Demystifying Disclosure: First Steps

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Demystifying Disclosure: First Steps

RONALD A. PEARLMAN*

I. INTRODUCTION

The subject of tax shelters is such a difficult topic. We struggle for a definition; we debate whether there is a problem; and we search for a response. David Weisbach’s article offers 10 propositions about tax shelters and tax avoidance.¹ He synthesizes a number of important considerations and offers some very helpful insights. Weisbach has made a timely contribution to the tax shelter literature.

Weisbach’s fourth proposition relates to disclosure. Essentially, he concludes that the focus on disclosure is misplaced, primarily because the tax shelter problem is one of substantive law. He also fears that private sector support for disclosure is prompted by self-interest.² I do not dwell on Weisbach’s assertion regarding private sector motives because I consider the assertion to be largely irrelevant to the discussion. If he intends merely to urge policymakers to exercise caution in considering tax disclosure options that are supported by the private sector, he does no harm. If, on the other hand, he succeeds in tainting enhanced disclosure proposals, he will have damaged the consideration of an important response to the tax shelter problem without any real discussion of the merits.

I have chosen to discuss tax shelter disclosure for two reasons. First, I think much of the tax shelter problem is attributable to the historic lack of effective tax enforcement. Second, unlike Weisbach, I think enhanced disclosure—that is, some level of disclosure over and above that required by current law and administrative practice—would contribute to improved enforcement and increase voluntary compliance. After some preliminary comments, I discuss three functions of a mandatory tax return disclosure regime. I then address some important implementation issues. I identify potentially relevant tax compliance literature, although my review of the literature has not

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² Id. at 229–31; see also David A. Weisbach, The Failure of Disclosure as an Approach to Shelters, 54 SMU L. Rev. 73, 75-79 (2001).
been exhaustive. My discussion also refers to Treasury’s temporary and proposed disclosure regulations\(^3\) and certain legislative proposals for enhanced disclosure, but I do not undertake a complete analysis of either. I refer to Weisbach’s specific comments about disclosure at appropriate points in my discussion.

The definition of “tax shelter” is particularly important to this discussion because it affects perceptions of the existence of a problem and influences deliberations on administrative and legislative responses. From a tax policy perspective, it is appropriate to encompass within the definition every action that reduces a taxpayer’s liability from a normative baseline without regard to whether the action is supported by current law. For example, a transaction that takes advantage of the low income housing credit,\(^4\) although structured to comply with the law, constitutes a tax shelter under this definition. I understand Weisbach to be making essentially the same point in the discussion of his second proposition, relating to references to a right to minimize taxes and to legitimate tax planning.\(^5\)

From a tax enforcement perspective, the tax policy definition of tax shelter is too broad. When used to analyze a taxpayer’s proper tax liability, the focus must be limited to tax planning that may not be supported by current law. Therefore, I suggest a narrower definition, one that is intended to cover an action that reduces a taxpayer’s tax liability if there is any possibility that the action does not comply with current law. Obviously, this narrower definition remains very broad. Only by a broad definition would it be possible for the Service to identify a potentially infinite range of questionable transactions and reporting positions. By “action,” I mean to include both specific transactions and interpretations of current law on which tax return reporting positions are based. Because I wish to include the tax shelter activities of individuals and unincorporated enterprises, as well as corporations, I use the term “tax shelter” to refer to the actions of any and all taxpayers. I do not refer to “corporate tax shelter” because this label suggests that the problem is one of corporate taxpayers alone. The tax shelter definition that I have adopted for this discussion excludes a purposive standard, such as contained in § 6662(d)(2)(C)\(^6\) or in various disclosure proposals.\(^7\) I also would prefer to avoid any subjectivity. I have been unable to craft a definition

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\(^4\) IRC § 42.

\(^5\) Weisbach, Ten Truths, note 1, at 220–2.

\(^6\) IRC § 6662(d)(2)(C)(iii) (A tax shelter exists “if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax.”).
that does so. My definition limits subjectivity, but does not eliminate it. I recognize that many actions will come within this tax enforcement definition even though they may comply with current law. This is intentional. My objective is to create a shorthand reference to actions that justify appropriate administrative and judicial review, even if the actions ultimately are found to comply with current law.

Recent tax shelter activity concerns me and causes me to conclude that a serious problem exists. Unlike Weisbach, I am not convinced that most tax shelters work; that is, that they comply with current law. At this relatively early stage in the tax shelter enforcement process, I think it is impossible to reach any informed conclusion. Thus, unless tax shelters are audited and challenged when appropriate, those that do not work will reduce government receipts. Second, although I am unaware of any documented link between aggressive tax behavior by business organizations and a decline in individual tax compliance, my intuition is that the likelihood of such a link exists. I believe that individual taxpayers are influenced by their perception of the level of tax compliance by others, including business organizations. Third, I am concerned by an increasing level of aggressiveness by tax shelter promoters, taxpayers, and their advisors in designing and undertaking transactions in which there appears to be no material nontax motive. Most often this activity is wasteful and corrodes responsible and ethical behavior.

Were there a consensus on the proposition that a tax shelter problem exists, policymakers and analysts nevertheless would disagree about its underlying cause. Some maintain that current law enables well-advised taxpayers to enter into transactions or take tax return reporting positions because of substantive law infirmities. If existing law is the problem, Congress and the administration should respond appropriately. The response might be a fundamental reform of the income tax, either abandoning the current system or substantially reforming it as Treasury proposed in 1984. Alternatively, the substan-

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7 See, e.g., 1 Staff of the Joint Comm. on Tax'n, 106th Cong., 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) 6-7 (Comm. Print 1999), 1999 TNT 142-72, July 26, 1999, available at LEXIS, Tax Analysts File [hereinafter Joint Committee Tax Shelter Study] ("[A]lthough it may be difficult to define precisely what it means to be a corporate tax shelter, a general principle should focus on a significant purpose to avoid or evade Federal income tax and be elaborated upon by more objective standards . . . ."").

8 Weisbach, Ten Truths, note 1, at 228.

9 Evidence of a possible link may be inferred from the hostile reactions of two individual taxpayers to a report of recent business tax shelter activity. See Ben Stanger & Pragna Patel, Letters to the Editor, N.Y. Times, Dec. 26, 2000, at A30.

10 Treasury Dep't, Report to the President: Tax Reform For Fairness, Simplicity, and Economic Growth (1984).
tive law response might focus on specific defects in current law and respond through legislative changes as issues arise. The recent addition of § 357(d) is an example of such a limited response. The substantive law response also might consist of broad anti-tax shelter rules, for example, a statutory economic substance doctrine, an anti-abuse rule modeled after the passive loss rules of § 469, or a heightened tax return filing standard, such as a requirement that certain reporting positions be allowed only by claim for refund.

Weisbach urges consideration of substantive law changes. I think his suggestion has merit; however, I do not think a primary focus on the substantive law will suffice. I reach this conclusion because I think there is at least one other important causal explanation of the tax shelter problem—namely, the historic lack of effective tax enforcement. I believe that some tax shelter transactions do not work under current law. Some are defective because the purported transaction on which the taxpayer’s return positions are based is not supported by actual facts; others are based on erroneous interpretations or applications of the statute; and still others fail to take into account relevant judicial doctrines, such as economic purpose, business purpose, and the step transaction doctrine. Tax shelters that do not work are not a substantive law problem; they are primarily a tax enforcement problem, and they require an enforcement response.

Developing an appropriate set of responses to the tax shelter problem is difficult, but one point seems clear to me. No single response likely will suffice. I share Weisbach’s view that implementation of an enhanced disclosure regime is not enough. I also see little reason to think, however, that substantive law changes will serve as a complete response if lack of enforcement encourages a low level of voluntary compliance. Moreover, substantive law changes, particularly bold legislative proposals, may never be enacted and certainly do not appear imminent. Whatever the state of the substantive law, effective enforcement should encourage a reasonable level of compliance and further inform policymakers of substantive law defects. Therefore, in ranking the components of a comprehensive response to the tax shelter problem, I list first the scope and effectiveness of the Service’s tax shelter enforcement response. I do not think the Service possesses the enforcement tools necessary to mount an effective attack on tax shelters—thus, my interest in disclosure.

This Article relates primarily to tax return disclosure, although I also refer to “early warning” disclosure, that is, pre-tax return disclosure by taxpayers and third parties. My hypothesis is that an ex-

11 Weisbach, Ten Truths, note 1, at 251–53.
12 Id. at 225–30.
panded tax return disclosure regime—what I refer to as "enhanced disclosure"—coupled with vigorous enforcement activity by the Service would uncover and discourage many defective tax shelters. This conclusion is based primarily on personal experience as a tax practitioner and on intuition. Available data are insufficient to validate this view. I have found no empirical research on the effectiveness of tax return disclosure by business organizations, and I have no actual information about the impact of the temporary regulations on the Service's audit capability or on deterrence. Thus, I recognize that my conclusion may be incorrect, and I invite challenge by those who think that my analysis is incomplete or otherwise defective. To the extent this discussion suggests the need for additional empirical research, I hope that it stimulates further inquiry.

