No Deductions for Tax Planning And Controversy Costs

By Calvin H. Johnson

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The law gives a negative tax or subsidy to tax planning and controversy work, because the costs of that work are generally deductible. But the return from the investment, in the form of less tax to be paid, is not taxed. The treatment is self-destructive in that the system gives a subsidy to undercut itself. Even without the negative tax, tax planning and controversy work are too profitable for the common good, because the taxpayer making the decision does not have to consider the harm done to other taxpayers who must make up the tax revenue.

This proposal would disallow the deduction of the costs of tax planning, return preparation, tax audits, litigation, collection, and refunds. Payments to tax experts — including in-house experts — and the costs of tax litigation would be disallowed in full. An intermediate remedy — denying 25 percent of the costs — would apply to investment planning and structuring by professionals who are not tax specialists and when the work is not primarily tax-related but tax issues are present.

The proposal is made as a part of the Shelf Project, a collaboration among tax professionals to develop proposals to raise revenue. The Shelf Project is intended to raise revenue without a VAT or a rate hike in ways that will improve the fairness, efficiency, and rationality of the tax system. Now is the time for congressional staff work to be done to prevent the impending revenue crisis. An overview of the Shelf Project is found in "How to Raise $1 Trillion Without a VAT or a Rate Hike," *Tax Notes*, July 5, 2010, p. 101, *Doc 2010-13081*, or *2010 TNT 129-4*. Congress enacted its first Shelf Project in March 2010. New section 871(1), enacted in the Hiring Incentives to Restore Employment Act, is based on the Shelf Project proposal by Reuven S. Avi-Yonah, "Enforcing Dividend Withholding on Derivatives," *Tax Notes*, Nov. 10, 2008, p. 747, *Doc 2008-22806*, or *2008 TNT 219-34*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

Tax planning and tax litigation are too profitable for the taxpayer. The tax accounting for tax planning and controversy work allows an exemption for the reduction in tax achieved by the costs and also generally allows a deduction for the costs of the work. The mismatch of the exemption of the benefit and deduction of the costs gives a negative tax or subsidy. Costs that would routinely be profitable under neutral tax accounting become extraordinarily profitable given the tax treatment. Litigation and tax-planning costs that would not be undertaken at all under neutral tax accounting become rational solely because of the tax benefits. The incentives to incur costs to reduce or avoid tax are especially intense for high-bracket taxpayers. The tax system is providing a strong incentive to undercut itself.[1]

The victories achieved by tax work, moreover, impose harm on other taxpayers that is more or less equal to the private benefit of the victory. Revenue lost by reason of a tax victory must be made up by other current or future taxpayers, or the defense or domestic benefits of expenditures must be reduced.

[1]Myron Scholes et al., *Tax Business Strategies: A Planning Approach* 6-8 (4th ed. 2010) (arguing that the code makes tax planning more profitable).

The taxpayer undertaking the tax planning or controversy work does not, however, have to take the attendant harm to others into account in making his investment. The private incentives to incur the tax-planning and controversy costs exceed their real economic merit. Between the tax subsidies and the ignoring of harms, we end up with too much tax planning and controversy work.

Seeking a reduction of tax by planning or controversy work is normal and natural economic behavior. Still, in the impending tax revenue crisis, transactions like these — that are better after tax than before tax — are especially worthy sources of revenue. We should use those transactions as a source of revenue before increasing any tax rate on transactions that already bear positive tax.

The proposal would disallow the deduction of all expenses paid to tax professionals and their supporting staff for tax work or advice in connection with tax planning, tax litigation, tax return preparation, tax collection, and tax refunds. Professional fees and salary paid to firms or departments that hold themselves out as tax specialists or spend most of their time on tax issues would be nondeductible in full. All the costs of discussion with an auditing IRS agent or a government tax litigator, including the work product in preparation, would be nondeductible. For internal costs, the tax element would include an overhead burden so that the treatment of internal experts gives no tax advantage over the costs of independent tax experts.

