Third Party Opinions as a Tool for Enforcing Tax Law

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1. Introduction

This essay examines several issues bearing on the general question whether lawyers, appraisers, and other suppliers of opinions to taxpayers should be used to police tax reporting on matters of legal or factual uncertainty. Recent experience suggests third parties cannot be relied upon to police reporting. In the most recent run of tax shelters many an abusive transaction was undertaken with a "more likely than not" opinion in hand from a once well-regarded accounting or law firm. But this experience may not be indicative. At the time the rewards to a lawyer from rendering an aggressive opinion were great and the perceived risks small. Few could have anticipated the criminal prosecutions and civil lawsuits by investors that destroyed at least one law firm and may destroy some people's careers. And statutory penalties were enhanced in 2004. Perhaps we have stumbled into a state of affairs where tax professionals and appraisers can be depended upon to opine fairly. And, if we are not there yet, perhaps opinions can be made credible with some feasible reforms.

While we are not there yet, this essay argues that there are compelling reasons to create incentives so that opinion suppliers will police reporting on matters of factual and legal uncertainty in limited situations. These reasons ground on what I believe is a heretofore unnoted effect of making the penalty rate for an under-payment the inverse of the audit rate, which is the generally accepted solution for encouraging compliance.[1]

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[1] The point that a penalty should be scaled by the inverse of the probability of detecting conduct that one wants to deter is commonplace in the literature on deterrence. Allingham & Sandmo, Income Tax Evasion: A Theoretical Analysis, 1 J. Pub. Econ. 323 (1972), extend the general point to tax underpayments. They do not address the separate issue of the optimal level of deterrence of tax underpayments and do not recommend an inverse penalty for tax underpayments. Further extensions of the core point account for risk aversion (indicating a lower sanction) and enforcement costs (indicating a sanction with a base higher than the social cost of the conduct to be deterred). There has been little work considering the optimal penalty to encourage taxpayer compliance in reporting uncertain items. Two recent unpublished papers address the matter and recommend an inverse penalty, missing the point made in this paper. See Kyle Logue, Optimal Tax Compliance and Penalties When the Law is Uncertain, SSRN Abstract 950379; Daniel Shaviro, Disclosure and Civil Penalty Rules in the US Legal Response to Corporate Tax Shelters, SSRN Abstract 955354. I am unaware of the point being made in the literature on the effect of legal uncertainty on the design of sanctions outside the tax context. Richard Craswell and John Calfee, Deterrence and Uncertain Legal Standards, 2 J. Law Econ. & Org. 279 (1986), is an earlier treatment of the general problem. Tom Baker, Alon Harel, and Tamar Kugler, The Virtues of Uncertainty in Law: An Experimental Approach, 89 Iowa L. Rev. 443 (2004), find in a behavioral experiment that introducing uncertainty of the probability of detection and the amount of the penalty tends to encourage compliance. They investigate uncertainty in the technical sense: the actor does not know the probability or value of possible outcomes. In this paper I use

Because of an asymmetry in the treatment of underpayments and overpayments – the former are scaled up by the penalty while the latter, at best, are refunded dollar for dollar – taxpayers have a strong incentive to underpay by a large margin when reporting on matters of factual or legal uncertainty. The effect is quite large at low audit rates and remains significant even at audit rates of 20 to 30 percent. At low audit rates an inverse penalty collects the right amount on average but it does this not by inducing taxpayers to report fairly, but rather by inducing taxpayers to take extreme positions and then imposing a large levy on the handful who are audited. This exacerbates the perceived unfairness of a large penalty for non-compliance. It also creates an additional dead-weight burden on transactions that involve legal or factual uncertainty if taxpayers are risk adverse or if the penalty is scaled sufficiently high to suppress gross under-payment.

Using a third party to validate a reported item is an attractive solution because of what is an agency problem from the taxpayer's perspective. A third party will reap only a fraction of the expected benefit from biased reporting, and so a much smaller penalty can suppress bias at low audit rates. A third party penalty can take the form of a fine that is a small multiple of the deficiency or, even better, indemnity liability to the taxpayer for a penalty paid by the taxpayer that is a small multiple of the deficiency. Third party opinion suppliers are likely to be professionals and repeat players, which makes available other enforcement strategies and sanctions. This may also make higher penalties politically palatable. Of course, third parties could respond by demanding a large share of the benefit from aggressive reporting, which would require a higher third party penalty to suppress aggressive reporting. I argue that this is not an insurmountable problem because the fee becomes an objective signal of the aggressiveness of a taxpayer's position.

More troublesome is the concern that inducing taxpayers to obtain third party opinions when reporting on a significant item of legal or factual uncertainty, and imposing a penalty on the third party if there is a significant understatement, will significantly increase expenditures on tax compliance. These expenditures are largely a deadweight loss when they are costs of investigating items of legal or factual uncertainty and costs of insuring against the risk of error. More generally, it is almost certainly not socially desirable to treat a tax underpayment like socially harmful behavior, such as pollution, when ensuring compliance is costly because the social cost of an underpayment is less than the amount of the underpayment. For these reasons I argue that rules inducing taxpayers to obtain opinions and penalizing opinion suppliers should be targeted at tax driven transactions that themselves impose deadweight losses.

2. Background: evidence of bias and the legal context

It is common knowledge that tax opinions and appraisals tend to be biased in favor of a taxpayer who pays for the opinion except when the opinion supplier has a

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the term uncertainty more loosely to include situations where an actor knows the probability and value of possible outcomes.

substantial risk of liability to others if the opinion is erroneous.[2] At the risk of being overly pedantic, this part reviews evidence of bias in tax shelter opinion letters and art appraisals to confirm the prevalence of bias. It also describes the legal environment in which opinions are supplied, covering both the rules that make an opinion valuable to a taxpayer and the rules that bear on the potential liability of an opinion provider if the position validated by an opinion is rejected. This is to establish that the existing sanctions are a meager deterrent. Readers who do not need to be persuaded on these points may skip to the next part.

(a) Opinion letters in the most recent run of tax shelters

Between 1998 and 2003 thousands of wealthy people paid hundreds of millions of dollars in fees and expenses to enter into legally risky transactions to eliminate billions of dollars in taxes. These transactions were designed, marketed, and implemented by accounting firms, law firms, and boutique "wealth preservation" firms.[3] The latter often were formed by alumni of accounting firms. In almost all of these transactions, the taxpayer purchased at least a "more-likely-than-not" opinion, often from a nominally independent law firm.[4] These opinions mattered to investors.[5] As Chaim Saban told Congress, he had only two questions before committing to spend an estimated $50 million in fees and expenses to permanently shield $1.5 billion capital gains from tax: "(a) is the transaction kosher, and (b) will a reputable law firm issue an opinion letter that it is kosher?"[6] KPMG used its in-house opinion as a marketing tool, telling investors "The opinion letters that we issue should get you out of any penalties," while adding that if an investor who was wanted an another "outside" opinion as further protection could

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[2] There is a substantial risk of liability when lawyers supply an opinion confirming the tax exempt status of a bond or an opinion to be included in the offering documents that confirms the tax-free status of a reorganization of a publicly traded corporation. In these situations, opinions tend to be quite conservative. I recall from may days as an associate that my firm's required standard for continuity of interest before it would opine that a reorganization was tax free was significantly higher than the standard suggested by the case law.

[3] One such firm was Heritage, which was run by Gary M. Kornman. See Janet Novak, Leaky Shelters, Forbes (Apr. 11, 2005)(reporting that Heritage averaged more than $30 million in fees annually).

[4] Even better is a "should" opinion, which is what Locke, Liddell & Sapp gave on E&Y's Contingent Deferred Swap. 2005 Senate Report at 79-81. Not everyone agreed. It is reported that David Garlock, a widely respected tax lawyer at E&Y, told people internally that he "isn't even at 'more likely than not . . . .'" Id. at 81.

[5] The opinions mattered to promoters. Quellos waited months to go forward with a strategy so it could get a "more-likely-than-not" opinion from Cravath. See Report of the Permanent Subcommittee of Investigations of the Senate Committee on Homeland Security and US Governmental Affairs, Tax Haven Abuses: The Enablers, The Tools, and Secrecy (Aug. 1, 2006)(henceforth 2006 Senate Report), at 57-61. And the opinions mattered to other participants. See Deutsche Bank, Boyle memo to Wood, July 29, 1999 ("you will get no clean sign off from RRC without a clean opinion . . . from Shearman & Sterling"). 2003 Hearings at 2612-2613.

[6] 2006 Senate Report at 98.

purchase it for $25,000 to $40,000.[7] On at least one of its shelters, KPMG also told investors that they could procure insurance to cover litigation costs and an adverse judgment. Only around six of 58 investors in the shelter purchased the additional insurance.[8] This suggests most investors thought the opinion provided sufficient assurance either that the position was legitimate or against penalties.

Consistent with their perceived value, the rewards for supplying positive opinions were considerable. Jenkens & Gilchrist received $267 million in fees from doing around 1,400 shelters between 1999 and 2003, with roughly half of this going to the three lawyers in the Chicago office who did the work. Roughly one third went to the firm and the other sixth went to third parties who helped execute the deal or who referred investors.[9] How much of this was for the opinion letter is not clear. Jenkens & Gilchrist did more than supply an opinion—its people designed the shelter, marketed it, and did much of the work executing the shelter. There also was good money in supplying a nominally independent opinion. For supplying a second opinion in 264 KPMG deals Sidley Austin Brown & Wood ("Sidley") was paid more than $23 million in fees. The amount of the fee was pegged to the amount of the tax loss with a minimum fee of $50,000. This was for "cookie-cutter" opinions that Sidley said it could turn out in 48 hours by taking the facts from the KPMG opinion.[10] Locke, Liddell charged the same

[7] 2005 Senate Report at 45. This was in connection with the SC2 shelter. Bryan Cave was identified as one source.

[8] 2005 Senate Report at 46 (for an estimate of the number purchasing insurance in the SC2) and 50 (for the number of SC2 transactions). One such policy, apparently from AIG, may be found in the 2003 Hearings, Volume 3 at 2915. It covers "contest expenses" and an adverse judgment, which would include the deficiency, interest, and penalties. The premium and the policy limits are redacted. Kenneth Gary, New Opportunity for Tax Lawyers: Insuring Tax Transactions, 104 Tax Notes 25 (2004), quotes an industry source that the average cost of "transactional tax risk insurance" is 5 to 10 percent of the tax liability. Rachel Silverman, Getting Insurance for Your Tax Bill, Wall Street Journal D1 (May 5, 2004), reports a cost of 5 to 11 percent with a substantial deductible.

[9] Lynnley Browning, Papers Said to Show Big Pay for Tax Lawyer, New York Times C-5 (Oct. 13, 2004). The story is based on reports from lawyers who saw confidential filings in the settlement proceeding. According to the story, of this amount $83 million went to the firm, $93 million went to Paul Daugerdas, $50 million went to financial and accounting firms that executed the transactions, $28 million went to Erwin Mayer, $4 million went to Donna Guerin, and $8 million went to Daugerdas' former firm. The story also reports that $75 million was to be paid in the settlement, of which Daugerdas was to contribute $3.9 million. The class action was eventually settled for a reported $81 million. See New York Times C-3 (Mar. 23, 2007). The firm closed in 2007 paying a $76 million penalty to the IRS and entering into a non-prosecution agreement. Wall Street Journal A-1 (May 17, 2007). The Wall Street Journal story, which is based on sources from Jenkens, confirms these figures. The number of 1,400 shelters comes from the Journal story and is based on IRS figures. The Times stories places reports over 1,100 and is based on the class action. Insurers paid $70 million of the $81 million settlement. 2/2005 American Lawyer 18 (Feb. 2005). Class counsel took 20 percent of the settlement. 2004 TNT 197-3. Partners forfeited their capital accounts. American Lawyer 22 (May 2007). For background on Daugerdas practice see Helter Shelter 12/2003 American Lawyer 65 (Dec. 2003).

