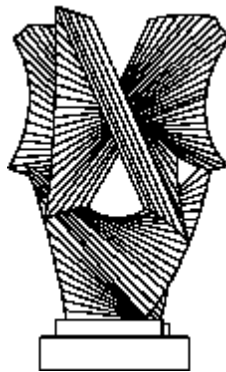


CHICAGO

JOHN M. OLIN PROGRAM IN LAW & ECONOMICS WORKING PAPER NO. 122
(2D SERIES)



TEN TRUTHS ABOUT TAX SHELTERS

David A. Weisbach

This paper can be downloaded without charge at:
The Chicago Working Paper Series Index:
<http://www.law.uchicago.edu/Lawecon/index.html>

The Social Science Research Network Electronic Paper Collection:
http://papers.ssrn.com/paper.taf?abstract_id=268831

TEN TRUTHS ABOUT TAX SHELTERS

David A. Weisbach

The University of Chicago Law School

May 10, 2001

Abstract

This paper advances ten propositions about tax shelters and tax avoidance. The first four propositions argue that tax shelters must be analyzed solely by the consequences of shelters and the responses, rejecting reasoning based on notions such as the right to tax plan, legitimate tax planning, or statutory interpretation. The next three propositions analyze the consequences of tax shelters by viewing shelters as unintentional gaps in the tax base and attacks on shelters as similar to broadening the base. At the margin, the benefits of broadening the base must be set equal to the administrative costs of doing so and the propositions examine these costs and benefits in detail. The last three propositions discuss issues relating to implementing anti-shelter rules, including the problem of getting empirical estimates, and the role uncertainty and motive should play.

Do not use without permission.
Send comments to: d-weisbach@uchicago.edu

Ten Truths about Tax Shelters

*David A. Weisbach**

May 10, 2001

Tax shelters are one of the most difficult topics in tax law. They are wrapped up in a variety of complex issues, including statutory interpretation, efficiency, problems of second best (for example, when the avoidance is of an inappropriate tax), the use of incentives in the tax law, the effect of uncertainty of the tax law, the appropriate use of rules and standards, disclosure of information, auditing techniques, and the role of lawyers. It is also an area that is usually analyzed without explicit regard for the consequences of approaches to the problem – the word “legalistic” comes to mind. For example, many analyses begin by assuming taxpayers have the right to alter their behavior to minimize taxes, without exploring whether granting such a right makes sense.¹ Others assume that the problem is one of statutory interpretation – whether judges should read statutes purposefully or whether they should stick with the literal language – without regard to the fact that the statute itself can always be changed to include or exclude purposive elements and that advice on the response to tax shelters should be addressed to more than just courts.²

The goal of this paper is to push the thinking on shelters towards analysis of the consequences of various regimes and away from legalistic thinking. I will do so by making and defending ten propositions about tax shelters. Some of the propositions criticize legalistic analysis, showing how that analysis often assumes its conclusion or fails to deal with the important problems at hand. Other propositions push toward consequentialist analysis, attempting to make small steps toward understanding the consequences of various approaches to shelters.

While each proposition is distinct and stands on its own, I have tried to organize them into a coherent argument. The argument has three basic components. The first step is to clear away some of the underbrush. To this end, the first proposition argues that statutory interpretation is not important in thinking about shelters. Statutory interpretation is primarily about the allocation of authority

*Professor, University of Chicago Law School. Preliminary draft. Do not circulate without permission. Send comments to d-weisbach@uchicago.edu.

¹For example, the current Assistant Secretary for Tax Policy has argued (while in a prior role) that proposals to limit shelters should not inhibit “legitimate tax planning.” See Washington Council Ernst & Young Comments on Corporate Tax Shelter Draft, 2000 TNT 146-21 (June 13, 2000). Similarly, most of the major bar or trade associations are on record as defending tax planning. See, e.g., New York State Bar Ass’n Tax Section, Report on Certain Tax Shelter Provisions, June 22, 1999; AICPA letter to Treasury, Tax Analyst Doc. 95-9765; TEI Calls for “Balanced” Solutions on Tax Shelter Problems, 83 Tax Note 1245 (1999).

²See, e.g., Joseph Isenbergh, Musings on Form and Substance in Taxation, 49 Chicago L. Rev. 859 (1982).

between branches of government while the policy question for shelters is to what extent should tax planning be allowed. The second proposition is that we should not assume when thinking about shelters that there is a “right” to minimize taxes. Congress can limit tax planning however it chooses and, therefore, starting the analysis by assuming a right inappropriately limits the analysis. The third proposition is that all tax planning, not just planning associated with transactions traditionally or commonly associated with shelters, causes inefficiencies and there is no *a priori* way to distinguish shelters from any other tax planning. We should be suspicious of all tax planning. The fourth proposition discusses the current proposals for disclosure. The various bar associations have advocated disclosure as a cure for the currently perceived shelter problem. This proposition maintains that to the extent there is a problem under current law, disclosure as it is currently being considered, will not help very much and to the extent it distracts from better solutions, it actually will hurt.

The next several propositions lay out an analysis of shelters, focusing on the consequences of responding to them. Proposition Five argues that we should analyze shelters assuming a constant budget constraint. Somehow the money raised from attacks on shelters will lead to lower taxes elsewhere. In particular, there is no reason to believe that attacks on shelters will generally lead to an increase in taxes on businesses or on capital income.

The sixth proposition argues that we can view shelters much like any other omission to the tax base and that attempts to limit shelters are much like a broadening of the tax base. The advantage of broadening the base is that it reduces substitution from items in the base to untaxed items, the shelters. Broader bases are generally more efficient than narrower bases. But broadening the base may be administratively expensive. Identifying shelters is difficult, just like identifying imputed rent is difficult and it is not clear that in all cases the benefits are worth the administrative costs. Finally, because we cannot perfectly identify shelters, attacks on shelters will lead to a collateral response – shelters will be restructured to avoid the attacks. This response, which I label the distortionary effect, creates deadweight loss and must be factored into the equation.

The last proposition in this section of the paper, Proposition Seven, discusses how we should consider tax revenues in the analysis. Often commentators disparage proposals as mere revenue grabs that have no basis in policy. This proposition argues that such statements are nonsense – revenue is central to analyzing the problem.

The last section of the paper, the last three propositions, discusses implementation. Proposition Eight discusses empirical estimates of shelter activity and argues that these estimates are surprisingly low given the attractive economics of shelters. Until we understand why the level of sheltering is so low, it is difficult

to make predictions about how shelters will respond to various attacks. Proposition Nine discusses the trade off between rules-based and standards-based attacks on shelters, focusing on uncertainty. The main point here is that uncertainty makes very little difference and claiming that a tax law is uncertain says nothing about its merits. Finally, Proposition Ten discusses the role of motive in addressing shelters, arguing that motive should be considered in distinguishing transactions.

The ten propositions in no sense provide a complete analysis of the problem. I am not ready to conclude at the end that we should address shelters by taking some specific action. Instead, the goal is to push the discussion toward an analysis of the consequences of shelters. Nevertheless, I think the analysis points in the direction of significantly stronger attacks on shelters and other tax planning than are currently being proposed.

1. *The shelter problem is not primarily about statutory interpretation.*

A taxpayer examining a shelter under existing law will look at the response to shelters as relating to statutory interpretation. The question for the taxpayer is the tax treatment of a transaction, whether it is a transaction that is being planned or a past transaction that is being challenged by the Service. The tax treatment will depend on the relevant statutory language and whether any principles exist that might over-ride the language – questions of statutory interpretation. That is, the tax shelter question for taxpayers is, to a large extent, one of statutory interpretation, pitting literal against purposive modes of interpretation.

The problem also looks like a problem of statutory interpretation to a judge deciding cases. The judge must decide whether a given transaction that arguably meets the literal language of some provision will be respected. The judge must choose between purposive interpretation, literal interpretation, pragmatic interpretation, or some other mode of deciding the case. Judges have also been frequent and eloquent speakers on tax shelters, setting forth many of the basic principles that we use today. Certain cases have become classic fact patterns and part of the lexicon of the lawyer. The language of these cases, the paradigmatic or authoritative statements on tax shelters, is often the language of statutory interpretation, as is appropriate. Perhaps for this reason, many articles addressing shelters approach the problem as one of statutory interpretation.³

The policy issues raised by shelters, however, are not about statutory interpretation. The reason is that any method of statutory interpretation that is deemed inappropriate under the internal logic or canons of statutory interpretation can be directly incorporated into the statute, converting the inappropriate

³See, e.g., Isenbergh, Musings, note _ supra.

interpretive method into a mandatory one. For example, suppose one concludes that the appropriate method of interpretation is literalist, strictly following the words of the statute regardless of consequences. One might base this conclusion on separation of powers concerns or a belief that literalist interpretation is more likely to reach congressional intent.⁴ Someone following this reasoning, therefore, would exclude considerations such as substance over form or the step transaction doctrine as impermissible glosses on the statute. But this conclusion would say absolutely nothing about the desirability of these doctrines. If they are desirable for independent reasons, Congress can incorporate them directly into the statute. The literalist would then be forced to use these doctrines when interpreting the tax law.

Another way to state the argument is that the statutory interpretation view takes existing statutory law as fixed and asks the appropriate response. Courts sit in this position. But statutes and regulations can be changed in any imaginable manner. An understanding of how best to interpret existing statutes, while crucial to the taxpayer or the judge, is entirely unhelpful in deciding how to craft new statutes or amend old ones to respond to tax shelters.

This is not to say that statutory interpretation doesn't affect how the statute reads – if the statute is to be interpreted literally, the language of the statute might be adjusted to achieve the correct policy. The language would look different if the statutory interpretation method were, say, purposive. In general, holding policy constant, the language of the statute will vary with interpretive methods. The policymaker, therefore, must be aware of these issues. But they do not reflect the ultimate content, only the drafting.

An argument that has been made against purposive interpretation in the tax context is that the artificial forms relied upon in the tax world have no underlying reality and, therefore, the judge has no choice but to interpret the words literally. Asking a judge to interpret the words purposefully, under this argument, is asking the impossible – statutes that rely on empty forms cannot be interpreted purposefully by their very nature. This argument is usually associated with Joe Isenbergh, who put the point pithily with the observation that “there is no natural law of reverse triangular mergers.”⁵

But the argument, as Isenbergh said of the court decisions he criticizes, simply collapses on close scrutiny.⁶ It simply does not follow that because Congress

⁴See, Adrian Vermeule, *Legislative History and the Limits of Judicial Competence: The Untold Story of Holy Trinity Church*, 50 *Stanford L. Rev.* 1833 (1998).

⁵Isenbergh at 879.

⁶Isenbergh at 874.

is creating formal requirements for a particular treatment that it cannot restrict the treatment in any way it chooses, including restricting them on the basis of business purpose, motive, economic substance, or whether the documents are written in Egyptian hieroglyphics. Congress could add to the list of requirements to get treatment as a reverse triangular merger any of the doctrines disparaged by Isenbergh. I'm not even sure that the argument tells us how courts should read statutes. If Congress can include these terms but, when enacting the statute, did not make them explicit because it assumed courts would include them, perhaps courts should interpret the statute that way. But even if the argument is sound regarding statutory interpretation, it tells us nothing about the appropriate response to shelters.

Statutory interpretation is a red herring. It is easy to view it as important because it is the focus of many eloquent speakers on shelters, speakers who happened to be deciding a case at the time. Practicing lawyers have also been frequent commentators on shelters and their natural point of view focuses on statutory interpretation because it is the focus of the advice they give clients. But it is not the relevant policy question. Instead, the appropriate focus is on the actual content of the law, whether it comes from congressional enactments alone, or some combination of Congress, the Executive branch, and the courts.