Tax planning costs are also incurred in payments to nontax specialists, mixed with investment advice or in structuring a transaction with heavy nontax elements. The proposal would adopt an intermediate remedy for investment and business structuring advice when tax is a cognizable issue but not the primary issue. The logic of the intermediate remedy is that the allocation of costs to tax should be equal to the tax rate on profit. The proposal would adopt a convention that the tax element of payments to professionals who are not tax specialists and to their support staff is equal to a deemed tax rate, and it sets the deemed tax rate at 25 percent of the costs. The deemed tax rate is a compromise between ordinary and capital gains rates for the highest-bracket taxpayers.

A. Current Law

Section 212(3) provides that an individual may deduct all the ordinary and necessary expenses in connection with the determination, collection, or refund of any tax. The regulations consistently provide that "expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible."[2]

An individual's costs of determination, reporting, and collection of tax are a miscellaneous itemized deduction.[3] That means 2 percent of adjusted gross income is subtracted from the deduction combined with other miscellaneous itemized deductions.[4] The excess over the 2 percent threshold is then an itemized deduction, which benefits the taxpayer only when all itemized deductions exceed the standard deduction, which is now at $11,400 for joint returns.[5] The 2 percent threshold and the standard deduction will take away most ordinary tax-return and determination costs for individuals.[6] Miscellaneous itemized deductions, moreover, are not allowed as deductions in computing alternative minimum tax, and the AMT can be as high as 28 percent.[7] A great deal of tax planning falls under the category of investment advisory fees, but those fees are similarly miscellaneous itemized deductions subject to the 2 percent threshold, standard deduction, and AMT limitations.[8]

However, much tax planning occurs under the category of ordinary and necessary business expenses.[9] Tax reduction is not itself considered sufficient to mean the expense is for business profit —

[2]Reg. section 1.212-1(l).

[3]Section 67(a) (because the costs of tax planning and controversy are not listed in section 67(b)); section 63(d) (defining itemized deductions as those not including deductions allowed to compute adjusted gross income, listed in section 62). *See* Malcolm Morris, "Determining Deductions Deserves Deductibility," 21 *Fla. St. U. L. Rev.* 75 (1993) (describing the history that led to current law).

[4]Section 67(a). Miscellaneous itemized deductions that must collectively meet the 2 percent of AGI threshold include individual costs of investment and employee expenses not reimbursed by the employer.

[5]Rev. Proc. 2009-50, 2009-2 C.B. 617, section 3.11, *Doc 2009-22746*, *2009 TNT 198-8* (reporting standard deduction for 2010 for joint returns).

[6]Almost two-thirds of all individual tax returns take the standard deduction, even assuming their miscellaneous itemized deductions exceed the 2 percent threshold. IRS, Statistics of Income, Individual Tax Stats, Table 1, col. 153, *available at* http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133414,00.html (91 million of 143 million returns (64 percent) took standard deductions in 2007).

[7]Section 56(b)(1)(A)(i). For computation of AMT, see, *e.g.*, Boris Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts* para. 111.4.5 (3d ed. on line accessed Aug. 18, 2010).

[8]*Knight v. Commissioner*, 552 U.S. 181, 184-185 (2008), *Doc 2008-948*, *2008 TNT 12-6* (investment advisory fees were miscellaneous itemized deductions).

[9]*See, e.g.*, *Forgeus v. Commissioner*, 6 B.T.A. 291 (1927) (cost of attorney's preparing income tax return deductible as ordinary and necessary expenses of taxpayer's trade or business). *Cf. Trust of Bingham v. Commissioner*, 325 U.S. 365 (1945) (attorney fees incurred by a trust in contesting income tax deficiency were deductible costs for the production of income).

the goal must be for pretax business profit.[10] But there is no special disallowance for planning once the transaction has a sufficient nexus to business to qualify under the tolerant ''ordinary and necessary'' requirement. Ordinary and necessary business expenses — including tax-planning, return-preparation, and controversy costs — are above-the-line deductions in the computation of AGI,[11] so they are not affected by the 2 percent floor, the standard deduction, or the AMT.