[10] Report of the Permanent Subcommittee of Investigations of the Senate Committee on Homeland Security and US Governmental Affairs, The Role of Professional Firms in the US Tax Shelter Industry (April 13,

amount per opinion on 70 Ernst & Young deals.[11] More was paid for opinions on "one-off" or limited run deals. Bryan, Caves was paid $1.3 million for supplying a "more likely than not" opinion to Chaim Saban on his shelter.[12] And King & Spaulding was paid at least $500,000 for its opinion for the transaction in Long Term Capital.[13]

As for the transactions themselves, they exploited one or more technical points of tax law to achieve a result such as boosting the basis of an asset, generating an artificial loss, nominally shifting income to a tax indifferent entity, shifting income off shore, and so on. The better opinions deal ably with the technical issues, though the opinions tend to be unduly optimistic in concluding that debatable technical issues would be resolved in favor of the taxpayer.[14] Courts are likely to resolve debatable technical points against a taxpayer to avoid a perverse result. The Achilles Heel of almost every shelter is the anti-abuse rules, and in particular the requirement of business purpose or economic substance. None of the transactions I am aware of would pass muster under the *ACM* standard of business purpose, which requires a reasonable prospect of profit after fees and costs are subtracted. Few would be likely pass to muster under more lenient standards of business purpose or economic substance. The opinions I have read surmount these problems by taking a Panglossion view of anti-abuse law and by making dubious assumptions of business purpose.

It may be that the suppliers of the shelter opinions were lying. They may have known the transactions had little chance of surviving audit but supplied a "more likely than not" opinion after a cynical calculation that the transactions were a good bet for the investors given the low risk of audit. Even more cynically, the suppliers may have calculated this was an even better bet for their firms because they would pocket a substantial fee with little legal risk and an acceptable reputational risk. A famous internal KPMG e-mail is suggestive of this sort of thinking.[15] After learning how BLIPS would

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2005)(henceforth 2005 Senate Report), at 98-99. The fee was pegged at 25 to 30 "basis points" (i.e., 2.5 to 3%) of the expected tax loss. Ruble, who seems to have done most of the work, recorded around 2,500 hours on KPMG opinions. This works out to less than 10 hours per opinion. The total expense on BLIPS was 7% of the expected tax loss. 2005 Senate Report at 68-69.

[11] 2005 Senate Report at 79. The all in cost was set at 1.25% of the capital loss. Total fees in Quellos' Point strategy were set at 3% of the expected tax loss. 2006 Senate Report at 93.

[12] Id. at 111.

[13] Long Term Capital Holdings v. United States, 330 F. Supp.2d 122, 176 (D. Conn. 2004). The district court opinion reports a total of $525,650 through June 24, 1997, consisting of $125,650 in hourly fees and costs and a $400,000 premium.

[14] KPMG's BLIPS opinion may be found at 2003 Hearings at 684. Brown & Wood's BLIPS opinion may be found at 781.

[15] An example of this sort of thinking is a 1998 KPMG memorandum concluding that OPIS should not registered as a tax shelter under § 6111, even if registration was required, because, at worst, "penalties would be no greater than $14,000 per $100,000 in KPMG fees." 2005 Senate Report at 57. Other arguments for not registering made in the memorandum are that it would put KPMG at a "competitive

be marketed, people in KPMG's Department of Practice and Professionalism questioned whether the shelter warranted a "more likely than not opinion." Philip Wiesner, the head of the firm's Washington National Tax office, responded in a long e-mail sent to other senior tax lawyers in the firm. He conceded the legal issue came down to economic substance and how "the transaction is sold to investors, what the investor's actual motive is and how the transaction actually unfolds." The e-mail is remembered for Wiesner's mangling of an old adage as he concluded:

> "I do believe the time has come to shit and get off the pot. The business decisions to me are primarily two: (1) Have we drafted the opinion with appropriate limiting bells and whistles (yes in my opinion), has the engagement letter been drafted with the right risk limiting language (from what I have seen, Yes) and is the marketing of the transaction limited to very sophisticated taxpayers who are made aware of the risk and properly advised by their own tax and investment advisers . . . and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? If the answers are yes to both questions, then we have done all that we can do from a technical point of view and it is time to move on and decide the business case. My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit."[16]

Wiesner seems to appreciate the legal risks to KPMG in rendering a positive opinion, but it is not clear that he thought that a "more likely than not" opinion on BLIPS was dishonest. At several points in the e-mail he remarked that the tax law risk hinged on "whether in fact the investors approached the transaction from a business like point of view with a real desire to make a profit other than from tax benefits." While Wiesner seems aware the representations of business purpose and profit potential in the prototype opinion might not be valid, he may have persuaded himself that KPMG was not responsible for their validity. He concluded "our opinion is only as good as the underlying factual assumptions and actions by the investors. We cannot control with any certainty what they will do in fact!"[17] And in the last sentence: "We should decide as a business matter to proceed and work to have in place controls to make sure that the sellers of the transaction and the investors in the transaction do not make a sham of our opinion." In any event, the internal dissenters gave in, approving the "more likely than

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disadvantage" because other accounting firms were not registering tax shelters marketed to individuals and that the IRS was not enforcing § 6111. The full memorandum, with supporting memoranda, is at 2003 Hearings, Vol. 1, pp. 393-399.

[16] 2005 Report at 19-20 has excerpts (May 10, 1999 e-mail). The full text of the e-mail is in the 2003 Hearings, Volume 1 at 625-626. The passage in text incorporates passages from the fuller version.

[17] Another example of compartmentalization of negative information is found in a Quellos shelter that required a pool of securities with built-in losses that could be shifted to the investors. Despairing at the cost and risk of acquiring such a pool, Quellos created a pool of virtual loss contracts by executing transactions between two offshore companies it controlled. The clients were led to believe that these were real securities. See 2006 Senate Report at 64-68. People from Quellos and Cravath disagreed on whether Cravath was aware that the transactions used virtual securities. Id at 67 n. 213.

not opinion" on BLIPS (an e-mail said "reluctantly") after requiring further representations from investors, presumably regarding business purpose.[18]

An internal memo from PwC is indicative of what I think is a common way of framing a question that tends to bias an evaluative or speculative judgment made on behalf of a client without conscious dishonesty or disloyalty. Members of PwC's review committee were instructed that they should reach a "more likely than not" conclusion on a strategy if they thought that other members could reasonably reach that conclusion on the strategy's technical merits.[19] Putting aside the emphasis on "technical merits," which could be interpreted as directive to ignore the issue of economic substance, the memo instructs an employee to reach a "more likely than not" conclusion if the employee thinks a reasonable person could do so. This is not unlike the standard in civil litigation defining when a factual issue must be submitted to the jury. The difference is that this is a directive to resolve any reasonable doubts in favor of validating a strategy. This is a natural way of making an evaluative or speculative judgment on behalf of a client when the client prefers an answer tending in one direction. An actor may rationalize that the client is entitled to the most helpful plausible opinion consistent with the client's preferences, and not the actor's own personal opinion. This also is a natural way of making an evaluative or speculative judgment when an actor is worried about potential personal liability or embarrassment. So long as an opinion is within the range of reasonable opinions it is unlikely to be characterized as negligent or worse.

(i) The legal environment during 1998 to 2003

The surge in shelter activity between 1998 and 2003 resulted from the confluence of several phenomena that are largely exogenous to tax law. The economic boom, particularly the stock market boom, created potential demand with large numbers of individuals holding substantial investment gains that they either realized or wanted to be able to realize. While tax law changes in the 1970s and 1980s, such as the at-risk rules and passive loss rules, made it difficult to shelter individual compensation they did not prevent sheltering investment gains and business income. On the supply side, a critical mass of tax professionals came to believe that through value-based billing extraordinary profits could be made by devising and marketing tax savings strategies to individuals and firm. That a critical mass of professionals were in the game was important for it encouraged others to join in the game, or at least to acquiesce when their firm joined in the game. It also created pressures to move strategies to market quickly to beat the competition. And investors took comfort from the number of firms that were offering

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[18] 2005 Senate Report at 17-22. Nine months later later, in February 2000, after learning that the taxpayers has not acted in accordance with the representations in the 66 BLIPS deals that had been completed (they closed out the position before year's end), Wiesner wrote an e-mail recommending that KPMG move to other strategies but also stating that he thought KPMG could still give "more likely than not opinions." 2003 Hearings, Volume 1 at 415.

[19] 2005 Senate Report at 89.

similar products, mistakenly believing that the number of sellers indicated the safety of what was being sold.

During this period tax law did little to discourage professionals from being aggressive in giving positive opinions for tax shelters. To the contrary, the law encouraged bias. It was widely assumed by promoters, opinion providers, and investors that a "more likely than not" opinion from an independent law firm would shield a taxpayer from the negligence and substantial under-statement penalty, which was typically assumed to be 20% of the deficiency.[20] This was not clear under the law at the time.[21] Still there was case law suggesting a taxpayer could almost blindly rely on a positive opinion from an independent law firm.[22]

Opinion providers would have thought they faced trivial risk of sanction by the government. The existing third party financial penalties were small, $1,000 or $2,000 per transaction, and had steep scienter requirements that would have made the prospect of levy seem remote.[23] The penalty for failure to register a non-corporate tax shelter was one percent of the investment and this liability was shared among everyone who participated in the sale and execution of the shelter.[24] If the possibility crossed their mind,

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[20] An opinion also is a shield from criminal sanction. 3 A.L.R.Fed. 665 (1998), collects cases.

[21] Section 6662 imposed a 20% penalty for negligence, disregard of rules or regulations, or a substantial understatement. The value of a "more likely than not" opinion had two statutory bases. One was old § 6662(d)(2)(c), which imposed the 20% substantial understatement penalty on a tax shelter position unless "the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment." § 6662(d)(2)(c)(i)(II). The special rule on tax shelters also prevented a taxpayer from avoiding the penalty by disclosure. Tax shelter was broadly defined to include any "arrangement . . . if a significant purpose of such . . . arrangement is the avoidance or evasion of Federal income tax." § 6662(d)(2)(c)(iii). The other base was § 6664(c), which provided for no penalty under §§ 6662 and 6663 (fraud) for an underpayment "if it is shown that there was reasonable cause . . . and the taxpayer acted in good faith . . . ." Regs. § 1.6662-4(c)(1) and 4(g)(4)(i)(B) spelled out baseline requirements for reliance on an opinion to be considered as in good faith. Especially pertinent was a requirement that the advice not be based on unreasonable factual assumptions as to business purpose. Reg. § 1.6662-4(c)(1)(ii).

[22] See United States v. Balboa Energy Funds 1991, Regional Resources, Inc. Tax Matters Partner, 85 F.3d 634 (9th Cir. 1996)(overruling tax court decision imposing substantial underpayment penalty because the government failed to establish that taxpayers did not reasonably rely on "more likely than not" opinion, reasoning that reliance could be reasonable though the taxpayers knew the investments had no reasonable expectation of profit-making if the taxpayers could have reasonably that the IRS might find otherwise).

[23] There was $1,000 penalty per interest sold for promoting an abusive tax shelter. This was changed in 2004 to 50% of the gross income derived from the activity. Culpable conduct includes making a statement with respect to the "allowability" of a tax benefit. The penalty requires that the actor "know or have reason to know" that a statement regarding a tax benefit "is false or fraudulent." § 6700. Under the general civil penalty for aiding and abetting an understatement there was a $1,000 fine for each act advising an understatement. It required that the actor "know" that following the advice "would result in an understatement." § 6701(a).

[24] See § 6707(a)(2)(imposing penalty on persons required to register under § 6111(a)(1)), § 6111(a)(1)(a "tax shelter organizer" must register), and § 6111(e)(1)(including in this "the person principally responsible

opinion providers would have thought there was no prospect of criminal prosecution so long as they did not knowingly participate in a sham transaction.[25] The scienter of tax fraud is actual knowledge that a position violates the law.[26] This is not a sensible way to talk about what is and is not a culpable state of mind when an actor expresses an opinion on an evaluative or speculative matter. And there was no precedent for criminal prosecution of professionals for aiding and abetting tax shelters that did not involve sham transactions.