II. JUSTIFICATION FOR MORE VIGOROUS TAX SHELTER ENFORCEMENT

Not everyone shares my concern with the current tax shelter environment and, thus, my interest in increasing tax enforcement. For example, efforts to improve enforcement and compliance may not interest those who view a weakening of the revenue-raising capacity of the current income tax as a way to reduce the size of government or to enhance popular support for an alternative tax system. Others may not be interested in enhancing compliance with a tax perceived to be inappropriate, such as the corporate income tax. Still others seem to believe that all tax planning is appropriate under current law—assuming that it is legal, whatever that means.

I think most students of the tax system would accept as a normative matter the simple application of the rule of law; taxpayers should be expected to comply with current law as finally determined by the courts even if they disagree with the underlying tax policy. Most also would agree that effective enforcement is necessary if tax-motivated transactions are to be held to this standard. If one believes that effective enforcement is important, it is not much of a leap to also support the serious consideration, if not endorsement, of the possible role of enhanced disclosure in improving enforcement.

Mandatory tax return disclosure of information relating to tax-relevant transactions potentially may serve three enforcement and com-

14 Ryan J. Donmoyer, GOP Leadership: Shelter Problem, What Shelter Problem?, 86 Tax Notes 1039 (Feb. 2, 2000) (quoting House Majority Leader Richard K. Armey as stating, "The business of a corporation is . . . to maximize its earnings for its shareholders. Since tax is a very large part of their costs, anything they can do to minimize that share of their costs would be a legitimate thing. Obviously, they need to do what is legal, and we presume they are doing that.").
pliance functions. First, disclosure may provide information that assists an IRS agent in evaluating the effect of a transaction on the disclosing party’s tax liability. I refer to this role of return disclosure as the audit function. Second, disclosure may constitute an important source of information for considering administrative and legislative responses to a particular transaction or to perceived broader defects in current law. I refer to this role as the tax policy function. Third, the existence of a meaningful return disclosure regime may discourage taxpayer investment in particularly questionable transactions. I refer to this role as the deterrence function.

A. The Audit Function of Return Disclosure

Improvement in tax enforcement is the primary reason for implementing an enhanced disclosure regime, even though the tax policy and deterrence functions of return disclosure are potentially very important. The discussion of the audit function in this subsection analyzes two assertions: (1) Because of the inadequacy of return information, the Service needs enhanced disclosure to enable revenue agents to effectively identify and analyze tax shelters. (2) To protect the revenue agent’s “right to know,” the category of transactions subject to an enhanced disclosure regime should be overly broad rather than unduly narrow.

1. Inadequacy of Return Information

Section 6001 grants Treasury very broad authority to require taxpayers to provide information relevant to the determination of their tax liabilities. Taxpayers must file tax returns in the particular form specified, provide other necessary information, and maintain appropriate records. In spite of Treasury’s broad authority and the fact that tax returns do include questions and mandated schedules intended to amplify the line-item entries on the returns, the current level of return disclosure, absent an enhanced disclosure regime such as that attempted in the temporary regulations, does not enable revenue agents to identify certain tax shelters. I use a hypothetical corporate tax audit to illustrate this point.

Assume that a Fortune 1000 corporate taxpayer files its tax return with all relevant numerical lines completed but without responding to the return’s narrative questions and without completing any required schedules. During the course of the audit, the revenue agent asks the taxpayer’s agent or representative to explain a specific numerical en-

15 Temporary Regulations, note 3.
try, for example, the facts underlying a loss that offsets a substantial gain. The taxpayer refuses to provide the requested explanation or information, but, hypothetically, the agent has no statutory authority to compel a response. Without the ability to inquire beyond the line-item entries, the agent would be unable to evaluate the propriety of the return. Essentially, the agent would be limited to checking the mathematical accuracy of the return.

Of course, this scenario is neither representative of current law nor consistent with the circumstances of a typical audit, at least one that does not involve a criminal investigation. Nevertheless, it is relevant to a discussion of tax shelters. The hypothetical facts often are not far from the circumstances faced by a revenue agent looking for the tax shelter needle in the haystack of a complicated business tax return. To obtain an accurate picture of a tax shelter audit, it is necessary to appreciate the inordinate complexity of the income tax return of a large multinational business, in particular, the extraordinary volume of transactions underlying the numerical entries on the return. A large number of these transactions would be described as tax-motivated (tax shelters under my tax enforcement definition) even though they are not necessarily improper or otherwise illegal.

In addition to the sheer volume of transactions encompassed within the line-item entries, consider also the format of existing return disclosures, particularly Schedule M-1 of Form 1120, the corporate income tax return. A 10-line schedule that constitutes a part of Form 1120, Schedule M-1 requires the corporate taxpayer to reconcile its financial accounting (book) income with the income it reports on its tax return. Some of the information required by Schedule M-1 is very general; the information provided often lacks sufficient detail to enable a revenue agent to identify any underlying transaction. Other information is required in great detail, resulting in the submission of large amounts of data. Consider, for example, line 5a of Schedule M-1, relating to depreciation. Imagine the number of depreciation entries that must be disclosed in order to comply with the itemization requirement of line 5a. Yet, in spite of the large volume of data, how does the information assist an agent in determining, for example, whether a specific leasing transaction complies with the Service’s leveraged lease guidelines? It does not; indeed, it may not even identify the leasing transaction.

Similarly, the book-tax component of Schedule M-1 of a multinational corporation reflects thousands of entries, including book-tax differences resulting from depreciation, nonqualified stock options, leveraged lease transactions, goodwill, and research and development expenditures. It often is impossible for a revenue agent to identify tax
shelter transactions from available Schedule M-1 data. The part­nership version of Schedule M-1 does not even require the disclosure of book-tax differences. Even less information is required of an unincor­porated sole proprietor on Schedule C to Form 1040. In spite of Weis­bach's lack of enthusiasm for enhanced disclosure, he concedes that efforts to improve disclosure on Schedule M may be useful.\textsuperscript{16} The Temporary Regulations attempt to do just that.\textsuperscript{17} Indeed, it would be easy to implement Weisbach's suggestion by labeling the required tax shelter disclosure statement as Schedule M-3.

Consider another example of current tax return disclosure. Form 1118, the corporate foreign tax credit form, requires the taxpayer to identify each foreign tax for which it claims a foreign tax credit. Imagine the foreign tax position of a large multinational corporation. It pays hundreds, if not thousands, of foreign taxes to numerous national and subnational jurisdictions. Assume that a particular tax shelter transaction involves the aggressive claim of a foreign tax credit. Without any information other than the entries on Form 1118, it is unlikely that a revenue agent, no matter how sophisticated, would be able to identify the questionable claim.

Return now to the facts of my fictitious audit. Assume that the revenue agent identifies data on the return or an accompanying schedule that causes her to inquire about a particular entry. For example, assume that a revenue agent on the examination team gives the taxpayer an Information Document Request seeking explanations of the 50 largest foreign tax payments for which the taxpayer claims credits. The corporation's agent or representative explains that it will take a substantial effort and considerable time to comply with the request. The revenue agent agrees to allow the taxpayer one month to prepare the response. One month passes, and the revenue agent receives no response. Two months pass, and no response is forthcoming. Each month the revenue agent inquires about the status of the request, and the company representative states, "We're working on it." Finally, the examination team completes the audit except for a review of the foreign tax credits that are the subject of the Information Document Request. The case manager responsible for the audit has a choice: Does he defer the formal completion of the examination until he receives the response, perhaps summoning the information from an uncooperative taxpayer, or does he accede to his supervisor's directive to forget the delinquent IDR response, close the audit, and move on?

Public information does not permit an accurate evaluation of the problems facing revenue agents in their search for and analysis of tax

\textsuperscript{16} Weisbach, Ten Truths, note 1, at 227.
\textsuperscript{17} Temporary Regulations, note 3.
shelters in the course of an audit. There is some published evidence of difficulties experienced by agents in timely obtaining helpful information in the case of audits of large taxpayers, although the information is dated. A 1994 General Accounting Office study of large corporate audits states that most IRS Coordinated Examination Program team coordinators reported that they did not receive information requested from taxpayers in a timely manner, and 30% of the team coordinators reported that they had to close audits without having obtained the information.\footnote{18 GAO, Tax Administration, Compliance Measures and Audits of Large Corporations Need Improvement (Sept. 1, 1994), 94 TNT 205-13, Oct. 19, 1994, available at LEXIS, Tax Analysts File [hereinafter GAO Report]. (The Coordinated Examination Program now is called the Large Case Audit Program.) It also is useful to recall instances in which taxpayers may have sought to obstruct the progress of an audit by resisting the Service’s request for information. See, e.g., United States v. Toyota Motor Corp., 569 F. Supp. 1158 (C.D. Cal. 1983) (Service sought foreign parent data).}

Even in the absence of more information on impediments to an effective audit, it is not hard to imagine the difficulties facing revenue agents. Many tax shelter transactions are exceedingly complex. The tax effects may be buried within a large dollar entry on a particular line of the tax return or they may be reflected in several entries. Some transactions are comprised of subtransactions, each of which must be reviewed in order to understand the whole. Some involve foreign entities that do not file U.S. tax returns. Some may look quite innocent unless the tax effects are considered on a multiyear basis. In the audit of a complex business tax return, unless the revenue agent has very precise information about potentially questionable transactions, he will miss some of them no matter how smart he is, no matter what level of training he has, and no matter what statutory authority he possesses to obtain information from the taxpayer. In such circumstances, the agent needs information regarding the particular transaction, either information that the Service has obtained from some other source or additional information obtained from the taxpayer.\footnote{19 Randall Smith & John McKinnon, IRS, Merrill Reach Pact on Shelters, Wall St. J., Aug. 29, 2001, at C1 (quoting Richard Andersen as stating, “The only really effective enforcement mechanism they have is disclosure.”).} Enhanced disclosure is one method of obtaining useful additional information.