Tax planning expenses are also subject to capitalization rules that treat costs as creating basis rather than immediate deductions.[12] Tax planning and controversy will not create a separate and distinct asset for the taxpayer,[13] but tax-planning costs will be capitalized if they facilitate the acquisition of a capital asset, including a trade or business, a loan, or a change in capital structure.[14] Capitalized costs include costs of many transactions with an important tax component, including section 355 distributions,[15] section 368 reorganizations,[16] formation of a tax disregarded entity,[17] and a nonrecognition transfer to a corporation or partnership under section 351 or 721.[18] The intangibles regulations on capitalization, however, severely limit capitalization so that, for example, compensation paid to employees is never capitalized even when it is part of the acquisition of a capital asset.[19] The costs of acquiring stock or all the assets of a target corporation are not capitalized until after the parties sign a letter of intent or pass a board of directors resolution, by which time substantially all the costs of planning have already been incurred.[20]

Section 275 provides that no deduction shall be allowed for federal income tax. The disallowance is fundamental, because tax rates are set to be imposed on an amount that includes the tax itself. An alternative tax system with the same economic impact could be constructed in which the tax itself could be deducted, but the stated tax rates would have to be much higher. The current 35 percent maximum tax rate, for instance, would become a 54 percent tax rate if the tax itself were deducted or excluded from the tax base.[21] Under the current system, neither an increase nor a decrease in federal tax will have any effect on the tax base itself. If a taxpayer can reduce tax paid by tax planning or litigation, the economic benefit he achieves will not increase his tax.

Section 265(a)(1) provides that expenses allocable to income wholly exempt from federal income tax shall not be deductible. Reduction of nondeductible taxes, however, has never been interpreted as a tax-exempt income that would trigger the disallowance of section 265.

Investment in tax planning and controversy work is apparently very profitable. According to the annual report of the Tax Court, taxpayers win 85 cents of every dollar of deficiency they present to the Tax Court, and some years they have won 94 cents of every dollar of deficiency.[22] At least by

[10]*See, e.g.*, *Rice's Toyota World Inc. v. Commissioner*, 752 F.2d 89, 94 (4th Cir. 1985) (saying that economic substance test ''requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits''); *ACM Partnership v. Commissioner*, 157 F.3d 231, 253 (3d Cir. 1998), *Doc 98-31128, 98 TNT 202-7* (saying losses are not deductible if they arose from a transaction ''entered into without expectation of economic profit and [with] no purpose beyond creating tax deductions.'').

[11]Section 62(a)(1); *Standing v. Commissioner*, 28 T.C. 789 (1957), *aff'd*, 259 F.2d 450 (4th Cir. 1958), *acq.*, 1992-1 C.B. 22; *Wood v. Commissioner*, 37 T.C. 70 (1961), *acq.*, 1969-2 C.B. xxv (tax litigation costs related to trade or business were above-the-line deductions not subject to itemization and miscellaneous itemized deduction limitations).

[12]Section 211 makes expenses allowed by section 212 subordinate to capital expenditure treatment under section 263. *See, e.g.*, *Suter v. United States*, 316 F. Supp. 834 (1970) (tax costs may be capitalized); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 17 (1974) (interpreting section 161 as subordinating the allowance of depreciation deductions under section 167 to section 263 capital expenditure treatment, just as section 211 subordinates section 212 deductions to section 263).

[13]Reg. section 1.263(a)-4(b)(3)(i) requiring capitalization in general only if a cost creates an asset separate and distinct from the underlying business, protected by property rights that are capable in principle of sale.

[14]Reg. section 1.263(a)-5(a), which overrides the separate and distinct asset test. Reg. section 1.263(a)-5(b)(2).

[15]Reg. section 1.263(a)-5(b)(4).

[16]*Id.*

[17]Reg. section 1.263(a)-5(b)(6).

[18]Reg. section 1.263(a)-5(b)(5).

[19]Reg. section 1.263(a)-5(d)(2).

[20]Reg. section 1.263(a)-5(e).