People were conscious of the risk of facing claims by angry investors if a shelter did not withstand challenge by the government.[27] This risk seems to have been what was on the mind of people at KPMG when Wiesner wrote the memorable e-mail to his colleagues urging the firm proceed with BLIPS. The safeguards Weisner mentioned – ensuring there were "limiting bells and whistles" and "risk limiting language" in the opinion letter while restricting marketing "to very sophisticated taxpayers who are made aware of the risk" – would reduce the risk of civil liability.[28] But these safeguards would tend to weaken a taxpayer's position against the government as these facts would undercut a taxpayer's argument that his reliance on an opinion was reasonable. For firms like KPMG the predominant concern regarding claims from disappointed investors would be reputation. Disappointed investors who brought civil suits would face numerous hurdles, including the difficulty of establishing a prima facie case of liability, a statute of limitations that may run from the date of the opinion, contract terms limiting liability to fees, and terms requiring arbitration. Typically, a firm's liability insurer would be expected to bear much of the cost of defending and settling claims for it is in the interest of plaintiff's counsel to structure a claim to keep the insurer on the hook. This is not to gainsay the reputational concern for reputation is vital to a large professional firm.[29]

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for organizing the tax shelter," "any person who participated in the organization," and "any person participating in the sale or management of the investment at a time when the tax shelter was not registered."

[25] The KPMG indictments assert violations of §§ 7201 ("willfully attempting to evade or defeat any tax . . . or the payment thereof"), 7206(1)(willfully making a false statement under penalty of perjury), and 7206(2)("willfully aids or assists in . . . or advises the preparation . . . of a return . . . which is fraudulent or is false as to any material matter"). Tinsley, Guidelines for Protecting the Tax Practitioner, 40 Taxation for Accountants 94 (1988), is illustrative.

[26] See Cheek v. United States, 498 U.S. 192 (1991)(holding held that a tax protester could not be convicted of tax fraud if the jury found he honestly believed the law was unconstitutional even if this was objectively unreasonable).

[27] See also E&Y memo from Coplan to numerous recipients, Jan. 17, 2000 ("CDS Lives!")("One point Mike Kelley stressed is that we should be very certain that the individuals we approach with this transaction are sophisticated investors who fully understand the economic and tax risks of the transaction, and would not likely seek compensation from us if the anticipated tax benefits are not ultimately realized.")

[28] While these facts might strengthen KPMG's position in a criminal prosecution it is unimaginable that Weisner would have written this e-mail if he thought there was a risk of criminal prosecution.

[29] A testament to this is that after Notice 99-59, which targeted BOSS, Price Waterhouse Coopers refunded its fees to investors and worked with the firms responsible for executing the shelters to unwind the transactions and refund other fees to return to investors as much of their investment as possible.

(ii) Today's legal environment

Today an investor considering an aggressive tax shelter faces significantly greater risks than were apparent five years ago. The government's success in forcing promoters and others to disclose client lists increases the prospect of detection when a shelter is widely marketed. The government has had an impressive success rate in litigated cases and it has settled cases on terms that give relatively little away.[30] In a prominent case applying pre-2004 law, a court imposed the 40 percent overvaluation penalty while rejecting a taxpayer's claim of reasonable cause when the opinion hinged on patently dubious factual assumptions.[31] Legislation in 2004 imposes a 30 percent penalty on a listed or "reportable avoidance transaction" that is not adequately disclosed.[32] There is no reasonable cause exception for an undisclosed reportable avoidance transaction. In other words, there is strict liability in the case of an undisclosed reportable avoidance transaction.[33] Disclosure reduces the penalty to 20 percent and makes available a reasonable cause defense. The reasonable cause requirement was strengthened by

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[30] Announcement 2005-80, 2005-46 IRB 967, covered 21 listed transactions and offered to settle for full taxes plus interest and from one-quarter to one-half of the penalty. The IRS reported a fairly high success rate on an earlier initiative to settle "Son-of-Boss" cases and transactions designed to defer option income on executive compensation. See 2005 TNT 132-7 (reporting a roughly two-thirds settlement rate on the both).

[31] See Long Term Capital Holdings v. United States, 330 F. Supp.2d 122 (D. Conn. 2004). The taxpayer fared better, avoiding penalties on the basis of the reasonable cause exception, in Klamath Strategic Investment Fund, LLC v. United States, 472 F. Supp.2d 885 (E.D. Tex. 2007). Richard Lipton has remarked that the necessary factual findings "strain credulity." Richard Lipton, Klamath Dispatches Another Tax Shelter, But Without Penalties, 106 J. Taxation 200 (Apr. 2007). The opinion is bizarre. The court found the taxpayers, wealthy plaintiff's lawyers, had a business purposes in making and terminating an investment in foreign currency (it was a BLIPS transaction) and that they became aware of the tax benefits only later. Nevertheless, the court denied the tax benefits on ground of lack of business purpose because Presidio – the promoter – structured the investment so investors had to terminate it quickly after realizing an artificial tax loss and before there was any realistic prospect of non-tax profit. Lipton notes that the finding that the taxpayers were unaware of BLIPS tax benefits is belied by the facts that they sought out advice of tax counsel and procured a positive tax opinion before proceeding with the transaction.

[32] IRC § 6662A. Reg. § 1.6011-4(b)(2)-(7) defines reportable transactions. These include transactions identified by notice or rule as being susceptible to abuse (either a listed transaction or a new category of "transaction of interest"), transactions offered on a condition of confidentiality with a minimum fee of $50,000 (individual) or $250,000 (corporation), transactions that make the fee contingent upon success, a transaction that results in a taxpayer claiming a large loss under § 165.

[33] This is in addition to the penalties under §§ 6707 and 6707A for failure to comply with the disclosure requirements under § 6111. Section 6707 imposes a $50,000 on a material advisor for failure to make adequate disclosure. In the case of a listed transaction, the penalty is the greater of $200,000 or 50 percent of the fee. Section 6707A imposes a penalty on the taxpayer for failure to disclose of $10,000 in the case of an individual and $50,000 in other cases. In the case of a listed transaction, these amounts increase to $100,000 and $200,000 respectively.

disqualifying reliance on an opinion from an advisor who is in cahoots with the promoter or who is paid a fee contingent on success.[34]

Providers of opinions validating widely marketed tax shelters who also promote the shelter, or who work in cahoots with the promoter, also face a very different landscape. Threatened with federal prosecution, and with Arthur Anderson's experience fresh in mind, KPMG entered into a deferred-prosecution agreement in which it paid a $456 million fine, admitted to fraudulent conduct, promised to make structural reforms, and promised not to pay the legal costs of former employees defending federal criminal charges.[35] Criminal charges were brought against 18 individuals connected with the KPMG shelters, all but two former KPMG employees.[36] What will come of this is unclear.[37] Jenkens & Gilchrist dissolved after entering into a non-prosecution agreement and paying a $76 million fine.[38] Jenkens reportedly paid $81 million to settle an investor class action, with liability insurers paying $70 million and partners the balance. I am told partners forfeited their capital accounts. KPMG settled a class action involving nearly 200 investors paying $153.9 million to cover transaction costs and losses but not penalties.[39] Class actions or other civil claims are pending against Ernst & Young, KPMG, Sidley, Locke Liddell, Deutsche Bank, and other promoters, opinion providers, and participants.[40] Whether these events will have a lasting impact on one-off tax planning is not clear. Jenkens and KPMG ran into a buzz saw because they commodified aggressive tax saving strategies. The number of transactions and the magnitude of the revenue loss and of the fees they were paid provoked criminal prosecution and civil litigation by raising the stakes while inviting skepticism of claims by promoters and opinion providers that they honestly believed the transactions had a business purpose.

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[34] The 2004 legislation also disqualified reliance on an opinion that hinged on dubious factual assumptions.

[35] See 2005 TNT 67-3 (Aug. 30, 2005).

[36] The charges are for conspiracy to defraud the United States (18 U.S.C. § 371), tax evasion (IRC § 7201), and obstruction of the tax laws (I.R.C. § 7212(a)).

[37] As of August 19, 2007, two pled guilty and the district court dismissed charges against 13 on the ground that the government violated their rights by coercing KPMG not to pay their legal fees in the criminal case.

[38] See 2007 TNT 62-94 (Mar. 30, 2007).

[39] See 2006 TNT 107-4 (June 2, 2006).

[40] See, e.g., Amato v. KPMG, LLP, 433 F. Supp. 2d 469 (M.D.Pa. 2006)(allowing claim to proceed against Sidley on theories of breach of fiduciary duty, fraud, and negligent misrepresentation, the gist of which is that Sidley misled the claimants into believing the opinion was independent); Swartz v. KPMG LLP, 401 F. Supp.2d 1146 (W.D. Wash. 2004)(allowing claim to proceed against KPMG and Brown and Wood on theories of breach of fiduciary duty and malpractice but not fraud because claimant did not reasonably rely where claimant was warned of the risk); In re Garlock, 463 F. Supp. 2d 478 (S.D.N.Y. 2006)(motion to quash subpoenas of principals of E&Y). The grounds include malpractice, misrepresentation, and breach of fiduciary duty. This arises out of a suit against Locke Liddell.

Less dramatic, but of more general relevance, are the enhanced third-party penalties for giving positive opinions on overly-aggressive transactions. These remain fairly meager. The promoter penalty for making false representations regarding tax benefits (which covers an opinion provider) was increased to 50 percent of the fee.[41] The steep scienter requirement was not changed – there is liability only if the actor "knows or has reason to know" that a statement regarding a tax benefit "is false or fraudulent as to any material matter."[42] Recent changes in Circular 230 (the standards for practicing before the IRS) have been widely criticized for imposing content requirements on written tax advice unless there is a prominent disclaimer that a taxpayer may not use the advice to avoid penalties. As a consequence, disclaimers have become boilerplate in written communications from tax lawyers to clients. For an opinion that is meant to be used as a "reliance opinion" the requirements are not very demanding – generally, an opinion must be reasonable in its factual assumptions and in its legal conclusions.[43] One might think these rules make an opinion provider subject to penalty for an honest but unreasonable "more likely than not" opinion. Wrong. The penalties of censure, suspension, or disbarment from practice before the IRS apply only to a violation that is willful, reckless, or through gross incompetence, or that is part of a pattern of providing non-compliant tax shelter opinions.[44]

(b) Art appraisals

Bias hardly is limited to tax shelter opinions. It is widely believed that appraisals commissioned for tax purposes are biased in favor of the taxpayer. This part briefly describes some supporting data involving art appraisals. The market for art appraisals is unlike the market for tax shelter opinions. The fee for an appraisal tends to be very small compared to the tax value, and I am unaware of value-based pricing of appraisals. The experience with art appraisals show that bias does not depend upon these features of the market for tax shelter opinions.

Since 1984, taxpayers have been required to obtain a qualified appraisal to substantiate the value of property contributed to a charity when the property is worth

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[41] The penalty 100 remains percent of the fee in the case of a gross valuation overstatement.

[42] IRC § 6700.

[43] An opinion must be based on reasonable factual assumptions, it must disclose these assumptions, the legal conclusions must be reasonable, the opinion must consider all significant federal tax issues (unless the scope is limited), it must provide a reasoned analysis, it must reach a "more-likely-than-not" conclusion on each issue or disclose why it cannot (a marketed opinion must reach a "more-likely-than-not" conclusion on every issue), and it must disclose if the opinion provider is being compensated by anyone else for promoting, marketing, or recommending the transaction. 31 C.F.R. § 10.35(c), (d), and (e).

[44] 31 C.F.R. §§ 10.52(a) and (b). AJCA amended 31 U.S.C. § 330(b) to permit a financial penalty not greater than the gross income derived from the conduct giving rise to the penalty.

more than $5,000.[45] In addition, when an estate has artwork worth in excess of $3,000, regulations requires that an expert appraisal be included with the estate's return.[46] Reviews of the valuation of art by the IRS's Art Advisory Panel show these appraisals often are heavily biased in favor of a taxpayer.[47] Tables One and Two report increases and decreases in the value of art recommended by the Panel from 2001 to 2004 and in 2006.[48] Table One reports items valued for estate and gift tax purposes. Under-valuation is generally (but not always[49]) in a taxpayer's interest in this situation. Over the period, 43.25% of items were deemed undervalued. The recommended increases total 40.5% of the reported values of all reviewed items and 80.44% of the reported values of items where an increase was recommended. Only 12.44% of items were deemed to be overvalued. The recommended decrease in value was 4.26% of the reported value of all items and 33.94% of the reported values of items where a decrease was recommended. In other words, errors that tend to be in a taxpayer's favor happened over three times as often and when they happened they were over twice as large as errors that tended in the other direction..

