a few million dollars. The taxpayer’s return will not be final until the statute of limitations has run for the year in which the shelter produces losses. The government can affect the taxpayer’s return (and perhaps the promoter’s reputation and future returns) before and after the shelter is uncovered. For example, the government can expand its power to subpoena documents, increase audit rates, or use other agencies (e.g., the Securities and Exchange Commission) to adopt rules that reduce the payoff to the shelter. The government’s moves are (mostly) public, while the promoter’s and taxpayer’s moves may remain hidden for years.

Of course, it is unrealistic to think of promoters and taxpayers as having the same interests. There are multiple promoters and taxpayers, many of which will face a different payoff structure on what may seem to be similar shelters. There are also agency issues between the promoter and the taxpayer. Some promoters may see themselves as reputational players in a multi–period game; others may see the game as having only one or two periods. A small group of promoters can hope to earn hundreds of millions of dollars in just a few years—the temptation to take the money and retire is substantial. Some taxpayers, at least, will realize this and adjust their reliance upon promoter representations accordingly.

The government, too, is comprised of multiple players, and any analysis of government behavior must take into account agency problems. These problems may be exacerbated by the great sums at stake, and the unavoidable fact that most leading tax experts will at some point have worked, and will work again, for intermediaries who sell the majority of shelters.

The complicated nature of these interactions may be seen in the dramatically

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8 An interesting exploration of this same theme may be found in Gergen (2002), commented on in Bankman (2002).
changing face of the shelter market. The high–basis, low–value shelters were sold to corporate purchasers by a mixture of accounting firms, investment banks and tax shelter boutiques in the early and mid 1990s. The tax shelter market had only recently risen to the level of public consciousness, even in the tax world, and the government did not have an aggressive or effective audit or detection strategy. The corporate purchasers were capable of evaluating the relative merits of shelters and the leading promoters were reputational, multi–period players. Shelters sold in this period, such as the high–basis, low–value shelter, clearly complied with the literal language of the relevant authority. However, shelters were not designed to survive rigorous scrutiny under the economic substance doctrine. The reason for this was three–fold. First, businesses found it generally efficient or desirable to separate tax–driven transactions from business transactions. Indeed, corporate decision–makers often required (or at least were given) assurance that shelters would not involve any business risk (Bankman, 2000). Second, there were not many recent cases involving the economic substance or related doctrines and shelter purchasers could hope that the doctrine would not be enforced in the then–current judicial climate. Finally, and most importantly, the odds of detection were low. As a result, it was not sensible to increase the perceived cost of the shelter by incorporating any real investment or risk.

In the end, the economic substance doctrine was almost uniformly upheld by courts, and the government won almost every case it brought against shelters of this era (Bankman, 2004a). However, the taxpayer’s reliance on the audit lottery paid off. The government did not have good success in finding shelters that were hidden in complex corporate returns. The number of reported cases, even added to the estimates of cases that settled without trial, is far below the number of estimated shelters. There are no known cases, for example, in which the government challenged the high–basis, low–value shelters. It seems likely that most of the shelters went undiscovered on audit, and the unlucky taxpayers whose shelters were discovered were able to settle on favorable terms with the government.

The success of this first generation of shelters, together with a booming economy, increased demand and led to rapid expansion of the shelter industry. Many of the new purchasers were individuals, who lacked expertise to judge shelter quality and who had once–in–a–lifetime gains to shelter. The increase in demand increased return to promoters and made it possible for a shelter promoter to earn enough to retire in just a few years. The result was an increase in one–period promoters and a group of unknowledgeable one–period purchasers. Shelters sold to this group, such as the COBRA shelter described above, were less well–designed than the shelters sold to the corporate purchasers a few years early. These shelters could be attacked on literal grounds. They were also extremely vulnerable to attacks using the economic substance doctrine, as individual–shelter purchasers generally had no ongoing business or investments to which they could tie the shelter transactions.

Moreover, within the audit period following the years these shelters were purchased, the government had adopted the aggressive discovery tools described above. These tools proved especially useful with respect to the individual shelters. The uncovering of only one shelter could (given the government’s newly established broad subpoena powers) lead to a paper trail uncovering hundreds of identical shelters sold by the same promoters.

