Public Accountants and the Tax Shelter Industry
Statement prepared for the U.S. Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, Hearings on U.S. Tax Shelter Industry
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I have been asked to help the Permanent Subcommittee on Investigations to evaluate the tax shelter industry and to advise the committee on the role of public accountants. I have been asked to look especially at two shelters promoted by KPMG, that is, the BLIP and SC^2 shelters.

My general conclusions are that the tax shelter industry has succeeded in doing real damage to the national tax system. Former IRS Commissioner Charles Rossotti has said that the IRS is losing the war against tax shelters: some 80% of the most sophisticated taxpayers are avoiding their legal share of tax. I think the objective measures support his assessment. Real or effective tax are running at a maximum of 10% from taxpayers the Congress wants and needs to tax at 35%. The tax system is not in healthy shape.

Every day well-trained, well-paid and highly motivated tax professionals have been launching vicious attacks on the tax base and they have had considerable success. KPMG destroyed considerably more tax with its BLIP and SC^2 shelters than the $75 million fees that they took in from selling them. Uncle Sam seems losing the war against tax shelters and tax shelter industry.

I applaud the Congress and the Treasury for adopting retroactive remedies for the BLIPs transaction, and hope they will do it again for other shelters, including the SC^2 shelter. Congress and the IRS should set up an office of "legislative audits" to find shelters and fix them retroactively.

I also applaud proposals to preserve the independence of certified public accountants by prohibiting CPAs from offering tax shelters and other advice to the public companies.

Finally, I also support a dramatic increase in the penalties for promoting shelters, for failing to register shelters and for giving opinions that turn out to be inaccurate.

1. BLIPS and the "Flagrant Disregard"

KPMG should not have sold the "Son of Boss" or "BLIP" shelter or told their customers that the shelter was more likely than not to prevail if challenged. For a goodly fee, KPMG sold its opinion so as to free clients from penalties for taking tax deductions for what KPMG knew to be artificial losses. The tax loss claimed on sale of taxpayer's partnership interest was not an accurate description of the taxpayer's economic position. Since 1960, the Treasury Regulations have provided that "only a bona fide loss is allowed" and that "substance and not form shall govern in determining a deductible loss."[1] The partnership anti-abuse regulations have been out since 1994 and they take away losses on sale of partnership interests that do not reflect the true income of the partner or the intent of the statute.[2] In ACM v. Commissioner, on October 13, 1998, the Court of Appeals denied the deduction of the "artificial" or "phantom" losses from a marketed corporate tax shelter that bears a strong family resemblance to the BLIP.[3] On August 14, 2000, the IRS identified the loss in Son of Boss or BLIP shelter as a "listed transaction," that is, a potentially abusive tax shelter because it entailed "an artificial loss" which does not "correspond to any actual economic loss"[4] KPMG stopped selling the BLIP shelter to new customers in September 2000, but it continued to give its opinion that the phantom loss would be allowed to its existing customers.

KPMG's legal position in BLIPS was rejected by Congress, Treasury and the tax community. The legal position behind BLIPs and Son of Boss is that the tax law is so blind that liabilities that the market understands to reduce value will nonetheless not be recognized by the tax law in calculating true net cost or basis. In BLIPs and related shelters, the taxpayer who buys the shelter contributes cash or other cost to a partnership or corporation. At the same time, the corporation or partnership assumes liabilities of the taxpayer that are not booked by the accountants. Accountants, for example, require that booked liabilities be fixed, they ignore rents and other future costs, and they do not require the costs of satisfying an option be booked until the option is exercised. As a matter of economics the liabilities assumed by the entity reduce the value of the partnership interest or stock. But KPMG's legal position is that those liabilities will be ignored as a matter of law when the partner calculates its net or adjusted cost for the shares or partnership interest. The taxpayer sells the stock or partnership interest and reports an artificial tax loss in the amount by which the assumption reduces the value of the stock or partnership interest in fact. There is no question that GAAP accounting books only certain liabilities, and ignores many other future costs. There is no question that tax often follows the accounting principles, even down the paths of bad economics. Still KPMG's legal position that tax law would endorse the artificial losses by ignoring assumption of economic liabilities seems to have upset the tax world.