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[45] IRC § 170(f)(11)(C). The appraisal must be included with the return if the property is worth more than $500,000.

[46] Reg. § 20.2031-6(b).

[47] There are good reasons to take the panel's valuation as being a fair estimate of value. The panel is composed of 25 art experts who serve without compensation. The panel does not know the tax effect of valuation for the experts are not told whether an item was valued for estate and gift tax purposes or charitable contribution purposes. The panel reviews items sorted by artist or object type and not by case. The report states that while discussions often are animated the panel usually reaches a consensus and that when the panel reach a consensus it seeks further information. The panel considers the taxpayer's appraisal, other evidence submitted by a taxpayer, and a taxpayer may ask for reconsideration.

There would be a selection bias if cases were presented to the panel because an agent accurately predicted an item was misvalued in a taxpayer's favor. There are two reasons to discount this bias. First, agents are required to submit artwork to the panel in any case selected for audit which contains artwork with a claimed value of $20,000 or more per item. See IRM 4.48.2 and IRM 8.18.1.3. Presumably, a significant number of cases were selected for audit for reasons other than a suspicion that artwork was misvalued in a taxpayer's favor. Second, agents do not have the information or expertise to make even an educated guess on the valuation of artwork. In a small number of cases, taxpayers requested a valuation from the panel under Rev. Proc. 96-15. In 2003, this was 6 of 122 cases. In 2004, it was 3 of 114. In 2005, it was 4 of 105. In 2006, it was 7 of 124. While one would expect there is less likelihood of a pro-taxpayer bias in the reported value in these cases, I do no exclude the cases from the total because the panel does not breakout the results on this subset of cases.

[48] The numbers are taken from Art Advisory Panel, Annual Summary Report. The reports may be found at http://www.irs.gov/individuals/article/0,,id=96804,00.html. Cases are total number of cases reviewed. Items are those for which review was concluded. 2005 is omitted because the statistical breakdown was not included with the report that year. The patterns in 2005 are consistent.

[49] When an estate is not subject to the estate tax over-valuation is in the taxpayer's interest because it establishes a higher basis in the property.

Table One: Panel review of art valued for estate and gift tax purposes

	Cases	Items	Increase	Decrease	Reported value: total (millions)	Reported value: increased items	Recommended increase	Reported value: decreased items	Recommended decrease
2001	83	623	210	88	110.5	67.8	65.7	14.9	5.5
2002	86	459	158	91	74.8	28.1	24.8	20.2	7.0
2003	118	558	171	108	83.4	38.2	30.1	17.5	5.9
2004	107	741	322	99	297.4	130.3	73.1	36.2	11.3
2006	114	1573	849	106	211.3	127.1	121.2	8.9	3.4
Total	508	3954	1710	492	777.4	391.4	314.8	97.7	33.2

Table Two reports items valued for purposes of claiming a charitable contribution deduction. Here over-valuation always is in a taxpayer's interest. Almost half (49.14%) of the items were deemed to be over-valued. The recommended decreases total 33.1% of the reported values of all reviewed items and 47.74% of the reported values of items where a decrease was recommended. In other words, in almost half the items reviewed there was an error in the taxpayer's favor resulting in almost doubling the value of the item. Errors not in the taxpayer's favor were almost non-existent (5 out of 350 items reviewed or 1.43% of all items), though when errors occurred they were fairly large (a 38.25% increase was recommended on average in these five cases).

Table Two: Panel review of art valued for charitable contribution purposes

	Cases	Items	Increase	Decrease	Reported value: total (millions)	Reported value: increased items	Recommended increase	Reported value: decreased items	Recommended decrease
2001	6	56	2	19	4.4	0.1	0.0	2.8	1.9
2002	4	4	0	3	25.4	0.0	0.0	25.2	15.1
2003	4	56	3	42	119.1	6.5	2.5	75.0	30.3
2004	7	184	0	69	8.9	0.0	0.0	7.4	5.1
2006	10	50	0	39	6.2	0.0	0.0	3.3	1.9
Total	31	350	5	172	164.1	6.6	2.5	113.8	54.3

An appraisal generally is assumed to protect a taxpayer from the substantial understatement penalty, as well as being required in the situations described above. Before 2006 there were no rules delimiting who could give a qualified appraisal or what was an acceptable methodology.[50] Nor were there appraiser penalties, other than the general provisions on criminal fraud and the general civil penalty for aiding and abetting a substantial understatement. Section 6995A, which was enacted in 2006, imposes a special penalty. If an actor supplies an appraisal knowing or with reason to know that it will be used for tax purposes, and the claimed value of the property results in a

[50] The Pension Protection Act of 2006 (PPA) provided statutory definitions of a qualified appraisal and appraiser for tax returns filed after August 17, 2006.

substantial or gross valuation misstatement, then the actor is liable for the lesser of 10 percent of the underpayment (but no lower than $1,000) or 125 percent of the fee paid for the appraisal.[51] This liability would be strict were it not for an odd exception covering when "the value established in the appraisal was more likely than not the proper value."[52] The exception is odd because it is not obvious how a valuation could be rejected to establish an understatement while also being characterized as "more likely than not the proper value."[53]

2. Why an inverse penalty rate will not eliminate bias in reporting on matters of factual or legal uncertainty

Low audit and penalty rates suffice to explain aggressive reporting by taxpayers and by third parties who supply supportive opinions under current law. A proposed solution for tax noncompliance is to impose a strict liability penalty on an underpayment that is the inverse of the audit rate, i.e., at a 5 percent audit rate a deficiency assessment (penalty plus tax) would be 20 times a deficiency. The usual reason for rejecting this solution is that at politically feasible audit rates the necessary penalty rate is politically unfeasible. While this may be enough reason to consider third penalties for the reasons explained in Part Three, I show there is an additional reason. An inverse penalty will not eliminate bias in reporting on matters of factual and legal uncertainty because of the asymmetric treatment of overpayments and underpayments. Because of this an inverse penalty has very troubling consequences at low audit and correspondingly high penalty rates. I also show a case can be made for a negligence penalty at low audit rates. This Part looks at the matter from the taxpayer's perspective. The next part will consider the effect of imposing a third party penalty on an opinion supplier.

I begin by modeling a deduction item of uncertain value with normally distributed possible values. I then extend the model to an income item with a non-normal distribution of possible values. Finally I briefly explain why these effects hold in reporting on a matter of legal uncertainty. For now you should have in mind taxpayers who do not knowingly put themselves into a position to be able to exploit uncertainty for tax purposes. You might imagine a taxpayer has given artwork to charity and later discovers its value is uncertain, that a taxpayer has received an income item of uncertain value and he is told he must value it for tax purposes, or that a taxpayer has received an object of certain value and must decided whether to treat it as a gift in circumstances where the classification of the transfer is not clear.

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[51] IRC § 6695A.

[52] IRC § 6695A(c).

[53] Another odd feature is for an item of speculative value there is no correct value or a "more likely than not" correct value. Rather there are a range of possible values. If one could construct the range, there would be a standard distribution of possible values with a mean. I guess the concept of a "more likely than not" correct value refers to the mean possible values.

(a) Deduction item with a normal distribution of possible values

Assume a taxpayer has given artwork of speculative value to charity. An asset of speculative value has no true value – instead its value falls within a range of possible values. In this part I assume these values are normally distributed. To simulate this I generated 400 random numbers with a mean of approximately $100,000 and a standard deviation of approximately $25,000.[54] The taxpayer must select a value to report knowing he will receive a tax benefit of 40 cents on the dollar. The taxpayer knows the reported value may be audited by the government. If the reported value is audited, the taxpayer expects the government will choose a value from the 400 random numbers with the following consequences. (1) If the reported value is higher than the assessed value, then the taxpayer will pay an amount equal to the deficiency multiplied by the inverse of the audit rate. (2) If the assessed value is higher than the reported value, then the taxpayer will be refunded the amount of the over-payment.

Diagram One shows the expected return to the taxpayer at different reported values assuming an audit rate of 10 percent. The taxpayer maximizes her expected return by reporting a value significantly higher than the average of the possible values ($100,407). If the taxpayer were risk neutral, then she would maximize her expected return by reporting a value equal to the highest possible value. A penalty that is the inverse of the audit rate does not induce a taxpayer to report the average value because a refund is not multiplied, though nine out of ten times if the taxpayer reports a value lower than what would have been the assessed value she does not get a refund because the value is never tested. The maximum expected return ($40,163) equals the average value ($100,407) times the tax rate (40 percent). Thus, if taxpayers are not risk adverse and report the highest possible value, the correct amount of tax is collected on an expected cost basis (or on average) but by facing a taxpayer with a nine-in-ten chance of getting away with deducting the highest possible value in the range ($186,000) and a one-in-ten chance of paying a levy that is ten times the tax benefit from reporting a value higher than the assessed value (which is likely to be no more than $100,000 and could be much lower).

[54] This was using targets of $100,000 and $25,000 respectively. The lowest number generated was $36,199 and the highest was $186,388.

Diagram One

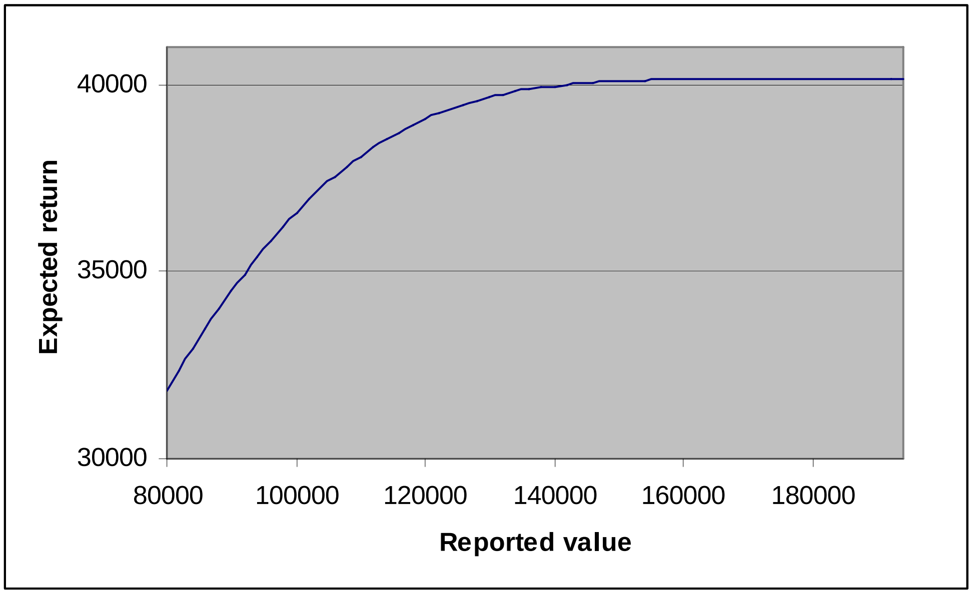
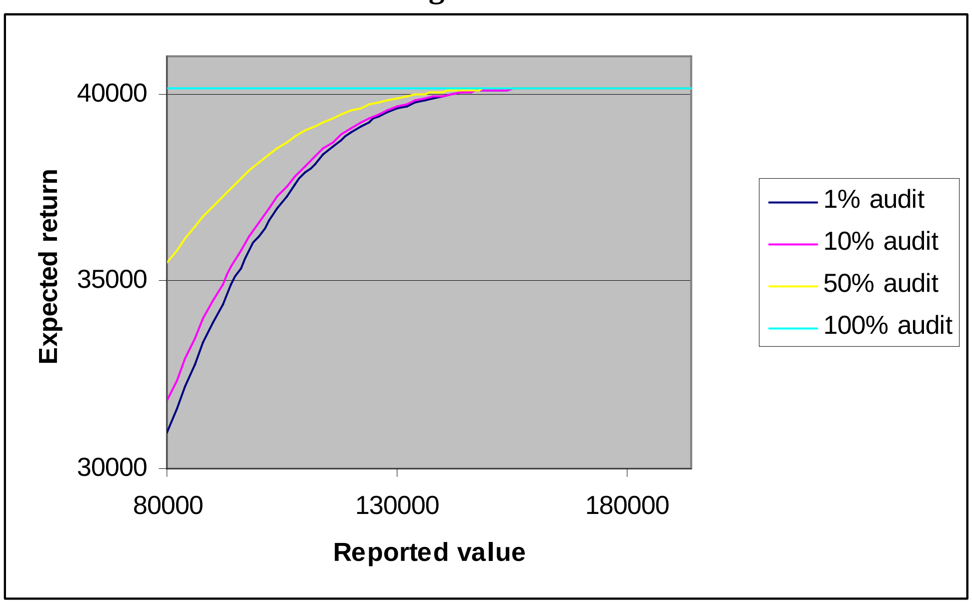