2. *The shelter problem cannot be resolved by references to a right to minimize taxes, to the scope of legitimate tax planning, or to various definitions of shelters.*

Many analyses of shelters start with the proposition that taxpayers have a right to alter their affairs to minimize taxes or that legitimate tax planning should not be curtailed.⁷ It is understandable that many commentators begin with this assumption because it is a truism of the case law, a right well-embedded in our tax system. Learned Hand waxed eloquently on this point, and other judges have followed in his path.⁸ We should not, however, assume any such right exists when determining the appropriate response to shelters.

The so-called right to tax plan stems from case law. The most commonly quoted statements on the right to tax plan come from Judge Hand's opinion in

⁷See sources cited in note ___.

⁸The number of cases citing this proposition is vast. Within the last several years, major cases plan include *Salina Partnership v. Commissioner*, T.C. Memo 2000-352; *Winn-Dixie v. Commissioner*, 113 T.C. 254 (1999); *ASA Investering Partnership v. Commissioner*, T.C. Memo 1998-305; *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); *Saba Partnership v. Commissioner*, T.C. Memo 1999-359

Gregory.⁹ While Hand cited two Supreme Court decisions, *Isham*¹⁰ and *Bullen*,¹¹ he essentially made it up.¹² It came from the ether. There is absolutely no basis for such a right in any source usually available to a judge.

The first place judges are supposed to look for the law is the statute. Hand, however, does not point to statutory provisions granting such a right because he cannot. Nothing in the tax law specifically grants a right to tax plan. Nor did he refer to the legislative history. And he did not refer to more general principles of statutory interpretation.¹³ If judges are supposed to interpret the law as passed by the legislature, Hand's decision to create a right to tax plan has no support whatsoever.

One argument for a statutory basis for the right is that it is implicit in the

⁹*Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934). Hand argued that

[A] transaction otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

For a similarly eloquent statement by Hand, see the statement in *Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, dissenting).

¹⁰*United States v. Isham*, 84 U.S. 496 (1873).

¹¹*Bullen v. State of Wisconsin*, 240 U.S. 625 (1916).

¹²Alternatively, Hand was faithfully following precedent, but the *Isham* and *Bullen* courts made it up.

¹³*Bullen* arguably states a general principle of statutory interpretation. It held that "when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits." 240 U.S. ___. But this has two problems. First, if lines necessarily have this property, the law can be changed, if desirable, to use fewer lines. Second, it is not clear why lines have to be interpreted this way. Courts can just as easily interpret lines based on intent. *Isham* states two reasons for allowing avoidance of the stamp tax at issue. First, is that "if the device is carried out by the means of legal forms, it is subject to no legal censure." 84 U.S. at ___. This statement is essentially identical to that in *Bullen*, and like that case, assumes the conclusion. The second reason is that looking beyond form to substance in the case of that particular tax, a stamp tax on negotiable instruments, would create inconvenience and difficulties in the monetary system. There is a strong need for negotiable instruments to trade freely. This reason does not necessarily extend beyond the particular tax considered and does not support any particular interpretation of the Internal Revenue Code. To the extent that Hand relied on these cases for the "drawing the line" principle, he may have correctly followed Supreme Court commands on how to interpret the law. But as noted in the text, finding a right to tax plan in the positive law is the worst case for those relying on a right to tax plan because, if desirable, Congress can always change the law.

language of the statute. The tax law refers to actions taken by taxpayers. If one does not take these actions, the law, by its terms, does not apply. The implication is that one is free to choose the actions one takes and merely apply the law as written. This is close to Holmes' famous statement about lines in the law, found in *Bullen* and relied upon by Hand. It is also similar to the statutory interpretation argument discussed above. The conclusion, however, doesn't follow from the premise. Congress could easily have intended the basic transactional rules to apply to everyday business transactions but at the same time intended the benefits granted in the statute to be severely restricted for tax motivated transactions. Or, alternatively, if it did not intend that to be the case, it could.

Moreover, if the right were found to be implicit in the terms of the statute, it is hard to see how calling it a "right" would be helpful. Viewing something as a right usually means there that is something profound or inviolate about it. But if the so-called right is just based on some language in the statute, nothing stops Congress from changing the language. Essentially there would be no "right." Instead there would be a privilege granted in the statute and the debate would be about whether the grant should be expanded, reduced, or even eliminated. This decision would have to be based on the consequences rather than a pre-assumed right. Those who depend on or hope for such a right would best argue against finding it in the statute.

If the right is based on a source more profound than mere statute, modifying it might be more troublesome. We would not want to limit fundamental rights or values. But Hand did not find the right in any such source. For example, Hand did not find such a right in the Constitution or any other foundational documents of our society. (These, of course, can be amended, but it is difficult to do so and analysts might then be justified in treating the scope of tax planning as basically fixed were such a right found there.) And the right to alter behavior to minimize taxes is not a basic principle of moral philosophy. It does not, for example, rank with the freedom of thought, speech, association, religion, or other principles supported by moral philosophers.

To summarize, no moral or philosophical basis for the right to tax plan has yet been articulated. There is no Constitutional right. There is no statutory right. There is, in short, no basis for a right to tax plan other than statements made up out of thin air by a few judges. Congress can limit or expand the scope of the right to tax plan with the stroke of a pen. If it is desirable to restrict tax planning, it should be restricted notwithstanding that doing so would reduce the scope of allowable planning permitted under current law.

The same is true with attempts to derive the definition of a shelter from thin air. One cannot derive the appropriate definition of shelters without considering the consequences of such a definition. For example, one recent article began its analysis

by defining tax shelters alternatively as “transactions taxpayers enter into with unrelated parties merely to permit them to take dubious tax positions” or “transactions that are entered into primarily for tax reasons.”¹⁴ Given these definitions of shelters, it considers how to draft a statute that limits their benefits. But the article has assumed its conclusion. Why, for example, should we limit shelters to transactions that are entered into primarily for tax benefits? The definition could easily have required that taxpayers enter into the transaction exclusively for tax benefits, or alternatively, as transactions with any tax motivation at all. And why require unrelated parties or dubious tax positions? Many transactions that we might care about involve related parties and even if a transaction does not involve a dubious tax position, we may want to change the law to disallow the tax benefits. We cannot start out the analysis with a definition. Instead, the definition must be the conclusion.¹⁵

Determining the scope of allowable tax planning requires analysis of the consequences of tax planning and of attempts to stop it. Starting the analysis with an assumed right to tax plan or a definition assumes the conclusion – the scope of the assumed right or definition tells us exactly what tax planning should (must) be permitted and what need not be. Instead, of assuming a right to tax plan, we should determine the appropriate limits on tax planning and anything left is what is allowed.

3. *There is no social benefit to tax planning*

If the above proposition is correct, there is no right to tax plan, in the sense that there is nothing stopping Congress from limiting tax planning any way it chooses. The immediate question is what is the value of tax planning. Perhaps tax planning should be protected as a matter of policy, so that even if there is no “right,” we get to the same place, following a different path.

But tax planning, all tax planning, not just planning associated with traditional notions of shelters, produces nothing of value. Nothing is gained by finding new ways to turn ordinary income into capital gain, push a gain offshore, or generate losses. No new medicines are found, computer chips designed, or homeless housed through tax planning. At a minimum, defenders of tax planning must justify why we should care about a nonproductive activity.

Tax planning is actually far worse than that. It is almost always positively bad

¹⁴See David Hariton, How to Define “Corporate Tax Shelter,” Tax Notes p. 883 August 9, 1999.

¹⁵To be fair to the author, he merely claims to be showing how a statute can be drafted consistent with these definitions, but by adopting these definitions as his baseline effectively endorses them.

for society – it is worse than worthless. Take a silly but instructive example. Suppose a clever lawyer invents a new shelter called the backflip shelter. Under this shelter, if you successfully perform a backflip, you get ten percent off your taxes.¹⁶ (A backflip is pretty straightforward compared to many shelters.) For each individual, attempting the backflip is a good idea – the cost of the backflip is well less than the taxes saved. But even though each individual may have a strong incentive to do gymnastics, society is worse off. If everyone manages the backflip, nobody at all saves taxes. Holding government spending constant, everyone's taxes are exactly the same with and without the backflip shelter, except that with the backflip, nominal taxes are higher and are then reduced by the tax gymnastics. And even though taxes are exactly the same, everyone is worse off because they had to do the backflip when they otherwise could have happily gone about their business without such silliness. Tax planning, to the extent it is like the back-flip example, potentially makes everyone worse off.

Of course, not everyone will do backflips or otherwise act to reduce their taxes, so there may be distributive consequences. The overall level of taxes is the same, but those who shelter are better off at the expense of those who don't. But it is hard to see the distributive benefit of such an outcome. Those who tax plan are not in some way more deserving of lower taxes than those who do not. There is no reason why we would want to distribute money toward shelterers.¹⁷

Using this line of reasoning, tax planning can be analogized to an externality. Those who tax plan impose costs on those who do not in the form of higher taxes. The person who engages in the tax planning does not take that external cost into account, nor is it reflected through the price system.¹⁸ There is, therefore, an incentive to engage in too much sheltering. The polluter imposes costs on neighbors that are not included in his cost/benefit calculation and, therefore, pollutes too much. Tax planning, in this sense, is just like polluting. The usual cure for

¹⁶Dan Shaviro uses the backflip analogy in his recent article on tax shelters and I thank him for the analogy. See Daniel Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, *_ Tax Notes* 221 (July 10, 2000).

¹⁷One could construct theories where disutility from paying taxes varies among taxpayers. Shelterers have a higher disutility from paying tax, as indicated by their revealed preference of sheltering. In this case, a transfer of tax burdens from shelterers to others improves welfare. It is doubtful that these distributive benefits, even if real, are sufficiently large to change the analysis.

¹⁸The technical difference between tax planning and externalities is that externalities, as classically defined, are actions that directly enter into another person's utility function. See, Hal Varian, *Microeconomic Analysis* 1992 (3d Edition), p. 432-439. Tax planning enters others' utility functions only because the government has to increase taxes as a result of the reduction in revenues from planning.

externalities is to force actors to internalize the costs imposed on others.¹⁹ The costs imposed on others in the case of tax planning are precisely the reduction in taxes from planning. If we make actors bear these costs, we would eliminate tax planning altogether.

The terminology used above was “tax planning” not “tax shelters.” There is nothing to distinguish shelters from all other planning – anytime anyone alters their behavior because of taxes we have the same problem – the changed behavior imposes costs on others that the person does not take into account. Therefore, the conclusion above does not change based on whether the backflip was so-called legitimate tax planning or a prohibited shelter. Although in the end, I agree that most tax planning must be allowed merely because of the impossibility of identifying it, the initial starting point should be that all tax planning, all altering of behavior in response to taxes, should be suspect. It is only other limits on anti-planning devices, such as the impossibility of identifying tax planning, that cause us to allow some tax planning to continue.

Consequentialist analysis has now completely reversed the usual internal tax logic. Rather than there being a right to tax plan which limits the possible anti-shelter rules, all tax planning should be eliminated if possible, subject only to the cost of doing so.

A broad and general point such this will inevitably have some exceptions and that is true here. There are functions of tax lawyers that are socially valuable and even some tax planning may be valuable. In particular, tax lawyers representing clients on audit or in litigation are performing basically the same role as others in our adversary system. There is nothing any better or worse about tax lawyers in this context than for lawyers representing clients before tribunals more generally. In addition, tax lawyers acting as return preparers help interpret the law and ensure compliance and these functions are socially valuable.

