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FORUM ON TAX SHELTERS

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SPEAKERS:

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PROCEEDINGS

MR. STEURLE: Eric is going to be followed by Donald Korb, who is the chief counsel of the Internal Revenue Service. He previously was a partner in the law firm of Thompson Hine and served as the assistant to the IRS Commissioner back in 1984 through '86. During that time he coordinated the IRS involvement in the Tax Reform Act of 1986, a piece of legislation which we have worked hard to undermine ever since. He has been a tax advisor to the Kemp Commission and also a tax partner at Coopers & Lybrand.

The last speaker will be Eric Solomon, deputy assistant secretary in the Office of Tax Policy at the Treasury Department. Previously he was a partner at Ernst & Young and before joining Ernst & Young served as the assistant chief counsel at the Internal Revenue Service. He's also practiced law in both Philadelphia and New York.

To moderate the discussion and lead in the questioning we are very fortunate to have Janet Novack, who is the Washington bureau chief of Forbes magazine and also an expert in her own right on tax policy and an individual who through her journalistic skills has set off several controversies here in town with such as articles as "Tax Shelter Hustlers" and "How to Cheat on Your Taxes."

She has written and studied extensively the complexity of the tax system as well as the alternative minimum tax. Before joining Forbes she was a journalist with the Dallas Times Herald and the

Philadelphia Bulletin.

Let me ask if Chris Bergin wants to add anything.

MR. BERGIN: No, thanks.

MR. STEURLE: Well, let me just turn it over to you, Janet.

MS. NOVACK: Well, I'm just going to give a little bit on a layman's perspective. The layman's perspective is that I think that the Tax Policy Center and Tax Analysts have very good timing because in just the last couple weeks we've had a few more recommendations from Joint Tax Committee and the Senate investigative subcommittee yesterday for further action on tax shelters. We've certainly come a long way in the debate. When we ran our first cover story about the growing promotion of abusive tax shelters some of the accounting industry said we were just trying to sell magazines which we were, of course, but also if anything had underestimated the size of the problem.

Today I think there is general agreement that the marketing of shelters got out of hand. The IRS says that one particularly heavily marketed ploy which is known as Son of Boss was used by thousands of taxpayers to escape more than 6 billion in tax.

The IRS admits it was slow to react. It has now moved aggressively against the promoters. Many shelter users are paying up. Promotion, particularly of high-end shelters, seems to be more restrained. We don't know what we don't know, of course. Thanks to the efforts of Treasury and Senate Finance we do have new rules, new penalties; they're churning out all sorts of new regs. But the real question now is have we done enough.

Well, as the gentlemen here are going to talk about, the government has recently lost some high-profile corporate shelter cases and litigation on high-end individual shelters such as Son of Boss is really just getting underway. We don't know yet whether the courts will uphold the penalties or even the taxes the IRS has asserted.

Two weeks ago in this wonderful 400-page report, probably must reading for anyone looking for revenue raisers -- it's got all sorts of suggestions to raise money -- Joint Tax came out with a new proposal for codifying the notion that a transaction that saves you a lot of tax should have some economic substance, some point, beyond just saving you a lot of tax. And yesterday the Senate investigative subcommittee in a bipartisan report called for writing economic substance into the tax code and that is something that, of course the Treasury does not agree with.

One reason that getting this enforcement balance right is so difficult is, frankly, Americans' attitude towards tax avoidance. I was recently interviewing someone who had used Son of Boss to save tens of millions in tax and he is now settling with the IRS. This is what he said to me. This is a direct quote.

"You and I know shelters are not new. It's impossible to close

every loophole. Good accountants, good CPAs, and good tax attorneys, it's their job to find these loopholes for their clients. At the end of the day if it works, terrific. What's the worst that's going to happen? I'm going to pay my tax."

Well, as long as we have a complicated tax code, a prevailing ethic that says hey, if it works it's fine, and a very low audit rate people are going to push the edge. That is why where we draw the line and how we enforce our rules and what sanctions we need to keep shelters at least in check is so crucial. And I think that this panel is uniquely qualified to answer those questions and I look forward to hearing what they have to say.

MR. TODER: Thank you very much. Just to introduce myself, I'm an economist and not a tax lawyer and the transactions that we'll be talking about today I read them and my eyes glaze over. They're extremely complex and I will leave that very technical discussion to the other panelists.

What I would like to do is just give an overview of where shelters fit in in terms of the larger world so I'll talk very briefly about trends in corporate tax revenues and I've passed out a couple of charts about overall estimates of noncompliance and speculate a little bit about how much of that is due to shelters, make some general comments on tax avoidance, what is a tax shelter, and a few general comments on what to do about them.

Corporate revenues as a percent of GDP is very low relative to 40 years ago but most of that drop actually occurred between 1960 and 1980. It's been stable since 1980 except for an up tick in the late '90s and a bit of a down tick in the last few years but it's coming back up by 2004.

Corporate receipts as a share of economic profits, and there's an awful lot of ambiguity with that measure, a drop between 1960 and '80 but has been stable since 1980 if you look at five-year periods except for a job in 2000 to 2004. That figure has also come back up, though, in 2004.

Why did corporate revenues fall? Previously it was partly corporate profits, the GDP falling because of rising corporate debt shares and the growth of the noncorporate sector among other things, also a lower ratio of taxes to corporate profits which reflected both tax law changes and increased international investment. More recently what affects the ratio changes of taxes to profits are a lot of things, tax law changes in recent years, a bonus depreciation dropped that ratio, differences in accounting rules, which are, again, perfectly legal, things like treatment of nonqualified stock options which don't reduce a company's profits but do reduce their taxable profits, and in some cases aggressive financial or tax reporting.

There is a potential that tax shelters have also contributed to some of that decline and there have been bits and pieces of evidence but there's nothing that I can say that's conclusive about that. There have been some articles in Tax Notes by Marty Sullivan that suggest some shifting of income to tax havens but, again, how much that is all affecting the overall picture is hard to say.

The next topic I want to turn to briefly is estimates of noncompliance generally. The IRS latest estimates for tax year 2001 was the gross tax gap, which is the tax that people owe but do not pay timely, was \$311 billion. Some of that will come back through late tax payments and enforcement activities so the net tax gap is about 50-55 billion less than that but 311 billion is the overall measure of absence of voluntary compliance. Of that amount under-reporting is 249 billion; that's about 80 percent of it. The rest of it is nonfiling, which really doesn't apply to the large corporate sector, and late payments for those who IRS knows they owe money but they haven't coughed it up.

Of that 249 billion of under-reporting, and there's a chart in your handout, the corporate under-reporting is estimated to be \$30 billion of which 25 billion is large corporations and 5 is small corporations. So when you're talking about corporate under-reporting in the aggregate as estimated by IRS it's less than 10 percent of the tax gap.