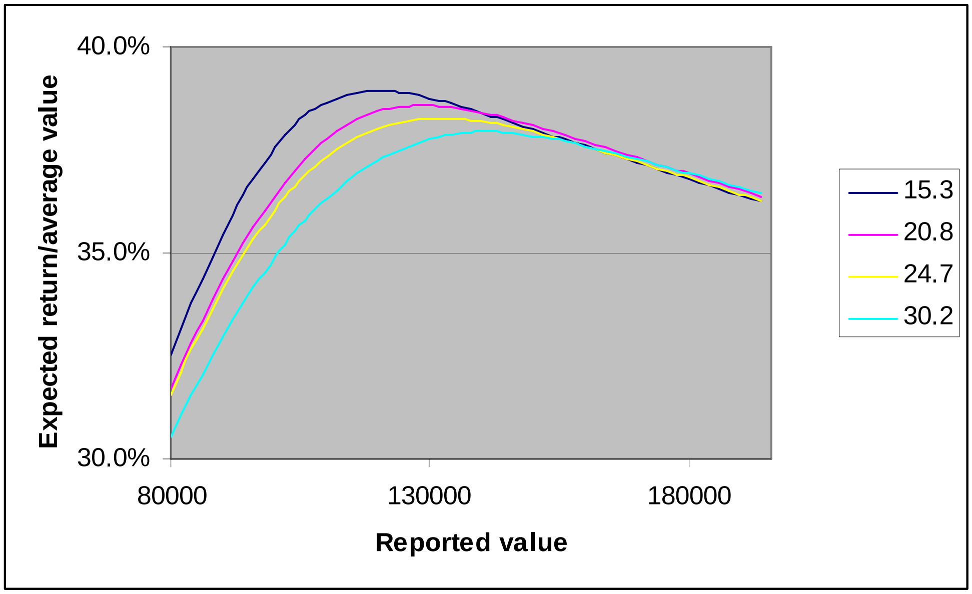
Diagram Two shows the effect of varying the audit rate while keeping the penalty on a deficiency equal to the inverse of the audit rate. The curve flattens as the audit rate increases because as the penalty on an under-payment decreases the asymmetry in the treatment of over-payments and under-payments lessens, finally disappearing at an audit rate of 100 percent. Multiplying a refund by the inverse of the audit rate has the same effect.

Diagram Two



Making the penalty slightly higher than the inverse of the audit rate suppresses the reported value while reducing the expected return. Increasing the standard deviation in the possible values of an item lessens the first effect while exacerbating the second effect. Diagram Three illustrates. It shows the expected return for four assets with increasing standard deviations in possible values. It assumes an audit rate of 10 percent and a penalty (including tax) of eleven times a deficiency. The average value of each asset is approximately $100,000. The lowest standard deviation is 15.3% of the average value. The highest standard deviation is 30.2% of the average value. For all of the assets the expected return is lower than the average value times the nominal tax rate. Increasing the standard deviation in possible values increases the return-maximizing reported value while decreasing the expected return. Increasing the standard deviation decreases the expected return because it increases the expected difference between the assessed value and the reported value and with it the expected cost of a penalty when the assessed value is lower than the reported value.

Diagram Three



At a very low audit rate and an inversely high penalty rate the first effect is exacerbated while the second effect is lessened. For example, if the audit rate is 2 percent (this is higher than current audit rates) and the penalty is 51 times the deficiency, the return maximizing reported value is $164,000 and the expected return is 39.4 percent of the average value.[55] Keeping the penalty the same but making it fault-based decreases the optimal reported value while increasing the expected return. For example, if a penalty of 51 times the deficiency is assessed only when the reported value is 150 percent or more of the assessed value (a significant difference between the reported and assessed value is a proxy for fault), the return maximizing reported value is $152,000 and the expected return is 44.9 percent of the average value.[56]

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[55] This assumes a standard deviation of approximately $30,000, no 10 percent surcharge, no fraud penalty, no discount in the refund when the assessed value is higher than the reported value.

[56] This keeps all other assumptions the same.

At a very low audit rate and an inversely high penalty rate the choice between negligence and strict liability involves a difficult trade-off. Strict liability produces an expected return closer to the tax rate times the average value, but it does this by encouraging taxpayers to report a high value and then extracting a large penalty from a small handful of people who are audited, including people who over-valued the item by a relatively small margin.[57] Some will think this unfair. In addition, risk adverse taxpayers will discount the expected return because of this risk. And the high stakes when a taxpayer is audited are likely to increase administrative costs. Taxpayers report lower values under a negligence penalty but the expected return is higher than the tax rate times the average value. A large penalty still is extracted from a handful of those audited but it is a smaller handful than strict liability because the penalty is limited to the unlucky few who have an assessed value below the mean.

Under current law there are multiple tiers of penalties. Adding a severe second-tier penalty for gross over-valuation makes it possible to suppress over-valuation with a first tier penalty that is a large fraction of the inverse of the audit rate. Diagram Four illustrates. It compares a strict liability and negligence penalty (the latter applies when reported value is 175 percent or more of the assessed value) of sixteen times the deficiency assuming an audit rate of five percent.[58] The negligence or strict liability penalty is coupled with an additional penalty of 20 times the amount of the deficiency if the reported value is 20 times greater than the assessed value. The return-maximizing reported value flattens out and then declines under a negligence rule at a value near the upper limit of possible values. If taxpayers are at all risk adverse, then they will report a value no higher than where the expected return begins to flatten out as higher values have a similar payoff with a higher variance. The expected return is approximately 35 percent greater than the tax rate times the average value.

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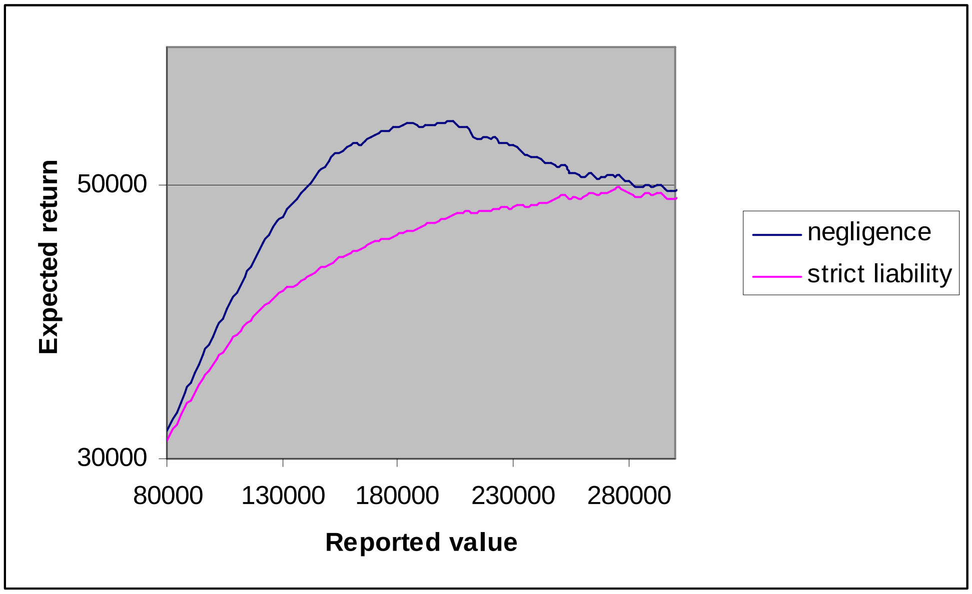
[57] For example, if the taxpayer reports $164,000 and the assessed value is $130,000, which is one standard deviation above the mean, then the penalty would be $680,000.

[58] The standard deviation in the data set is approximately $30,000 and the mean is approximately $100,000.

Diagram Four



(b) Income item with a non-normal distribution of possible values

These results generally hold in the case of valuation of an income item (or an item subject to the wealth and estate tax) except the direction of the bias is to under-value the item. At existing low audit rate penalty rates the tax minimizing strategy is to report a de minimis value on an income item of speculative value when there is a large cluster of low possible values.[59] Diagram Five illustrates. To produce the diagram I generated 800 random numbers with a mean value of $10,000 and then eliminated all values below zero. This produced a set of 523 possible values with a mean value of $22,333. Diagram Five shows the effect of the audit rate on the expected tax cost at different reported values assuming a negligence penalty of 50 percent of the deficiency if the assessed value is 66 percent or less of the reported value.[60] The current negligence penalty is 20 to 40 percent. The cost minimizing strategy is to report a de minimis value (here specified as $500) except at an audit rate of 60 percent.

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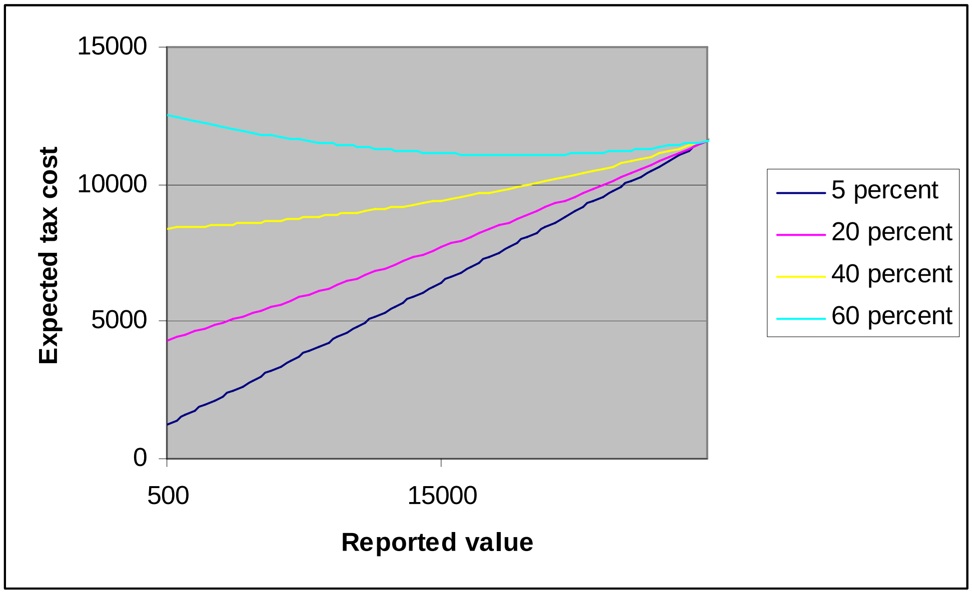
[59] This justifies the decision in the Section 83 regulations not to tax a service provider on receipt of a non-publicly traded option but instead to assess the amount of compensation on exercise of the option. The same reasoning holds for a profits interest or a carried interest in a partnership, which is a matter of current debate.

[60] I also assume: (i) a surcharge of 10 percent on a deficiency; (ii) a fraud penalty in addition to the negligence penalty if the assessed value is 25 percent or less than the reported and the amount of the deficiency is $25,000 or more; and (iii) the recovery of an over-payment is discounted by 25 percent.

Diagram Five



Unlike the item modeled in 2(a), this item has a non-normal distribution of possible values. The distribution of possible values has a long tail on the high side but a truncated tail on the low side because of the zero floor. A non-traded compensatory stock option is an example of an income item with a speculative value that is likely to have such a pattern of distribution of possible values. The skew in the probability distribution slightly alters the effect of the asymmetry in treatment between under-payments and over-payments. Recall that with a strict liability penalty that was inversely proportional to the audit rate this asymmetry pushes taxpayers to err strongly on the side of under-payment, with worrisome consequences. At high audit rates and correspondingly lower penalty rates the expected tax cost is higher than the nominal tax rate and increases with the standard deviation in possible values. At very low audit rates and correspondingly higher penalty rates these effects disappear (assuming taxpayers are not risk adverse) but with other worrisome consequences described above.