There may even be limited cases where tax planning is socially valuable. For example, if Congress intended taxpayers to get a particular treatment for a general type of transaction but required a particular form to get the treatment, helping taxpayers meet the requirements seems to be socially valuable, although the boundaries of this category are uncertain. It is as if the lawyer helped a client fill out an application, making sure the right boxes were checked.

The most difficult case is where there is an obvious wart on the tax system and tax lawyers help clients plan around the problem. For example, a given transaction might be grossly over-taxed relative to others, creating economic

¹⁹See Varian, note ___.

distortions. For various reasons, including the difficulty of drafting the law precisely, planning may reduce the tax to the appropriate amount more cheaply than actually amending the law. But this is a dangerous path because it depends on judgments about the merits of the underlying law. It is generally not a defense to a violation of the law that the law is stupid (try this next time you get pulled over for speeding). It is, therefore, not clear that we should think that planning around warts in the law is socially valuable.

A blanket statement that we should get rid of tax lawyers, therefore, would clearly be too broad. But notwithstanding these cases where tax lawyers perform valuable functions, we should not kid ourselves that tax planning is productive (or is even merely worthless). In considering how to structure our tax law, tax planning deserves little or no protection.

4. *Disclosure is not enough.*

Disclosure is the currently favored response to shelters.²⁰ Those who advocate increased disclosure have observed an increase in tax shelter activity and argue that it creates a serious problem for the tax system. They argue that taxpayer disclosure is the appropriate solution to the problem rather than a change to substantive law. I have written elsewhere that, assuming there is a current problem, disclosure is insufficient to solve it.²¹ Rather than repeat the argument in all its gory details, I will just outline the general points.

Disclosure is important because it has the potential to change the likelihood that a shelter is challenged. To the extent that disclosure increases the chance of *successful* challenges, it can alter the economics of sheltering for the worse and,

²⁰The Joint Committee on Taxation has generally argued for this approach. See Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters), Staff of the Joint Committee on Taxation (JCS-3-99), (July 22, 1999). The bar associations have supported this approach and generally argued against changes to substantive law. The New York State Bar Association Tax Section has been unequivocal in this regard. See, e.g., the reports of the New York State Bar Association Tax Sections in Tax Notes, May 10, 1999, p. 879, and Tax Notes, August 14, 2000, p. 937. The ABA has been less clear but has generally advocated penalty and disclosure regimes and refrained from supported changes to substantive law. See ABA Testimony Before the Ways & Means Committee, November 10, 1999, and Letter to Congressman Doggett Regarding H.R. 2255: Abusive Tax Shelter Shutdown Act of 1999, September 23, 1999. Perhaps the clearest statement in favor of only using disclosure to address shelters is Peter Canellos, A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and Tax Shelters, 54 SMU L. Rev. 47 (2001).

²¹See David A. Weisbach, The Failure of Disclosure as an Approach to Shelters, 54 SMU L. Rev. 73 (2001); David A. Weisbach, It's Time to Get Serious About Shelters, Tax Notes, September 25, 2000 p. 1677.

therefore, reduce sheltering somewhat. I do not think, however, that disclosure will work as hoped for two reasons.

First, disclosure will not significantly change the likelihood of successful audits. Disclosure forces tax shelters or promoters to send documents to Washington detailing the structure of their shelters. That is, disclosure is aimed primarily at giving information to the policymakers in Washington. There is nothing about disclosure to the policymaking offices in Washington that necessarily increases the chances of audit challenges.

Instead, documents and records that detail the specific shelter transactions and that are available to auditors are the most important sources of successful challenges. Rules enhancing the documents and records available on audit can be changed or improved without regard to whether the documents are sent by taxpayers to Washington. For example, the tax law requires taxpayers to reconcile their book and tax records through a form known as Schedule M. Virtually no shelters in the current market reduce book income, so Schedule M adjustments should point to way to most shelters. Unfortunately, Schedule M is often obscure and complex. Making Schedule M more useful would clearly be a productive enterprise, but this has nothing to do with the disclosure proposals on the table. Similarly, the customer list requirement, which requires to maintain a list of taxpayers who purchase shelters, assists auditors in a way that disclosure of shelter information to Washington does not.

The chances of successful audits may also change if there is central coordination of attacks on shelters by experts in the transactions. Disclosure seems to help here because the documents are sent to a centralized office. But centralization of shelter audits can be achieved without disclosure through mere internal communications within the Service. For example, the new Office of Tax Shelter Analysis may be a great idea, but it can operate without the new disclosure rules as long as it has close communications with the field auditors.

Disclosure rather than focusing on audits, is really about letting the policymakers know about shelters. But the policymakers need to know about shelters for only one reason – so that they can change to law where appropriate to eliminate them.

This brings up the second problem with disclosure: many if not most shelters work under current law. To the extent the disclosure proposals have any bite, they are about making it easier to change substantive law. But if this is the case, we need to compare this approach, disclosure of shelters followed by repeated amendments to the law to shut them down, to other approaches to shelters, such significantly increasing the strength of anti-tax avoidance doctrines. I, for one, do not think repeated amendments to complicated rules is the better approach.

While I do not believe that disclosure is an effective policy, there is an even more troubling, even if not surprising, aspect of the practitioner and bar association support for disclosure. The same individuals claiming that the audit lottery is the cause of the tax shelter boom offer opinions that the shelters entered into by their clients work under current law. That is, the members of the bar associations, even many at the highest levels of these organizations, individually spend vast portions of their time analyzing shelters and concluding that the shelters in front of them work. Some even peddle the shelters to third parties. But their policy recommendations to the government are based on the hypothesis that most shelters do not work under current law. If the shelters work under current law, they have nothing to fear from the audit lottery. And if they have to fear changes in the audit lottery, their opinions are incorrect.

I don't know how to reconcile the bar associations' actions with their words. It looks to me like they do not want the government to notice the tax sheltering man behind the curtain. Instead, they ask the government to pay attention to the smoke and mirrors of disclosure. Worse, disclosure actually helps the members of the bar associations. Disclosure leads to constant legal change to eliminate the shelter *de jure*. It makes the law less stable and more complex. This means more work for tax lawyers. They can command high fees for interpreting the latest changes and even higher fees for structuring new shelters that avoid the changed rules.²²

Perhaps one should not expect more from even well-intentioned individuals who face strong monetary incentives to protect tax sheltering,²³ but the serious attention paid to the bar associations' comments by the government worries me. Disclosure is not a sufficient solution to the problem.

5. *Strengthening the shelter rules should not be an occasion for increasing the tax burden on businesses.*

One objection to strengthening the rules against shelters is that doing so increases taxes on businesses. If the level of business taxes is already too high or just right, increasing taxes on business would be inappropriate. It may be for this reason that businesses often oppose strengthening the rules against shelters.

But changing the strength of anti-shelter rules should not be and does not have to be an occasion to raise taxes on anyone. All of the revenue from

²²See Joseph Bankman, The New Market for Corporate Tax Shelters, Tax Notes, June 21, 1999, p. 1775, for this argument.

²³Louis Eisenstein might have been correct about bar associations is describing the ABA as a "venerable organization from which little should be expected." Louis Eisenstein, The Ideologies of Taxation, p. 210 (1961).

strengthening anti-shelter rules can, if appropriate, be plowed back into the businesses whence it came. The two, the strength of anti-shelter rules and the net level of taxes on businesses are largely unconnected.²⁴ The decision to respond to shelters is about reducing tax avoidance behavior, not about taxing capital or businesses more.

In fact, everyone can be better off if we do this. Suppose that the current level of business taxes is about right, that it is otherwise a good idea to increase the strength of some anti-shelter doctrine, that doing so reduces sheltering and increases tax receipts, and that all of the increased tax receipts are used to reduce taxes on the businesses that were previously avoiding tax. The businesses will have exactly the same tax burden as before, but they will no longer have to engage in crazy tax schemes like the backflip shelter. Everyone is better off.

The right way to think about the problem, therefore, is by holding total tax receipts constant. In the jargon of economics, we should try to find the optimal tax system subject to a constant budget constraint. If a tax law change raises additional revenue, corresponding changes (such as changes to the overall rate structure) should be made so that the government budget remains fixed. This procedure allows us to make comparisons among different tax proposals to try to find the cheapest method of raising the money. Any other method risks comparing apples and oranges – the choice with the higher tax receipts is likely to look worse.

The idea of returning the money from shelters to businesses may strike some as odd. If we catch someone with their hand in the cookie jar, we do not give them the cookie. If businesses should not have been engaging in various shelters, stopping the shelters while giving them the revenue seems perverse.

Notwithstanding the intuitive appeal of this objection, it does not make sense. The overall level of businesses taxes and the strength of anti-shelter rules are largely independent.²⁵ If business taxes are too low now, whether because of sheltering or some other reason, they should be increased. Whether the taxes should be increased by strengthening the rules against shelters or by some other method is an independent decision about the merits of particular proposals. Similarly, if business taxes are at the right level under current law, strengthening the rules against shelters should not be an occasion for increasing business taxes.

²⁴One sense in which they are connected is that the incentive to shelter is greater the higher the tax rate is, which in turn may create a need for stronger responses to shelters. In addition, more efficient taxes may affect the desirability of redistribution. See text accompanying note ___ for a discussion of this point.

²⁵See text accompanying note ___ for how they might be connected.

The problem businesses face in thinking this way is that they cannot force policymakers to use money raised from anti-shelter laws to reduce taxes on the businesses. If businesses requested an exchange of lower taxes for stronger anti-shelter rules, there is no guarantee that money raised from stronger anti-shelter rules would not be used for other purposes. Congress could take only half of such a proposal and, even holding revenue constant, give tax reductions to others. The strategy of supporting stronger anti-shelter rules, therefore, is risky for businesses, even if, in the long run it is likely to make them better off. Congress or the Treasury could try to alleviate this problem by committing to using any revenue from anti-shelter laws to reduce business taxes, but they have not done so.

6. *Anti-shelter rules can be analyzed as gaps in the tax base*

We are now (finally) ready to consider the consequences of limiting shelters. I will take it in several steps, considering first the efficiency aspects of the problem and then the distributional aspects. From an efficiency perspective, I will analyze shelters as omissions from the tax base and attacks on shelters as similar to expansions of the tax base. The analysis will have three parts. First, I will discuss why shelters can be viewed as omissions to the tax base. Second, I will discuss a general framework for determining the appropriate scope of the tax base. Finally, I will apply framework to shelters.

Shelters can be viewed as omissions from the tax base. We might have thought we were taxing income, but if the taxpayer creates the right capital structure, buys and sells the right exotic derivatives while in a Caribbean island, or structures transactions through enough convoluted steps, no taxes are due. They are fundamentally like any other omission to the tax base, such as the failure to tax fringe benefits, imputed rent, unrealized appreciation, or much income from oil and gas exploration. If a taxpayer engages in the right sort of activity, lower taxes are due.

The effects of shelters are very similar to the effects of other omissions from the tax base, and, on the margin, the effects should be identical. Taxpayers shift toward owner-occupied housing, fringe benefits, assets that produce long-term capital gain, and oil and gas exploration because they are tax favored. They shift toward exotic shelters because they are tax favored. In each case, they will shift to the tax-favored activity until the marginal benefits are equal to the marginal benefits available from other methods of reducing tax. Otherwise, the taxpayer could substitute one avoidance method for another and pay lower taxes without increasing costs. On the margin, therefore, the costs of shelters should be exactly the same as the cost of other omissions from the tax base. In fact, from this perspective, there really is no way to distinguish shelters from other omissions from the tax base. There is no *a priori* definition of shelters, so that all we can observe is various tax-induced distortions in behavior as taxpayers move toward low-taxed activities.