[21]In our system in which tax included is included in the tax base, the tax inclusive rate (T_{inc}) fits within the following calculation:

$$(1)\ TY - T_{inc} * TY = PTY:$$

where TY is taxable income and PTY is posttax income. From equation (1), it follows by algebra that $PTY/TY = 1\text{-}T_{inc}$. Thus a 35 percent tax rate reduces income from \$100 pretax by 35 percent * \$100 to \$65 posttax. But when the tax itself is not included in the tax base, the \$35 must be collected from \$65 tax base, which requires a tax rate of 54 percent or 35/65 * 65 to reach the \$35 tax. The logic of a tax-exclusive tax base is that:

$$(2)\ TY - T_x * (PTY) = PTY:$$

where T_x is the tax exclusive rate. From equation (2), it follows that $1 + T_x = TY/(PTY)$ and that $PTY/TY = 1/(1+T_x)$. From equations (1) and (2) combined, it follows that $1 - T_{inc} = 1/(1+T_x)$ [with PTY/TY dropping out of both equations] and that $T_x = 1/(1\text{-}T_{inc}) - 1$. With T_{inc} of 35 percent, T_x becomes 54 percent.

Tax rates under a tax-exclusive system will exceed 100 percent whenever tax rates under a tax-inclusive system exceed 50 percent.

[22]''U.S. Tax Court Fiscal Years 1996-2006 Annual Report,'' Table 4 (reporting government was awarded 14.7 percent of

(Footnote continued on next page.)

reputation, the Tax Court is not an especially taxpayer-friendly court, so tax controversy costs are probably even more profitable in other courts. Lillian Mills, Merle Erickson, and Edward Maydew estimate that the return on tax-planning investments is four times the cost.[23]

The recent Volcker commission report on tax reform options estimated that individuals, small businesses, and large corporations spend $192 billion a year on tax planning, compliance, and controversy.[24] At assumed average tax rates of between 20 and 25 percent, that would imply revenue of $38 billion to $48 billion that is at stake by reason of the deduction. These estimates are considerably higher than previous estimates. The Volcker commission, for example, estimated that large businesses spent 12 percent of revenues on tax-related work, and previous estimates were that large businesses spend 0.05 percent of revenue on tax-related work.[25] The IRS's Statistics of Income report $6.4 billion in tax return preparation fees,[26] but fees below the thresholds of the standard deduction and 2 percent of AGI would not be reported. Also, business-related tax planning and controversy expenses do not need to be separately identified on any return.

B. Reasons for Change

Investments in tax planning and tax controversy have a payoff that is higher to the taxpayer than is justified by their economic value to society as a whole. The excess return is caused in part by the tax accounting for the costs. The system undermines itself with a negative tax subsidy on avoiding tax. Tax savings achieved by the taxpayer, moreover, mean that some other taxpayer now or in the future must make up the cost or lose a federal benefit, but the taxpayer undertaking the tax planning and controversy costs does not need to take account of the harm his own tax reduction imposes.

1. Mismatch of deduction and exemption. The tax system provides a negative tax or subsidy to tax planning and tax controversy work. The investment in tax planning and controversy work has a higher value after tax than before tax. The increase arises from a mismatch in which the revenue from the investments is exempt from tax but the costs are generally deductible.

The mismatch between tax-exempt revenue and deductible costs turns investments with modest pretax returns into investments with extraordinary after-tax return rates. Assume, for instance, that a taxpayer could achieve a net present value of $105 less tax by adopting last-in, first-out accounting. LIFO requires conformity, under which the taxpayer must adopt LIFO on nontax books reporting to shareholders and creditors, which would lower reported earnings.[27] The taxpayer needs to investigate whether he can manage the lower reported earnings mandated by conformity. Assume that the cost of this and other work in connection with the LIFO election is $100. Assume there is a one-year lag between the $100 cost of making the decision and the $105 tax savings to be achieved. That means there is a 5 percent pretax return to the costs. Risk-free, short-term federal rates are now at 0.5 percent,[28] so the 5 percent return is a rate that allows some risk, but not much.[29] Assume the $100 cost can be deducted this year either as a business expense or above the 2 percent threshold for miscellaneous itemized deductions, and that it will save tax of 35 percent of the cost.