In 2000, Congress amended the assumption of liabilities provisions of section 358 retroactively to take away cost basis when the corporation assumed future obligation of a shareholder.[5] The BLIP transaction claimed there was a "hacker's window" or fault in section

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1 Treasury Reg. §1.165-1(b)(1960). Bruce Lemons, James Whitmire, Randy Bickman, *Selling the "Noneconomic Loss Doctrine,"* 96 TAX NOTES 415 (2002) try to argue that the bona fide loss requirement of the regulations refers only to timing of the loss and does not affect artificial losses. They argue, for instance, that section 1014 (step up in basis at death) produces artificial losses. For example if a taxpayer inherits an appreciated building and then sees it burned down, there is no economic loss, but there is a tax loss measured from the section 1014 fair market value basis at death. Section 1014 is premised on the assumption that the taxpayers capital investment is the value of the building. Section 1014 may well be bad tax accounting but there is no question that losing a valuable building is an economic loss, and bears little resemblance to the artificial or phantom losses from packaged tax. In any event, there is no reasonable basis for assuming that Treas. Reg. §1.165-1(b) governs only timing and does not affect losses that artificial in total and forever.

2 Treasury Reg. §1.702-2(a)(3)&(b)(proposed May 17, 1994 and adopted Dec. 29, 1994).

3 ACM v. Commissioner, 157 F3d 231 (3d Cir. 1998)

4 Notice 2000-44, 2000-2 C.B. 255 (Aug. 14, 2000).

5 Community Renewal Tax Relief Act of 2000, §309, enacting IRC §358(h)(December 22, 2000) effective retroactively to Oct. 19, 1999.

358, created by clever mal-interpretation, and it was not part of the beautiful system that Congress intended to write. Section 358, which provides that basis in shares is reduced by liabilities assumed, was crafted by the American Law Institute and then adopted in the Internal Revenue Code of 1954. Section 358 represented the best that Congress could do with the advice of the best tax minds and tax professionals in the country. The section 358 system was not supposed to be so easily destroyed. The amendment to section 358 to fix the BLIPs or Son of BOSS fissure was enacted on December 22, 2000, but it was retroactive by more than a year to transactions that occurred after October 18, 1999. Congress adopts *retroactive* amendments only when in its judgment the misinterpretation is both shocking to ethical norms and substantial in amount and because the misinterpretation is not what the tax law intended to do.

I applaud Congress on making the cure retroactively so as to catch people who had created and exploited the hacker's window. The tax law can not be made so perfect that it can withstand the attacks by Skunk Works operations such as KPMG's, no matter how smart Congressmen are about learning the details of the tax law. Every morning a large, well-paid, well-trained and high-motivated cadre of tax professionals called accountants, lawyers and investment banks wake to spend their day on vicious attacks on the tax system and sometimes for all their pay they succeed. Congress will need to go back and fix the system and repair the rips from such attacks once it sees what damage the attack is doing. Litigation over whether something is an abuse, moreover, is no way to run a tax system and retroactive legislation or regulation amendment avoids litigation. The fix of Son of Boss or Blips should be viewed as a good precedent and Congress should do it more often. Indeed, I would advise that the IRS and Congress should set up a permanent institution of "legislative audits" in which they identify abuses arising from misinterpretation or misapplication of the law in shelters and protect the tax system from attack as soon as possible by retroactive legislation.

On June 23, 2003, the Treasury issued temporary regulations making consistent corrections to the assumed liabilities rules for partnerships, and those amendments took away the loss from the BLIP shelter. With the invitation of Congress, the amended partnership-assumed-liabilities regulations are retroactive by almost four years, also to October 19, 1999.[6] The Treasury amends the law retroactively only when the original position represents a serious misinterpretation of the intent of the law. I applaud the Treasury for making its Regulations retroactive so as forego expensive litigation and to catch the people who had created and exploited the hacker's window. That retroactive legislation represents the Treasury's appropriate response to the call of its duty to defend the American tax base.

B. John Williams, the former chief counsel of the IRS, usually takes the position that IRS should not over-do its enforcement of tax law, and he usually takes the position that the term "abusive tax shelter" is just an emotional reaction.[7] Nonetheless, for BLIPS and Son of BOSS, he got emotional:

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[6] Temp. Treasury Reg. 1.752-6T, T. D. 9062 (June 23, 2003) applicable to transactions after October, 18, 1999.