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9 Shelter–related losses to the fisc during this period were recently estimated at $15 billion per year (U.S. General Accounting Office); this far exceeds the sums at stake in reported cases, and the sum of known settlements.
The individual shelters were, therefore, both easier to attack and more readily detected than the early generation of corporate shelters. Not surprisingly, these investments have proven much less profitable. This can be seen by the terms of the government’s settlement offers for the COBRA and other Son–of–BOSS shelters: payment of all tax owed, interest on the tax, and penalties of up to 20 percent. Since the highest penalty usually faced is 20 percent, the settlement offers taxpayers little, but the cases are seen as hard to win and thousands of taxpayers have agreed to the settlement (Stratton, 2004b).10

The complex dynamics of the taxpayer–promoter–government shelter game make it difficult to predict the future equilibrium. At the present, however, the market for individual shelters is in disarray, and this condition seems likely to hold for at least the near future. Shelters are expensive to develop and market, and individuals have less taxable gain to shelter than corporations. The individual–shelter market will be profitable only if shelters can be standardized and widely marketed. That, however, dramatically increases the chances of government detection. In addition, because individual shelters are prepackaged, and because individuals will not have ongoing business operations in which shelters can be hidden or integrated, these shelters will continue to be vulnerable under the economic substance doctrine.

What about corporate shelters? Corporations face the same array of anti–tax shelter weapons as individuals and, for reasons explained above, corporate shelters today face a much higher likelihood of detection than did the shelters of a decade ago. However, the presence of ongoing investments gives corporations options individuals do not have. For some time, commentators have speculated that second and third generation corporate shelters may be designed to blunt attacks under the economic substance doctrine (Bankman, 2000). Corporations may be able to tie shelters more closely to legitimate investments, to put some (but not too much) money at risk in shelter investments, and to select transactions with respect to which the legislative history is more clouded.

There is some evidence that this has in fact occurred. Consider, for example, the so–called SILO, or sale–in, lease–out shelter. Under this shelter, property is purchased from a municipality and then leased back to that municipality. The payoff for the purchaser is a depreciation deduction that the municipality, which is tax exempt, cannot use. A typical shelter might involve a transit district selling part or all of its subway system to a newly–formed leasing arm of a large company, and then leasing back the right to operate the system. SILOs first became widely known in the tax world in 2003. They are, therefore, too new to have generated any cases, and the public record on SILOs is very much incomplete. There is some evidence, though, that in their brief life, SILOs have been responsible for transferring hundreds of billions of dollars of depreciation from municipalities to for–profit corporations (Sheppard, 2004).

In many respects, SILOs seem like typical shelters. They are tax–motivated investments that are unrelated to a company’s prior business operations. The investments are marketed by well–known shelter promoters, involve substantial transaction costs and are unlikely to produce any operating efficiencies. The investments threaten to substantially, and unexpectedly, reduce government revenue. The investments seem inconsistent with Congressional intent.

10 Many taxpayers will nonetheless escape liability for these shelters if Congress does not extend the statute of limitations (Gary, 2004).
On the other hand, courts have upheld some tax–motivated sale–leasebacks of buildings and other forms of tangible property and the government has acquiesced in these decisions (Klein et al. 2003, pp. 554–7). It is possible that some shelter purchasers have put some money at risk and can expect (or at least claim to expect) a positive before–tax rate of return, in addition to the significant tax benefits. For these purchasers, the investments may be said to constitute a separate line of (admittedly, tax–favored) business. As a result, the shelters may be hard to attack on the economic substance doctrine. Indeed, for the same reasons, the investments may fall outside the definition of tax shelter discussed above, even though they raise some of the same social problems as tax shelters.

There is yet another reason to doubt that the government will be able to close down the shelter market. The economic substance doctrine conflicts with a powerful strand of jurisprudential thought. Support for literal interpretation of statutes and regulations has increased dramatically in recent years, in tax and in law more generally. This trend is particularly pronounced in recent judicial appointments (Bankman, 2001). The economic substance doctrine is an anti–literalist doctrine: it is used to deny tax benefits that comport with a literal reading of relevant authority. A formalist judge might well reject the doctrine as overly vague and without statutory support.

POLICY OPTIONS

The tax–shelter battle is worth waging. Shelters significantly reduce tax revenues. Shelters have been estimated to cost the fisc somewhere in the range of ten billion dollars a year over the past decade (Slemrod, 2004). Shelters make fiscal planning difficult and redistribute the tax burden in an undemocratic manner. Shelters also threaten to reduce overall compliance rates. Most taxpayers will be dispirited by stories of high–end shelters and some may respond by taking aggressive steps to reduce their own tax. Tax reduction at this level may take the form of overstated deductions, omitted income, or participation in obviously illegal schemes. The amounts involved may be high in the aggregate but low in each individual case and, therefore, relatively costly for the government to detect and challenge. Finally, the shelter industry siphons away resources from more productive enterprise. Shelters are expensive to develop, market and set up.11

Unfortunately, there is no easy answer to the tax shelter problem. Most proposals solve only a small part of the problem and/or impose real costs (Bankman, 1999). For example, some have advocated limited tax–book conformity, so that corporate taxpayers claiming tax losses were forced to recognize losses for financial accounting purposes. One difficulty with this proposal is that financial accounting and tax rules serve different purposes, making conformity undesirable. Other difficulties include the fact that financial accounting rules are sometimes poorly related to their intended purposes and the fact that proposals would not reach shelters purchased by persons not subject to the financial reporting requirements.