In comparison another figure is that the estimated noncompliance rate of corporations relative to what they should have paid, the latest figures was 17.6 percent, which is not insignificant. All taxpayers are around 15 percent.

These estimates come mostly from old TMCP data. Since large corporations are audited fairly regularly the numbers for large corporations some of the internal things I heard were that if it were done now it wouldn't be all that different for large corporations.

It's worth saying something about the bias in these numbers. What these numbers measure is what IRS auditors' recommendations are for increased taxes so that has two biases that are offsetting.

One, it does not count the stuff that IRS auditors miss so it understates the gap in that way. But it also doesn't take account of the fact that not all of those recommendations will be sustained and so in that sense it overstates the gap. So whether it's net, plus, or minus I really can't tell.

MR. SOLOMON: But I just want to emphasize the point you made. My understanding is that these are based on numbers that are 15 years old, approximately? Is that correct?

MR. TODER: These are old but I am told that the update of the large corporate numbers since people have looked at those numbers and just haven't put out a new report that if they did the large corporate figures would not be all that different.

Now, what part of that is due to abusive shelters? This gap comes from a lot of things, nonreporting income, overstating deductible expenses, inappropriate reporting of legitimate transactions such as inappropriate reporting of depreciation or inappropriate transfer pricing rules and so forth, things that are not typically considered in the abusive shelter category.

Abusive shelters are thought to be complicated transactions

promoted to large corporations and wealthy individuals that may arguably conform to the letter of the law but provide unintended benefits and would not be undertaken except for the tax system. Now, that definition is obviously very subjective. It depends on what you think would not be undertaken except for the tax system and means it depends on what you think "unintended" means. It's like pornography, I guess. A lot of people know it when they see it and there's certainly a lot of it going on that can be clearly identified.

Unfortunately we lack good estimates of the size of this problem. One academic some years ago estimated the government lost 10 billion a year from tax shelters and lots of people cite that estimate but I've never been able to figure out how it came about.

IRS did a study which IRS did not release but GAO reported on this study that showed from 1993 to 1999 an annual gap between 11.6 and 15 billion a year. GAO said in their report that the reliability of the estimates is suspect due to data and methodological constraints. I'll talk more about that later if anyone's interested. The question, of course, is whether that 11 to 15 billion if in fact that is the right number is a subset of the \$30 billion total corporate gap or should be added to it. In principle it's a subset of the gap because the audits are supposed to cover everything, including shelters and everything else, but if shelters are rising it could be that the gap is bigger as well and that's something we, again, don't know.

Shelters and tax avoidance, just as an economist you can think of shelters as one of a number of responses to avoid paying taxes which come from real economic responses like shifting your investments or working less to portfolio responses to changes in the timing of reporting income. Shelters are not the only, of course, abusive transaction. The IRS is also dealing with simple misreporting, sometimes very complex, such as the use of offshore credit cards to hide income. There's a big effort in the IRS underway on that.

But my point is that these responses are all substitutes for each other and when you have a period in the 1990s when corporate profits are rising and there's a lot of income around to shelter there is an incentive to use more of each of them alternatively. If you make it more difficult to shelter there will be some other economic substitutions that will take place.

What to do about shelters? Do a better job of finding them. We'll hear more about that and legislation, whether we should codify the common law doctrines. And one other thing that is probably worth some discussion is tax policy changes because tax policy and tax administration are not separate animals. They are related to each other.

When you pass a bill that says manufacturing is taxed at a lower rate than other corporate activities you do give rise to the potential for additional tax shelters. Tax shelters work off inconsistencies in the code. In an international and complex world having inconsistencies getting rid of all of the inconsistencies is impossible but we should certainly try to minimize them whenever we

have a chance.

MS. NOVACK: Thank you.

Mr. Korb, were you going to go next?

MR. KORB: Actually, what I'm going to talk about, Eric did help me prepare this a couple of years ago. There's a outline in the materials here that I prepared before I became chief counsel. My views are the same but it is a little dated because there's been some legislative activity since and some case law activity. But I think it's a useful tool and I'm going to refer to it here because the themes are pretty much the same. You'll find as you get to know me I don't really change my views no matter which side of the street I'm on. Your views are your views.

First I'm just going to point out a couple of things here and I will refer to the pages if you want to look at it later. One thing I find fascinating is let's not kid ourselves. Tax advisors have been figuring ways to reduce taxpayers' liabilities forever. I have four examples on the front page here.

Look the first one. In ancient Rome farmers of small farms would obtain tax relief by transferring their lands to the nearest military chief or large land owner and rid themselves of tax obligations. The peasant farmer was better off. Tied to the land anyway, he could live in the same house, farm the same land, and use the same animals. Only the tax picture changed. The Roman tax man would now have to deal with the small farmer's master, who had the wherewithal to handle a Roman tax man so it was like 1 BC version of sale leaseback. You could see the 1 BC version of the Big Four running around the Roman Empire marketing this thing.

There's another one here. I like this one. During the Middle Ages in Syria, Egypt, and other areas of the Islamic world the land tax could be avoided by newly conquered native populations if they became Muslims. Unfortunately for the tax collectors people caught on and you had mass conversions of the population whenever they showed up and they had to change the law; otherwise their revenue was going to go down.

And finally if you go to Charleston, South Carolina, today you can see very good evidence of tax shelters that were created back in the 1820s and '30s. You'll go down certain streets and you'll notice the houses have about a 10-foot frontage on the street but they're about 60 feet deep. Now, why did that happen?

Well, in those days the real estate tax was not based on the value of the land or the value of the improvement. It was based on the frontage of the structure on the street. So you could see the Charleston tax lawyers and accountants club in 1830 sitting around talking about the latest thing they're going to be marketing to all their clients, build these long, narrow houses. So this is something that's been going on forever, number 1.

Number 2, Eric T. talked a little bit about this. On page 2 the way I view tax shelters is there are three groupings and we'll see if

Eric agrees with this. Number 1, you have the legitimate tax shelters and these are tax-favored investments clearly sanctioned by the code. Nobody will disagree with that. That's one end of the spectrum.

On the other end of the spectrum, though, you have these abusive tax shelters and I thought Eric T. had a very good definition here. I like Michael Graetz's, "a deal done by very smart people that absent tax considerations would be very stupid."

So you have that group. It's this middle ground, that gray area, where the results sought by the taxpayers may be available under current law but the tax preference is in fact unintended and this is really the battleground, if you will, where controversies are.