[7] B. John Williams, Jr., Statement to Senate Finance Committee Hearing on Tax Shelters: Who's Buying, Who's Selling and What's the Government Doing About it? (Oct. 29, 2003), 2003 TAX NOTES TODAY [ELECTRONIC EDITION] 209-33.

> I am very concerned that promoters continued to promote -- and taxpayers continued to participate in -- "son of boss" transactions following issuance of Notice 2000-44, which identified "son of boss" and similar transactions as a listed transaction. I am also more than concerned to hear that even today these transactions or similar transactions may be being promoted. In my view, "son of boss" transactions are almost uniformly clearly abusive and will not withstand scrutiny by any court. In this circumstance, enforcement of the law is clearly necessary; otherwise, such flagrant disregard of the Notice will undermine voluntary compliance and the public's confidence in the IRS. I cannot foreclose the possibility of a public resolution initiative for "son of boss," or any other transaction that has been listed as a reportable tax avoidance transaction.[8]

It may well be that former Chief Counsel Williams overreacted, although indeed the retroactivity of the Congressional and Treasury cure indicates he was not alone. Still, when former Chief Counsel Williams gets upset at such flagrant disrespect, we can be assured that there is something to get upset about. KPMG should not have sold or given its opinions on BLIPs.

2. The Destructive Power of SC^2.

The shelter that KPMG is offering called "SC^2" involves a very serious hole in the tax base. Everyone can have a tax haven in one's own back yard. The gaping hole is serious enough and so inconsistent with the intent of subS that the loophole is going to have to be fixed by both regulations and legislation and it needs to be done fast and retroactively.

The important idea behind SC^2 is that a tax-exempt shareholder is allocated the taxable income and gains of a subS corporation, but the tax-exempt entity never gets to see any of the money from the income or gains. A subS corporation is not generally a taxable entity. It just allocates the tax items calculated at the corporate level to its shareholders in strict proportion to their fractional ownership of stock. Since 1996, tax exempt entities have been allowed to be owners of subS corporations.[9] Thus, for example, if a subS is 90%, or, for that matter, 99.9% owned by a tax exempt shareholder, then 90% to 99.9% of the any capital gain or income the subS corporation reports becomes immune from federal tax. The plan works best if an ESOP is the tax exempt entity owning the shares. In 1997, Congress exempted ESOPs from tax on unrelated taxable income and that means that even any business income can be shielded from all tax.[10]

In SC^2 the tax-exempt shareholder, however, will never see any of the income allocated to it for tax purposes. The real owners who are high-bracket shareholders have an option to buy the tax exempt's shares for a fixed price after some number of years have gone by. Or without modification in the impact, the corporation is given an option to repurchase the shares. During the time that the option is outstanding, there is an agreement that shareholders will receive no dividends. The tax exempt shareholder interest is also not voting so that the tax-exempt can not manage corporate assets nor change the arrangements. The stock can also not be sold. The tax-

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[8] B. John Williams, Jr., Speech to the Chicago Bar Association, Federal Taxation Committee (February 25, 2003), 2003 TAX NOTES TODAY [ELECTRONIC EDITION] 40-20.

[9] IRC § 1361(c)(6), added by section 1316(a)(2) of the Small Business Job Protection Act of 1996.

[10] IRC § 512(e)(3), added by section 1523(a) of the Taxpayer Relief Act of 1997.

exempt shareholder is basically just an accommodation party – one's own pension fund works well for that. It receives the option price and perhaps a side fee, but nothing else. The high bracket shareholders exercise their option and own all or substantially all the shares of the corporation. The interim income or gain that was allocated to the tax exempt shareholder becomes the property of the high bracket shareholder. When that income or gain is distributed to the high bracket shareholder, it is treated as if it were previously taxed amounts and it is first a recovery of the owner's basis and then 15% capital gain.[11]

Section 1361(b)(1)(C) of the Internal Revenue Code attempts to prevent income being taxed to a low or zero tax shareholder while it really received by a higher bracket taxpayer by preventing a corporation eligible for SubS status from having a second class of stock. All income items, of whatever tax character, must be allocated strictly according to what fraction of the common shares any one shareholder has. But for section 1361(b)(1)(C), a high bracket shareholder could put shares into the hands of children or tax exempt nominees, hold an interest that is convertible into shares and by conversion grab all of the income that had been previously allocated to the low tax shareholders. The one-class of stock rule also prohibits the "fruit of the tree" from being taxed to someone who does not own the tree itself. In a subS corporation there can be no slicing of since asset into an income interest and a capital interest. The owner of the capital interest must be taxed on the income interest.