We do not know how many of the litigated tax shelters and other cases in the audit pipeline came to the examining agents’ attention through return information, through discussions with the taxpayers during the course of the audits, or through information provided by industry specialists, the IRS National Office, or third-party sources. Although the data are not clear, it appears that promoters have registered at least 1,268 confidential corporate tax shelters since Septem-
ber 2000\textsuperscript{20} and that taxpayers have filed 144 tax shelter disclosure statements.\textsuperscript{21} Although no information relating to the specific transactions disclosed is publicly available, I would be surprised if these submissions have brought no transactions to the attention of revenue agents of which they otherwise were unaware.

2. The Revenue Agent's Right to Know

My second assertion regarding the audit function of mandated disclosure relates to the desirable breadth of disclosure. In suggesting the need for a broad standard, I begin with a fundamental proposition that I caption "the revenue agent's right to know." The proposition is very straightforward: The Service is entitled to know all of the facts related to any taxpayer action that is relevant to a proper determination of its tax liability.

From a taxpayer's perspective, an action,\textsuperscript{22} may appear to be clearly correct under current law—the result of legitimate tax planning. Even so, the revenue agent is entitled to review the action. For example, an agent is entitled to seek the facts on every reorganization as defined in § 368(a)(1)(B) to which a corporate taxpayer was a party during the relevant audit period in order to determine whether the "solely for voting stock" requirement was satisfied. Indeed, for many years, the regulations have required taxpayers to report garden-variety reorganizations as well as other routine transactions in addenda to their tax returns.\textsuperscript{23} To my knowledge, taxpayers have not challenged these disclosure requirements nor do they argue that the disclosures impede legitimate transactions. There is no basis for the assertion that a revenue agent may not review a particular transaction because it constitutes legitimate tax planning.

Consistent with the revenue agent's right to know, the Service also is entitled to seek additional information from taxpayers in advance of an audit in the form of a targeted tax return disclosure if it determines that such a disclosure will aid in the audit selection process, in developing the audit plan once a return is selected for examination, or merely because it determines that certain transactions cannot be readily identified by the revenue agents during the course of the audit on


\textsuperscript{22} I previously defined "action" to include specific transactions and interpretations of current law on which tax return reporting positions are based. See text following note 5.

\textsuperscript{23} Reg. § 1.368-3; see also Reg. § 1.351-3 (disclosure for incorporation transactions); § 1.302-4(a)(1) (disclosure relating to § 302(b)(3) waivers); § 1.1033(a)-2(c)(2) (disclosure relating to involuntary conversions).
the basis of existing tax return information. This is a simple extension of the agent's right to know. As with an agent's inquiries during the audit, there is no basis for arguing that enhanced disclosure may not include information about a particular category of transactions merely because the category constitutes legitimate tax planning.

If there is merit to the assertion that the Service is entitled to obtain information deemed relevant to a determination of the taxpayer's liability, why do private sector comments on enhanced tax shelter disclosure complain about the adverse effect of disclosure on legitimate tax planning? For example, the Financial Executives Institute stated that the temporary regulations will cause taxpayers to feel at risk when engaging in widely accepted and entirely appropriate transactions.24 The Federal Taxation Committee of the Chicago Bar Association asserted that "certain elements of the [Temporary] Regulations...will result in unwarranted disclosure...of transactions which are clearly supported by the tax law and are generally accepted."25 Even the ABA Tax Section, which was an early proponent of enhanced disclosure, recently complained that the temporary regulations will result in the disclosure of a large volume of transactions that are not corporate tax shelters.26

There are at least three possible reasons for assertions that enhanced disclosure poses a threat to legitimate tax planning. First, it may be good politics. Taxpayers and their advisors realize that enhanced disclosure enables a revenue agent to more readily identify and challenge questionable transactions. By claiming that disclosure will impede legitimate tax planning, opponents of enhanced disclosure may succeed in eliciting an accommodating political response, such as Senator Charles E. Grassley's statement that the Senate Finance Committee is studying ways to address tax shelter abuses "without interfering with legitimate business transactions."27

Rhetoric about legitimate tax planning is inevitable. It is important, however, that congressional staff working on proposed disclosure legislation, as well as the Service and the Treasury, keep this possible

27 Heidi Glenn, Patti Mohr & Fred Stokeld, TEI Meeting—Congressional Leaders Say AMT Fix, Corporate Tax Breaks on Horizon, 91 Tax Notes 210, 211 (Apr. 9, 2001).
political motivation in mind. It is particularly important that Congress not leave the impression that a taxpayer's right to tax plan places limits on a revenue agent's right to know. Congressional committee report language that seeks to limit the Service's ability to obtain information considered relevant to a tax audit under the guise of an impediment to legitimate transactions could have negative long-term implications that extend beyond tax shelters.

Beyond the obvious self-interest that may motivate attempts to discredit disclosure proposals by linking them to legitimate tax planning, there are two more substantive reasons underlying an asserted "disclosure-legitimate transaction" link, namely, the relationship of disclosure to the accuracy-related penalty and taxpayer burden.

The primary reason for private sector references to the potential impact of enhanced disclosure on legitimate tax planning results from the fact that the design of a disclosure regime intended to serve as an effective audit tool has become intertwined with the accuracy-related penalty. For example, the preamble to the tax shelter disclosure regulations states that failure to disclose may affect the taxpayer's exposure to the accuracy-related and fraud penalties. The Senate Finance Committee staff's Tax Shelter Discussion Draft has an even more far-reaching impact by calling for a 40% penalty on a "tax shelter understatement" unless, inter alia, "the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return." Considering the importance of the definition of tax shelters under this proposed penalty structure, it is understandable that taxpayers and practitioners would focus on the definition and express concern that a broad statute may implicate so-called legitimate transactions. On the other hand, if the design of an enhanced tax shelter disclosure requirement were separated from changes in the accuracy-related penalty, so that a new disclosure obligation is viewed solely as a legislative expansion of § 6011, then the breadth of transactions subject to disclosure is less important and arguments against catching "legitimate transactions" are considerably less persuasive.

28 IRC § 6661 (prior to repeal in 1989).
31 See, e.g., Rachelle B. Bernstein, Coalition for the Fair Tax'n of Bus. Transactions, Comments on Temporary Tax Shelter Regulations (May 26, 2000), 2000 TNT 116-60, June 15, 2000, available at LEXIS, Tax Analysts File ("[T]he members of the Coalition want to express their concern with the Administration's demonizing of taxpayers that are trying to plan transactions in a tax-efficient manner. The scope of the transaction . . . impacted by Treasury's regulatory . . . proposals goes well beyond 'tax shelters.'"); Luby, note 24.
A final reason that legitimate transactions might be implicated by enhanced disclosure is private-sector concern with the inevitable additional administrative burden imposed on taxpayers by reason of a broadened disclosure requirement. If the standards for disclosure were broad, the amount of information that must be collected, reported, and retained by taxpayers would increase, potentially significantly. Taxpayers might understand and accept this burden in the case of transactions they perceive to be particularly aggressive; they would not understand the reason for this added burden if they were required to report transactions that they believe are clearly supported under current law.

The potential burden of any new enforcement requirement is a legitimate taxpayer concern, and taxpayers and practitioners should not be criticized for expressing this concern. One of the benefits of developing enhanced disclosure through the regulations process is the opportunity afforded the private sector to review and comment on the proposal. Unfortunately, complaints of taxpayer burden as a result of the temporary regulations have been quite general; the Service and the Treasury are entitled to greater specificity. Are there examples of situations in which taxpayers cannot comply with the reporting and recordkeeping burden? Are there specific matters that are required to be disclosed that are particularly burdensome? Does the early warning or return disclosure requirement create timing problems? For example, is the return preparer likely to receive the information too late in the return preparation process to enable the preparer to fully comply with the disclosure requirements? Is the preparer concerned about relying on information provided from remote corporate sites by people who do not understand the disclosure requirements?

Documentation of the specifics of taxpayer burden does not complete the analysis; an inevitable tension exists between administrative burdens on the taxpayer and the Service's need for additional information. The ultimate determination regarding the scope of enhanced disclosure should be left with the Service. It is in the best position to know what problems revenue agents face in the examination process and what additional information would most likely contribute to an efficient and effective audit. No rational administrative purpose is

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served by requiring taxpayers to disclose each and every tax-motivated transaction. For example, a revenue agent will not be interested in the details of every purchase of depreciable property by a taxpayer that was motivated by a more favorable tax result when compared with a hypothetical lease of the property. Just as legitimate tax planning should not preclude disclosure, tax motivation (legitimate or otherwise) cannot be the sole filter for enhanced disclosure.