By the way, this paper was designed to be Tax Shelters 101. I've used this talk a number of times at law schools around the country. I actually gave it last night at American University to set the stage so students could understand how we got where we are today and what we do about it.

One of themes that you'll see running from pages 7 to maybe 44 is really fascinating. When you compare the response of the government to the individual tax shelter problem that existed in the late '70s and early '80s to the response today you see some incredible parallels.

Now, what am I talking about? Usually when I talk to younger audiences they don't know what the hell I'm talking about when I talk about the old days but this crowd is old enough that you can remember the heyday of the individual tax shelters, the late '70s-early '80s. It was a gigantic problem. We had 80,000 cases in the tax court when I was there the last time compared with roughly 15-20,000 normally today, huge problem. It was gnawing at the tax system.

What was the response? Well, you had judicial response. You trotted out all these judicial doctrines. As you look back there was a number of cases that came out of that period where they were used, economic substance, sham, all that kind of thing. That was one way to do it.

Another way was the congressional response. Starting in '76 and continuing in '78 and '80-'81 what they would do is they would identify specific problems and they would tinker and they would change the law, at-risk rule, nonrecourse financing because Ms. Crane in the famous footnote and Supreme Court case in the '30s led to the magic of leverage. They decided to deal with that and they put an at-risk rule that applied to everything but real estate.

Again, those of you who are old enough to remember back before 1976, the last week in December was a very busy week for tax lawyers. What were you doing? You were setting up partnerships because in those days, believe it or not, you could become a partner in a partnership on December 31 and get a full year of losses; that was the law. So they changed that, a number of individual targeted things. It didn't work.

In TEFRA 1982 let's change this around now. Let's start putting

new penalties in. Let's put in this substantial understatement penalty. Let's go at it that way. Let's make promoters register these things. It didn't work.

Ethical rules, let's amend 230. Let's get the ABA tax section to amend its ethical rules to point out to lawyers, accountants, et cetera you're not supposed to be doing this kind of stuff. It didn't work. What it took was the passive loss rule, Section 469, which shut it down overnight, and there are some people in this audience who worked on that. That's what it did and that industry disappeared overnight.

Let's fast forward now. We have this new insidious version of tax shelters. I think Eric T really hit the nail on the head. What it is is taking a series of code provisions and pieces of transactions, each one of which may work, putting them together in one transaction which anybody who looked at it would say that's not supposed to work. That's my personal view. That's when you get to the heart of the matter of what's going on here. You'll see in this paper I talk about different indicia of tax shelters, different building blocks. It's all the same way of saying the same thing.

So what have we done? Right in the '90s the first thing, we do is we tried out the same case law. Every 20 years we bring this out to deal with it and we've had mixed success. Long-term will prevail but in the short term mixed success. The other thing that has happened is Congress deals with very specific abuses. You go in there, you stop this, you stop that, like putting the finger in the dike.

On the administrative front we've really expanded that dramatically and I'll talk a little bit about what we're doing at the Service but also in the code with penalties, registration, list maintenance, all this kind of stuff. We've got to sit back and ask ourselves. You can see the parallel. Haven't taken the final step. Is there some final step that needs to be taken to really drive a stake in the heart of these things? So I think that's pretty informative. Remember, you're a product of varying experiences. History means something so let's learn from the history.

Now, what have we done from the Service perspective? Eric I'm sure will talk about it from a policy perspective but I'm talking about administrative here. I think the Service has done a great job here. I've only been on this job 10 months so most of my views were formed before I got here. But I could see how this was developing and I thought they were doing a very good job in a lot of respects.

They set up this Office of Tax Shelter Analysis to coordinate all this work. Taking Treasury's lead, people like Pam Olson and Eric, they decided that transparency, sunshine, is one of the best way to deal with this so we have all these disclosure rules and registration rules and list maintenance rules.

The idea is the way I always did it with my clients. Let's pretend the IRS revenue agent is sitting right here in the room as we're planning this transaction. Would we be afraid to sit there and explain why this works? And that's all good.

Penalties, there's work being done on penalties here. I think you can reach a limit. You can do too much in terms of penalties but I think there's been some good tightening there. To me one of the smartest things that was ever done, and this was the last Tax Analyst seminar, was the accrual work paper Announcement 2002-63. There were four circumstances where the IRS would no longer follow its practice of restraining itself in seeking the tax accrual work papers of the accounting firms.

In the Arthur Young 1984 Supreme Court case we had the absolute right to seek those papers but the IRS for a lot of good reasons has only done it in very unusual circumstances. I thought it was a brilliant idea in four very limited cases to say that rule's going to change and they all revolved around listed transactions.

I saw personally before I got here, the impact that had because it changed the calculus on the companies. Again, before I got here. At some point once you're a contact you've got to stop working but I was still allowed to go, for example, with clients to corporate boards to talk about transactions. I saw at least two situations where companies decided not to do a transaction that probably would have worked if it had been changed somewhat. But their concern was the IRS would list it as a listed transaction, they already had one other listed transaction on their tax return, and they'd have to turn over the accrual work papers showing all the soft spots in the return so they did not make that investment. I thought that was powerful so I think the Service did a great job in that and you can refer back to the last time we did this. There were articles about it.

Circular 230, I think there now you're trying to develop standards that should be followed by practitioners so it's our first line of defense so people understand it's not their professional responsibility to go out and develop and market these things. There are certain rules they've got to follow.

All of this in my view comes down to we've lost the battle when the tax shelter has been sold because then we've got to clean it up. Then we've got to deal with 500 or 400 Son of Boss cases. I'd much rather have rules out there that stop the activity very much like Section 469 basically stopped the tax shelter industry in those days.

One other comment and that is I think what's been overlooked here, and I cover it in this paper at the end, 44 and 45, is the marketplace response. I'm not talking about the market responding to not market these tax shelters. That's one response. The response I'm talking about is lawsuits against Big Four accounting firms, investment banks, and law firms who did this kind of thing.

I think that has the potential for doing much more to stop this activity than anything else because people don't like to reach in their pockets and pay huge amounts of money because they've done something they shouldn't have done. So I think that's something we all ought to keep our eye on here and see how these cases develop.

Another response of the market, just to give another example, is the second opinions that a lot of corporate board audit committees

are now asking. In other words they're not accepting the marketer of the particular idea as being the final word. They're looking for advice, having a second opinion. So those are two very good examples where the market is responding to this in a very positive way.

MS. NOVACK: And I hope that when we have questions you'll answer on is there something else we need to do and what it is.

MR. SOLOMON: First I need to apologize. I need to leave at 10:00 o'clock so when I stand up and walk out the door I do not intend to make a statement in any aspect other than I need to go. So first please accept my apologies for having to leave at 10:00. The second thing is Janet and I have never met but I wanted to express my personal thanks particularly for your article in 1998.