There is, however, a very ill-advised regulation safe harbor that on its face allows avoidance of the second class of stock rule. Treasury Reg. §1.1361(*l*)(4)(*iii)*(C) provides that if an option has an exercise price that is more than 90% of the value of the underlying stock at the time that the option is issued, then the option is not a second class of stock. For the SC^2 stock, that safe harbor is thought to be extraordinarily easy to meet by bootstrapping. The stock held by the tax exempt entity has no value except for the price that the tax exempt shareholder will get when the option is exercised. In the meantime, the stock is non-saleable, nonvoting and gets no dividends. The value of the stock is thus just the option exercise price that the tax-exempt shareholder will receive, discounted by the time value until the option will be exercised and also discounted by the chance that it will not be exercised. Since the discounted exercise price itself fixes the maximum value of the tax-exempt entity's shares, the exercise price has to exceed 100% of the market value of the stock by definition. There can be $10 billion of taxable income or gain put into the S corporation and given haven from tax, but if the tax-exempt shareholder holds the shares subject to an option that it must sell the shares for $2.69, the shares are not worth anything more than the discounted present value of the $2.69. Anything exercise price or value of more than $2.69 is just window dressing to fool the IRS.

The IRS can and should beat the SC^2 retroactively. The one-class-of-stock rule was intended to prevent tax of income to one taxpayer, while another would own the remainder or corpus and the real owners of the corpus are the high bracket shareholders. There is also no way that the tax exempt shareholder is going to be allowed to keep the 90-99% of the assets, notwithstanding that the income from the assets were allocated to the tax-exempt shareholder. When the safe harbor test is understood to be a smart rule adjusting to get the accounting to describe the economics, the option itself can not be allowed to reduce the value of the stock under the safe harbor test. The IRS needs to issue a Notice that retroactive to the first SC^2

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[11] IRC §1368(c)(1)

transaction, the safe harbor of Treasury Reg. §1.1361(*l*)(4)(*iii)*(C) will be amended so that it does not apply unless the option price is also over 90% of the fractional value of subS assets represented by the underlying shares subject to the option, and also over 90% of the value of the optioned shares, ignoring the option itself.

Full litigation should show that as a matter of substance over form, the tax exempt shareholder is not the real owner of the 90-99% or the income allocated to it and is not the economic owner of the shares. But litigation on substance over form is always a long and sloppy thing and the safe harbor of Treasury Reg. §1.1361(*l*)(4)(*iii)*(C) does not help any. A retroactive amendment of that regulation to destroy subS status will forego litigation and reach results consistent with an accurate accounting for the economic situation. The ultimate goal of tax accounting, like all accounting, is to describe the economics with clarity and accuracy.

The inevitable exercise test is too lax to capture many of the schemes like SC^2 set up to allocate the tax items to the tax exempt shareholder while giving the high bracket taxpayer the real beneficial or economic ownership of the income. The law needs to be worried about the cases in which the high bracket shareholder *might* end up as the real owner, because those "*mights*" get turned into "*wills*" in the hands of aggressive planners. The regulations need to be amended such that when the value of the stock exceeds 100% of the option price, the holder of the option will be taxed on the income the undistributed SubS income that the option holder is ultimately going to grab. We can fix uncertainties about whether the option holder will receive the income after the fact by giving the option holder a corrective tax loss if the option lapses. Of course conversely, the owner of the shares subject to the option needs to have income, to match the option holders loss, when against expectations, the option lapses.

An even simpler solution consistent with the simple solution of current law – the outright prohibition of a second class of stock -- would simply prohibit options on subS stock, and that I think is the remedy that that is going to have to be required eventually. The Service really can not tell before hand who will be the true owner of the income with respect to optioned stock and it should not be required to guess. This gaping hole needs to be fixed quickly. As long as tax exempt shareholders are allowed to be owners of subs corporations, any rule allowing options is going to be a serious problem.