I am willing to assume that the Service's senior management has no desire to create paperwork that will not be productive. It has bigger fish to fry. Nevertheless, the Service should not be permitted to act in a vacuum. It should be expected to justify its demand for additional information to affected taxpayers, to Treasury colleagues, and ultimately to Congress in the exercise of its oversight responsibility.

The regulations process assures that the private sector will be heard and that Treasury will have its say. The regulations process, however, does not assure protection from behind-the-scenes pressure on the Service that waters down and substantially weakens the resulting disclosure regime. I am concerned about this prospect in connection with the temporary regulations. The temporary regulations, generously in my opinion, excuse a taxpayer from the duty to disclose if the taxpayer determines that there is no reasonable basis for denial of a significant portion of the tax benefits from a transaction.33 As if this were not enough, the ABA Tax Section recently suggested that in the case of a reportable transaction other than a listed transaction, within the meaning of Temp. Reg. § 1.6011-4T(b), disclosure should not be required if the Service lacks substantial authority to support a challenge to the taxpayer's claimed treatment of the transaction.34 Similarly, the Tax Fairness Coalition suggested in its comments on the Temporary Regulations that disclosure not be required if the taxpayer reasonably determines that the government does not have a realistic possibility of success in sustaining a challenge to the transaction.35

I am troubled by these exceptions to a broad disclosure requirement. Authorizing the taxpayer to determine whether the Service has a sufficient basis for successfully challenging a transaction that the Service may never identify if there is no disclosure invites nondisclosure and will result in controversies regarding the meaning of the standard and its applicability in particular cases. The standard is the

35 Tax Fairness Coalition Comments, note 32.
essence of enhanced disclosure.\footnote{Son of Rusty Pipes, Shelter Insider Raises Important Issues, 91 Tax Notes 346, 346 (Mar. 30, 2001) ("That standard is where the rubber meets the road in the entire disclosure scheme . . . ").} If disclosure is going to be effective, the net must be cast wide.

Another criticism of enhanced tax shelter disclosure is that the Service will be unable to effectively utilize the volume of additional information.\footnote{See Kenneth J. Kies, PricewaterhouseCoopers, LLP, Comments on Senate Finance Comm. Corporate Tax Shelter Draft Legislation (June 9, 2000), 2000 TNT 117-12, June 16, 2000, available at LEXIS, Tax Analysts File (Service would need to hire scores of employees; sheer volume of submissions would jeopardize the chance the proposal would identify questionable transactions); Luby, note 24 ("[T]he government likely will find itself inundated with voluminous disclosures that will make it unwieldy at best (and impossible at worst) to use these disclosures in the fashion Treasury envisions."); John D. McKinnon, Professional Groups Criticize Tax-Shelter Rules, Wall St. J., June 12, 2000, at A2 (AICPA Tax Shelter Task Force “doesn’t want Internal Revenue Service resources ‘wasted on chasing shadows.’”); Sheryl Stratton, IRS Tax Shelter Office Geared Up to Handle More Disclosures, 91 Tax Notes 213, 214 (Apr. 9, 2001) (reference to query by Neil D. Traubenberg, Storage Technology Corp., whether the Service is worried that it will get buried in paper, and reference to “disclosure overload” by David G. Harris, director, IRS Office of Tax Shelter Analysis).} Frankly, I am suspicious of such private sector warnings. Do taxpayers really care whether the Service is overburdened? On the other hand, tax administrators should care. A disclosure requirement may be so broad that the volume of materials received by the Service does not aid the audit process. Indeed, enhanced disclosure may be counterproductive if the submission of a large volume of new documents succeeds in hiding questionable transactions. I assume that the Service and Treasury are sensitive to the potential for document overload. Former Acting Chief Counsel Richard Skillman is reported to have said that the key to the new disclosure was to empower the government to find out about potentially abusive transactions without “burying everybody in paperwork.”\footnote{Christopher Bergin, Heidi Glenn & Warren Rojas, Top Officials Preview Upcoming Anti-Corporate-Shelter Initiative, 90 Tax Notes 1295, 1295 (Mar. 5, 2001).} If the Service overshoots and is overwhelmed, it will have erred in its design of the enhanced disclosure regime. As far as I am concerned, that is the Service’s problem.

Development and refinement of the tax shelter disclosure standard should be considered a dynamic hit-or-miss undertaking. The Service may choose to begin with a wide net because it is not fully aware of the numerous transactions in the marketplace. As its audit experience increases and as it evaluates transactions that are disclosed, it should be able to adjust the disclosure definition to better conform to the information that it needs. If the Service and Treasury have not already done so, they should apply the disclosure standards of the temporary regulations to the facts of decided tax shelter cases and
relevant cases in the audit pipeline to determine those that would have come to the Service’s attention without the temporary regulations and those that likely would have escaped detection. With experience, I expect that the Service will adjust reportable transactions through notices and revenue procedures, excluding some existing transactions or categories and adding new transactions or different transactional characteristics.

I wish to make two final points in connection with the audit function of disclosure, involving the potential consequences of enhanced disclosure in the audit process. The first relates to the possibility that enhanced disclosure will result in accelerated audits.39 The acceleration of an audit may result in an earlier-than-usual denial of the tax benefits of a defective tax shelter or it may fail to provide time to fully develop the relevant facts or afford the taxpayer a full opportunity to explain its legal position. The second concern relates to the possibility that some revenue agents will characterize every disclosed transaction as an abusive transaction that is unsupported by current law rather than analyze the transaction to determine its merits.40 Absent experience, the audit-related procedural effects of disclosure are speculative; however, the Service must recognize that disclosure may change the dynamics of the audit, sometimes in an appropriate manner and sometimes inappropriately. It should implement procedures to minimize inappropriate consequences and provide a mechanism for dealing with situations that may arise in specific audits.

B. The Tax Policy Function of Return Disclosure

Information that comes to the attention of the Service in connection with the audit of a specific taxpayer, or by means of an early warning filing by the taxpayer or a promoter, may be useful for nonaudit purposes, such as the development of administrative guidance in the form of notices, revenue rulings, and revenue procedures. The information also may serve as the basis for revised or new regulations, and it may be an important factual resource in considering substantive law changes. This serves an important tax policy function independent of the audit function.

Weisbach describes the temporary regulations as a Washington-based disclosure model.41 He states that current disclosure proposals are not well designed to increase the chance of successful audits be-

39 Stratton, note 37, at 214.
40 Bergin et al, note 38, at 1295 (quoting Kenneth Kies’ statement that the disclosure rules have created a “scarlet letter effect” in the field, encouraging revenue agents to audit transactions that presumably Kies concluded should not have been examined).
41 Weisbach, Ten Truths, note 1, at 227.
cause they require taxpayers to send information to Washington and, therefore, do not increase the chance of audit.\textsuperscript{42} This is a puzzling statement because he also recognizes that taxpayers are required to include the disclosed information with their tax returns.\textsuperscript{43} Weisbach is correct that the early warning filing has a tax policy purpose,\textsuperscript{44} but there also are very important audit-related reasons for requiring taxpayers to send information to Washington in advance of the filing of the tax return. The information becomes immediately available to subject matter experts in the National Office who may analyze the disclosed transactions in advance of the audits and thereby provide better support to revenue agents. Thus, imposition of a centralized pre-return filing requirement does not justify a mischaracterization of the audit function of the disclosure regime. As long as the disclosed information reaches the revenue agent through a return filing or from the National Office as a result of an early warning filing, the fact that the early warning disclosure also informs Washington policymakers is icing on the cake.

C. The Deterrence Function of Return Disclosure

The most intriguing aspect of enhanced disclosure is its potential deterrence effect. If taxpayers realize that the Service will know of the existence of tax shelters in which they participate and, accordingly, will be more likely to audit the transactions, they may be more reluctant to engage in certain transactions in the first place. Just as important, they also may analyze more carefully the legal merits of transactions in which they do engage, insist on factual accuracy, and anticipate the need for full factual documentation.

It is clear that deterrence is one of the objectives of the Service’s tax shelter compliance activities.\textsuperscript{45} There is anecdotal evidence that the temporary regulations may have had such an effect,\textsuperscript{46} although it is

\textsuperscript{42} Id. at 226.
\textsuperscript{43} Id.
\textsuperscript{44} The “early warning” prong of the disclosure regulations is intended to “allow the IRS, the Treasury Department, and, to the extent necessary, the Congress sufficient time to react to and stop the spread of the latest fad of the corporate tax shelter genre.” Treasury Dep’t, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals 84 (1999), 1999 TNT 127-12, July 2, 1999, available at LEXIS, Tax Analysts File [hereinafter Treasury Tax Shelter Study].
\textsuperscript{45} IRS Fact Sheet No. FS-2001-10 (Sept. 4, 2001), 2001 TNT 172-6, Sept. 5, 2001, available at LEXIS, Tax Analysts File (“A critical part of the overall LSMB strategy is deterring the promotion of abusive tax shelters through specific regulations, including: ... Requiring Taxpayers to Disclose ‘Reportable Transactions.’”).
also possible that the reported reduction in tax shelter activity was prompted by early court decisions in the Commissioner’s favor or recognition that the Service was directing more enforcement resources to tax shelters. It is also possible that any observed reduction in tax shelter activity was temporary. Recent taxpayer victories in tax shelter litigation may embolden the tax shelter industry. Nevertheless, my intuition and experience suggest that an enhanced disclosure regime will have a deterrence effect. In the absence of additional data, however, this judgment necessarily is speculative. My purpose in the following discussion is to briefly review some potentially relevant literature and identify the need for further analysis. The discussion begins with a reference to the audit lottery.