I joined the Treasury Department in 1999 and it is true that for a significant period of time there was a variety of people who would argue that there was no tax shelter problem at all. There was a need to make public that an issue existed in order to move forward on these issues. So I sincerely want to thank you particularly for the first article, "The Hustling of X-Rated Shelters," because that was one of the first times in which it was made public that there actually was a problem. And it did take a significant period of time in order for the general public and practitioners to recognize that there was a problem that needed to be addressed. So I do want to thank you for your work in this regard.

One other point, I just want to emphasize that we spend a lot of time talking about technical tax shelters, talking about the transactions that you've described up on this panel. I call them technical tax shelters. I just want to point out it's just one aspect of the compliance issues that we face. We can talk about all sorts of categories besides these intricate tax shelters that involve both corporations and individuals as they are described by Eric and Don.

But there are also, of course, scams and schemes, that is to say, various arguments or assertions that taxpayers make that really have no basis in the law at all. And then there is what I'll call the traditional noncompliance of under-reporting, non-reporting, et cetera. So this is just one aspect of the many compliance issues that we face and so today we're really only talking about I think just one aspect of larger compliance issues.

The next point I just want to emphasize at the beginning is as in all matters that we deal with in the government there's a question of balance. Whenever decisions are made as to what policies we might adopt there's the question of trying to reach the appropriate balance.

Let's talk about technical tax shelters. We're not talking about all taxpayers. We're talking about a very small minority of taxpayers. Yes, there may have been a time where it was becoming much more prevalent but most taxpayers pay their taxes. We have a voluntary tax system; it's the best in the world. We are dealing with a minority of taxpayers and we need to prevent that minority of taxpayers from engaging in these transactions.

At the same time we have to be sensitive. While we're trying to shut down this behavior we have to be sensitive to the burdens that we place on the vast majority of taxpayers and practitioners and striking that balance and striking it correctly we always have to keep our eye on it. It's extremely important because the burdens of our tax system, the burdens of compliance, the burdens of complexity, are things that we constantly have to understand and be vigilant about.

One other thing, I don't know whether we're going to talk about it but what's the current trend? What's going on with tax shelters now? There's always a momentum in these things; that is to say, looking back five years, no one would admit there was a problem. Now we admit that there has been a problem and the question I pose to all of us now is well, what is the nature of the problem today. Yes, there are scams and schemes; there's under-reporting, nonreporting but, talking about specifically technically tax shelters, I would be interested in people's views with respect to the prevalence of these technical tax shelters.

I think the key aspect of technical tax shelters is marketing. Marketing is the key aspect. There are always sophisticated transactions that are done for taxpayers and there are always transactions planned maybe on one side of the line or the other side of the line. But I think the key aspect of the trends that we've seen in the last five years is marketing what they call tax products. I think a key aspect of dealing with these issues is stopping the marketing.

So the question I pose is with all the things that have happened in the last couple of years has the marketing been substantially reduced. That's a question I ask all of us. I say what are you hearing? Is the marketing continuing?

I must say anecdotally we are not hearing of this extensive marketing as occurred before but to me that's an essential part. That is to say, money is made on tax shelters, particularly for those who promote these, from marketing them to many people and if you prevent these transactions from being marketed to many people in some ways you cut off the supply. And so if one is successful in cutting off the supply you may have a very positive impact with respect to tax shelters.

Now, everybody up here I think has defined a tax shelter and I think a technical tax shelter. I'll give you my definition and I think it's going to sound a whole lot like Eric and Don's definition. In my view it's a tax-engineered transaction normally with little business purpose except to save taxes with minimal risk or profit potential often designed to create a tax loss without an economic loss or in some cases to make income nontaxable.

Looking at the majority, if I had to describe in my view what the majority of the technical tax shelters were, they're loss generators, generally transactions that create a tax loss without a book loss. Sometimes there would be situations where you'd have a loss and an offsetting income and the income would get allocated to a tax-indifferent party and the loss would be allocated to the taxpayer

who needs a loss. Certainly the most notorious are the tax-loss generators and usually they're without a book loss.

A tax shelter is often based on a literal reading of the code and the mechanical application of a series of code provisions with a result contrary to what Congress intended. We can all define a tax shelter generally but, as Eric said, you know it when you see it.

The basic problem that we have here is we have a fundamental tension in the tax law. We have a tax code that has specific words that talk about the taking of property from the American people. That is to say, the government raises revenues and all of us should know our responsibilities to pay taxes so there's an obligation on the government to be clear about its rules. But by having literal words people generally should be able to rely on the literal words. But having such literal words creates opportunities for taxpayers to follow the literal rules yet to get opportunities to get tax benefits that Congress did not intend.

So we have a fundamental tension in our tax code between literal words and it's too good to be true. The question is in any particular set of facts and with respect to any area of the law implicated it's understanding what should control, the literal words or whether the sense of what Congress intended should control.

The bottom line is we're not going to have a straight answer in every single case. It's going to depend upon the facts and circumstances of the particular case and the area of the tax law that's implicated to know what the answer should be. In certain cases there are going to be differing views.

I think, Don, you talked about that vast middle area. If you just describe that again just for a moment in this vast middle area it may not be absolutely clear but there certainly is a category of cases as I described where transactions are entered into that follow the literal words that are clearly contrary to what Congress intended and those are tax shelters that should not withstand scrutiny.

One other aspect of this is the complexity of our tax laws. Our tax laws are very complex, I think, for a couple of reasons. One reason is because we have a very complicated economy and we need to have clear rules so everyone knows their obligation so that leads to complexity. But another reason for complexity is that our tax code has social purposes embedded in it and there are various purposes beyond the raising of revenue reflected in our tax code.

All this complexity contributes to the opportunity and ability for taxpayers to engineer sophisticated transactions, technical tax shelters. So in part the complexity of our code, which in fact burdens all of us and creates great compliance difficulties both for taxpayers and the IRS, is the source of the problem. And, as I mentioned before, marketing contributes to the problem and if you can stop marketing I think it would go a long way to stopping technical tax shelters.

As Eric and Don perhaps described, the Treasury focus and the IRS focus has been, and this goes back to some Treasury proposals in

March 2002, deterrence by disclosure. As Don said, stopping these things before they happen is the best evidence. Cleaning up afterwards through audit and litigation is extremely inefficient so I want to echo Don's point on that. Deterrence by disclosure is the most important way to deal with this.