It is time also to stop allowing ESOPs to be shareholders of a subS corporation. Subchapter S was written to prevent double taxation of corporate income, not to give a tax haven to business income that has never been taxed. A tax incentive for ESOPs is a terrible idea because it causes employees to under-diversify their investments. Employees via ESOPs invest their life savings in the same company on which their livelihood depends and when that company goes bust both the livelihood and nest egg evaporate. ESOP ownership of subS corporations is just an invitation for tax schemes like SC2, for the awful purpose of risking destruction of employees' livelihood and nest egg all at once.

There may also be an issue of a tax deduction when the tax exempt shareholder becomes an owner. That is just a red hearing, however, especially when the option price is down toward the $2.69 end of the spectrum. The real issue is allocation of income to the tax exempt shareholder, which the tax exempt shareholder never sees.

3. CPAs can not offer tax shelters.

In this post-Enron world, Certified Public Accountants should not be offering sleazy tax shelters or indeed any tax-minimization or client-loyal advice to public companies. The remedy is simple: Firms auditing clients for certification for SEC-required financial statements need to separate their auditing and advising functions into two unrelated companies, by spin-off or by sale.

The Certified Public Accountant is a cop, who needs to be independent, even skeptical and hostile to the firm it is auditing. This practice of CPAs selling sleazy shelters to public firms undercuts auditor independence. It is much like a CPA arriving and announcing

> "I am your auditing Certified Public Accountant this year, and the model of rectitude and independence,… "

and then opening up his trench coat, showing off his wares, and asking,

> "… and would you like to buy some fake Rolexes from me?"

Auditor independence is crucial to our capitalist economy because financial statements so profoundly influence the flow of precious investment. When financial statements mislead investors, capital goes to less meritorious activities. Or capital is utterly wasted, as happened, for instance, in Global Crossing and Enron.

Cheating financial statements, certified by auditors, make it difficult for legitimate, successful enterprises to raise capital by selling stock. When diversified investors do not have reliable information about the firm, they must underbid for stock of the firm to take account of risks that the stock is a "lemon," worth less than the available information suggests. When foreign or diversified investors cannot count on accurate financial reports about stocks, they flee the market.

In every part of the globe, if diversified investors do not have legal protection and accurate information, the market for stock is anemic. Firms must then raise their capital from bank financing. When banks lend, they want to control corporate decisions. Misleading financial reports may provide a short-term advantage to the company that cheats, but the cheating hurts the common good of all companies in the economy by raising the cost of equity capital or making it entirely unavailable.

Cheating financial reports also steal from individual investors who rely in good faith on a company's audited financial statements. Certified Public Accountants do not seem to understand the intensity of the justifiable anger of investors at losses they incurred because auditors taught their audited clients how to mislead the market. Auditors were supposed to have stopped the deception. It is imperative that the SEC's auditor independence rules ensure that audited statements will not betray investors' trust.

The critical even sacred role of the accountant in the proper functioning of the stock markets and capitalist system means that an auditor firm must be zealously loyal in protecting the interests of investors. The auditor must always place investor protection above accommodating management goals. The interest of an auditor that thinks of itself as a friend of management in provision of non-audit services inherently conflicts with the auditor's responsibility to maintain the necessary zeal to audit the company on behalf of investors. The efficient market is the auditor's true client. An auditor owes *no* duty to the audited firm, except insofar as enhancing the reliability of all financial reports makes equity capital cheaper for all.

As Chief Justice Burger, on behalf of a unanimous Supreme Court put it,

> the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. [12]

He said further that "[i]f investors were to view the accountant as an advocate for the corporate client, the value of the audit function itself might well be lost."[13]

There is no reason to define "independence" narrowly. The free competitive market will provide all the business advice that a client is willing to pay for. If CPA firms are prohibited from giving business advice, because they are cops, the competition will adjust quickly and good advice will still be available. There is no harm to the system in prohibiting the CPA from engaging in activities that might in fact be harmless to independence. Broad prophylactic prohibitions are appropriate.

Sale of tax shelters or tax minimizing advice to the audited firms makes it impossible to maintain the necessary degree of skepticism about financial reports. No human being can be zealous in defeating the IRS for the benefit of the client on the one hand and maintain the necessary level of independent skepticism on the other hand.