The $105 tax saved by the tax planning is a tax-exempt benefit. This is a necessary result of the nondeductibility of tax payments. A lowering of the nondeductible payment is an economic benefit, but the benefit of lower tax is not itself taxed.

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deficiencies subject to Tax Court petitions for 1996-2006. In 2004 the government recovered 5.6 percent of deficiencies).

[23]Lillian Mills, Merle M. Erickson, and Edward L. Maydew, "Investment in Tax Planning," 20 *J. Am. Tax'n Assoc*. 1 (1998).

[24]The President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," 42, 46, 65 (Aug. 27, 2010), *available at* http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report_for_final_vote.pdf.

The report said individual tax-related costs were $92 billion, of which 30 percent were for returns and 70 percent were for record-keeping and tax planning. Small businesses spent $16 billion for professionals and $45 billion (at $25 an hour) internally on records and tax-related work. Large corporations spent $40 billion.

[25]Arthur Hall (Tax Foundation), "The High Cost of Tax Compliance for U.S. Business," *Tax Notes*, May 16, 1994, p. 887, *94 TNT 97-47* (reviewing the literature and reporting compliance costs of between $4,808 and $6,080 per business; also reporting costs of 0.5 percent of sales for small business dropping to 0.05 percent for big business).

[26]IRS, SOI, Individual Tax Stats, Table 3, col. 54, *available at* http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133414,00.html (2007 tax year).

[27]Section 472(c). There have been responsible calls for repeal of LIFO accounting (see Edward D. Kleinbard, George A. Plesko, and Corey M. Goodman, "Is It Time to Liquidate LIFO?" *Tax Notes*, Oct. 16, 2006, p. 237, *Doc 2006-20617*, or *2006 TNT 200-29*), but LIFO is certainly legal under current law if the conformity requirement is met.

[28]Rev. Rul. 2010-20, 2010-36 IRB 312, *Doc 2010-18363*, *2010 TNT 160-4*, Table 1 (AFR of 0.46 percent for Sept. 2010).

[29]Assume there is a 1-in-20 risk of failure, for instance, because the taxpayer reveals books to creditors and shareholders that breach section 472(c) conformity, or the taxpayer abandons the conversion by deciding the earnings hit required by conformity is too draconian. The 1-in-20 risk of failure would more than wipe out the 5 percent expected gain, because the expected value is 1/20 * 0 + 19/20 * 105, which is 99.75 or an expected return less than cost.

Under the assumptions, the 5 percent pretax return generates a 62 percent annual return after tax. In a 35 percent tax bracket, the deduction reduces the cost of the tax planning from $100 to $65 ($100 - (35 percent * $100)). The $105 tax benefit is not reduced by the tax itself. A net investment of $65 to make $105 in a year is like a 62 percent annual interest rate.[30] With short-term federal rates at 0.5 percent, a 62 percent return is very attractive. Returns like that will attract many dollars into tax planning and tax controversy.

The mismatch in the tax accounting will also induce tax planning and tax controversy costs that would not be undertaken in absence of tax and should not be undertaken. Assume, for instance, that in a transfer pricing dispute, the taxpayer could spend another $1 million on experts and legal expenses to back up the taxpayer's position that the profits of the group were properly attributed to an offshore tax haven. With the extra expertise on its side, the taxpayer expects the court to allow it a better decision by $700,000.

Investing $1 million in experts to reduce taxes by $700,000 is economic waste — the experts and lawyers are not expected to earn their fee in real economics. Still, given the mismatch, the economic waste is privately profitable to the taxpayer. When deducted, the $1 million cost is reduced by 35 percent to $650,000, and the $700,000 expected benefit is not reduced by tax. An investment of the $650,000 to make $700,000 gives a sufficient return at 7.7 percent to justify the expense, even though the transaction is a social waste.

The structure of the subsidy means there is more subsidy inherent in the tax accounting in the higher tax brackets than in middle or lower tax brackets. Moreover, the 2 percent of AGI threshold for miscellaneous itemized deductions and the standard deduction will also strip out the value of the deduction for smaller costs for individuals. Thus, the incentive can be expected to undercut the progressive nature of the income tax by reducing tax collected in higher tax brackets.