What we've tried to do is create the web of disclosure. I'm sure you are all aware of the various disclosure rules for taxpayers and practitioners. In addition recently we revised the M-3. We created an M-3, which is to disclose book tax differences on tax returns, particularly on corporate tax returns, and again it goes back to my comment before with respect to book tax differences. The loss generators were intended to create tax deductions without book losses so the revision to the M-3 again will help with this notion of transparency. These things will be clear on the tax return. The notion is to shine the light on these transactions so that taxpayers know if they're thinking about entering into it they're going to have to disclose it and thus there will be deterrence.

Another focus that Treasury and the IRS have had is, again, to prevent the marketing and therefore focus on promoters as well as taxpayers. I know the IRS has been very vigilant with respect to promoter audits. Don mentioned Circular 230, the recent final regulations there.

Perhaps the greatest success that Treasury and the IRS have had is with respect to listed transactions, again clear statements as to particular transactions that the IRS and Treasury think are not appropriate transactions. There are about 30 listed transactions and I would say in terms of giving clear indications to taxpayers the listed transactions in my view has been the most successful aspect. It goes back to Notice 99-59, which was the very first one, and there have been 29 since then.

Again, just a couple of points just to repeat a point I made before, at the same time we're thinking of ways how to deal with these issues we always have to take into account the burden that we impose and we always have to be flexible and be willing to make adjustments to the rules that we write in order to be more effective. You always have to be flexible to make adjustments as necessary and appropriate to make the rules more effective.

With respect to where the Treasury is right now, as I said, March 2002 the Treasury proposals were in a little white paper and largely the Treasury approach was adopting the JOBS Act that says the notion of more disclosure and penalties if you fail to disclose. With respect to incentives or motivations that may exist now with respect to whether taxpayers would be interested in considering these aggressive transactions, I think there's been a number of factors right now that in my view would discourage taxpayers. First is all the activity by the IRS in the last few years. Certainly when the cop is on the beat it makes a difference and therefore, it discourages taxpayers from entering into aggressive transactions.

In addition, again thanking Janet, the press stories have been instrumental. No one wants to be on the front cover of the Wall Street Journal or on any other leading publication. I think the Enron

debacle has made a difference. Sarbanes-Oxley has clearly made a difference.

The legislation of creating meaningful disincentives for taxpayers and promoters to engage in these transactions makes a difference and finally I think something that Don referred to, the suits the taxpayers are bringing against promoters. So I think all of those things have contributed to change the current environment.

With that I'll stop.

MS. NOVACK: Well, I have lots of questions but since you have to leave at 10:00 I think in fairness we should throw it open to the audience first to make sure they can ask you any of their pressing questions.

QUESTION: This is for Eric Solomon. I'm David Brunori with Tax Analysts. Given your definition of tax shelters, do you support an economic substance requirement and why does Treasury oppose it, as Janet mentioned before?

MR. SOLOMON: Well, it goes to the definition of what is a tax shelter. A tax shelter has this fundamental tension, as I said, between code rules and judicial doctrines, economic substance and judicial doctrine. Whether something is a tax shelter and whether something should be struck down under the judicial doctrine of economic substance, as I said, should depend upon the facts and circumstances of the case and the particular area of the law that's implicated.

Trying to codify a judicial flexible doctrine that the courts have applied to all the varying different facts and circumstances and all the varying aspects of the Internal Revenue Code that could be implicated in my view would not advance the ball. It wouldn't give any more clear definition to when something should be sustained or when something should fail because again in my view these judicial doctrines their application depends upon the facts and circumstances of the case and the area of the law that's specifically implicated; therefore, to take the doctrine and take it out of a judicial doctrine and put it into law is not going to answer the fundamental question any better.

Former IRS Commissioner Donald Alexander QUESTION: Eric, I think you're doing a great job, in fact all three jobs, and I hope you get paid for all three of them.

MR. SOLOMON: I'm going to hire you to represent me.

QUESTION: I do have a problem with one expression you used. I think you called that tax system a voluntary --

(Interruption)

QUESTION: -- if we could call them illegal protesters. I guess we can't use those words any more? I think that's the pitch they're making and I'm sure you don't want to associate yourself with that.

MR. SOLOMON: And I take your point. That is to say we all file our tax returns on April 15th and all. We are willing to put down the amount we owe. But I do agree that an aspect of it is that we are required to pay our taxes and so I do second your point that it is a matter of a law that we are required to pay our taxes. And when we don't pay our taxes then the IRS rightfully takes enforcement measures. You're absolutely right.

I would go even further and say the fact that we have as high as 85 percent estimated compliance is because a whole lot of income is withheld at the source or matched so it's very easy for the IRS to check. The compliance problems we have are largely in the areas where the IRS does not have that ability.

QUESTION: Like the cop on the beat statement that you made, Eric, I've got one last little question. When are we going to get some new data to replace this mythical \$311 billion tax gap?

MR. SOLOMON: That's for me, I guess.

QUESTION: That's for you.

MR. SOLOMON: The NRP database will only improve the measure of individual compliance. It's not on anything else. But individual reporting is a big piece of noncompliance. That study has been completed. IRS has the database. I'm not privy to what shape it's in or when they feel they'll be able to release numbers or when they will have done enough analysis but the audits are all done so that process is on the way.

QUESTION: Could I ask Mr. Korb about that?

MR. KORB: I really can't add anything in terms of timing but the data are being looked at. Keep in mind it's already three years old but that always was true in the old days of TCMP and you just have to stay tuned on that. I suspect there are going to be some hearings in the spring where that will be discussed.

QUESTION: I wonder where the noncompliance with the earned income tax credit fits in compared to other evasions or avoidance of taxes and if there are any estimates among the experts of what the benefit cost comparisons are between cracking down on that aspect of tax avoidance and other aspects of tax avoidance.

MR. TODER: I'll take a crack at that. When you talk about benefit cost you can look at it in one or two ways. You can say how much dollars do you get for every dollar of enforcement effort expended in a narrow sense or you look at it broader as to what kind of noncompliance do we care about the most. We obviously don't care about all kinds of noncompliance the same.

If we really wanted to maximize the benefit cost we would be spending a whole lot more resources on collection of stuff that we already know is due and on working cases that are automated under-reported cases where we've identified -- I'm no longer with the IRS; I shouldn't you use the word "we" -- they have already identified how much is owed but just haven't got enough people working for them to

work all those cases. Those have an extremely high return.

The shelter cases have a very high potential return but they're also very difficult to work. If you look at the return on corporate audits it certainly is significant but it's not on the order of the return from those automated cases. Now, in the case of the EITC there was congressional pressure and for a long time special congressional funding to spend more on EITC enforcement. If you were looking at it purely from a tax code matter you would not be spending as much on EITC probably, relative to other things although it is true there is a fairly high return, not very high, not like the automated cases, but a reasonable return, per dollar on EITC cases.