CPA sales of tax advice, moreover, put the CPA in the position of auditing his own product. For example, if KPMG with its consigliore hat on has sold the audited client a BLIP, then KPMG with its cop hat on can not be expected to say "we sold you bad product and you need to accrue and pay a tax liability." No man is a proper judge of his own sleaze. The principle that a CPA can not judge its own product goes beyond the the product, narrowly defined. There were many products with names like "Son of Boss" or whatever, that relied on the assumption that the tax law would be dumb and blind and would fail to recognize real economic liabilities. KPMG having sold a client on the (mistaken) principle that real economic liabilities will be ignored for tax will not be properly hostile to that principle when it shows up in a tax shelter sold by another promoter.

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[12] United States v. Arthur Young & Co., 465 U.S. 805, 817-818 (1981).

[13] *Id.* at 819-20 n.15.

Auditing committees, formed under Sarbannes-Oxley to supervise the CPAs, are also going to need to take heed of the damage that tax shelters do to auditor independence under current law. An auditing committee that approves a CPA firm that is going to audit its own work or audit tax principles that it has sold to other public companies has breached its duties to the investing public. In my opinion, an investor who loses money in reliance statements that turn out to be incorrect that were audited by a CPA firm that compromised its independence should be able to recover personally from the members of the audit committee who approved the CPA.

4. Remedies under the Bad Man theory.

I suspect that there is no reason for KPMG to regret ever having sold BLIPs and other shelters. KPMG constructed and sold the BLIP and similar shelters and gave its opinion that they would work because it concluded, after careful deliberation, that the legal penalties it would face for wrong doing were less than the profitable fees it would make, when the penalties were discounted by time and by the considerable chance that KPMG would avoid penalties or avoid getting caught. Some observers have concluded that the penalties, e.g., for failing to disclose potentially abusive tax shelters, are trivial.[14] The fact that KPMG sold the BLIP is superb evidence that the penalties were not high enough to prevent the "flagrant disregard" of the anti-BIPS Notice. The Wall St. Journal has reported staff estimates that KPMG made $75 million dollars from sale of BLIPs and SC^2.[15] They clearly made the assessment that the discounted value of the penalties would be under $75 million, and I think they were right.

KPMG is a "bad man" under Oliver Wendell Holmes, Jr.'s meaning of the term. Holmes has told us, famously, that the law must be written under the assumption that it will need to shape bad men:

> A man who cares nothing for an ethical rule which is believed and practiced by his neighbors is likely nonetheless to care a good deal about being made to pay money, and will want to keep out of jail if he can.[16]

We can not presume that the promoters who sell and give opinions on abusive or potentially abusive tax shelters have ethical feelings toward their Uncle Sam, that is, toward the U.S. or us. A system needs to be constructed under which it is in the objective interest of the promoters and opinion writers not to write erroneous opinions and not to sell transactions that fail to comply with the law as ultimately determined, even if they do not want to do that. Accuracy should be understood here as the amount that would have been required had all issues gone to final judgment after full litigation, but without the full litigation. It must be in the self interest of the promoters and opinion writers not to undercut the accurate reporting of tax and to tell their clients that it would be too dangerous to tolerate errors in tax on the down side.

Unfortunately, as a matter of strict economics, the penalties needed to make it in the self interest of the bad man to report tax accurately are rather high. For example, if there is a 10%

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[14] David Shurberg, David Gilberton & Bruce Larson, *Failure to Comply with Tax Shelter Disclosure Regulations: What's at Stake?*, 55 TAX EXEC. 135 (2003).
[15] Cassell Bryan-Low, *KPMG Didn't Register Strategy*, WALL ST. J., Nov. 17, 2003 at C9.
[16] Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1896).

chance of an audit, a 20% chance of the auditor identifying the transaction, a 50% chance of a government lawyer with a good case surviving the hazards of litigation, then the chances of correction of the error are only 10%*20%*50% or 1%. The penalty necessary to make it in the interest of a bad man to report tax accurately with only a 1% chance of correction must be a no-fault penalty of 100 times the deficiency. The penalty of 100 times deficiency is simple math, necessary to offset the 1/100 chance of its getting imposed.[17] Minor adjustments in the accuracy penalty, say from 20% to 30%, are not going to do it. Nobody wants to impose the economically mandated penalty of a 100 times tax due for every error. The bad man is going to win this war.