These results generally hold in the case an asset with a non normal distribution of possible values. As an asset's value becomes more speculative, the tax-minimizing reported value decreases and the expected tax cost increases. To show this I modeled three assets with different distributions in possible values. Diagram Six shows the distribution in the possible values. Asset 1 has the least speculative value and Asset 3 the most. The average values are approximately the same. Diagram Seven shows the expected tax cost at different reported values for each asset based on assumptions similar to those used to generate Diagram Three. The audit rate is 25 percent and there is a strict liability penalty of 4 times the amount of the deficiency.

Diagram Six

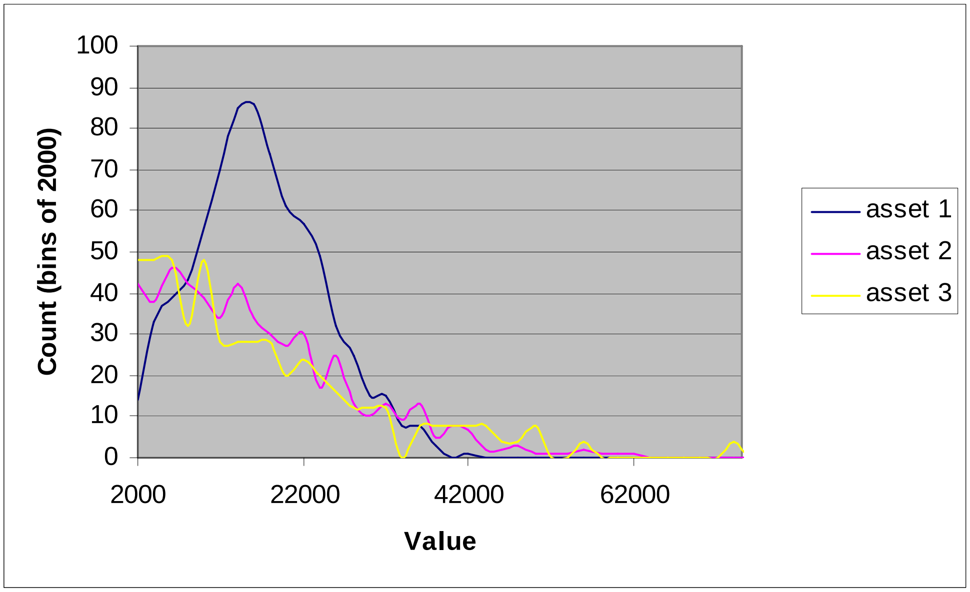
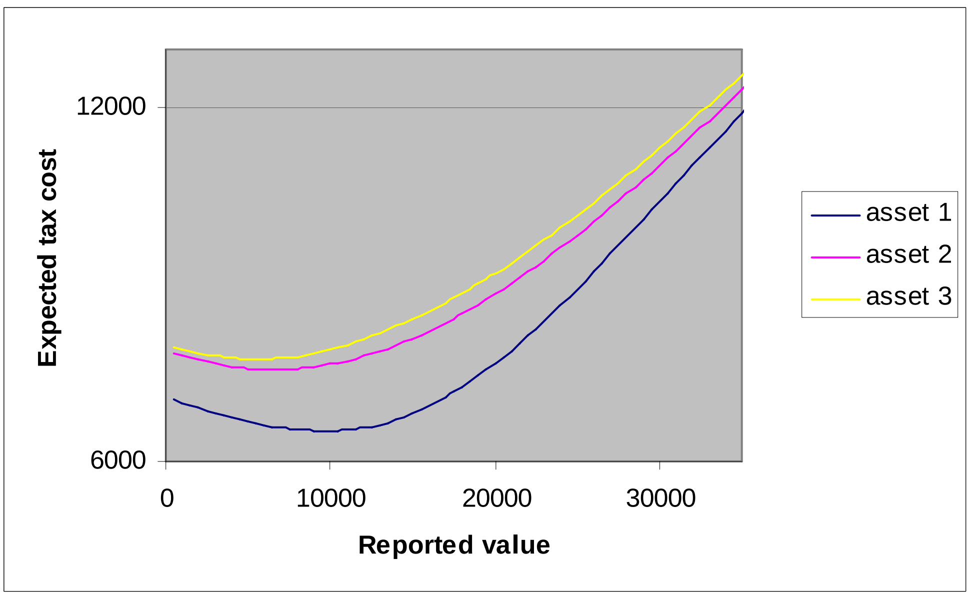
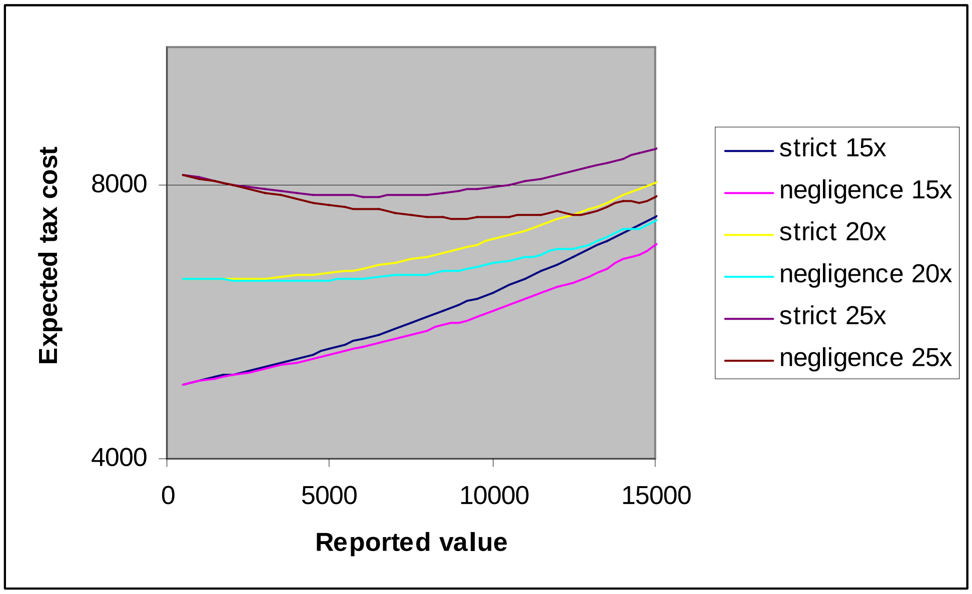


Diagram Seven



The truncated tail has one noteworthy consequence. At very low audit rates the dominant strategy is to report a de minimis value under both a negligence and strict liability regime unless the penalty rate is very high. Diagram Eight illustrates. It assumes no fraud penalty because the stipulated penalty – 25, 20, or 25 times the deficiency – is already quite high. The audit rate is 5%. The model uses Asset 2.

Diagram Eight



The pattern generally is consistent with Diagram Four – a taxpayer reports a higher value but has a lower expected tax cost under a negligence rule (the negligence penalty applies if the assessed value is 175 percent or more of the reported value). The noteworthy point is that a negligence and strict liability penalty diverge only at a very high penalty rate. The reason is that under even a moderately high penalty the dominant strategy is to report a de minimis value even under a negligence rule. Thus there are few instances where the penalty will not apply even under a negligence rule. The upshot is that there is little functional difference between strict liability and a negligence-based penalty for this type of asset even at a moderately high penalty rate.

A side note is that the mean value of the asset is $15,771, so the correct tax at a 40 percent rate is $6,308. A penalty that is the inverse of the audit rate (20 times a deficiency) has a slightly higher expected tax cost but it does not produce this result by inducing taxpayers to report the average value. Most taxpayers will get away with under-valuing the item but a handful will pay a large penalty. Again this is because of the asymmetry in the treatment of over-payments and under-payments.

(c) Legal uncertainty

These effects hold for reporting an item that is legally uncertain. A crude example suffices to show the effect of the asymmetric treatment of an over-payment and an under-payment. Imagine a law professor receives a $1,000 bottle of wine from an old classmate who is a partner in law firm for which the professor occasionally consults. Whether the bottle is a gift for tax purposes is uncertain. To keep it simple, assume there is a one-in-four chance the wine will be classified as a gift. Obviously, at a low audit and penalty rate she is better off treating it as a gift. But even if the penalty rate is the inverse of the audit rate she is better off treating it as a gift. Assume the audit rate is 5 percent and the penalty increases the levy to 20 times the deficiency. If she declares the wine as income and we assume (wildly counter-factually) that if she is audited the government will review and correct a classification favoring the government, the expected tax cost is $395 ($400 minus $5, or the $400 refund in the event the government classifies the wine as a gift discounted by the 5 percent probability of audit and the 25 percent probability the bottle will be classified as a gift). If she treats the wine as a gift, then the expected tax cost is $300 ($8,000 discounted by the 5 percent probability of audit and the 75 percent probability the wine will be classified as income). If we assume 400 taxpayers in the same position who are not risk adverse, who act rationally, and who weigh only the financial cost of the under-reporting penalty, no-one will declare the wine as income, 20 will be audited, and 15 will pay $8,000 each. While this yields the right amount of tax on average ($300 per taxpayer) it does this not by inducing compliance but rather by imposing a severe sanction on a handful of non-compliers.

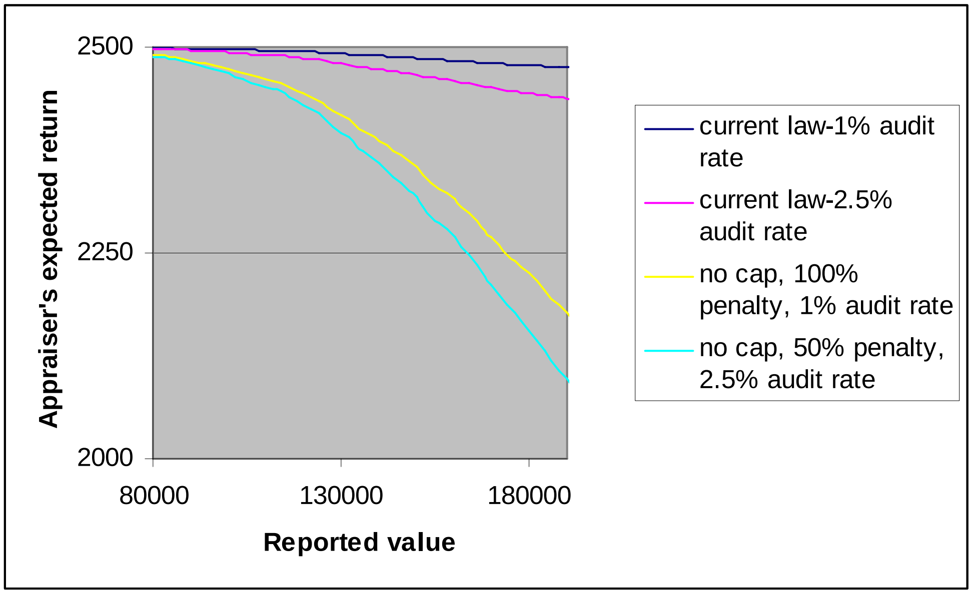
3. Third party penalty

This part considers the effects of imposing sanctions on a third party who supplies an opinion validating a taxpayer's reported position when the position results in an under-payment. As in the last part, this part focuses on valuation because it is more illuminating. You might imagine that a taxpayer gives artwork of speculative value to charity and obtains an appraisal to determine the amount of the deduction. This part shows that a third party penalty can be effective at lower audit and penalty rates because an opinion supplier reaps only a fraction of the expected value of a biased opinion. While a taxpayer may compensate an opinion supplier for the risk in rendering an aggressive opinion the fee paid for an opinion becomes a signal of the aggressiveness of a position that the government may exploit.