I think it's more the case that people view it as a social program than as a tax provision and compared to other social programs the monitoring of the EITC is not great. Compared to tax programs if we were just trying to look at the tax system alone and not look at it as a social program we probably would not be justified spending as much as we do on the EITC but there are different perspectives and I think that's more how the political system views money we're giving out as opposed to money we're not taking in.

QUESTION: This question is for Mr. Korb directly but I can open it up to the panel as well. In the excellent summary handout that you had for discussion of different ways of structuring tax shelters one of the interesting things that I notice in here is you've got indications of new style corporate tax shelters and number 4 is presence of a tax transparent entity because of the check the box regulations.

Could you draw that out a little more? I think that's an interesting concept and I'm curious to see how that's been used especially since LLCs for the most part, came about after the '86 reform.

MR. KORB: Right. Which page is it on there? Page 10, take a look at page 10. What I was trying to do here was just to set the stage for the next part of the discussion and give some indicia of factors that are present. Really 3 and 4 go together because we see a lot of where you create an entity where you're trying to obviously put income to a party that doesn't pay any tax and you want your deducts to go to a tax-paying entity.

I think it was Harry Helmsley who was the first to really understand the value of a transparent entity, meaning a limited partnership, in the late 1940s. He got it and understood what a great vehicle this is. This is a vehicle where you can invest in a property, number one, but you don't have to put your personal assets at stake. You can have an ownership interest but you can't lose any money. That's the nature of being a limited partner. You combine that with the function of leverage and nonrecourse loans and you wonder why we had the problem that existed until about 1986.

When the IRS decided to go to the check the box it opened up that possibility again. Well, now you had a new type of transparent entity that could be used where you could have a legal entity for state law tax purposes, for contract law purposes, for all these

other things yet for tax purposes is ignored and it led to the same kind of thing so that's what I'm talking about.

QUESTION:

MR. KORB: Right but also there's another effect. Look at number 6, Convoluted Structure of the Transaction, well, what happens when you look at these things in the old days when they were going after organized crime you'd have these charts and you'd show how the mob worked and you had all these arrows and spider webs, well, it was the same kind of thing with these deals, the way they were done. You'd have these convoluted structures. So really, 3, 4, and 6 all fit together.

QUESTION: I'd like to ask about the involvement of tax-exempt entities as either accommodation parties or more specifically even potentially as promoters. There was some hints that the IRS was looking at certain exempt entities even in a promoter role and I'm just wondering if there's anything you're prepared to say about what you're finding out about public charities, social welfare organizations, pension funds.

There's been some release of information from the Hill recently suggesting they're becoming quite concerned and I would
57 just like to see how you're looking at this and how you're thinking about it.

MR. KORB: What you ought to do is take a look at our website. I gave a major speech on this very point in Boston at the end of September at the ABA Tax Section. This was the theme.

Again, you're a product of your own experiences. I saw this developing in practice. Again, this is the tax-indifferent parties. They weren't satisfied going with the foreign entities so now they went on shore here and came up with this great idea that you could bring in an entity that's not subject to tax and you could bifurcate the economics of the deal you're cooking up here.

And it gets worse for a lot of these charities. All they get out of it is a fee. They get X number of millions of dollars; that's it. And it's not just charities. Cities are doing this same thing. Silos are a good example so it's a huge problem.

Now, fortunately this is one that was caught early on. If you look at the commissioner's strategic plan he's picked out four major things and this is one of the four to focus on the use of tax-indifferent parties in promoting and furthering these tax shelters. So yes, it's very important. I think if you're to look at the listed transactions a surprising number deal with the type of entity you're talking about being somewhere in the transaction.

It's going to be very visible. There was a hearing I attended with Mark back in I think June. The Senate Finance Committee had a hearing on this sometime in there and you're going to see more of that, no question about it.

MR. SOLOMON: But when you go through the listed transactions

there are two different animals here. Many of them have tax-indifferent parties and we've got to distinguish. As I described, you shunt the income off to a tax-indifferent party and the loss is off to the tax-sensitive party. That's a larger circle. Then there's the smaller circle of tax-exempt entities, that is to say what we call traditional 501(c)(3)s or similar kinds of charities. So those are two different groups.

One thing of interest, the report that came out yesterday from the Senate investigation committee describes one of those transactions, an S-corporation situation where you would have a tax-exempt entity as an S-corporation shareholder for a period of time to soak up some income. So again there is the larger category of tax indifferent parties and a smaller category of, for example, charities and, of course, they always have to worry about UBIT, unrelated business income tax. They have to avoid that to be a participant that can avoid taxation on income.

QUESTION: The UBIT rule is any kind of expense outside the S-corp area where they have to * * * because that's going to generate UBIT. It doesn't seem to me that it's clear at all * * *

MR. SOLOMON: Correct. Another point of emphasis here. Charities are very important in our country. Again, I would probably believe that it's a very small group of charities that may be engaging in this activity, so I don't want to be painting a broad brush here. Charities are very important to our country and they do wonderful things so that is an important point but in addition yes, the UBIT rules in some cases may not be enough protection against tax-exempt entities engaging in transactions.

MS. NOVACK: May I ask a follow-up there too? Is it possible as you look more deeply at the tax-exempt involvement that there are certain types of tax exempts such as certain types of supporting orgs that are simply too susceptible to abuse and they need to simply be outlawed or severely restricted?

MR. KORB: See, I think that's a whole different issue. I think that is a question in and of itself. Are there abuses in the private foundation and the tax-exempt area that really aren't tax shelters? Again, that is something being focused on quite extensively.

Again, go back and look at that speech I gave because I outlined exactly the kind of thing you're talking about, Janet. It went through the laundry list of all the things that were being done. Tax shelters, as Eric said, actually is a pretty small piece of it but we've got to be careful it doesn't get out of hand.

So this is one, I think, where we got ahead of the curve on. Wouldn't you say that, Eric? As soon as it surfaced I think people were warned about it and that's the best thing to do is to prevent it from happening.

MS. NOVACK: But I do think we've seen a pattern of promoters moving from one entity to another just a step ahead of the IRS. Oh, trusts, they're not on any partnerships? Oh, tax-exempts. So it might be that there are certain entities that just shouldn't be there.

MR. KORB: Well, let me tell you one thing that we're looking at very seriously. Again, look at history here. History is '86 everyone thought it really shut it down and it did for a while but promoters moved on. Well, they're moving on now.

What we're trying to do is not just think about today's problem; we're trying to think about five years from now where the promoters are going to be next so when they show up we're waiting for them. That's going to be the sea change in how we're going to function. I think that could be very powerful.

MS. NOVACK: I should actually have the question-people identify themselves.