One may protest that shelters are different because in many shelters money merely goes around in a circle (or to where it was going anyway through a more complicated route). Shelters of this sort can be done indefinitely and involve no economic costs or distortions. Other behaviors caused by omissions to the tax base, such as a shift toward fringe benefits, owner-occupied housing, capital gain assets, or oil and gas exploration, require real changes in economic behavior and, therefore, are more limited.

But virtually all shelters have hidden costs, such as the costs of discovery, design, and implementation. These are not really any different than the costs of receiving compensation in less than desirable forms or living in owner-occupied housing when rental housing is more desirable. We know these costs are present or taxpayers would use shelters to eliminate all of their tax liability. One surface-level difference is that the many of costs of shelters are transfers to shelter promoters rather than direct costs. But shelter promoters incur opportunity costs, so the real effect is the same. Unless taxpayers are sheltering all of their income (and the evidence is that most don't), they should be setting the marginal benefits of shelters equal to the marginal benefits of other tax avoidance mechanisms.²⁶

If we view shelters as gaps in the tax base, we can view attempts to reduce shelters as expansions of the tax base. The proper scope of the tax base is a quite general problem. In general, a broader tax base is more efficient. It reduces tax-induced substitutions to non-taxed activities and allows lower tax rates. The mantra

²⁶An alternative possibility is that shelters are truly costless but some external constraint keeps taxpayers from sheltering too much. For example, it may be costless to eliminate capital income but impossible to use these shelters to reduce wage income. In economic jargon, there is a corner solution so that taxpayers do not set marginal costs equal.

The economic effects in this case might be slightly different and potentially much worse than the case considered in the text. Like other omissions to the tax bases, shelters in this case reduce revenues, requiring other taxes to be raised. Unlike other omissions from the base, they would not impose economic costs on the margin because, by hypothesis, they are costless. But they may impose another significant cost. Suppose that the ability to shelter some set portion of income does not change the marginal tax rate faced by the taxpayer. For example, a taxpayer may be able to shelter some capital income but still face the normal tax rate on capital income for new investments. In this case, taxpayers face all the distortion on the margin from the tax system but it raises no revenue. Shelters would be acting like a lump sum rebate and would be extremely inefficient.

To make this clear, suppose that capital income can be sheltered but labor income cannot be. Rates on labor income must be increased because of the shelters that protect capital income. Suppose also that shelters do not affect the tax rates on capital income that taxpayers face on the margin. New capital investments, therefore, will face the tax on capital income and, therefore, be distorted. The capital portion of the tax will still have all the distortions associated with that tax but raise little or none of the revenue. Effectively, there is a double hit – shelters in this example force us to raise the tax on labor income while not reducing the distortions of the tax on capital income.

from the 1986 act of “broad base, low rates” is widely accepted. But we do not want to expand the tax base indefinitely because doing so would be too costly. For example, the costs of taxing imputed rent on owner-occupied housing may well be higher than the benefits. The costs of eliminating the realization rule may be higher than the benefits. We only want to expand the tax base until the marginal benefits equal the marginal administrative cost. We need, therefore, to consider more carefully the costs and benefits.

The most obvious benefit of expanding the tax base is that doing so reduces the incentive on taxpayers to substitute to non-taxed items. If we tax imputed rent on owner-occupied housing, we reduce the tax distortions in the housing market. If we tax fringe benefits, we reduce the distortions in compensation arrangements. Tax-induced changes in behavior create deadweight loss, in the sense that taxpayers are worse off because of the change in behavior but the government receives no tax revenue. Reducing these tax-induced substitutions reduces the deadweight loss of the tax system.

We can measure the benefit of reducing distortions as a change in the compensated elasticity of taxable income, which is the percent change in taxable income when the tax rate are changed. It measures the overall efficiency of a tax because on the margin all omissions from the base have the same cost. Otherwise, as discussed above, taxpayers could shift their behavior from high marginal cost behaviors to lower marginal cost behavior and pay the same taxes.²⁷ A high elasticity of taxable income means that taxpayers are willing to shift their activities in response to a tax rate change. This can occur because a primitive preference, such as labor supply, is elastic but it can also occur because the tax base is narrow. Broadening the tax base reduces the elasticity of taxable income because, with fewer avenues for tax reduction, a change in tax rates will induce a smaller change in taxable income.

We can also view this benefit in terms of revenue rather than in terms of utility. When the tax base is expanded, taxpayers have a lower incentive to alter behavior to avoid tax, which means that they will shift somewhat back to taxed activities that they previously avoided. They will, as a result, pay more tax. In fact, it can be shown that under not unreasonable assumptions, the reduction in deadweight loss and the revenue gain are basically the same.²⁸

A second effect of expanding the tax base is that tax revenues will be

²⁷For a discussion of the elasticity of taxable income, see, Martin Feldstein, *Tax Avoidance and the Deadweight Loss of the Income Tax*, NBER Working Paper No. 5055 (1995); Joel Slemrod, *Methodological Issues in Measuring and Interpreting Taxable Income Elasticities*, 51 *National Tax Journal* 773 (1998); and Joel Slemrod and Wojciech Kopczuk, *The Optimal Elasticity of Taxable Income*, NBER Working Paper No. 7922 (2000).

²⁸See Slemrod and Kopczuk, note ____.

increased because of the taxation of the previously untaxed good. If imputed rent is taxed, many individuals will continue to live in their homes and pay new taxes as a result. If fringe benefits are taxed, some compensation will still be in the form of fringes and individuals will pay higher taxes as a result. Note that this source of revenue is distinct from and in addition to the revenue discussed above, which resulted from individuals shifting back into previously taxed items. Together, the two sources of revenue add up to the overall revenue effect of expanding the base.

A third effect of expanding the base is that individual choice is restricted, in the sense that previously untaxed items are now taxed. Because of the expanded base (and leaving aside offsetting changes to the tax system to make the government revenue neutral), taxpayers can consume or save less. Therefore, individual utility will go down. For example, individuals currently have the choice of taxed cash wages or tax-free fringe benefits. If we tax fringes, individuals will be worse off because of the tax.

The final effect of expanding the base is that administrative expenses may change. It is not always clear whether administrative expenses go up or down when the base is expanded – a broad base may be administratively cheaper than a base filled with many holes. For example, exemptions for income from oil and gas exploration may make the system more complex and broadening the base by eliminating the exemptions would simplify the system. But for most of the examples mentioned above, fringe benefits, imputed rent, realization, and tax shelters, broadening the base will generally increase administrative costs. Determining imputed rent, calculating the consumption value of fringe benefits, or taxing unrealized appreciation, would be expensive and difficult. And, as discussed below, attacking tax shelters is not easy.

We can use these effects to determine the optimal scope of the tax base. At the margin the cost of raising revenue by expanding the tax base must be equal to the marginal cost of increasing the tax rate.²⁹ Otherwise, we could expand or narrow the base and improve welfare. For example, if the marginal cost of expanding the tax base is less than the marginal cost of raising rates, we can expand the base and lower the rates and improve welfare. Alternatively, if the marginal cost of raising rates is lower than the marginal cost of expanding the base, we can narrow the base and raise rates and improve welfare. It is conceivable that when we apply this analysis to imputed rent, fringe benefits, realization, or other commonly discussed gaps in the tax base, that expanding the base is not a good idea.

We need to apply this analysis to shelters. The obvious benefit of expanding the base to reduce shelters is that it reduces the elasticity of taxable income – it

²⁹This condition is fairly intuitive, but for a derivation, see Shlomo Yitzhaki, A Note on Optimal Taxation and Administrative Costs, 69 *American Economic Review* 475 (1979).

reduces the incentive to distort behavior to reduce taxes. Equivalently, fewer resources are spent finding, creating, and structuring shelters. This is usually the stated goal of attacks on shelters – attacks on shelters prevent taxpayers from altering their behavior to reduce tax.

Expanding the tax base often raises revenue through the new tax on the previously untaxed item. In the case of shelters, however, we should expect little tax from this source. If a shelter is taxed, nobody does it any more. Nobody in their right mind does transactions like the ACM transaction, dividend strips, or corporate owned life insurance without tax incentives and when the incentives are removed, the transactions disappear.³⁰ Therefore, the only source of revenue from attacking shelters is that limiting shelters prevents taxpayers from shifting into untaxed activity. As noted above, this source of revenue is equivalent to the reduction in deadweight loss because behavior will be less distorted.

There are two costs to attacking shelters. The obvious cost of attacking shelters is that it is expensive. Whether we amend the law to eliminate shelters through a rules-based approach, attack shelters through anti-abuse rules, expand audit rates, or use some other method of combating shelters, the administrative costs of running the tax system go up. (We cannot consider here the benefit of reducing the costs of searching for shelters, which may go down as the number of shelters is reduced, because this was included above.) For example, amending the statute to eliminate known problems often makes the statute more complex. Anti-avoidance doctrines often require information that is difficult to obtain, such as information about mental states.

An equally important but less obvious cost of attacking shelters is that shelters themselves may get worse.³¹ Consider anti-avoidance doctrines and imagine a world where there are no anti-avoidance doctrines but all else is held equal. Without anti-avoidance doctrines, taxpayers would be able to enter into costless shelters. With no business purpose requirement, substance over form test, or economic substance doctrine, taxpayers would quickly find a few cheap and powerful shelters and do them to their hearts' content. Because they would be perfect, they would be just like taxpayers electing on their return to pay lower taxes. There would be no empty glass buildings, useless master recordings, or offshore subsidiaries holding bizarre financial products.

Now suppose we impose anti-shelter doctrines such as the business purpose

³⁰To the extent the shelter rules imperfectly describe their targets, there may be some revenue because taxpayers may continue to enter into these erroneously caught transactions.

³¹This argument is based on David Weisbach, *An Economic Analysis of Anti-Tax Avoidance Doctrines*, forthcoming, *American Law and Economics Review* (2001).

or economic substance doctrines. Shelters would not be eliminated. Instead, they would become more exotic. The economic substance doctrine says that taxes can be reduced only if there is a real change in economics. The business purpose doctrine says taxes can be reduced only if there is a real business. These doctrines create incentives to actually change behavior and taxpayers given these incentives would do so, thereby creating distortion. I call this effect the distortionary effect of anti-avoidance doctrines. It arises because enforcement is not perfect. Whether we attack shelters through changes in the statutory rules or through anti-avoidance doctrines, some tax-avoidance transactions will not be caught and taxpayers will have an incentive to shift their activity to the remaining avoidance opportunities. These avoidance opportunities will generally be worse than the ones they replace.

To take an actual example, consider the facts of *Knetsch v. United States*.³² Mr. Knetsch borrowed money from an insurance company and purchased an annuity from the same company with terms basically identical to the loan (other than the insurance company's fee). Interest payments were immediately deductible on the loan but interest income was deferred on the annuity, creating a tax arbitrage. The Supreme Court held that the transaction was a sham and disallowed the tax benefits. After the Supreme Court's decision, (and if section 264 had not been enacted), Mr. Knetsch could still have received the tax benefits. To do so, all he would have had to do was to alter the terms of either the loan or the annuity so that the payments did not exactly match. The IRS, then, could not have asserted that the transaction was a sham because it would not have been – it would have had real consequences.

The effect of the anti-avoidance doctrines in this case is to encourage Mr. Knetsch to take risk. Under the decision, he can no longer move money in a perfect circle and claim tax benefits. Instead, there must be some mismatch. It is as if we are paying him to distort his economics. He probably does not want a mismatch, but we give him huge tax benefits if he creates one.