2. Benefits at others' expense. Tax-planning and controversy costs are an especially unworthy set of costs to subsidize by any method, because the private benefit of tax-planning and controversy costs exceeds the public economic benefit. Taxes saved by planning or controversy costs disappear for the taxpayer, but they do not disappear for the community at large. Even after a taxpayer victory by planning or litigation, the need for the revenue survives. Taxes are the apportionment of the burdens of government among the citizens. A reduction of tax for an individual that does not reduce the overall programs will just mean that the overall burden will have to be apportioned to someone else. Taxes are a zero-sum game: When someone wins a tax case, someone else must necessarily lose to make up the difference. Generally speaking, the losers in the game may be an unidentified mass of lower-tax-bracket wage earnings subject to Form W-2. The losers may be the next generation, which will have to make good on deficit borrowing. The losers may be beneficiaries of government security and domestic spending that become impossible because defense and security needs cannot be financed.

Making up the revenue by taxing other taxpayers or future taxpayers instead of the taxpayer who avoided the tax will frequently increase the damage that tax does to the economy as a whole. The structure of the tax subsidy means there is more tax-planning and controversy subsidy in high tax brackets than in low brackets, so the subsidy undermines progressivity. Progressive taxes, for instance, do less damage to the whole economy because they collect more revenue from those best able to pay, and they collect less tax from those who would be most hurt by the loss of a dollar.

Tax-planning and tax-controversy costs are a natural economic cost. Of course, to quote Judge Learned Hand's famous aphorism, "there is not even a patriotic duty to increase one's taxes."[31] As he also said, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury."[32] Still, tax planning and tax controversy work is more profitable to the private actor making the choice of what to invest than it is to the overall good of the country. The subsidy inherent in the tax accounting for tax planning and controversy should be repealed for the overall good of our country.

C. Explanation of the Proposal

The proposal would provide that the costs of tax planning, determination of tax, preparation of tax returns, tax audits, tax litigation, tax collection, and tax refunds are not deductible. The proposal would repeal section 212(3), which allows the deduction of expenses in connection with the determination, collection, or refund of any tax, and it would also reverse the outcome of cases that allow the deduction of tax-related costs that arise in a trade or

[30]$65 * (1+i) = $105, where i is interest. So i = $105/65 - 1 or 67.15 percent.

[31]*Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[32]*Id.*

business. Many tax-planning costs are capitalized as a part of the acquisition of a capital asset under current law, but the proposal would not give the taxpayer basis, so the disallowance would be permanent.

1. Consistent with tax principle. Although the proposal would reverse current law, the disallowance is consistent with sound principles recognized by current law. Section 265(a)(1) now disallows deductions of expenses allocable to tax-exempt income other than interest, and section 265(a)(2) disallows deductions of interest allocated to tax-exempt municipal bond interest. While reducing federal income tax by planning or controversy work has never been interpreted as tax-exempt income, the reduction has an economic effect identical to a receipt of tax-exempt income. The proposed disallowance of tax planning and controversy costs would be drafted as a new subsection of 265 to display the proposal's continuity with the current disallowance of costs of tax-exempt income.

Expenses draw their character from what they were undertaken to achieve. On its own, an expense is a cipher or sponge that acquires its tax character from the character of the income to which the expense is allocated. Thus, the costs of achieving capital gain are offset against capital gain, and the costs of tax-exempt income are invisible to tax because they merely offset tax-exempt benefits. Under current tax, moreover, the character of a payment depends on what the payment is in lieu of, and costs that reduce federal tax are comfortably categorized as in lieu of the taxes.[33]

Consistent with the proposal, current law also disallows the deduction of the out-of-pocket costs incurred in a transaction that does not have a business purpose or the purpose of making a pretax profit. If a shelter transaction is found to be a sham without a sufficient pretax meaning to be recognized, not only are the artificial losses disallowed, but also the real out-of-pocket costs lost in acquiring the shelter.[34] The proposal goes beyond current law, however, in disallowing tax-planning and controversy costs that are incurred in a normal business or profit-motivated transaction, whereas current law will allow the tax-planning costs once the transaction as a whole is justified by business or profit motives.