Weisbach doubts that the audit lottery is the driving force behind the current tax shelter boom. Rather, the problem is the substantive law.47 If “audit lottery” is considered to encompass only taxpayer speculation regarding selection of a return for examination, he undoubtedly is correct, at least in the case of large corporate taxpayers that are continuously examined in the Coordinated Examination Program. This view of the audit lottery is too narrow, however, when considering the manner in which sophisticated taxpayers evaluate tax shelters. It is important also to consider taxpayer speculation about the likelihood that a revenue agent will identify a particular tax shelter transaction in the course of an examination. I doubt that it would be possible to reliably quantify the extent to which sophisticated taxpayers consider audit risk in deciding whether to engage in tax shelter activity. If asked, I assume that many, if not most, taxpayers would say “of course not.” Thus, one must rely on anecdotes.

Practitioners will have different views about the role of the audit lottery in tax planning decisions by business organizations. I think the relevance of the audit lottery on decisionmaking varies among taxpayers. Some refuse to consider the audit lottery and make their decisions whether to engage in a specific tax-motivated strategy on the basis of their analysis of the merits of the proposed transaction. Others have more of a gambler’s instinct and tend to be interested in predictions of the likely consequences of an audit. While I do not think the audit lottery frequently is the determinative factor in making a tax shelter investment decision, based on my experience as well as that of colleagues in the private bar with whom I have discussed this topic, it often is a material factor and, thus, should not be ignored.

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47 Weisbach, Ten Truths, note 1, at 229.

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level has diminished. I’m not saying that it’s gone, but it has rapidly declined.”); Goldwyn, note 21, at G4 (IRS Advisory Council Chair Paul Cherecwich, Jr. is reported to have observed increasing reluctance to invest in tax shelters, which he attributes to the government’s increased shelter activity).
Furthermore, consideration of deterrence should not be limited to whether a taxpayer will or will not engage in a tax shelter transaction. We should be interested as well in whether disclosure causes the taxpayer to exercise greater diligence, whether it causes the taxpayer to undertake a more careful analysis of the legal merits and risks and, very importantly, whether it causes the taxpayer to make certain that the facts as assumed in designing a tax-minimization scheme are the actual facts of the transaction in which the taxpayer engages and that the actual facts are adequately documented.

Lacking the ability to factually document taxpayer behavior, I refer to the compliance literature for guidance on the likely effect. My limited review of the literature does not add much to the deterrence analysis. I reviewed two categories of analyses, nontax literature that deals primarily with the deterrence effect of public disclosure and some of the tax compliance literature that addresses the relationship between detection and compliance.

1. **Public Disclosure**

Certain nontax public disclosure literature asserts the existence of a positive relationship between disclosure and the behavior of the disclosing party. Because the disclosure is public, however, the literature tends to focus on the impact of the marketplace rather than government mandate as the incentive for extracting meaningful information from the disclosing party. For example, if public disclosure is perceived by securities issuers to be beneficial to potential investors, and if issuers risk ex post private action fraud claims in the event of inadequate disclosure, then issuers have incentives to accurately disclose. Even here, the literature is not conclusive; indeed, some of the commentary suggests that public disclosure may not have a positive behavioral effect.

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Analyses suggesting that public disclosure may have a positive deterrence effect are not helpful in determining whether a link exists between tax return disclosure and tax compliance because return disclosures are confidential\(^{50}\) and, thus, ordinarily are not the subject of public scrutiny. Indeed, a taxpayer’s incentives to voluntarily disclose information to the Service or to enthusiastically comply with the letter of a mandatory disclosure requirement are the opposite of the incentives that operate in a marketplace that employs disclosure as an incentive. Tax return disclosure increases the chance that a revenue agent will obtain information necessary to successfully challenge a transaction, thereby increasing the disclosing party’s tax liability and decreasing its after-tax income. Absent some cost for failing to disclose, there is no financial reason for a taxpayer to provide such a roadmap to the Service. Thus, I do not find the nontax public disclosure literature helpful.

There is, however, one link to public disclosure that may be relevant in designing a tax shelter disclosure regime. There appears to be a strong association between public information disclosure, that is, nontax information reporting by public companies, and high tax compliance.\(^{51}\) Presumably, these taxpayers realize that more information will be available to the revenue agent or conclude that it will be more difficult to reconcile differences in public nontax disclosures that are available to a revenue agent and their tax returns.

2. Detection and Compliance

Contemporary tax compliance analysis rejects the application of a constrained criminal behavior model based on self-interest in which the taxpayer simply compares the income-maximizing benefits of non-compliance with the various costs of detection in favor of an analysis that considers other variables, such as the tax administrator’s ability to detect underreporting and the tax law’s penalty regime.\(^{52}\) Nevertheless, there is extensive commentary on the effect on taxpayer behavior of the probability of detection and the likelihood of audit.\(^{53}\) This commentary suggests a weak relationship between high individual audit

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\(^{50}\) IRC § 6103(a).


rates and increased individual compliance.\textsuperscript{54} There appears to be a strong correlation, however, between increased compliance and specific forms of mandated disclosure that make noncompliance more visible to the Service.\textsuperscript{55} Third-party information reporting is the clearest example of a mandated disclosure requirement that has increased compliance.\textsuperscript{56}

The analysis of the deterrence effect of tax return disclosure is very limited. Although my search was not exhaustive, I am aware of only one study that analyzes the effect of mandated return disclosure, and it is of little help in analyzing an enhanced tax shelter disclosure regime. The study analyzed the behavioral responses to the TINS for TOTS legislation enacted as part of the Tax Reform Act of 1986.\textsuperscript{57} This legislation, now contained in § 151(e) in expanded form, mandated the inclusion of the taxpayer identification number of every dependent over five years of age who was claimed as a dependent on the tax return.\textsuperscript{58} The legislative history contains conflicting descriptions of the behavior that Congress sought to alter. Two members of the Senate, where the provision was added as a floor amendment, referred to dual claims for a child's dependency exemption by parents following separation or divorce.\textsuperscript{59} Another Senator suggested a broader abuse in his statement that the amendment "will deter people from claiming dependent deductions for phantom children."\textsuperscript{60}

Even though the penalty for failing to comply with the TIN requirement was very low ($5 for each omission\textsuperscript{61}), the apparent behavioral response to the legislation was quite significant. A study published by

\textsuperscript{54} Helen V. Tauchen, Ann Dryden Witte & Kurt J. Beron, Tax Compliance: An Investigation Using Individual Taxpayer Compliance Measurement Program (TCMP) Data, 9 J. Quantitative Criminology 177, 199 (1993) (suggesting the potential for a higher correlation in the case of high income individual taxpayers if the Service were to direct greater audit resources to this group).


\textsuperscript{60} Id. at 14,501 (Sen. Durenberger).

\textsuperscript{61} IRC § 6109(e).
the IRS Research Division in 1990 reported that dependent exemptions claimed on 1987 tax returns, the first year in which the predecessor to § 151(e) was effective, were 7 million less than projected.\textsuperscript{62} Since the comparison in the study was between exemptions claimed and exemptions estimated, it is not possible to conclude that claimed exemptions actually were reduced by 7 million; it is only an estimate. Based on the 69.7 million exemptions claimed,\textsuperscript{63} however, the estimated reduction is quite significant. Moreover, the study's analysis of the 1986 and 1987 tax returns of specific taxpayers provided even more compelling evidence of changes in taxpayer behavior. In the case of 11,627 returns, reported dependents decreased seven or more, and decreases from four to six dependents were reported on an additional 66,612 returns.\textsuperscript{64}

The Service's 1990 TINS for TOTS study suggests the compliance potential of disclosure. For several reasons, however, caution is in order. As the study indicates, following enactment, the Service and the Social Security Administration undertook a vigorous educational campaign to familiarize taxpayers with the new law, including direct mail notifications of the change to selected taxpayers. The Service also undertook an aggressive enforcement effort, including referral of 4% of closed returns (approximately 34 taxpayers) to the Criminal Investigation Division for possible fraud prosecution.\textsuperscript{65} Thus, it is not clear whether enactment of the new mandate caused the change in behavior or whether it was the Service's outreach and enforcement efforts that caused the change. But, when coupled with the newly enacted mandated disclosure, it is fairly clear that the law had a significant deterrence effect. Because the study relates only to individual taxpayers, it provides only indirect insight on the possible deterrence effect of disclosure by corporate taxpayers, and it is likely that the study does not provide much insight regarding high net worth individuals.