Another example is the reaction to the decision in *ACM v. Commissioner* and related cases.³³ In ACM-type transactions, taxpayers used an enormously complex offshore partnership to do essentially nothing while creating tax losses. The trick involved a misallocation of basis when property is sold for a contingent payment to be made in the future. Under the rules in effect at the time, basis was over-allocated to late payments and under-allocated to early payments, effectively creating up-front gain and loss later on. The offshore partnership, usually located in a Caribbean tax haven, allowed the gain to be allocated to a foreign bank which did not pay taxes and the loss to be allocated to a domestic company to use against their taxable income.

³²364 U.S. 361 (1960).

³³*ACM v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); David Hariton, *Sorting Out the Tangle of Economic Substance*, 52 *Tax Lawyer* 235 (1999).

The transaction was structured so that as little as possible happened, primarily through the use of financial instruments that hedged out all the risk and ensured that money merely went in a circle. The courts have disallowed the claimed benefits of this transaction on theories similar to those used in *Knetsch*.

What the taxpayers did wrong, commentators have noted, is that they did not comply with the economic substance doctrine. One commentator suggested, apparently seriously, that had they built an empty building in Bermuda where their shell subsidiary was located, rather than just moving some paper around, they would have won their case.³⁴ But encouraging taxpayers to build empty buildings on tropical islands that nobody wants to inhabit does not seem like the best policy.

In fact, this sort of advice, to adjust transactions to make them slightly more “real” is the daily fare of transactional tax lawyers. They advise clients on how long they must wait before a transaction is “old and cold” for corporate tax purposes. They advise clients how much risk must be inserted into a costless collar to avoid the constructive sale rules. They ensure that investors have just enough equity stake to be considered partners, that financial instruments have enough debt-features to be classified as debt, and so on. It is the attacks on shelters that creates the need for this type of advice, and taxpayers heeding this advice are creating real economic distortions.

The distortionary effect of attacks on shelters are not unique. Attacks on shelters are like any other tax. They raise revenue at some cost. Part of the cost is the mere administrative cost of the tax, such as filing, audits, litigation, and the like. But an additional part of the cost is deadweight loss of the tax. In the case of things we normally think of as taxes, such as the wage tax, the deadweight loss is caused by decisions to alter behavior in the face of the tax toward lower-taxed items. This deadweight loss arises even when we expand the tax base because some items are inevitably left out, so that if we expand the wage tax to include fringe benefits, other forms of tax-free compensation will be found because we cannot perfectly specify the tax base. And even if we could perfectly define wages, individuals could always work less. The distortionary effect of shelters is exactly the same – it is caused by shifting toward the more expensive shelters that remain.

To summarize, we can view shelters as gaps in the tax base and attacks on shelters as similar to other attempts to expand the tax base. Attacking shelters reduces the incentive to distort behavior towards low-taxed shelters. Effectively, reducing shelters reduces the elasticity of taxable income, making the system more efficient. This can be restated in terms of revenue – if shelters are reduced, taxpayers will shift less into shelters and stay more in taxable activities, so that tax receipts go

³⁴Hariton, Economic Substance, at 269.

up. The notion is basically the same, whether one thinks of it in terms of utility or revenue. This comes at a cost. It is expensive to attack shelters, just like it might be expensive to expand the tax base in other ways. In addition, because we cannot perfectly identify shelters, attacks on shelters make those shelters that remain worse. They have a distortionary effect. We should set strength of our attacks on shelters so that the marginal cost of raising revenue this way equals the marginal cost of raising revenue other ways.

My own view on the empirics, and these are nothing more than guesses, is that the administrative costs of significantly expanding anti-shelter doctrines such as the economic substance doctrine, would be low. It would be relatively cheap to identify a vastly broader class of tax motivated transactions and disallow the benefits. In addition, if anti-shelter doctrines are expanded significantly, the revenue effect or utility effect would be reasonably large and the distortionary effect small. To avoid taxes with a vastly expanded economic substance or other anti-avoidance doctrine, taxpayers would have to significantly alter their behavior to avoid tax and my guess is that most would be unwilling to do so, particularly if any revenue from reducing shelters is used to lower tax rates.

The discussion so far has left out the distributional aspects of attacking shelters. A common claim is that tax shelters reduce the progressivity of the tax system because they are available only to the rich. Alternatively, shelters are more readily available for capital income than for wage income. The capital income portion of our tax is more progressive than the wage portion (so the argument might go), so avoidance of the capital portion of the tax reduces progressivity.

Contrary to this intuition, however, there is no reason to think that reducing shelters directly increases progressivity. If tax shelters were reduced, the extra revenue could be used to reduce other taxes on the rich. That is, the existing marginal rate structure might already take into account the existence of tax shelters. Therefore, the distributional question seems somewhat independent of the efficiency question. This is basically the argument of point five above, that attacks in shelters need not mean that the tax on capital or on businesses will be increased.

There is, however, a more subtle connection between shelters and the distribution of the tax burden. The connection is that attacks on shelters affect the elasticity of taxable income and, therefore, the efficiency of the tax system. Redistribution becomes cheaper when the tax system is implemented more efficiently, and, under most views of the appropriate distribution of wealth in society, we are likely to want more redistribution as it becomes cheaper. Therefore, attacks on shelters might lead to more progressivity.³⁵

³⁵See Slemrod and Kopczuk, note ___, for a detailed analysis of the relationship between the elasticity of taxable income and progressivity.

One can view the 1986 Act this way. The 1986 tax reform made the tax system more efficient while leaving burdens basically the same. The reform was in the spirit I have discussed for shelters, where the base is broadened and the money raised from the broadened base is returned to the same people through lower rates or other adjustments. But over the next decade, marginal rates on the wealthy were repeatedly raised. Although one cannot know the underlying motivations, one factor might have been that raising marginal rates on the wealthy was relatively cheaper once the tax system had been made more efficient. One might expect to see a similar effect if shelters were reduced significantly.

7. *Revenue matters*

The discussion immediately above outlined the basic approach that I believe we should take with respect to shelters. An important part of the analysis is tax revenues and it is worth separately emphasizing the point. If attacking shelters did not raise revenue, it would not be effective in reducing the deadweight loss caused by shelters and, therefore, would not be a good idea.

Changing tax rules “merely” to raise revenue is not at all unprincipled. A change that raises revenue cheaply is good tax policy and a change that does not raise very much revenue but induces economic distortions is bad tax policy. This is true even if the change has no relation whatsoever with the definition of income, horizontal equity, or other traditional notions of tax policy. Thus, for example, the idea that the deficits of the 1980's and 90's drove a relentless search for revenue and, therefore, led to bad tax policy, is incoherent. Revenues and tax policy are inextricably intertwined. There is no such thing as tax policy considered separately from revenues.

One way to make the role revenue plays more explicit is to use the notion of the marginal cost of funds. Daniel Shaviro's recent paper on tax shelters used this approach.³⁶ The basic intuition is that all taxes create economic distortions. These economic distortions impose some marginal economic cost for the next dollar of revenue to be raised. We should set each tax so that the marginal cost of funds is the same as for all other taxes. Otherwise, we can raise the tax with low marginal costs of fund and lower the tax with high marginal costs of funds and be better off. We would raise the same amount of money at a lower cost.

There are many ways to measure the marginal cost of funds, but one of the simplest and most intuitive is the method proposed by Joel Slemrod and Shlomo

³⁶Dan Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, ___ Tax Notes 221 (July 10, 2000)

Yitzhaki.³⁷ They showed that marginal costs of funds can be measured by the ratio of static revenue estimate (i.e., the estimate assuming no changes in behavior) and the actual revenue estimate (i.e., the estimate assuming taxpayers shift their behavior to avoid taxes). The lower the ratio, the better the tax (because the cost of funds is lower). For example, if the ratio is one, taxpayers cannot adjust their behavior to change their tax liability at all and, therefore, the tax is efficient.³⁸ If, on the other hand, the marginal cost of funds is high, taxpayers are altering their behavior a lot because of the tax and the tax is inefficient. One of the nice aspects of this measure of the cost of funds is that it is based on data that is routinely gathered for tax law changes. In addition, it can be adjusted to take into account the administrative costs of taxes.

Revenue is central to this approach. The measurement is based on how much revenue a tax actually raises compared to how much it potentially raises. There is no such thing as good tax policy absent revenue considerations. This is true for shelters. Attacking shelters in a way that did not raise any revenue (i.e., did not directly raise revenue, not a rule that raised revenue but was implemented with compensating adjustments to make the entire package revenue neutral) would be bad tax policy. The marginal efficiency cost or funds of such a tax law would be extremely high and other sources of revenue would be more attractive. Similarly, an attack on shelters that raised a lot of revenue may be efficient (although not necessarily, depending how the static revenue estimate and administrative costs).

8. *It is surprising how little shelter activity there is.*

The preceding three propositions outlined a general approach to the shelter problem, but they are a long way from an actual proposal. The results will depend on empirical outcomes and on implementation. For example, the approach discusses general effects of attacks on shelters without distinguishing between amendments to statutory rules and over-riding anti-abuse doctrines. The last three propositions discuss a few of the implementation issues. This proposition is about some of the empirical problems in estimating the effects of anti-shelter laws. The next proposition discusses about the trade off between rules-based and standards-based approaches to shelters with particular focus on uncertainty. The last proposition is about the role of motive in addressing shelters.

To determine the effects of shelters and attacks on shelters, we must have empirical estimates of how shelter activity responds to various tax law changes.

³⁷Joel Slemrod & Shlomo Yitzhaki, *The Cost of Taxation and the Marginal Cost of Funds*, International Monetary Fund Working Paper (vol. 43, No.1 1995).

³⁸In fact, can be less than one if one tax reduces the distortions caused by another tax, such as when we expand the tax base.

These estimates, however, are very hard to get. Many shelters are secret and systematic data are difficult to obtain. We have anecdotal data from taxpayers, practitioners, and promoters, but it is difficult to draw confident conclusions without more. In addition, it is difficult to draw conclusions about how taxpayers respond to various attacks on shelters from the static observations.

An even worse problem is that it is difficult to explain the available data. Perhaps the most surprising fact about tax shelters is that there is not more sheltering. This may seem an odd statement because the explosion of tax shelters is considered by many to be one of the most pressing problems facing our system today. But consider the economics of shelters. There are a wide variety of shelters available, many of which can be done on virtually any scale.³⁹ They allow taxpayers to save taxes at very low economic cost. They are not quite, but sometimes not that far off from, simply checking a box to pay less taxes. Moreover, the chances of any given shelter being challenged are low, the chance of the challenge being successful is low, and the chance of losing more than merely back-taxes plus interest is extremely low. The economics, on their face, seem irresistible. It is not clear, given the wide variety of shelters, why any business pays tax at all.

Of course, we don't really know how much sheltering goes on, so it is hard to make too many assertions about the issue. Shelters are notoriously hard to track. They are generally not public transactions, they are almost always designed not to alter book income, and they are sufficiently complex that examination of public documents does not readily reveal their presence. There is no way to measure their size directly. We are left with calculating the difference between tax payments and various measures of corporate income, such as book income, and inferring that portions of the difference that cannot be otherwise explained are due to shelters.

The numbers obtained with this methodology are large but not overwhelming. For example, estimates tend to be in the \$10 billion per year range.⁴⁰ This number standing alone is substantial, but it is relatively small compared to the actual corporate tax receipts of about \$190 billion per year. Moreover, the mere fact

³⁹See Joseph Bankman, *The New Market for Corporate Tax Shelters*, 83 *Tax Notes* 1775 (1999) for a description of some of these shelters.