Tax planning, tax return preparation, and tax controversy costs would be nondeductible without regard to whether the results achieved are correct results under some yardstick. It may well be that the tax costs of compliance are too high because our tax system is too complicated and should be simplified, or that taxes in general are too high because government is too big. It is possible to look at the costs of compliance and controversy as just another cost of government, a supplement to stated tax. However, the economic concern with the subsidy to the costs of planning, compliance, and controversy does not require an inquiry as to whether the tax asserted is too high. The subsidy for planning and controversy is too high. The proper base line of tax due is the tax determined with unsubsidized nondeductible cost of planning and litigation.

2. Administrative sub-rules. The proposal recommends several sub-rules intended to make uniform and comprehensive enforcement of the disallowance more administrable. The subsidy does enough harm that some over-inclusiveness in the remedy would be justified, but a sub-rule or convention must be as accurate as administrability allows.

The proposal would disallow the deduction of all expenses paid to outside tax professionals for tax work or advice in connection with tax planning, tax litigation, or tax return preparation. If the professional holds himself out as an expert or a specialist in taxation, the entire fee paid to him would be disallowed. The disallowed costs would include the overhead costs the professional incurs to pay support staff, rent, and computer technology. The tax professional, of course, would be entitled to deduct the costs of staff wages, rent, and computer technology, but the taxpayer would not be entitled to deduct the supporting costs, whether aggregated within the overall bill or stated separately.

Tax controversy work would be disallowed in full. If there is a government agent on the other side, all the costs of preparing and presenting the taxpayer's position would be nondeductible. Costs of applying for a ruling or transfer pricing agreement would be nondeductible. All the costs of a discussion with an auditing IRS agent, Appeals officer, or Justice Department or IRS tax litigator — including the work product in preparation — would be nondeductible. All the costs of litigation and of a tax controversy and costs of collection would be nondeductible. All expert fees for litigation would be disallowed.

All the costs of contacting the administration or Congress to clarify or reduce taxes would similarly be treated as nondeductible costs.

[33]*Indeck Energy Serv., Inc. v. Commissioner*, 85 TCM 1128, 1136 (2003), *Doc 2003-9424, 2003 TNT 71-56* (settlement was in lieu of stock sale price in full).

[34]*Farmer v. Commissioner*, T.C. Memo. 1994-342. A taxpayer may not deduct out-of-pocket cash losses from a tax shelter that lacks economic substance, even if the taxpayer intended to make a profit. *Illes v. Commissioner*, 982 F.2d 163, 165 (6th Cir. 1992); *Marinovich v. Commissioner*, T.C. Memo. 1999-179, *Doc 1999-19167*, *1999 TNT 104-5*; *Hoffpauir v. Commissioner*, T.C. Memo. 1996-41, *Doc 96-3741*, *96 TNT 26-10*.

If an outside professional does not primarily do tax work or hold himself out as an expert or specialist in tax, the fee will still be disallowed if the work is for tax planning or controversy. All the work in the settlement, litigation, or appeal of a tax case would be nondeductible, even if the work is done by litigation specialists. A transaction undertaken primarily to reduce tax will be treated as generating disallowed costs in full.

A like-kind exchange and a tax-free reorganization are tax-driven transactions, although the tax issues are usually not controversial. All the costs of effecting a like-kind exchange or tax-free reorganization will be treated as tax-related costs.

The proposal would also disallow in full the costs of an internal tax department or staff. The disallowed costs would include an overhead burden of the costs of the firm as a whole at a rate appropriate to professional staff. Under current law, compensation paid to employees is not treated as facilitating the acquisition of a capital, even if the employees' work is a cost of the acquisition.[35] The rule gives an incentive, for instance, to bring legal work in house, forgoing the advantage of expertise that outside specialists acquire. The proposal would avoid giving a tax advantage for in-house tax counsel or accountants. In determining the overhead burden, the standard to meet is that the costs of in-house professionals should be the same as what the company would have paid if the same professionals receiving the same compensation had instead worked for the outside counsel or accountant.