I have found no direct analysis of the deterrence effect of disclosure on business taxpayers generally or on corporations. Apparently, one such study is in process and might prove relevant. The Service is reported to have commissioned an independent confidential random survey of 1,400 large corporate taxpayers to determine the extent to which these taxpayers are documenting their transfer pricing methodologies in order to satisfy the documentation prong of the exception to

\footnotesize{\textsuperscript{62} Szilagyi, note 57, at 63.}\footnotesize{\textsuperscript{63} Id. at 64.}\footnotesize{\textsuperscript{64} Id. at 69-70.}\footnotesize{\textsuperscript{65} Id. at 70.}
the substantial valuation misstatement penalty. The Senate Appropriations Committee requested the study in 1999.

Further analysis of the deterrence function of return disclosure, particularly on business taxpayers, and on decisions regarding tax shelter activities, is necessary before it is possible to assert more confidently the existence of a disclosure-compliance link. Sufficient anecdotal evidence exists that disclosure may have a deterrence effect in these circumstances. Therefore, I think it is appropriate to take the effect into consideration in evaluating the desirability of enhanced disclosure and in reviewing alternative disclosure regimes.

III. MAKING DISCLOSURE WORK: DISCLOSURE INCENTIVES

It is clear that mandated disclosure will be effective only if taxpayers comply with the mandate. Therefore, policymakers must assure that sufficient incentives exist to encourage voluntary compliance with the disclosure requirements. This final Section considers possible incentives.

Perhaps the mere existence of an enhanced disclosure requirement combined with vigorous enforcement by the Service by means of predictable audits would cause taxpayers to take greater care in undertaking tax shelter transactions that comply with current law even in the absence of a civil or criminal penalty for willfully failing to disclose. This result would appear to be more likely when the reduced avoidance opportunity results from third-party disclosure, such as wage withholding or dividend and interest reporting. For this reason, the registration requirement imposed on tax shelter organizers under § 6111 may serve a particularly useful function in the limited situations in which it applies. Not all questionable transactions, however, result from confidential tax shelter products “purchased” by the taxpayer from a promoter. Some will be self-generated; others will be based on the advice of the taxpayer’s regular outside advisors. In such cases, the promoter registration rules of § 6111 will serve as no deterrent whereas some form of disclosure by the taxpayer may, provided that taxpayers comply with the disclosure mandate.

The following discussion refers to certain other potential disclosure incentives, including (1) relief from the accuracy-related penalty, (2)

66 IRC § 6662(e)(3)(B).
determination that a return, which does not include a disclosure statement or includes an incomplete disclosure statement, is not a complete and timely filed return, (3) the imposition of civil or criminal penalties on the taxpayer in the event of noncompliance with the disclosure requirements, (4) the imposition of civil or criminal penalties on the taxpayer's agents, and (5) public disclosure of information regarding penalties imposed on the taxpayer or its agents. Perception of a moral obligation to comply with the tax law also may constitute an important incentive. In fact, I think a sense of a moral obligation causes many business taxpayers to comply with the law. For purposes of this discussion, however, I adopt a more cynical view.

A. Relief From the Accuracy-Related Penalty

A two-tiered increase in the rate of the accuracy-related penalty from 20% to 40% in the case of a so-called "tax shelter understatement," with relief granted from the 40% rate if, inter alia, the taxpayer adequately discloses the facts of the transaction, is a central feature of the Finance Committee 2001 Discussion Draft. On its face, relief from the penalty when a transaction is disclosed may have the desired incentive effect.

I have three reservations about a link between the accuracy-related penalty and disclosure. First, I expect that the Service would be very reluctant to assess a 40% penalty and would do so only in rare circumstances, even if the penalty is not subject to a reasonable cause exception. With the exception of the 20% accuracy-related negligence penalty imposed on Compaq Computer Corporation and upheld by the Tax Court although later reversed, I am not aware of the imposition of an accuracy-related penalty on a public corporation, although I recognize that available information regarding the imposition of penalties is limited because of the taxpayer privacy rules. If my speculation regarding the Service's reluctance is correct, taxpayers will quickly factor this reluctance into their decisionmaking calculus.

The second reason that I do not favor a link between the accuracy-related penalty and the disclosure requirement relates to my view that


70 Finance Committee 2001 Draft, note 30, § 101(a)(1) (proposing amendment to § 6662(a)).

the revenue agent's right to know should not be limited to cases in which a questionable transaction is determined to fail under current law. As the Seventh Circuit stated in United States v. DiVarco, "In light of the need for accurate information . . . so that the Internal Revenue Service can police and verify the reporting of individuals and corporations, a misstatement . . . is a material matter [without regard to the existence of a tax liability]."\(^72\)

Third, and most importantly, the impact on the scope of disclosure because of a link to the accuracy-related penalty is unwelcome. Naturally, policymakers will be sensitive to the category of transactions that may be subject to a 40% penalty. Thus, it is likely that the higher penalty would apply to a narrower category of transactions. If a 40% penalty could be avoided by disclosing the transaction on the tax return, then it is likely that the category of transactions subject to disclosure would be conformed to the category of transactions to which the 40% penalty potentially applied. In other words, Congress will seek to minimize the number of disclosure standards, if for no other reason than to ease compliance with, and administrability of, the rules. Similarly, because the preamble to the temporary regulations warns of a link between a failure to disclose and the potential applicability of the current accuracy-related and fraud penalties,\(^73\) taxpayers and their advisors understandably desire to narrow the category of transactions subject to disclosure.

A disclosure standard linked by legislation or administrative practice to the accuracy-related penalty will be narrower than it will be if disclosure were a freestanding, return-filing requirement with no overlapping effect. The narrower the standard, the less utility disclosure will have in the audit process. If it were possible to have two tax shelter definitions, a narrow one that applies for purposes of the accuracy-related penalty and a more expansive one that defines the category of transactions subject to disclosure under § 6011, my concern would be eliminated. Legislative or administrative adoption of two disclosure standards is unlikely, however, as the Finance Committee 2001 Discussion Draft indicates\(^74\) and as the private sector commentary has urged. Therefore, I think it is a mistake to link relief from the accuracy-related penalty to disclosure.

\(^{72}\) 484 F.2d 670, 673 (7th Cir. 1973).
\(^{74}\) Finance Committee 2001 Draft, note 30, § 101(a)(1) (proposing amendment to § 6662(a)).
B. Incomplete Return

Section 1.6011-1(b) of the regulations provides that a tax return that does not fully and clearly set forth the required information will not be considered to meet the requirements of the Code, presumably including the statutory requirement of a timely filed return. The regulation is silent on the impact of the omission of a mandated attachment to the corporate income tax return, and I have located no case in which the adequacy of a corporate return has been rejected because of a failure to provide required information. Based on existing authority, I think it is possible to speculate that a corporate income tax return that otherwise is complete would not be characterized as an incomplete return merely because the taxpayer failed to complete Schedule M-1 or failed to file a mandated tax shelter disclosure. Perhaps a sufficient incentive to file would exist, if the Service could successfully assert that a return that does not include a mandated tax shelter disclosure is not timely filed. I do not think the Service would succeed. Moreover, I am not certain that the Service should challenge the completeness of such a return; the potential consequences seem disproportionate to the omission.

C. Criminal Prosecution of the Taxpayer

It is a misdemeanor under § 7203 to willfully fail to file a return or fail to supply information required by the statute or regulations. For this purpose, a tax return includes any schedules and statements that are required to be filed with the return. The Service has successfully prosecuted individual tax protestors under § 7203 who filed incomplete income tax returns, and in Pappas v. United States, the Service successfully prosecuted an individual member of a two-person partnership under the 1939 Code for intentionally failing to complete balance sheet information specifically required on the partnership return. Each of the tax protestors included material omissions

75 IRC § 6072.
77 Cf., Germantown Trust Co. v. Commissioner, 309 U.S. 304, 309-10 (1940) (return must contain all data necessary to compute tax liability).
78 See, e.g., United States v. Franks, 723 F.2d 1482, 1486 (10th Cir. 1983) (prosecution under § 7206(1); taxpayer filed incomplete Form 4683, relating to foreign bank accounts).
79 See, e.g., United States v. Quimby, 636 F.2d 86, 88 (5th Cir. 1981) (return included only the taxpayer's name, address, "other basic identifying information," and a protest statement).
80 216 F.2d 515 (10th Cir. 1954) (enforcing § 145(a) of the 1939 Code, which corresponds to § 7203 of the 1986 Code).
of income. The conviction in *Pappas* for omitting return information was based on particularly egregious facts. The revenue agents repeatedly attempted to obtain balance sheet information from the defendant, and the defendant refused to supply the information, even after he was threatened with criminal prosecution.81 Thus, these authorities do not provide reliable guidance regarding a court’s willingness to uphold the conviction of a business taxpayer for failing to attach a tax shelter disclosure to its return, particularly if the shelter is not defective or does not result in a material additional tax liability.