⁴⁰See, e.g., George K. Yin, *How Much of the Recent Evidence of a Corporate Tax Shelter Problem is Explained by Increased Stock Option Activity?*, University of Virginia School of Law Public Law and Legal Theory Working Paper 00-11. Yin's study is unique in that it controls for stock option activity, which creates a book-tax disparity but Yin also notes that his sample size is insufficient to support strong conclusions. See also Martin Sullivan, *Lobbyist's Figures Flawed, Data Indicate Corporate Shortfall*, 86 *Tax Notes* 309 (2000); U.S. Congressional Research Service, *Average Effective Corporate Tax Rates* (2000). PricewaterhouseCoopers estimates even lower revenue loss due to corporate tax shelters. See U.S. House Ways and means Committee, hearing on "Corporate Tax Shelters," 106th Cong. 1st Sess. (1999) (statement of Kenneth J. Kies, PricewaterhouseCoopers).

that we collect about \$190 billion indicates that vast portions of corporate income are not being sheltered. Individuals show a similar pattern, where the limited attempts to study the issue show that individuals do not generally engage in sophisticated planning to minimize taxes.⁴¹ While we cannot be sure, the evidence is quite strong that only a small portion of corporate income (and income of high net worth individuals) is sheltered. We do not have any satisfactory theories to explain these facts.

The issue is similar to the tax compliance issue – tax compliance should be much lower than it is under existing theories of taxpayer behavior. The basic models are built on Becker’s model of criminal behavior. In these models, individuals consider the likelihood of detection and the sanction and compare this to the benefit of avoidance (or criminal behavior, in the case of Becker’s models).⁴² They set the marginal benefit from evasion equal to the marginal penalty. If individuals are risk averse or the risk of detection goes up with evasion, there will be some optimal amount of evasion.⁴³

For these theories to explain the observed facts, the risk of shelters must increase very rapidly as tax payments go down and businesses must be very risk averse. The level of sheltering is too low to be explained under a model of this sort unless risk and risk aversion are very high.

Risk might be high if a taxpayer shelters a lot because an auditor is much more likely to challenge a tax return if it shows extremely low taxable income (relative to some measure of actual income, such as book income) than if it shows taxable income just a little off what might otherwise be expected. Similarly, a court is more likely to disallow extremely aggressive use of shelters than mild use. So, for example, a corporation may be able to shelter the first ten percent of its income with relatively low risk, but the next ten percent may be riskier, and so forth. Sheltering all or almost all of its income might be very risky. Given the risk return profile the corporation desires, its desired beta, if you will, we should not expect corporations to shelter all their income any more than we should expect them to put all of their cash in extremely risky securities in search of a higher return.

⁴¹See e.g., H. Nejat Seyhun & Douglas J. Skinner, *How Do Taxes Affect Investors’ Stock-Market Realizations? Evidence from Tax-Return Panel Data* (University of Michigan Working Paper 1991); James M. Poterba, *How Burdensome Are Capital Gains Taxes? Evidence from the United States*, 33 *J. Pub. Econ* 157 (1987).

⁴²See Joel Slemord and Sholomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, forthcoming, *Handbook of Public Economics*, for a summary of the literature.

⁴³If individuals are not risk averse and the likelihood of detection does not increase with evasion, the solution will involve either paying all taxes due or paying none.

Many practitioners have observed that corporations are very risk averse when it comes to tax risk. But we need to explain the cause of the risk aversion better – risk aversion would not normally be expected by corporations whose shareholders can diversify. This is particularly true with respect to tax liability, which is unlikely to play a huge role in the overall riskiness of the business. One way to explain this better is to analyze corporations' tolerance for shelters as a function of behavioral norms, where the sanctions for sheltering are reputational or social.⁴⁴ The story might be that in the staid old world of corporate America, one simply did not take extremely aggressive tax positions. The job of the tax director was to ensure compliance and otherwise stay out of the way. If the tax director was too aggressive, he or the corporation risked being labeled something bad, hence the norm-based sanction. Tax directors could also hire outside counsel to help enforce this norm (by offering conservative tax advice) against other parts of the business that would like to be more aggressive. Practitioners have observed that this norm has broken down in recent years and claim this explains the increase in shelter activity.

A norms-based theory may well explain corporate risk aversion, but it has not been sufficiently studied to claim we understand it. We do not know why such a norm would arise, why it would break down, and how it might constrain behavior, particularly because shelters tend to be secret. Moreover, the norm would require consistent violation of fiduciary duties to shareholders – it would be difficult to claim that shareholders themselves enforce these norms on corporations. There is no evidence that shareholders avoid corporations that take aggressive tax positions – corporations that are household names that depend on the goodwill of the populace, engage in very aggressive transactions.⁴⁵

There are, therefore, plausible stories about the levels of risk and risk aversion, although as just noted, we do not fully understand these effects. But even with these stories, it is difficult to reconcile observed behavior with current theories. The savings from shelters are simply too high given the plausible penalties. Corporations can almost surely get a better return for the risk by investing in tax shelters rather than in, say, marketable securities.

The seeming failure of corporations to use tax shelters to their full advantage is not just a curious fact for academics to study. To design appropriate responses to

⁴⁴Eric Posner made a similar norms based argument for individual tax compliance. See Eric Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 *Virginia L. Rev.* 1781 (2000). The argument, however, is much more plausible in Posner's case than in the corporate shelter case.

⁴⁵For example, recent shelter cases involved companies such as Colgate, UPS and Compaq. See, *ACM v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); *United Parcel Service of Amer., Inc. v. Commissioner*, 78 T.C.M. 262 (1999); *Compaq Computer Corp. v. Commissioner*, 113 T.C. 363 (1999).

shelters, we need to understand how taxpayers respond to incentives, which means we need to understand what limits corporations' use of shelters under current law. For example, bar associations have argued that changes to the penalty structure are sufficient to change behavior significantly. They assert this is true because penalties are viewed as a terrible punishment compared with an equal dollar payment of back taxes or interest – each dollar of penalties is equivalent to a very large number of dollars in interest or back taxes. It is not at all clear why this might be true – an uninitiated observer might think that a dollar is a dollar to a profit maximizing corporation. One answer might be that penalties show incompetence. There are so many shelters available with similar risk/return profiles that getting caught with penalties indicates a failure to screen out the dogs properly. But the implication is that increasing the dollar value of penalties will simply lead to more careful screening rather than a real change in behavior. Moreover, applying penalties to a broader class of transactions, so that they no longer indicate incompetence, would have no special effect – at that point, a dollar would become a dollar. The bar associations simply point to observed behavior, but without a better understanding, we cannot predict reactions to changes in the rules.

I cannot over-emphasize what a pivotal point this is. We need to understand phenomenon such as the response to penalties if we are to determine the appropriate response to shelters. The elasticity, how much shelters decrease for an increase in penalties, a change to an anti-avoidance rule, or some other strategy, is a central fact in responding to shelters. Yet, right now, we do not have a good understanding of taxpayer behavior.

9. *The Effects of Uncertainty are Uncertain.*

There are two common approaches to shelters. One approach is to amend the substantive law once a shelter is found to eliminate the gap or hole that the shelter uses. For example, section 264 was added to the Code to eliminate the transaction entered into by Mr. Knetsch, borrowing to buy a tax-deferred annuity. The other approach is to use broad standards, commonly known as anti-abuse rules, to deny tax benefits in certain loosely specified classes of transactions, notwithstanding literal compliance with the rules. Many people have argued that changes to the substantive law are preferable to broad anti-avoidance rules, the primary reason being that changes to the substantive law provide more certainty. I do not believe this claim about uncertainty has force. Before turning to uncertainty, consider why we might want broad anti-avoidance rules at all.

The argument, which traces back to *Surrey*, is that broad anti-avoidance rules

reduce the complexity of the law.⁴⁶ A rules-based approach specifies the law in advance of taxpayers acting (hence the desired certainty). If the tax law were fully specified in advance, however, it would have to correctly specify the treatment of not only everyday, common transactions but rare and unusual transactions as well. The reason is that if a rare transaction is taxed incorrectly, that transaction will become common as taxpayers take advantage of the problem. Therefore, a pure rule-based system, one that is fully-specified in advance, will tend to be very complex. This in fact is a reasonable description of many shelters we see today, where some obscure detail in the tax law is used in completely unanticipated ways to create tax benefits. Rules-based responses to these shelters tend to make the law more complicated.⁴⁷

If, however, the law is not completely specified in advance, that is, if it takes a standards-based or anti-avoidance rule approach, it can be less complex. The reason is that rare transactions need only be dealt with as they arise. If rare transactions are dealt with as they arise, taxpayers cannot count on their mistaxation. There will, therefore, be less of an incentive to find mistaxed rare transactions because there is no tax advantage to doing so. Thus, the rare transactions that arise under the imperfectly implemented set of rules do not arise under the uncertain standards and the law can be less complex.

We should expect, then, to see rules designed for everyday transactions backed up by anti-avoidance doctrines that cover mistaxed, unusual transactions. Congress or the Treasury can easily find out about common transactions and devise appropriate tax rules for these cases. But to keep these rules relatively simple, Congress or the Treasury must back up these rules with broad standards or anti-avoidance rules to prevent the mistaxation of rare transactions. This mixed strategy of rules and standards combines the best parts of rules with the simplicity allowed by standards.

The criticism of this approach is that broad standards are seen as imposing excessive uncertainty. This uncertainty, it is argued, imposes costs on taxpayers and is a reason to minimize the use of broad anti-shelter doctrines. The tax law, it is claimed, should provide clear answers to most questions. After all, people need to fill out their tax returns.⁴⁸

⁴⁶See Stanley Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L & Contemp Probs 673, 707 (1969). See also, David Weisbach, *Formalism in the Tax Law*, 66 U. Chicago L. Rev. 860 (1999).

⁴⁷Joe Bankman argues in addition, that rules based approaches generate fees for tax shelter promoters because they put a premium on the ability structure around newly enacted rules. See Bankman, *The New Market*, note ___.

⁴⁸For a strong statement of this approach, see Kenneth W. Gideon, "Assessing the Income Tax: Transparency, Simplicity, Fairness," *Tax Notes*, Nov. 23, 1998, p. 999.

This claim, however, is not based on any analysis of how uncertainty affects behavior or welfare. In fact, it is not clear what the claim is based on other than mere assertion and maybe force of habit, in that many tax laws now provide significant certainty and people are used to this. It may also represent self-interest by the tax bar to the extent that the ability to provide certain answers makes the services offered by bar more valuable. To have credibility, the argument against uncertainty must provide more.

There has, however, been surprisingly little analysis of uncertainty in the tax law. We are left to turning to analyses of uncertainty in other contexts for guidance. The most relevant analysis is a model of uncertainty in the tort law by Craswell and Calfee.⁴⁹ They consider a potential defendant in a tort suit who engages in a beneficial behavior which also causes harm. At the social optimum, the marginal benefit from the action equals the marginal harm. Tort damages, if perfectly set, would force the defendant to pay damages or a fine equal to the harm caused if they violate the legal standard of care. Craswell and Calfee then suppose that instead of a fixed standard of care, the defendant faces an uncertain standard of care. The probability of being found liable at any point is uncertain but goes up as the level of care or level of the activity goes up.⁵⁰

The defendant then chooses behavior that optimizes profits when subject to this uncertain tort law. How does the defendant act? There is an incentive for the defendant to take too little care because there is some chance of not getting caught when engaging in bad behavior. Loosely, this is type 2 error – the chance that a guilty defendant will go free. There is an offsetting incentive to take too much care because each additional increment of care reduces the probability of being let off.

⁴⁹Richard Craswell and John H. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J. Law, Economics, & Organization 279 (1986).