(a) Fee is independent of tax benefit

Even at very low audit and penalty rates, a small appraiser penalty can deter bias when the appraiser's fee is independent of the tax benefit from a biased appraisal. This is for the obvious reason that an appraiser faces a penalty in the event of audit when the appraisal results in an under-payment while the appraiser does not share in the expected tax savings from a biased appraisal. The recently enacted appraiser penalty is not a meaningful deterrent to bias because the penalty is a small percentage of the deficiency– 10 percent – and is capped at 125 percent of the fee. Diagram Nine shows the expected return to an appraiser at different reported values under current law at audit rates of one percent and 2.5 percent. This is in the ballpark of current audit rates though probably at the high end. The expected cost of the penalty is de minimis even at high reported values. Diagram Nine also shows the effect of making the penalty 100 percent of the deficiency at a one percent audit rate or making it 50 percent of the deficiency at a 2.5 percent audit rate. The penalty applies only in case of a substantial understatement (i.e., the assessed value is 150 percent or more of the reported value). The fee is $2,500. The asset modeled has a mean value of approximately $100,000 with a standard deviation in possible values of approximately $29,000. Even these fairly low penalties entail a significant expected cost on a biased appraisal.

Diagram Nine



(b) Fee is dependent on tax benefit: the fee as a signal

Often an opinion supplier's fee will depend in some way on the value of the tax benefit resulting from the position supported by the opinion. There is a crude form of dependence when an opinion supplier knows he is more likely to be hired if he has a reputation for supplying a pro-taxpayer opinion. This part models a variation where the appraiser's fee is an explicit function of the taxpayer's tax savings from the appraiser's valuation of a deduction item. This creates an asymmetry in the treatment of appraisals that result in over- and under-payments that is similar to the asymmetry in the treatment of over- and under-payments by a taxpayer.[61] It is possible to reduce bias at lower audit and penalty rates than using a taxpayer penalty because an appraiser shares in only part of the tax benefit from an aggressive position.

Diagram Ten illustrates the general point as well as a related point that follows from the general point. It shows the expected return to an appraiser at different reported values assuming the appraiser increases a base fee of $2,500 by different stipulated percentages of the tax savings from reporting a value above the mean value of a deductible item (the mean value is slightly over $100,000). It also assumes the appraiser reduces its fee by the same percentage of the foregone tax benefit when a value lower than the mean value is reported. I assume the appraiser pays a penalty of six times the deficiency when the reported value is 150 percent or more of the assessed value. This is similar to a negligence rule. I assume the audit rate is 5 percent. Under these assumptions, a penalty of six times the deficiency makes the return-maximizing strategy

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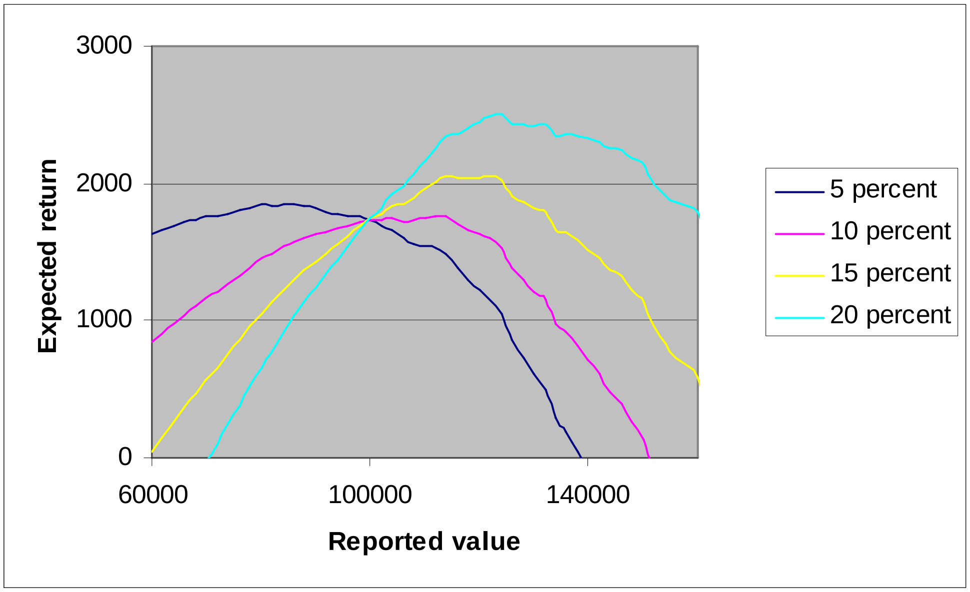
[61] A difference is that a taxpayer has some expectation of recouping an over-payment while and appraiser will recover nothing if an appraisal results in an over-payment. Indeed, an appraiser may expect adverse consequences in this situation.

for the auditor to be to report approximately the average value when the auditor shares in 10 percent of the tax benefit from reporting a value above the mean value.[62] Increasing the appraiser's share to 15 or 20 percent of the tax savings induces the appraiser to report a higher value.[63] But the reported value still is much lower than the return-maximizing reported value to the taxpayer if the taxpayer faced a penalty that was a fraction of the inverse of the audit rate. Reducing the appraiser's share to 5 percent induces the appraiser to report a value substantially below the average of the possible values.

Diagram Ten



A taxpayer and an appraiser can improve their individual payoffs by increasing the appraiser's share of the tax benefit to induce the appraiser to report the value that maximizes their joint expected return considering the costs both face in the event the reported value is audited and the assessed value is less. In theory, this could make a third party penalty no more effective than a taxpayer penalty. But the fee paid the appraiser becomes a signal of the aggressiveness of a reported position that the government can exploit. When the tax benefit from aggressive reporting is large, even a penalty that is a relatively small fraction of the inverse of the audit rate can have an observable effect on the fee paid for an opinion. Diagram Ten illustrates. On the stated assumptions, an appraiser would charge a fee $2,146 when he shades the value to $80,000 while he would

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[62] As a rule of thumb, an appraiser will maximize his own expected return by reporting the mean value of an asset when the penalty is the amount of the deficiency multiplied by roughly twice the inverse of the audit rate discounted by the appraiser's share of the tax savings from a biased valuation. For example, if the audit rate is 2.5 percent, and the appraiser's fee is increased by 5 percent of the tax savings from a biased evaluation, a penalty set at four times the deficiency makes the return-maximizing strategy for the auditor to be to report the mean value of an asset.

[63] As a point of comparison, the fee charged for a capital gains tax shelter opinion routinely ran around 15 to 20 percent of the tax savings.

charge a fee of $5,405 to go out on a limb and report a value of $124,000. To go even further out on the limb and report a value of $180,000, which is slightly above the highest possible value, but still below the reported value that maximizes the joint expected return assuming both parties face a separate penalty of six times the deficiency, the appraiser would charge a fee of $14,707.

Turning the question around, we can ask at what audit rate and penalty rate is an appraiser likely to charge an observably higher fee for an aggressive opinion. To get a very rough sense of an answer, Table Three shows the expected cost to an appraiser (as a percentage of the adjusted base fee) of reporting a value of one and two standard deviations above the mean possible value at different audit and penalty rates. As above, possible values have a mean value of approximately $100,000 with a standard deviation of approximately $30,000, the unadjusted base fee is $2,500,[64] and the penalty applies only if the reported value is 150 percent or more of the appraised value. At low audit and penalty rates the audit rate dominates, as one would expect. The key point to be taken away is that a penalty rate that is as little as 1/10th the inverse of the audit rate has an expected cost to an appraiser who aggressively values a deduction item that is a large fraction of the base fee when the base fee is as high as 2.5 percent the average value of the item. The rows vary the audit rate. The columns vary the penalty rate. The cells show the expected cost to the appraiser of reporting a value either one standard deviation above the mean (the first number) or two standard deviations above the mean (the second number). The penalty applies if the reported value is 150 percent or more of the appraised value. At an audit rate of 5% and a penalty rate of 200%, which is 1/10th the inverse of the audit rate, the appraiser should charge a premium of at least 25.6% of the base fee to report a value one standard above the mean and a premium of 70.9% of the base fee to report a value two standard deviations above the mean.

Table Three: Expected cost of reporting a value one or two standard deviations above the mean as percentage of adjusted base fee

Audit	**Penalty rate**					
rate	**50%**	**100%**	**150%**	**200%**	**250%**	**300%**
1%	1.2%/3.2%	2.3%/6.4%	3.5%/9.7%	4.7%/13.0%	5.9%/16.3%	7.1%/19.7%
3%	3.5%/9.7%	7.1%/19.7%	10.8%/30.0%	14.7%/40.6%	18.7%/51.6%	22.8%/63.0%
5%	5.9%/16.3%	12.1%/33.5%	18.7%/51.6%	25.6%/70.9%	33.0%/91.2%	40.8%/112.8%
7%	8.3%/23.1%	17.3%/47.9%	27.1%/74.8%	37.6%/104.0%	49.1%/135.8%	61.7%/170.5%

* * *

There are two advantages to regulating taxpayer reporting of the value of items of uncertain value by requiring or encouraging a taxpayer to obtain a supporting appraisal and penalizing the appraiser if the reported value results in a substantial understatement of tax. First, an appraiser penalty can deter bias at a much lower audit and penalty rate when the appraiser receives a small fraction of the tax benefit from a biased appraisal.

[64] The base fee is adjusted to equal the expected return at the stated audit and penalty rates when the appraiser reports a value of $100,000.

And second, even at relatively low audit and third party penalty rates appraisers can be expected to charge fees that are observably higher for biased appraisals. An observable signal of aggressive tax reporting can be exploited by the government by targeting the signal.

The same holds for reporting on a matter of legal uncertainty. My earlier crude example involving the receipt of $1,000 bottle of wine that may or may not be a gift suffices to show this, though the low value requires a bit of fantasy. Assume (fantastically) that the law requires a taxpayer to obtain an opinion confirming that a transfer of this amount is a gift when so reporting. Assume (even more fantastically) that a tax professional charges $20 for a positive opinion and nothing otherwise. A penalty that is 1/10th the inverse of the audit rate makes the expected return to the opinion provider of supplying a positive opinion negative unless she concludes it is more likely than not that the wine is a gift.[65] The taxpayer could compensate the professional to be more aggressive by making a side payment. Keeping the penalty at 1/10th the inverse of the audit rate, each 1 percent increase over 50 percent in the probability that the wine is income requires a 40 cent (2 percent) increase in the $20 base fee.

4. Implementation

With meaningful third party sanctions – perhaps as low as one-tenth the inverse of the base audit rate – the fee paid an opinion supplier becomes the Achilles Heel of a biased opinion or appraisal. Taxpayers may be required to report the fee they paid for a reliance opinion or appraisal.[66] The government could collect this data and use it to identify abnormally high fees. It could then announce that an abnormally high fee may trigger an audit of the position supported by the opinion. If opinion suppliers expect an abnormally high fee to increase the probability of audit, then an interesting dynamic develops. As an opinion becomes more aggressive the fee must be scaled up both for the increase in the probability of audit and the increase in the risk of a deficiency assessment and penalties in the event of audit. As just shown, at a low base audit rate a small increase in the probability of audit significantly increases the cost to an opinion supplier of a biased opinion.

Other measures copied from the government's tactics in fighting the latest round of tax shelters can enhance the effective cost of a penalty to an opinion supplier. An opinion supplier who is found culpable in a sufficiently gross understatement may be required to divulge the identities of other taxpayers for whom he supplied a reliance

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[65] For example, if the audit rate is 5%, the penalty would need to be twice the deficiency (1/10th of 20). The expected payoff if there is a 50% chance the wine is a gift would be zero ($20 - $400 * .5 * .05 * 2).

[66] Taxpayers are unlikely to lie about the fee because of the severe sanctions, including criminal penalties, for outright fraud. There is a risk that taxpayers will try to cloak the fee. This possibility arises when the opinion supplier also provides other services to the taxpayer such as advising the taxpayer on the transaction in question. This could be prevented by requiring a taxpayer to obtain an opinion from a professional who performs no other services for the taxpayer. Or taxpayers could be required to report both the total fees paid to the opinion supplier and the fee attributable to the opinion.

opinion.[67] The government could announce that it will audit a percentage of those taxpayers on the reported position supported by the opinion. The culpable opinion supplier would be required to notify all clients whose identity he discloses of this audit risk. This scales up both the expected cost of the penalty and the expected audit rate when an opinion supplier is in the practice of rendering aggressive opinions. It also creates a risk in hiring an opinion supplier who has a reputation for supplying aggressive opinions.