Notwithstanding the absence of direct authority, the willful failure to file a mandated disclosure may be the basis for criminal liability under § 7203.82 It is possible that the Service will identify situations in which taxpayers intentionally chose not to disclose their tax shelter activities. In such cases, the willful failure to file a tax shelter disclosure statement may give the Service an opportunity to explore the scope of § 7203.

It may be more difficult to allege violation of § 7203 solely on the basis that a schedule such as a tax shelter disclosure statement is incomplete or the information contained in the statement is inaccurate. The “tax return” standard articulated by the Supreme Court is whether the purported return “contained all of the data from which a tax could be computed and assessed.”83 The case law tends to involve extremes, where either no meaningful information was provided84 or the omissions were minor.85 The Court has held that a bona fide misunderstanding regarding a taxpayer’s duty to supply information required by an income tax return precludes the necessary finding of willfulness required for criminal conviction.86 On the assumption that an accused corporate taxpayer could explain the basis for any incomplete or inaccurate information and would offer to correct the inaccuracies, I can understand the absence of reported cases involving

81 See also United States v. Pirro, 212 F.3d 86 (2d Cir. 2000) (omission of Schedule K-1 from S corporation return); United States v. Taylor, 574 F.2d 232 (5th Cir. 1978) (failure to attach Schedule F to Form 1040; omission of a substantial amount of income was determinative); Siravo v. United States, 377 F.2d 469 (1st Cir. 1967) (failure of an individual to attach Schedule C to Form 1040; not clear what the court would have decided if the omitted income had not been material).
82 See United States v. DiVarco, 484 F.2d 670, 673 (7th Cir. 1973).
84 See, e.g., *White v. Commissioner*, 72 T.C. 1126 (1979) (Form 1040 contained only the taxpayers’ names, address, and Social Security numbers).
85 See, e.g., *McCaskill v. Commissioner*, 77 T.C. 689 (1981) (otherwise complete individual returns for four years were held to constitute timely filed returns even though the taxpayers reported a net income figure on their Schedules C rather than fully filling out the schedules.)
incomplete corporate returns and the likely reluctance of prosecutors to invest resources in pursuing such cases.

If there is no real threat of criminal prosecution in cases of willful noncompliance with a tax shelter disclosure requirement, the price of nondisclosure will be limited to the possible imposition of a civil penalty, a potential additional monetary transaction cost. Thus, if return disclosure is considered an important audit tool, the Service and the Justice Department must be willing in appropriate cases, such as when it can be established that the taxpayer was aware of the disclosure requirement and chose not to disclose, to seek criminal penalties. Failure to do so is a serious abrogation of their law enforcement obligation.

D. Imposition of a Civil Penalty

Section 6651(a)(1) imposes a penalty for failure to file a timely return, and § 6652 imposes penalties for failing to file certain specific information returns. If a taxpayer timely files a document that is deemed a return, there is no civil penalty applicable if the return is incomplete. Thus, in the absence of legislation, a taxpayer would not be subject to a penalty for failing to attach a tax shelter disclosure statement to its return as required by the temporary regulations, assuming that the tax return is deemed to constitute a timely filed return. This is a very significant defect in current law that should be corrected. The Finance Committee 2001 Discussion Draft would apply a civil penalty in the event of a failure to file the tax shelter disclosure statement. The penalty would be equal to the greater of 5% of any deficiency attributable to a reportable transaction or $100,000, or 10% of the deficiency or $200,000, in the case of a listed transaction. It is possible that even a penalty as large as that proposed by the Finance Committee will not be a sufficient incentive to cause taxpayers to disclose tax-motivated transactions that may result in multimillion dollar tax savings. The proposed penalty, however, is not intended as a punishment for engaging in the transaction; the accuracy-related penalty serves that purpose. Rather, the penalty is intended merely as a sanction for nondisclosure. As such, it needs to be measured in amount. Although $100,000 may not be sufficient, it cer-

87 The 1994 GAO Report notes the absence of a penalty for willfully failing to provide requested information in connection with a corporate audit. GAO Report, note 18, at 56. The Service has threatened imposition of a negligence penalty when sole proprietors failed to file a separate Schedule C for their separate businesses. Rev. Rul. 81-90, 1981-1 C.B. 572. No similar threat has been made regarding schedules or mandated attachments to the corporate tax return.

88 Temporary Regulations, note 3.

89 Finance Committee 2001 Draft, note 30, § 102 (proposing § 6707A(b)).
tainty is not de minimis, and it should attract the attention of corporate management and other regulators.

Conditioning the proposed nondisclosure penalty on the absence of substantial authority for a contrary position, or a realistic possibility of success on the merits, as recently suggested by the ABA Tax Section, is inconsistent with the principle that the Service is entitled to inquire into the specifics of a transaction even if it ultimately is determined to comply with existing law. Therefore, I think such a qualification is inappropriate.

I have expressed my concern with a link between the design of an enhanced disclosure regime and a redesign of the accuracy-related penalty. I recognize that the link is a good-faith effort to craft a meaningful disclosure incentive, and I have no basis for concluding that relief from a much higher deficiency-related penalty would not provide an effective incentive. An important consequence of the link, however, is the pressure that it places on the definition of the class of discloseable transactions, which in the current debate is coterminous with the definition of tax shelter. I am confident that if the link is retained, the range of discloseable transactions will be narrowed, thereby disadvantaging the audit process. Thus, I believe the tax-writing committees and Treasury should attempt to separate the disclosure requirement, including specifically the definition of discloseable transactions, from changes in the accuracy-related penalty.

No penalty will provide a compliance incentive if the Service is unwilling to assert it. The conventional wisdom is that the Service has been unwilling to assert a penalty against a publicly-held corporation, perhaps fearful that it will be accused of using the penalty as a bargaining chip in the tax audit. The Service’s action in Compaq is a departure from this apparent past practice and, thus, is a significant development. Indeed, a senior Service official stated that the Tax Court’s imposition of the penalty in Compaq will cause the Service to be less hesitant to impose penalties against large corporations. This statement preceded the recent reversal of the Tax Court’s decision. Thus, time will tell.

90 ABA Comments, note 26.
91 See text accompanying notes 71-74.
93 Sheryl Stratton, IRS Defends Record on Shelter Cases, 86 Tax Notes 889 (Feb. 14, 2000) (quoting Cynthia Mattson, then IRS Assistant Chief Counsel (Litigation and Field Service)).
94 Id.
E. Other Disclosure Incentives

It is possible that no monetary penalty imposed on a corporate or other business taxpayer will be sufficient to encourage an acceptable level of compliance with enhanced disclosure. Accordingly, it is worthwhile to consider other measures that might encourage the timely submission of accurate disclosures. I suggest two, public disclosure of failure-to-disclose penalties and personal accountability.

1. Public Disclosure of the Penalty

A 1987 individual taxpayer opinion survey conducted for the Service by an opinion research firm, Louis Harris and Associates, focused on the relevance of public disclosure to individual tax compliance. The study indicated that 51% of the individuals interviewed thought that the publication of the names of “tax cheaters” would reduce cheating, and 70% thought that publicity would serve as additional punishment.95 Because the survey involved individual taxpayers, it provides no direct insight regarding corporate taxpayers. To my knowledge, there exists no tax compliance analysis of the public disclosure of a penalty by a large business taxpayer.

The May 2000 preliminary discussion draft on corporate tax shelters prepared by the Finance Committee staff offered the prospect of legislation that would have enabled researchers to fill the data gap. It included a provision (proposed § 6116) that would have required a corporation to disclose to its shareholders payment of a tax shelter understatement penalty in excess of $1 million.96 The Finance Committee 2001 Discussion Draft contains a different penalty structure, including a penalty for failure to include a tax shelter disclosure with the return (proposed § 6707A), but it does not include a shareholder disclosure requirement.97

Recently, the Service publicly announced an agreement with Merrill Lynch that resulted in a “substantial payment” to resolve issues relating to tax shelter registration penalties.98 The announcement presumably was made with Merrill Lynch’s consent but likely resulted from the Service’s insistence. If penalties are imposed on other business taxpayers and similar public disclosures follow, or if the Securities and Exchange Commission were to require reporting companies to refer-
ence the imposition of a tax shelter disclosure penalty in public documents, it may be possible to evaluate the deterrence effect.

Perhaps large, sophisticated promoters and taxpayers, particularly large corporate taxpayers, will not be deterred even if their names are disclosed. Indeed, public disclosure of tax shelter activity may be perceived as a badge of courage. The Service, however, must have thought that disclosure of the Merrill Lynch settlement could have some deterrence effect, and the press release did result in relatively prominent publicity, including an article in the Wall Street Journal under the headline, “Settlement May Signal Similar Future Actions Against Other Firms.”99 Moreover, the Tax Executives Institute criticized the Finance Staff’s proposal to disclose penalties in excess of $1 million,100 and the Tax Fairness Coalition characterized the proposal as a “troublesome precedent by giving the tax-writing committees direct jurisdiction required by the securities law.”101 These protestations may be some evidence of sensitivity to public disclosure within the business community.