⁵⁰More formally, they assume the defendant engaged in activity that is measured by the variable x and has benefit $B(x)$, with $B'(x) > 0$, and $B''(x) < 0$. The activity causes losses $L(x)$, $L'(x) > 0$, and $L''(x) < 0$. At the optimum, x is set at x^* so that $B'(x^*) = L'(x^*)$. Suppose that there is some probability $F(x)$ that the defendant is held liable for a given x , $F'(x) > 0$. The defendant maximizes its net profits $P(x) = B(x) - F(x)L(x)$. Differentiating and evaluating the result at the social optimum x^* , we get

$$dP/dX = [1-F(x^*)]L'(x^*) - F'(x^*)L(x^*).$$

The first term on the right hand side is the gains to the defendant from reducing the size of the potential fine $L(x)$ by reducing x . The marginal reduction in the fine, $L'(x)$ is discounted by the chance of not being found liable, $[1-F(x)]$. Thus, the defendant will not face the full social gains from reduction in x and, therefore, from the first term set x too high. The second term represents the benefit to the defendant of decreasing x through a reduction in the likely penalty. Decreasing x reduces the change of being found liable by a factor of $F'(x)$. This creates an incentive to set x too low. We cannot determine without more which term dominates.

Loosely, the defendant is afraid of type 1 error – the chance of innocent behavior being found guilty – and, therefore, increases care. We do not know which of these two offsetting incentives dominates. Uncertainty could lead to either too much care or too little care. Moreover, we do not even know *a priori* whether reducing uncertainty will increase or decrease the level of care.

Craswell and Calfee's observations apply directly to the tax law. Suppose there is uncertainty about the tax effects of some behavior and there is some desired effect (which could be minimal change from pre-tax behavior). For example, there is uncertainty about whether a variety of instruments are debt or equity and about whether various partnership transactions will be respected in light of the partnership anti-abuse rule. The behavioral effect of the uncertainty cannot be predicted. It could be the case that taxpayers will be too conservative because of the possibility of type 2 error. But it could be the case that they are too aggressive, taking advantage of type 1 error. We cannot tell whether the uncertainty has good or bad effects. And we cannot determine whether reducing the uncertainty is a good or bad idea. It can go either way. If this is the case, we should have no strong feelings against uncertainty – increasing uncertainty may hurt, but so may decreasing it.

I believe those arguing against uncertainty would accept this but they posit an additional fact. They argue that taxpayers vary in their risk aversion, so that uncertainty affects taxpayers differently. The aggressive, or risk seeking, will react to uncertainty by taking more aggressive tax positions, while the meek (or maybe moral in some versions of the argument) will be deterred. This it might be argued is unfair – uncertainty in the tax law helps the bad guys and hurts the good guys.

It is not clear, however, why this is more unfair than disparate responses to other elements of taxation. Some individuals might be so averse to taxation of labor income that they become beachcombers, while others may not be affected at all. Some might save almost nothing because of the taxation of the time value return to savings while others might save more. The hard workers and savers are taxed to the benefit of the lazy and profligate. As long as individuals are diverse, identical tax rules will affect them differently. Unless uncertainty is somehow special, it is hard to see a significant fairness argument.

There are number of additional arguments about uncertainty and I will review a few of them here. First, people have considered how uncertainty affects reporting positions. In this regard, Suzanne Scotchmer and Joel Slemrod argue that uncertainty creates incentives for taxpayers to report higher amounts on their tax returns.⁵¹ They argue this affect occurs because of an asymmetry in the penalty structure. Suppose a taxpayer reports a single number and there is uncertainty about

⁵¹Suzanne Scotchmer and Joel Slemrod, Randomness in Tax Enforcement, 38 Journal of Public Economics 17 (1989).

the correctness of that number. If audited, the IRS will determine whether the number is correct. If a taxpayer over-reports income and is audited, he gets a refund. If he under-reports income by the same amount and is audited, he must pay back taxes and, in addition, may be subject to a penalty. The penalty structure creates an asymmetry between under and over-reporting. To minimize the effect of the uncertainty, taxpayers will report a higher amount than otherwise. The greater the uncertainty, the greater the asymmetry and the higher the number taxpayers report. The bar associations', in addition to recommending more disclosure, have recommended enhanced penalties and this fits well with the Scotchmer/Slemrod theory – increasing penalties will increase the asymmetry and, therefore, cause taxpayers to report higher incomes.

On the other hand, there is the possibility that greater uncertainty allows more aggressive reporting positions. Suppose that taxpayers, because of their greater bargaining ability, will capture the majority of the difference between the taxpayer's reported position and the government's asserted tax liability, taxpayers. Greater uncertainty allows greater dispersion of potential tax positions. Taxpayers will have greater room to take aggressive positions and, knowing that they will capture the majority of the surplus (i.e., the difference between their reporting position and the government's position) will have an incentive to do so. If this is true, more uncertainty might lead to lower tax revenues.

Uncertainty may also create the possibility of corruption. The more uncertain the tax law, the greater the discretion by tax auditors, and, therefore, the opportunities for corruption.⁵² Clearly specified laws, on the other hand, reduce the opportunities for corruption because they take discretion away from auditors. If corruption is a serious problem, clearly specified laws may be necessary. Thousands of years of history with corrupt tax collectors may explain the culture of certainty in the tax law, but it is not clear how much this argument applies in today's corporate tax shelter context, where corporations significantly out gun the tax collector.

There is much more to say about uncertainty in the tax law. But we cannot merely assert that uncertainty is bad without justifying the position carefully. We need to specify exactly why it is bad in terms of the consequences. If tax law is special, so that uncertainty is more important in the tax law than in, say, the tort law, we need to specify why.

10. *Motive matters*

The complaint about using anti-abuse doctrines to attack shelters that is second only to uncertainty is that they inappropriately base tax results on intent or

⁵²See Hariton, *Sorting Out the Tangle*, note ___ for an allusion to this argument.

motive. Two taxpayers that engage in the identical transaction can be taxed differently depending on what goes on in their head. The taxpayer with dirty tax avoidance thoughts will get caught by an anti-avoidance rule but the taxpayer with clean thoughts will not. Taxes, it is asserted, should be based on economics and two taxpayers with the same economics, the same net income, should be taxed the same.

This argument just assumes its conclusion. It assumes that taxes should be based on economics. It defines similarly situated taxpayers, to which we apply notions of horizontal equity, as taxpayers with the same economics or the same transaction. But this choice must be justified rather than just assumed.

Looking only to economics is not the standard approach taken in other areas of the law or even in the tax law. The most obvious place that looks beyond actions to motive or intent is criminal law. The definition of various crimes, including serious crimes such as murder or rape, depend on the mental state of the defendant. The consequences of the wrong mental state are not, in these cases, mere payment of extra tax dollars. We take away peoples' freedom and even execute them based on their mental state. The legal definition of racial or other discrimination is often based on intent.⁵³ Contract law imposes a duty of good faith. Securities law fraud, mail fraud, wire fraud, and insider trading all require scienter.⁵⁴ Property law often looks to intent, such as in the cases of abandonment and adverse possession.⁵⁵ It is not true that the law generally looks only to actions and not mental states.

Moreover, there are good reasons to base anti-avoidance doctrines on motive or intent. There is a difference between somebody engaging in a transaction for purely business reasons that happens to have fantastic tax consequences and somebody entering into the transaction solely to reduce taxes. In the former case, where the taxpayer enters into the transaction for business reasons, there is no economic distortion caused by taxes – while the person pays low taxes, behavior is not distorted by this prospect. In the latter case, where the motive is taxes, there are real economic costs because behavior is distorted. The two cases are different precisely because of mental states.

If one wants to think of this in horizontal equity terms, the two cases are not

⁵³Washington v. Davis, ___ U.S. ___ (19___).

⁵⁴See, for example, Troutman v. United States, 100 F.2d 628, 632 (10th Cir. 1938) (scienter required for §17(a) of the Securities Act of 1933); United States v. Painter, 314 F.2d 939, 943 (4th Cir. 1963) (mail and wire fraud statutes); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (insider trading).

⁵⁵See relevant chapters in Burke, Burkhart and Helms, Fundamentals of Property Law (1999).

similar because they have different amounts of economic distortion. That is, rather than defining horizontal equity in terms of economics, we can define it in terms of economic distortion and, using this notion of horizontal equity, the two transactions with different mental states should not be taxed the same.⁵⁶ As Mark Gergen has put it, “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.”⁵⁷

Of course, it is hard to determine motive or intent. We cannot read minds. Therefore, the use of motive or intent must be limited. This, however, is an administrative concern rather than a fundamental or absolute argument against the use of motive or intent. The question becomes how expensive it is to determine motive. Like I suggested above, I think it would be relatively easy to identify a vastly broader class of transactions as tax motivated and to eliminate their tax benefits. I do not think it takes a mind-reader to know that transactions such as the transactions in ACM, Winn-Dixie, or Compaq are substantially if not solely tax motivated and courts could easily identify a much broader class of transactions as similarly tax motivated. Therefore, the use of motive should be expanded rather than reduced.

Conclusion

Rather than summarize all ten propositions, let me go back to the basic goal of the paper. The goal is to nudge the thinking on shelters towards analysis of the consequences and away from internal tax logic or mere assertions of conclusions. Statements about rights or legitimacy are not helpful in deciding on the appropriate approach to shelters. The consequences of shelters and of attacking shelters are the relevant considerations.

The consequences of various approaches to addressing shelters are complex and conclusions will be based on contested empirical judgments. But these complexities and lack of data should not obscure the thinking on the matter. Ultimately we must make informed guesses about the empirics, and thinking through the likely consequences can help identify the relevant empirical factors and perhaps identify ways to measure these factors.

⁵⁶Horizontal equity has a number of serious problems as a normative criteria. See, Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 *National Tax Journal* 139 (199_). I use it here only because the argument against intent is framed in terms of horizontal equity and I want to show that even if one believes in horizontal equity, the argument does not hold.

⁵⁷Mark Gergen, *The Flaw in the Case in Principle Against the Standards of Tax Motive and Economic Substance*, 54 *SMU L. Rev.* 131, 140 (2001).

Readers with comments should address them to:

David A. Weisbach
Professor of Law
University of Chicago Law School
1111 East 60th Street
Chicago, IL 60637

773-702-3342

d-weisbach@uchicago.edu

Chicago Working Papers in Law and Economics
(Second Series)

1. William M. Landes, Copyright Protection of Letters, Diaries and Other Unpublished Works: An Economic Approach (July 1991).
2. Richard A. Epstein, The Path to *The T. J. Hooper*: The Theory and History of Custom in the Law of Tort (August 1991).
3. Cass R. Sunstein, On Property and Constitutionalism (September 1991).
4. Richard A. Posner, Blackmail, Privacy, and Freedom of Contract (February 1992).
5. Randal C. Picker, Security Interests, Misbehavior, and Common Pools (February 1992).
6. Tomas J. Philipson & Richard A. Posner, Optimal Regulation of AIDS (April 1992).
7. Douglas G. Baird, Revisiting Auctions in Chapter 11 (April 1992).
8. William M. Landes, Sequential versus Unitary Trials: An Economic Analysis (July 1992).
9. William M. Landes & Richard A. Posner, The Influence of Economics on Law: A Quantitative Study (August 1992).
10. Alan O. Sykes, The Welfare Economics of Immigration Law: A Theoretical Survey With An Analysis of U.S. Policy (September 1992).
11. Douglas G. Baird, 1992 Katz Lecture: Reconstructing Contracts (November 1992).
12. Gary S. Becker, The Economic Way of Looking at Life (January 1993).
13. J. Mark Ramseyer, Credibly Committing to Efficiency Wages: Cotton Spinning Cartels in Imperial Japan (March 1993).
14. Cass R. Sunstein, Endogenous Preferences, Environmental Law (April 1993).
15. Richard A. Posner, What Do Judges and Justices Maximize? (The Same Thing Everyone Else Does) (April 1993).
16. Lucian Arye Bebchuk and Randal C. Picker, Bankruptcy Rules, Managerial Entrenchment, and Firm-Specific Human Capital (August 1993).
17. J. Mark Ramseyer, Explicit Reasons for Implicit Contracts: The Legal Logic to the Japanese Main Bank System (August 1993).
18. William M. Landes and Richard A. Posner, The Economics of Anticipatory Adjudication (September 1993).
19. Kenneth W. Dam, The Economic Underpinnings of Patent Law (September 1993).
20. Alan O. Sykes, An Introduction to Regression Analysis (October 1993).
21. Richard A. Epstein, The Ubiquity of the Benefit Principle (March 1994).