QUESTION: Gene Steuerle, The Urban Institute. The charitable case gives rise to a question that I often ask. It has to do with the role of both the professional and perhaps even at some point the legal role of the accountant in reporting, an example being if I'm giving to a charity I might really be concerned whether that charity is engaged in some of these tax-shelter transactions. It may be the type of thing I don't really want to give my money to so therefore I would argue perhaps in this case and a variety of other ones that I actually am a party of interest who has a right to know about these types of transactions.

Does the accountant then have a professional obligation? And we could go beyond that to say whether he or she should have a legal obligation to make quite visible -- this goes back to your party -- that these types of activities are going on.

The charity case to me is a very obvious one because there are people like givers who may have real concern about this. But we could go beyond that even to the case of the corporation and whether the stockholder and ultimately, one could ask this question, the government or the taxpayer has a right to information and does the accountant have a professional obligation beyond not just reporting accurately but if there's something clearly shelter-like, somebody's come to this corporation or this charity and sold something as a tax scheme to pay a fee, to make that very identifiable with people, that it's beyond reporting, that all my numbers are adding up and it's beyond bookkeeping but that people want this information and have a right to it and is that part of the professional and perhaps even legal obligation of the accountant to report?

MR. TODER: One question I have and then I'll let others answer is exactly what information about what transaction? That is to say, again, just like Don described, there is a spectrum and do you want information with respect to all reportable transactions or just about listed transactions? Perhaps there may be a desire to have more information about listed transactions because in general the IRS believes it's going to be sustained in those but, for example, for reportable transactions I would say reporting is not necessarily determination of whether a transaction is good or bad, and that's an important point about our disclosure approach.

Our disclosure approach is trying to detect transactions but not

all reportable transactions are bad as to say there is no bias. If you report something that is not necessarily a determination it's bad. Now, listed transactions the government does believe and will take the position that the transaction does not work.

So my first question is exactly what reporting about what and when I think would be a very important question in deciding whether you'd want to give information to the public and necessarily would good would it do at what stage of the process.

MS. NOVACK: Can I ask a follow-up here? You've all talked about the importance of disclosure and the marketplace discipline. So, following up on Gene's question, why not for publicly-traded companies make at least some version of the M-3 if not the complete M-3, which is the reconciliation of the reported tax income that you report to your shareholders and those you report to the IRS why not make that public? Why not require a public company to give it to its shareholders?

MR. TODER: Well, again, to me it's the striking of the balance. Taxpayers have a right to privacy in their financial information and there's a lot of information there that companies don't want to be public. So it's striking a balance between taxpayer privacy and the right of the public to know and trying to figure out which of these things should have primacy.

MR. KORB: To follow up on what Eric just said, remember, the way our system works it's very important that taxpayers feel that when information is provided to the IRS that their neighbor's not going to be able to see it. I mean, it's confidential so they are more forthcoming than they otherwise might be if they knew this information would be disseminated far and wide. That's a cornerstone principle.

I think Pam Olson likes to refer to the data the IRS has as an national treasure. That's what it is. This database is not for people to mine.

On the other hand I will point out back in the 1930s, I think, corporate tax returns were publicly available so the Congress could decide. They're paid money to decide what the public policy is.

MR. TODER: And charitable returns are publicly available.

MR. KORB: I wanted to follow up on Gene's question. I'm going to take a much bigger picture view of this. Again, I'm not an accountant so I may not know what I'm talking about.

My sense is that the word "CPA" meant something at one time. When the rules were being developed probably early last century as to what is the role of a CPA the rule probably was to be, I suspect, more of a public watchdog. You're supposed to reporting what the hell's going on here so people who buy stocks in the companies or whatever know what they're getting into. I think that goes to the heart of the point Gene was making that got turned around here, certainly in the '90s, where they really weren't serving that function vis-~~227~~-vis their attest clients.

I think that's a very good question and I think Congress bit by bit is looking at that with Sarbanes-Oxley, with setting up peek-a-boo. I mean, those are questions that will be looked at, I think, by those agencies. But I think it's a very important question.

QUESTION: I'm Van Ooms from the Committee for Economic Development. There's been a certain amount of discussion for some time about the adequacy of the budgetary resources that IRS has for its service and compliance and enforcement rules. I wonder if members of the panel would comment on that with relation to the tax-shelter issue. Are there enough resources there to do the kind of job that we should be doing on tax shelters?

MR. TODER: Well, I guess it's easier for me to comment since I'm not in the government. Enforcement resources for the IRS, as is well known, dropped significantly in the late 1990s and that had a lot to do with the 1998 legislation and the increased emphasis on customer service and all the other restrictions that were put on the IRS. I should say taxpayer service.

The commissioner has said that both service and enforcement are important but he wants to shift the balance within the IRS a little bit back to enforcement and in fact over the past few years IRS enforcement resources have been rising although they're not back to where they were in the 1990s and arguably I think they should be a good deal larger.

Now, that's obviously not something the IRS can determine; that's something that Congress and the political system has to determine. But I do believe that a sustained and gradual, and I think ex-Commissioner Rossotti has made the same point, increase in IRS resources over a long period of time would be a very good thing.

MS. NOVACK: I should also point out that the IRS oversight panel, the advisory group, is always saying give more money than the administration has proposed and then Congress has actually given less than the administration had proposed. There's always been this concern or this pattern that even when they give money for enforcement it gets diverted to something else like paying for pay raises.

In the new budget that came out last week, and I don't quite know if this will really work or how it works, there's language to the effect that we want this money for enforcement and there's going to be a mechanism to make sure we really use it for enforcement and not for pay raises.

There's been a lot of talk about the revival of enforcement but I just looked at the numbers again and you just don't see it in terms of staff is still down 20 percent from '96. And if you only look at your in-person audits of people who are earning more than \$100,000, and I think those in-person audits have a bit more of an effect than a letter, I mean, they're still down to one-fourth of what they were.

So the enforcement really has to be an issue if you're going to have this complicated tax code and an ethic that says it's okay,

actually very American, to arrange your affairs to pay the minimum tax possible. You really have to go out and look at how people are doing that.

MR. KORB: Mark Everson is committed to the equation, if you will, service plus enforcement equals compliance, and changing that balance. What happens in my experience and I've been at this now 30 years -- it's my third time here -- is when those two components get out of whack something goes wrong. So if you go too far the enforcement side, the pendulum swings way over here, you're going to have problems and we've seen incidents of that. And if you go too far to the other side we're going to have problems; we're in that right now. So you've got to strike that balance and we're trying to do that.