2. Personal Accountability

A corporate taxpayer that decides to engage in a tax shelter transaction may choose not to comply with a disclosure requirement, and, instead, risk the imposition of a monetary penalty if the nondisclosure is detected. After all, it is only money. But what if risk is imposed on one or more of the corporation’s officers or members of its board of directors? If they are subject to some form of personal liability, might the individuals’ potential liability cause a change in the corporate taxpayer’s behavior?

Section 6062 requires a corporate officer to sign the corporate tax return, and § 6065 requires that the return be verified under the penalties of perjury. In addition, § 7206(1) imposes criminal liability in the case of a willfully false declaration. Thus, theoretically under the authority of § 7206(1), the Service could prosecute a corporate officer who signs a tax return under penalties of perjury if the return does not include a mandated tax shelter disclosure statement or contains an

99 Smith & McKinnon, note 19, at Cl.
inaccurate statement. I have found no evidence of any enforcement action against a corporate officer in these circumstances. If prosecution for violation of the general tax return verification requirement is unlikely in the case of such an incompleteness or inaccuracy, might the risk of prosecution increase if an officer is required to verify the tax shelter disclosure form itself? This question was put in play in the tax shelter debate by a proposal to require a senior corporate officer to verify the accuracy of the enhanced tax shelter disclosure under penalties of perjury.

In 1999 testimony before the Ways and Means Committee, the ABA Tax Section proposed what has become known as the “corporate officer attestation” requirement. Specifically, the Section recommended that the disclosure form include a statement to be signed by the chief financial officer or comparable senior corporate officer under penalties of perjury that the facts set forth in the disclosure form are true and correct as of the date the return is filed. As explained in its testimony, the Section thought that an attestation requirement by a senior officer would increase the likelihood that the disclosure would be accurate and possibly assure that an increased degree of care would go into consideration of the tax shelter transaction. If successful, the attestation would improve the utility of the disclosure statement by a revenue agent and enhance deterrence. Subsequently, the Staff of the Joint Committee on Taxation and the Finance Committee 2000 Preliminary Discussion Draft made the same recommendation, and Treasury made a similar recommendation.

The corporate community’s reaction to the corporate officer attestation proposal predictably was negative, and the proposal was not included in the Finance Committee Staff 2001 Discussion Draft. I consider this deletion unfortunate.

Not only would a senior corporate officer attestation likely result in more careful attention to the completeness and accuracy of the disclosure, but also it would cause more careful consideration of the tax shelter transaction prior to the time the corporation engages in the activity. Presumably, that is one of the reasons that the chief financial officer must sign financial statements of reporting corporations. The same approach is appropriate here.

103 1 Joint Committee Tax Shelter Study, note 7, at 242-43; Finance Committee 2000 Draft, note 96 (proposed § 6662A).
104 Treasury Tax Shelter Study, note 44, at 85-86 (“corporate officer who has, or should have, knowledge of the actual underpinnings of the transaction . . . .”)
Notwithstanding its apparent demise, it is useful to explore the potential impact of agent accountability on corporate compliance with an enhanced disclosure requirement. Certain nontax literature suggests that in some instances penalties imposed on an individual agent of the corporation may have a greater deterrence effect than a penalty imposed on the corporation itself.\textsuperscript{106} In addition to an individual’s concern about the financial impact of a monetary penalty or the possibility of incarceration, individuals may be particularly concerned about their reputations.\textsuperscript{107}

The tax law incorporates agent accountability in the § 6065 tax return verification requirement. There is no case law, however, regarding the applicability of the § 6065 verification requirement in the case of an incomplete corporate income tax return, such as one that contains an incomplete Schedule M-1, or in the case of an incomplete or inaccurate mandated attachment such as a tax shelter disclosure statement.

Historic lack of prosecution under § 7206(1) in the case of incomplete returns may further encourage corporate officers to sign corporate tax returns that do not include tax shelter disclosures if they desire to avoid detection of the tax shelter transactions. As a result, it is difficult to predict how a meaningful risk of personal liability may impact corporate compliance with a mandated disclosure requirement. Therefore, if personal accountability is considered to be an appropriate compliance incentive, it is likely that specific legislation requiring officer attestation of the disclosure document itself, as distinguished from the current § 6065 requirement, will have to be enacted.

Legislative imposition of personal liability would have to include safeguards against disclosure errors that are not the fault of the attesting individual. A reasonable cause exception that would enable the individual to avoid any penalty when she is able to establish diligence in attempting to meet the disclosure requirements should adequately serve that purpose. It also would be important to assure as reasonably as possible that the proposed imposition of an individual civil or criminal penalty for failure to comply with a mandated disclosure requirement is not used by a revenue agent as a weapon against the corporate taxpayer in seeking its agreement to an entity-level penalty or the disposition of the underlying substantive issue in a manner favorable to the government. Although it would be impossible to provide absolute


assurance that enforcement efforts against a corporate officer and the corporation will not become intertwined, certain administrative actions could be implanted to substantially reduce the risk. For example, different offices and individuals within the Service might handle the individual and corporate enforcement actions, communications between Service employees responsible for the two actions could be prohibited, senior management could be required to review any individual enforcement action, and Treasury's Inspector General for Tax Administration and the Joint Committee on Taxation staff could use their oversight authority to determine how the Service was administering individual enforcement authority.

F. IRS Audit Activity

A perfectly-designed mandated disclosure requirement and an ideal set of penalties and other incentives will not cause taxpayers to take the disclosure requirement seriously unless the Service undertakes a vigorous audit program of which taxpayers, large and small, incorporated and unincorporated, are aware. Taxpayers and their representatives will quickly determine if an enhanced disclosure document constitutes an unused piece of paper. If so, efforts expended to develop a meaningful disclosure regime will be wasted.

G. The Need for Implementing Regulations and Legislation

Weisbach asserts that congressional action or even lengthy regulations are not necessary to give better documents to auditors. He thinks that changes to the forms and existing recordkeeping requirements would suffice. I agree with his observation regarding congressional action relating to the design of an enhanced disclosure regime. Treasury possesses clear statutory authority under § 6011 to require taxpayers to provide information deemed necessary to determine tax liability. Indeed, I would go further than Weisbach by opposing legislation that imposes a specific disclosure regime. Intrusion by Congress in tax administration by insisting on a modification to a tax return or requiring the submission of additional return information puts in question Treasury's authority under § 6011 and represents undesirable micromanagement. To its credit, Treasury did not wait for Congress in developing and implementing enhanced tax shelter disclosure under its general regulatory authority. I would prefer to see Congress exercise an oversight role. Therefore, unless the temporary regulations are watered down to the point that they will be ineffective,

108 Weisbach, Ten Truths, note 1, at 227.
Congress should let the Service and Treasury exercise their responsibilities.

I do not agree with Weisbach that legislation relating to disclosure is unnecessary. At a minimum, legislation must be enacted to authorize the imposition of a penalty for failure to comply with a mandated disclosure. Indeed, I suggest that the legislation should be broadened to authorize the imposition of a penalty whenever a taxpayer fails to provide mandated return information whether related to tax shelters or otherwise. I also am less comfortable with Weisbach's statement regarding the sufficiency of changes in tax forms or existing recordkeeping requirements without a foundation in the regulations.109 There is precedent for using regulations to impose recordkeeping and reporting requirements even when the Code does not mandate promulgation of regulations.110 Regulations put the full force and effect of the Secretary's authority under § 6011 behind the disclosure regime and are likely to receive greater deference from the courts. In addition, the regulations process assures receipt and consideration of private sector comment.

IV. Conclusion

As the reader has undoubtedly noted, this is an advocacy piece. I argue that a properly designed tax shelter disclosure regime would constitute a powerful tax enforcement tool and would result in enhanced compliance and deterrence. Indeed, I suspect that the temporary regulations already have affected compliance. In advocating this view, I also acknowledge the absence of relevant empirical analysis establishing the efficacy of mandated return disclosure by business enterprises, and, thus, the possibility that my assertions are incorrect.

Implementing enhanced disclosure entails some risk. There is a risk that disclosure will be unproductive. There is a risk that disclosure will be counterproductive if, for example, the Service is swamped in paper. There is a risk of an added compliance burden on taxpayers. There also are positive tradeoffs. Enhanced disclosure may substantially improve the quality of the audit process by better informing revenue agents. Further, it may cause taxpayers to exercise greater care in deciding whether to engage in a particular tax shelter transaction in the first place and in designing and documenting transactions that they do undertake. I believe that the risks of overstating disclosure's potential are outweighed by the possibility of significant gains.

109 Id.
110 See, e.g., Reg. § 1.274-5 (travel and entertainment expenses), § 1.6038-2 (certain affiliated foreign corporations).
Weisbach's plea for substantive law change is not incompatible with this view. There need be no single answer to the tax shelter problem; indeed, I think there is none. Rather, the tax shelter problem demands a multifaceted response, and more effective enforcement is a vitally important part of the response. Research regarding the effectiveness of disclosure in the case of business taxpayers essentially is nonexistent. The current tax shelter environment provides a laboratory in which to evaluate the effectiveness of disclosure, an evaluation that has implications well beyond the subject at hand.