22. Randal C. Picker, An Introduction to Game Theory and the Law (June 1994).
23. William M. Landes, Counterclaims: An Economic Analysis (June 1994).
24. J. Mark Ramseyer, The Market for Children: Evidence from Early Modern Japan (August 1994).
25. Robert H. Gertner and Geoffrey P. Miller, Settlement Escrows (August 1994).
26. Kenneth W. Dam, Some Economic Considerations in the Intellectual Property Protection of Software (August 1994).
27. Cass R. Sunstein, Rules and Rulelessness, (October 1994).
28. David Friedman, More Justice for Less Money: A Step Beyond *Cimino* (December 1994).
29. Daniel Shaviro, Budget Deficits and the Intergenerational Distribution of Lifetime Consumption (January 1995).
30. Douglas G. Baird, The Law and Economics of Contract Damages (February 1995).
31. Daniel Kessler, Thomas Meites, and Geoffrey P. Miller, Explaining Deviations from the Fifty Percent Rule: A Multimodal Approach to the Selection of Cases for Litigation (March 1995).
32. Geoffrey P. Miller, Das Kapital: Solvency Regulation of the American Business Enterprise (April 1995).
33. Richard Craswell, Freedom of Contract (August 1995).
34. J. Mark Ramseyer, Public Choice (November 1995).
35. Kenneth W. Dam, Intellectual Property in an Age of Software and Biotechnology (November 1995).
36. Cass R. Sunstein, Social Norms and Social Roles (January 1996).
37. J. Mark Ramseyer and Eric B. Rasmusen, Judicial Independence in Civil Law Regimes: Econometrics from Japan (January 1996).
38. Richard A. Epstein, Transaction Costs and Property Rights: Or Do Good Fences Make Good Neighbors? (March 1996).
39. Cass R. Sunstein, The Cost-Benefit State (May 1996).
40. William M. Landes and Richard A. Posner, The Economics of Legal Disputes Over the Ownership of Works of Art and Other Collectibles (July 1996).
41. John R. Lott, Jr. and David B. Mustard, Crime, Deterrence, and Right-to-Carry Concealed Handguns (August 1996).
42. Cass R. Sunstein, Health-Health Tradeoffs (September 1996).
43. G. Baird, The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms (March 1997).
44. Richard A. Posner, Community, Wealth, and Equality (March 1997).
45. William M. Landes, The Art of Law and Economics: An Autobiographical

- Essay (March 1997).
46. Cass R. Sunstein, *Behavioral Analysis of Law* (April 1997).
 47. John R. Lott, Jr. and Kermit Daniel, *Term Limits and Electoral Competitiveness: Evidence from California's State Legislative Races* (May 1997).
 48. Randal C. Picker, *Simple Games in a Complex World: A Generative Approach to the Adoption of Norms* (June 1997).
 49. Richard A. Epstein, *Contracts Small and Contracts Large: Contract Law through the Lens of Laissez-Faire* (August 1997).
 50. Cass R. Sunstein, Daniel Kahneman, and David Schkade, *Assessing Punitive Damages (with Notes on Cognition and Valuation in Law)* (December 1997).
 51. William M. Landes, Lawrence Lessig, and Michael E. Solimine, *Judicial Influence: A Citation Analysis of Federal Courts of Appeals Judges* (January 1998).
 52. John R. Lott, Jr., *A Simple Explanation for Why Campaign Expenditures are Increasing: The Government is Getting Bigger* (February 1998).
 53. Richard A. Posner, *Values and Consequences: An Introduction to Economic Analysis of Law* (March 1998).
 54. Denise DiPasquale and Edward L. Glaeser, *Incentives and Social Capital: Are Homeowners Better Citizens?* (April 1998).
 55. Christine Jolls, Cass R. Sunstein, and Richard Thaler, *A Behavioral Approach to Law and Economics* (May 1998).
 56. John R. Lott, Jr., *Does a Helping Hand Put Others At Risk?: Affirmative Action, Police Departments, and Crime* (May 1998).
 57. Cass R. Sunstein and Edna Ullmann-Margalit, *Second-Order Decisions* (June 1998).
 58. Jonathan M. Karpoff and John R. Lott, Jr., *Punitive Damages: Their Determinants, Effects on Firm Value, and the Impact of Supreme Court and Congressional Attempts to Limit Awards* (July 1998).
 59. Kenneth W. Dam, *Self-Help in the Digital Jungle* (August 1998).
 60. John R. Lott, Jr., *How Dramatically Did Women's Suffrage Change the Size and Scope of Government?* (September 1998)
 61. Kevin A. Kordana and Eric A. Posner, *A Positive Theory of Chapter 11* (October 1998)
 62. David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law* (November 1998)
 63. Jack L. Goldsmith and Eric A. Posner, *A Theory of Customary International Law* (November 1998)
 64. John R. Lott, Jr., *Public Schooling, Indoctrination, and Totalitarianism* (December 1998)

65. Cass R. Sunstein, Private Broadcasters and the Public Interest: Notes Toward A "Third Way" (January 1999)
66. Richard A. Posner, An Economic Approach to the Law of Evidence (February 1999)
67. Yannis Bakos, Erik Brynjolfsson, Douglas Lichtman, Shared Information Goods (February 1999)
68. Kenneth W. Dam, Intellectual Property and the Academic Enterprise (February 1999)
69. Gertrud M. Fremling and Richard A. Posner, Status Signaling and the Law, with Particular Application to Sexual Harassment (March 1999)
70. Cass R. Sunstein, Must Formalism Be Defended Empirically? (March 1999)
71. Jonathan M. Karpoff, John R. Lott, Jr., and Graeme Rankine, Environmental Violations, Legal Penalties, and Reputation Costs (March 1999)
72. Matthew D. Adler and Eric A. Posner, Rethinking Cost-Benefit Analysis (April 1999)
73. John R. Lott, Jr. and William M. Landes, Multiple Victim Public Shooting, Bombings, and Right-to-Carry Concealed Handgun Laws: Contrasting Private and Public Law Enforcement (April 1999)
74. Lisa Bernstein, The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study (May 1999)
75. Richard A. Epstein, Deconstructing Privacy: and Putting It Back Together Again (May 1999)
76. William M. Landes, Winning the Art Lottery: The Economic Returns to the Ganz Collection (May 1999)
77. Cass R. Sunstein, David Schkade, and Daniel Kahneman, Do People Want Optimal Deterrence? (June 1999)
78. Tomas J. Philipson and Richard A. Posner, The Long-Run Growth in Obesity as a Function of Technological Change (June 1999)
79. David A. Weisbach, Ironing Out the Flat Tax (August 1999)
80. Eric A. Posner, A Theory of Contract Law under Conditions of Radical Judicial Error (August 1999)
81. David Schkade, Cass R. Sunstein, and Daniel Kahneman, Are Juries Less Erratic than Individuals? Deliberation, Polarization, and Punitive Damages (September 1999)
82. Cass R. Sunstein, Nondelegation Canons (September 1999)
83. Richard A. Posner, The Theory and Practice of Citations Analysis, with Special Reference to Law and Economics (September 1999)
84. Randal C. Picker, Regulating Network Industries: A Look at *Intel* (October 1999)

85. Cass R. Sunstein, *Cognition and Cost-Benefit Analysis* (October 1999)
86. Douglas G. Baird and Edward R. Morrison, *Optimal Timing and Legal Decisionmaking: The Case of the Liquidation Decision in Bankruptcy* (October 1999)
87. Gertrud M. Fremling and Richard A. Posner, *Market Signaling of Personal Characteristics* (November 1999)
88. Matthew D. Adler and Eric A. Posner, *Implementing Cost-Benefit Analysis When Preferences Are Distorted* (November 1999)
89. Richard A. Posner, *Orwell versus Huxley: Economics, Technology, Privacy, and Satire* (November 1999)
90. David A. Weisbach, *Should the Tax Law Require Current Accrual of Interest on Derivative Financial Instruments?* (December 1999)
91. Cass R. Sunstein, *The Law of Group Polarization* (December 1999)
92. Eric A. Posner, *Agency Models in Law and Economics* (January 2000)
93. Karen Eggleston, Eric A. Posner, and Richard Zeckhauser, *Simplicity and Complexity in Contracts* (January 2000)
94. Douglas G. Baird and Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost* (February 2000)
95. David Schkade, Cass R. Sunstein, Daniel Kahneman, *Deliberating about Dollars: The Severity Shift* (February 2000)
96. Richard A. Posner and Eric B. Rasmusen, *Creating and Enforcing Norms, with Special Reference to Sanctions* (March 2000)
97. Douglas Lichtman, *Property Rights in Emerging Platform Technologies* (April 2000)
98. Cass R. Sunstein and Edna Ullmann-Margalit, *Solidarity in Consumption* (May 2000)
99. David A. Weisbach, *An Economic Analysis of Anti-Tax Avoidance Laws* (May 2000)
100. Cass R. Sunstein, *Human Behavior and the Law of Work* (June 2000)
101. William M. Landes and Richard A. Posner, *Harmless Error* (June 2000)
102. Robert H. Frank and Cass R. Sunstein, *Cost-Benefit Analysis and Relative Position* (August 2000)
103. Eric A. Posner, *Law and the Emotions* (September 2000)
104. Cass R. Sunstein, *Cost-Benefit Default Principles* (October 2000)
105. Jack Goldsmith and Alan Sykes, *The Dormant Commerce Clause and the Internet* (November 2000)
106. Richard A. Posner, *Antitrust in the New Economy* (November 2000)
107. Douglas Lichtman, Scott Baker, and Kate Kraus, *Strategic Disclosure in the Patent System* (November 2000)
108. Jack L. Goldsmith and Eric A. Posner, *Moral and Legal Rhetoric in International Relations: A Rational Choice Perspective* (November 2000)

109. William Meadow and Cass R. Sunstein, *Statistics, Not Experts* (December 2000)
110. Saul Levmore, *Conjunction and Aggregation* (December 2000)
111. Saul Levmore, *Puzzling Stock Options and Compensation Norms* (December 2000)
112. Richard A. Epstein and Alan O. Sykes, *The Assault on Managed Care: Vicarious Liability, Class Actions and the Patient's Bill of Rights* (December 2000)
113. William M. Landes, *Copyright, Borrowed Images and Appropriation Art: An Economic Approach* (December 2000)
114. Cass R. Sunstein, *Switching the Default Rule* (January 2001)
115. George G. Triantis, *Financial Contract Design in the World of Venture Capital* (January 2001)
116. Jack Goldsmith, *Statutory Foreign Affairs Preemption* (February 2001)
117. Richard Hynes and Eric A. Posner, *The Law and Economics of Consumer Finance* (February 2001)
118. Cass R. Sunstein, *Academic Fads and Fashions (with Special Reference to Law)* (March 2001)
119. Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective* (April 2001)
120. Douglas G. Baird, *Does Bogart Still Get Scale? Rights of Publicity in the Digital Age* (April 2001)
121. Douglas G. Baird and Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganization* (April 2001)
122. David A. Weisbach, *Ten Truths about Tax Shelters* (May 2001)