Tax work is also often mixed with transactions with a heavy nontax element. Thus the costs of investment advice, retirement planning, or college financing will generally have some tax element, but also a heavy nontax element. The formation of offshore subsidiaries is similarly tax-rich in the decisions, but it also has nontax elements. The advantages of tax specialization are such that the frictions can be expected to prevent a significant shift from professionals holding themselves out to be tax specialists to professionals who hold themselves out as generalists. Thus, enforcement against nontax specialists need not be 100 percent to be constructive. Still, if the outside professional works a tax issue or a primarily tax transaction, he should be presumed to be a tax specialist in full.

The proposal recommends an intermediate rule when there is some tax element, but the work is done by nontax specialists: Twenty-five percent of the costs of the investment planning would be allocated to tax. The rationale for the rule is that ordinary income tax is now as much as 35 percent of the future cash flows, and capital gain is as much as 15 percent of future cash flows. The 25 percent rule is halfway between current ordinary and current capital gains rates. The 25 percent disallowance rule would not override the basic rule that the costs of all tax specialists' work and tax-motivated transactions are disallowed, and that the costs of a transaction that is primarily tax would be disallowed, but it would avoid the allocation of costs between tax and nontax in cases that would be difficult to unmix. The 25 percent disallowance rule would apply only if there is some nontrivial tax issue at stake in the planning.

A cost does not cease to be a tax-planning cost even though the plan chosen requires more tax. In the face of predictions of higher tax rates in future years, it is common for a taxpayer to try to move taxable income into the current year. It is also common that the counterparty to a transaction can pay less tax if the taxpayer pays more, and can share the benefits with the taxpayer. For example, in a divorce negotiation, one former spouse will commonly agree to take payments from the other in the form of taxable alimony payments rather than tax-exempt child support or property settlements.[36] If one former spouse who pays alimony is in a higher tax bracket than the former spouse receiving alimony, the ex-spouse in the higher bracket will get enough added value from the alimony deductions to pay the other ex-spouse more than enough to make up for giving up the exemption for child support or property settlement in the lower bracket. Tax planning might similarly increase the taxable income and tax for an affiliate within a corporate group that is in a low-tax jurisdiction, so as to reduce taxable income in a high-tax jurisdiction. Thus, tax planning by tax specialists remains nondeductible even if the taxpayer pays more tax.

It was considered that a small amount should be allowed for the costs of the mere ministerial activity of filling out a tax return that has no discretionary or tax-reduction component, but that alternative was rejected. For individual costs, the small costs are already absorbed by the standard deduction and the disallowance of 2 percent of AGI for miscellaneous itemized deductions. It is difficult to determine the typical return preparation expense for any category of taxpayer. Planning and tax minimization takes place even within return preparation narrowly defined. In the end, it was concluded that return preparation is a tax, much like

[35] Reg. section 1.263(a)-5(d)(2).

[36] Section 71 taxes an ex-spouse on alimony, but not child support or property settlement payments.

jury duty and obeying traffic rules, which may be a burden on the taxpayer but still should not be deducted.

Tax planning around the proposed tax-planning disallowance can be expected. Professional work now conducted by tax specialists will undoubtedly be broken down to leave a small portion of work when the tax expertise is called for, and a much larger portion to be done by nonspecialists. Some planning is fine: All that is called for is an administrable disallowance of tax planning, and if the parties carve out nontax professional work by real measures, the carveouts should be used in the disallowance. In other cases, the support work for tax planning is still all tax planning, and the separate statements will have to be ignored. Some of the carveouts will be aggressive planning, or even fraud camouflaging the nature of the work. As time goes on, there may need to be more sub-rules proposed to handle identifiable abuses. Even if the disallowance is not enforced 100 percent, the tax-planning costs that the disallowance does manage to reach will improve the economic efficiency of the tax law by reducing the tax subsidy, even if some subsidy remains.