The alternative is to increase the audit rate, and to increase the education and talent of IRS auditors and lawyers. The IRS' Office of Tax Shelter Analysis, for example, is modestly staffed. It has seven program analysts, one manager and no attorneys.[18] I doubt their total annual budget would cover the annual Holiday Parties for the Skunk Works factories they are competing against. We should be increasing the salaries of IRS officials to match those of the private sector against whom they are competing and we need more IRS officials. Jail time for underreporting tax also reduces the monetary penalty we would need to impose to keep the bad man in rein --professionals tend to be easily deterred. The penalty structure required by the bad man theory and neutral economics is rather higher than anyone wants to adopt, so we are looking for cheap remedies, to reach some better state of compliance.

One remedy that might help some is to give the Federal Government a private right of action to go after promoters and opinion writers for the damage that they do to the tax system when their opinions prove to be in error and their shelters fail. Sometimes the taxpayer is caught and is solvent, so that the federal government is hurt only by the cost of catching the client taxpayer. Still, the government should be able to collect its auditing, litigation and collection costs if the promotion or the opinion caused it that unnecessary expense. A possible remedy, approaching the level required by the bad man or neutral economic theory level, would be to collect the tax lost from the opinion writer and promoter on failed shelters, even when the IRS collects the tax by deficiency against the client. That money would be a proxy for all the case that the IRS did not catch the client but should have. The Federal Government should also be able to turn over the suit for damages to aggressive plaintiffs lawyers for a reasonable fraction of the return. The plaintiffs' lawyers need to go after the promoter's houses and Cayman Island trusts. Sometimes the government is just not creative or aggressive enough in litigation.

Before anyone dismissing the economic or bad-man theory penalties entirely, they also need to be aware of the extraordinary damage to the tax system which these shelters do. As Former IRS Commissioner Charles Rossotti stated at the time of his departure from office, the IRS is losing the war against tax cheats, especially the wealthiest and most sophisticated among

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[17] The seminal work is Michael Allingham and Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 11 J. OF PUB. ECON. 325 (Nov. 1972).

[18] Sheryl Stratton, *Inside OTSA: A Bird's Eye View of Shelter Central at the IRS*, 100 TAX NOTES 1246 (Sept. 3, 2003). There are about 70 IRS attorney's working on tax shelters within the Large and Midsize Business Division of the IRS. *Id.*

them, because the IRS can not keep up with them. The majority of major tax cheats, he said, in some categories 80%, will be allowed to get away without paying their legal share.[19]

I do not see any objective evidence for optimism better than view. KPMG was able to charge $75 million for its abusive BLIP and SC^2 shelters because its customers avoided many times that amount in taxes. On my figures the real or effective tax rate that any corporation faces is not above 10%, as shown by the fact that the market for tax exempt bonds now allows any taxpayer to buy their way out of tax on capital by taking a 10% reduction in interest paid. The market for tax exempt bonds is a thermometer that measures the health of the entire tax system. That thermometer tells us that the tax system is in terrible shape.[20] Congress, by its orderly process of law, has determined that the burdens of war and of government need to be distributed such that taxpayers better able to pay tax should pay tax at 35%. When Congress can in fact collect no more than 2%-10% from its best sources, then worse sources --poor folk and middle class voters--have to make up the difference. Great nations fail because they let their tax system fall apart and this nation's tax system is well on the way.

We have a measure to monitor how the tax shelter wars are going. When the market for long-term tax exempt bonds shows that taxpayers are willing to forego interest on the order of 34-35% of fair market value taxable interest, then we will know that we are doing a pretty good job across the economy. But we are a very long way from that level of compliance.

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[19] David Cay Johnston, *Departing Chief Says the I.R.S. is Losing Its War on Tax Cheats,* N.Y. TIMES NOV. 5, 2002, at A1; *Rossetti gives Oversight Board End-of-Term Report* (Sept. 25, 2002), 2002 TAX NOTES TODAY [ELECTRONIC EDITION] 188-5.

[20] Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax,* 56 SMU L. REV. 13, 23 (2003)(showing that maximum real tax rate has been between 11% and 2% over the last 5 years).