I expect adopting these policies would drive taxpayers to abjure reliance opinions except when an opinion is required. When an opinion should be required is discussed in the next part for the question directly raises the larger question of balancing compliance costs and the cost of non-compliance when tax assessment turns on a matter of factual or legal uncertainty. As an alternative to requiring an opinion, to create an incentive to obtain an opinion the government could identify items on which biased reporting is thought to be a problem and announce a more vigilant audit policy when the taxpayer does not have a supporting opinion. In addition, an opinion supplier may be required to indemnify a taxpayer for penalties assessed against the taxpayer, perhaps including the deficiency itself.[68] So long as the expected cost borne by an opinion supplier when an opinion is erroneous is a sufficiently large multiple of the inverse of the base audit, it does not matter whether it is a separate penalty or an indemnity obligation.

An indemnity obligation is preferable to a separate penalty for several reasons. First, it gives taxpayers an incentive to monitor the financial reliability of an opinion supplier. A financial penalty poorly deters an actor who has no assets that can be reached. Second, an indemnity obligation creates a conflict between a taxpayer and an opinion supplier when a taxpayer is audited or expects to be audited because the financial cost of an adverse decision is borne by the opinion supplier. In the most recent run of tax shelters, once the legal risks in a shelter became apparent, many investors in shelters abandoned their reporting positions and sued the promoters, opinion suppliers, and other parties that facilitated the transaction. Third, the deterrent effect of a separate taxpayer penalty may be diminished if taxpayers are unable to assess accurately the legal risk in a reporting position. An indemnity obligation places this risk on actors who should be better informed about the legal risk. Finally, an indemnity obligation may be more palatable politically. Rather than dragooning professionals to police their client's reporting by the threat of third party sanctions, the government would merely insist that professionals hold their clients harmless when an opinion is erroneous.

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[67] For an argument for the efficacy of this strategy in deterring mass marketing of tax shelters see Mark Gergen, The Logic of Deterrence: Corporate Tax Shelters, 55 Tax Law Review 255 (2001).

[68] If the deficiency is excluded the penalty must be larger and so it is better that be included. The deficiency may be included by characterizing the liability of the opinion supplier as a species of warranty liability. If the liability is characterized as a species of misrepresentation, then the opinion supplier would not be liable for the deficiency because it is not caused by the misrepresentation.

As explained earlier, the choice between a negligence-based penalty and a strict liability penalty involves difficult trade-offs. A negligence-based penalty encourages reporting a less aggressive value than a strict liability penalty but with a significantly higher expected return. There may be other differences. A negligence-based penalty may have lower administrative costs because it reduces the number of cases where an opinion supplier is subject to an indemnity obligation. A negligence-based penalty also creates a potential conflict between an opinion supplier and a taxpayer when the indemnity obligation includes the deficiency. There is a potential conflict because liability for the deficiency shifts from the taxpayer to the opinion supplier if a position is found negligent. These differences are less significant if opinion suppliers (or their liability insurers) bear the cost of defending a position on audit and have the power to control the defense. This is standard in liability insurance.

Under a negligence-based valuation penalty, the taxpayer penalty would apply and the indemnity obligation would arise when the reported value exceeds a stipulated ratio of the assessed value. For example, in a case of over-valuation, the penalty might apply and the indemnity obligation would arise if the reported value was 150 percent or more of the assessed value. Comparable rules on overly aggressive legal positions would impose a penalty and an indemnity obligation when a court determined that a position had a probability of success below some defined threshold, e.g., a position reported as more likely than not merited no better than a prediction of a reasonable prospect of success. Breach of a standard of permissible error would be treated as negligence per se by an opinion supplier.

5. When the benefits of a third party penalty almost certainly outweigh the costs

While aggressive reporting on positions that involve legal or factual uncertainty is an endemic problem it probably is unwise to employ measures such as those described in Part Four globally.[69] Against the benefit of less aggressive reporting must be set the cost of opinions. There is the cost in resources expended by an opinion supplier in evaluating relevant law or facts. This is a deadweight loss unless the effort has non-tax value. Imposing a liability risk on opinion suppliers also has costs. Supplying an opinion on a matter of legal or factual uncertainty entails a risk even if the opinion supplier takes a moderate position. For example, in the case of the deduction item that is the basis for Diagram 10, if the appraiser reports the average of the possible values, then she faces a slightly greater than a one-in-eight chance that if the item is audited the reported value will be 150 percent or greater than the assessed value. One can think of this as the risk that the government will assign an improbably low value to the item. If opinion suppliers

[69] A global approach would look something like the current rules on the substantial understatement penalty adding an indemnity obligation on an opinion supplier. The audit and penalty rates would have to be structured to encourage taxpayers to obtain an opinion when reporting on an uncertain item that could result in a substantial understatement. At a minimum this would require a higher expected audit rate if the taxpayer did not obtain an opinion. There could also be a two tier penalty structure with a lower penalty if the understatement was supported by an opinion.

are permitted to insure against this risk, then they will pass through the cost of insurance to taxpayers. If they are not permitted to insure against this risk, then they will charge a premium. In either form, the resulting increase in the cost of an opinion partly spreads the loss when the government assigns an improbably low value to an item across all taxpayers in the relevant risk pool. But some of the increase will be a deadweight loss, such as the cost of writing and administering insurance contracts.

These costs generally magnify the deadweight cost of a tax when the tax consequences of a transaction are uncertain. One example illustrates the general point and suggests the complexity of the problem of determining whether the benefits of using third parties to police reporting outweigh the costs. Taxpayers who contribute art to a charity now are required to obtain an appraisal. Consider the consequences of making an appraiser liable for a small multiple of a deficiency resulting from over-valuing art. The cost of appraisals would rise, decreasing the benefit of donating art. Presumably some gifts that would otherwise be made would not be made because of the cost of an appraisal. Whatever benefits justify the charitable contribution deduction (itself a vexed question) would be lost in these cases. On the plus side of the ledger, art donated to charity would be less likely to be over-valued. While this also decreases the benefit of donating art, and so reduces giving at the margin, there are good reasons to think these consequences are largely positive. Insofar as lower valuation does not alter giving there is a revenue gain and no welfare loss. When lower valuation does reduce giving there is a welfare loss but presumably this loss is diminished by the fact that the benefit the taxpayer would have realized by making the contribution was insufficient to justify the contribution unless the taxpayer overstated the probable value of the gift and got a larger deduction than the probable value warranted.

Looking at the matter from a broader perspective, there is a reason to be skeptical that measures such as those proposed in Part Four will reduce the total cost of administering the tax law if applied globally. It is useful to distinguish between two types of decision regarding the expenditure of resources to determine tax liability when it is uncertain. One decision goes to the total amount of resources to be spent to resolve tax liability. The other decision goes to the allocation of those resources between the public and private sector. A rule making a positive opinion insurance against a deficiency assessment and penalties encourages taxpayers to expend resources to obtain positive opinions, increasing the expenditure of resources in the private sector. One would hope this increase could be matched by a decrease in resources spent in the public sector. But a decrease in public sector resources presumably means a decrease in the audit rate. A decrease in the audit rate undermines the effectiveness of the measures proposed in Part Four. To be effective the measures proposed in Part Four probably would require maintaining (or maybe even increasing) existing resources spent in the public sector while significantly increasing the expenditure of resources in the private sector to determine tax liability when it is uncertain.

More generally, it is almost certainly the case that tax underpayments should not be treated like socially harmful behavior such as pollution when compliance is costly to taxpayers or to the government. The reason is that the social cost of a tax underpayment is less than the amount of the underpayment. The social cost of a tax underpayment depends upon its fiscal effect. For example, if the government responds by raising the tax rate, then the social cost is the additional deadweight loss resulting from the increase in the tax rate. If the government responds by reducing expenditures, then the social cost is the benefit of that expenditure but offset by the benefit to the taxpayer of having additional resources. If the unpaid tax and foregone expenditure would have redistributed resources used for consumption from someone who is wealthy to someone who is poor, then the social cost is the additional welfare the poor person would have derived from consuming the resources.

Nevertheless, there are situations in which the benefits of a third party penalty almost certainly outweigh the costs. These are tax-driven transactions that entail significant transaction costs. In these situations, if the cost of obtaining an opinion deters a taxpayer from entering into the transaction, then this is to the good. A good candidate is family limited partnerships. This is a strategy to minimize the estate tax. To take a simple example, a parent who owns ranch land worth $10 million might put the land in a partnership structured to make the interests and the land illiquid. The parent then makes inter vivos gifts of fractional partnership interests to her heir. These interests would be discounted as illiquid minority interests. When the parent dies her remaining interest would be discounted as illiquid and because the outstanding minority interest makes the remaining interest less valuable. Many taxpayers who engage in these transactions take aggressive discounts. But some discount is appropriate because dividing interests in property, and imposing contractual restrictions on its liquidity, reduces the value of property. People destroy wealth in entering into family limited partnerships to reduce estate and gift taxes.

This paper suggests a way the government could strengthen its hand in the fight against family limited partnerships. Appraisals already are required. Amend Section 6995A to make an appraiser liable for a small multiple of the deficiency, say two or three times, if the assessed value is 150 percent or more of the appraised value. Require taxpayers to report the amount they pay for an appraisal. Appraisers will be less likely to aggressively under-value property. Or, when they are aggressive, they will charge more for the risk they bear. But appraisers and tax planners will know that a high fee may attract unwanted attention. Valuations will be less aggressive. Appraisers will charge for the risk they still bear and to compensate them for the additional effort in taking care in appraisals. The lower expected tax benefit and increased cost will deter some people from undertaking these transactions. And that is a good thing.

This strategy could be extended to other areas where it is desirable to deter the underlying transaction. An obvious candidate is listed transactions if the listings are sufficiently narrowly specified. This is a rather large if. Consider the listing of LILOs and SILOs. The Treasury has identified the key feature of a LILO and SILO that makes these transactions worrisome. It is the fact that the repayment obligation on the lease and the price of the repurchase option are fully defeased. This feature makes the transaction similar to a leveraged lease where the taxpayer (purchaser) gives the asset owner a nonrecourse note from the amount defeased. In other words, this feature makes a LILO and SILO resemble the old safe-harbor lease. The transaction is no more than a sale of tax benefits at fairly high transaction costs. Whatever one thinks about the merits of safe-harbor leasing,[70] it is bizarre to allow this to happen surreptitiously and using foreign assets and domestic publicly owned assets. For these reasons LILOs and SILOs seem a natural candidate for the strategy proposed in this essay. But the Notice listing LILOs and SILOs suggests Treasury does not understand why defeasance is so important and it can be interpreted to include some leveraged leases that have a genuine financing component. If so, then the strategy proposed in this essay would raise the cost of leveraged leasing across a broader range of transactions.

6. Conclusion

Aggressive reporting by taxpayers on items that involve legal or factual uncertainty is an endemic problem in tax law. While aggressive tax shelter opinions have attracted the most attention aggressive valuations backed up by aggressive appraisals probably are a greater problem. We cannot know for sure because it is very difficult for the government to police valuations. Taxpayers have an informational advantage and it is costly for the government to contest a valuation. If a taxpayer is audited, then she can expect to be able to settle on favorable terms. This essay shows that this problem is not solvable by increasing the audit rate, expending more resources to contest aggressive positions, and imposing a penalty that is the inverse of the audit rate when a substantial underpayment is found. Even at fairly high audit rates taxpayers are likely to continue to take aggressive positions when reporting items that involve legal or factual uncertainty because of the asymmetric treatment of overpayments and underpayments. Another solution beckons. This is to require taxpayers to obtain an opinion or appraisal supporting their position, imposing a penalty that is around 1/10th inverse of the audit rate on a taxpayer if there is a substantial underpayment, and requiring the opinion supplier to indemnify the taxpayer for this penalty. This strategy is likely to suppress aggressive reporting if the government also requires taxpayers to report the fee paid for an appraisal and announces a policy of auditing transactions with abnormally high fees. The problem with this strategy is that if applied globally it would significantly increase expenditures on tax compliance, which is a dubious good. But this strategy should be employed to deter tax motivated transactions that themselves are wasteful.

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[70] See Warren and Auerbach