Others have tried to define shelters more precisely and to amend or replace the economic substance doctrine with statutes or doctrines based on those newly–drawn definitions (Hariton, 2003a, 2003b; Hyde and Kohl, 2003). These proposals help

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11 These costs, together with enforcement costs, could obviously be reduced to near zero if the government stopped fighting shelters. The market would standardize around one or two shelters, and the price of those shelters would plummet. At that point, however, the government would have lost virtually all revenue from capital and perhaps substantial revenue from labor.
shed light on the tax–shelter problem; some of the suggested language is no doubt superior to that used under existing law. However, these proposals would be plagued by almost all of the same ambiguities that now make application of the economic substance doctrine difficult. To take but one example, all proposals must contain an exception for (but obviously cannot provide a definition of) transactions consistent with legislative intent.

A number of scholars and practitioners have proposed more modest statutes aimed at some common forms of shelters (Peaslee, 2004). Some of these proposals may be worth adopting but would not solve the shelter problem. These proposals, like the more ambitious proposals to reform the economic substance doctrine, cannot avoid many of the ambiguities that make present law difficult to apply. Perhaps the best that could be hoped for is that the proposals would increase the cost of shelter development, as promoters would be forced to abandon all variations on some often–used forms of shelter.

In the short run, perhaps the most attractive policy option is for the government to raise the ex–ante cost of shelters by increasing penalties. The government might, for example, raise the principal penalty levied on shelters from 20 to 40 percent and remove any protection offered by opinion letters. The increased penalty could apply to transactions that lack economic substance. There is some evidence that shelter purchasers are quite sensitive to penalty levels. In 2003, California adopted a similar, but slightly lower, penalty regimen (Bankman and Simmons, 2003). The legislation was tied to an amnesty provision: the new penalties did not apply to taxpayers who voluntarily paid taxes, interest and penalties owed under prior law. The amnesty brought in approximately $1.3 billion, which represented roughly $15 billion of shelter–related deductions thrown back (Bankman, 2004b). Pinning increased penalties to transactions without economic substance has the added advantage of giving that doctrine some statutory basis, making it less likely that it will be thrown out by a formalist court.

Legislation incorporating the increase in penalties suggested above has been proposed for many years; the major stumbling block has been, and is, opposition to the codification of the economic substance doctrine. Opponents have argued that the proposed codifications expand and rigidify the doctrine (see New York State Bar Association (2003)). The California approach circumvents this problem by leaving the definition of economic substance to the courts.

Increasing shelter–related penalties will not remedy the inherent limitations in the economic substance doctrine. Moreover, increased penalties will increase compliance and transaction costs and some portion of this increase will be borne by taxpayers who conclude correctly (but only after lengthy review) that they are on the right side of the law. A realistic hope is that the higher penalties, together with strong enforcement, might limit the shelter market to a manageable size.

The only long–term solution to the shelter problem is structural reform. The present tax treatment of capital is a mixture of mark–to–market, or “pure income tax,” realization, yield–exemption, cash flow, and interest–group–related preferences. A massive set of rules is required to prevent taxpayers from arbitraging between those differing systems (for example, by deducting debt used to purchase tax–exempt bonds). Many tax shelters involve newly–discovered arbitrage opportunities or, more common yet, flaws in the set of rules designed to prevent arbitrage. Other shelters take advantage of flaws inherent in the two–tier tax on corporate income, the related distinction between debt and equity, and rules designed to shore up that system and distinction. A pure cash
flow tax would (in most of its proposed forms) remove competing forms of capital taxation and obviate the rules needed to prevent arbitrage between those forms. It would also eliminate the two-tier tax on corporate income and the distinction between debt and equity. None of the shelters offered in the past two decades would work in such a system.12 The same result would be obtained in the (less likely) event that a pure mark-to-market tax were adopted.

However, even the most wide-reaching reform would not completely eliminate shelters. For example, scholars (and no doubt promoters) have already noted shelter opportunities in seemingly pure consumption tax proposals (Weisbach, 2000). Any actual reform will contain some “impure” political compromises; these, together with the unavoidable ambiguities of language, will create more opportunities for shelter.

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12 Since, under plausible assumptions, the net present value of tax on new investment under a cash flow tax is zero, the ability of such a tax to eliminate shelters on capital might seem obvious and not a separate advantage of a cash flow tax. It should always be possible to avoid a tax–induced distortion (including tax shelters) by eliminating the tax that causes that distortion. For our purposes, however, the point remains that a cash flow tax would reduce the social costs of shelters. It would not eliminate those costs because, as noted in text below, the cash flow tax would not, in fact, eliminate all shelters.
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