We've got to give the current commissioner a lot of credit for recognizing that and working within the rules and publicly saying what he can. He looked at the budget the other day. The idea is to increase enforcement which means, as it's explained in there, you have to cut something out on the other side and that's going to be very controversial. So how is he going to do it?

The numbers I see are showing a trend up. You can't turn an ocean liner in the middle of the ocean around overnight, it takes time, and I like what Eric said. For example, if we were to get money to double the number of revenue agents tomorrow we couldn't do it; you just can't do that.

That's dumber than not giving us any money in a sense because then you'd be just wasting the money. You've got to do it in a planned, orderly way and that's what we're trying to do right here, probably not fast enough for some but that's what we're trying to do.

QUESTION: Len Berman, Urban Institute and Tax Policy Center. Talking about the trade off between compliance, enforcement, and customer service reminds me of the new provision that was enacted in the American Jobs Creation Act that lets the IRS have private collection agencies go out and collect tax debts. It just seems like a terrible idea.

The legislation actually holds the government harmless for any abuses that these agencies might perform. The IRS will have as much control over these guys as anybody has over a collection agency. You don't have to comment on it if you don't want to but it seems like it's a related issue. We talked about the \$30 billion or so that's not collected every year.

MS. NOVACK: Can I ask a question that will annoy every tax lawyer here? When I first started writing about shelters it was explained to me very clearly, well, people have always arranged their affairs and structured their entities when they're building businesses and doing deals so as not to pay taxes. What's different here is marketing and that's what we've heard today. You've heard people say that if we can only get the marketing out and the production of products we'll be okay.

The question that's always bothered me is if you can afford to

have the most expensive tax lawyer on staff and you pay him by the hour and you can somehow in the course of structuring a real economic deal not pay taxes on real profit or not pay taxes on a real gain when you sell a business or something like that that's okay but it's not okay to package it and sell it to the guy who sold his trash hauling company and only made 20 million.

I've talked to some of those guys who only made 20 million, and obviously everybody's greedy but part of the reason they believed this might work is they knew the guy with billions had the lawyer structuring things in such a way that sometimes in fact they were able to avoid paying these taxes. They would say to them look, this is what the big guys have and now you have it too.

I wonder whether some sort of general, anti-abuse rule, which I know all lawyers hate the idea of, or some sort of standard that says Congress expected you to pay tax, this is really an economic profit, is needed here.

MR. KORB: I think there's a little confusion. What you first started talking about is the difference between tax accounting and financial accounting. It has nothing to do with the anti-abuse rules or whatever. That's the system we have. Congress decided that there are certain instances where we have two parallel systems. That's the first piece.

MS. NOVACK: Maybe we shouldn't.

MR. KORB: Well, that's right. There are people from the Hill here. Go to talk to them about that point. That's the reason why tax lawyers, accountants, whoever, can sit down and structure a transaction. That's the way it is. You have economic income going one way and you have tax benefits going another. There's something called depreciation that's an example of that.

MS. NOVACK: That's something Congress said they wanted.

MR. KORB: I know but that's what you're talking about, right?

MS. NOVACK: Yes.

MR. KORB: In terms of a general anti-abuse rule it goes to something that Eric talked about. I did a speech that I think was handed out there on economic substance a couple weeks ago in Los Angeles. One thing we can't avoid here is we have a tax code. It's grown dramatically since I was in law school. It's gigantic. But we are a nation of laws, we have rules, and so you have to have those rules.

People then can come up with ways where they can put the rules together in ways that weren't intended. That's where these judicial doctrines come in and the fact of whether it's codified doesn't matter; those judicial documents are out there. They've been there for 70 years. We just have to use them in the appropriate way.

So I think all the tools are there and it's just got to be used in the proper way. If you have some general abuse rule then you've

opened yourself up to if the tax man doesn't like it he or she can shut it down. That's just not the way our system works.

MS. NOVACK: Well, let me ask two follow-up questions on that. Number one is I understand, and I'm not a lawyer, economic substance. Really if you end up with a benefit Congress didn't intend but you're doing it in the course of structuring a real deal with at least some economic profit potential then you can have that benefit so that the economic substance doctrine even if fairly enforced would not prevent that situation which is exactly the point I was talking about, that we have this discontinuity between accounting and tax reporting and we think it's okay for really smart tax lawyers to play off that and avoid taxes in ways Congress didn't intend. Congress does intend depreciation. And so do we have a problem in terms of the next level down, perception? And when the guy who sells his business for 25 million avoids tax in a marketed shelter then we have a perception problem the next level down.

MR. KORB: That's a totally different question. And the question there I laid it out in this paper, my view, is that you have to have a transaction rationally related to a useful, nontax business purpose that is plausible in the light of the taxpayer's conduct and economic situation. That's French for saying there has to be some reason other than tax to do the thing.

Secondly the transaction has to result in a meaningful and appreciable enhancement of the net economic position of the taxpayer other than to reduce his tax and that's French for what you're saying. That's saying forget about all this other stuff. You still have to have some net economic benefit that comes to you for this thing to stand up. I think it's pretty clear and that's the law. I'm not making this up.

MS. NOVACK: That's why I said I'm going to annoy tax lawyers because they think that's the way it should be.

QUESTION: Jim K * * * Senate Budget Committee. But doesn't that immediately bring up the question of how much? If there's a penny of economic substance --

MR. KORB: Read it carefully. See, people ought to read. Listen to what I said here. I said "a meaningful and appreciable enhancement." Does that sound like a penny?

QUESTION: Don and Eric had mentioned Sarbanes-Oxley a little bit. There's a perception out there, at least I have this perception, that Sarbanes-Oxley, particularly the requirements for restating financials and things like that, can make a pretty big dent in the shelter world because if you take an aggressive shelter position and it turns out to fall apart the back side down the road there's a lot of potential issues for corporate management. I was wondering do you anticipate that having a significant effect on the shelter business?

MR. KORB: That's part of the market, the impact of the marketplace. Again, I told that story. I saw it personally in my practice before I came here and that was all as a result of Sarbanes-Oxley. These are big companies, the largest banks in the country, one

case, and it was very clear that that board was reacting to the Sarbanes-Oxley, that the audit committee was going to take very seriously what their job was.

They want to be briefed personally, they want to talk, they want to get a second opinion from a professional who had nothing to do with this transaction. They want to be told the whole story and the bottom line is they decided not to do it. I think that's working so Sarbanes-Oxley is going to be a big part of this.

QUESTION: So you attribute it to Sarbanes-Oxley?

MR. KORB: That instance, well, that plus the IRS having that rule that said that if you have more than one listed transaction on your tax return even if it's disclosed you're going to have to turn over your accrual work papers. It's really neat when you think about what happened there. Sarbanes-Oxley created the milieu, created the meeting. Those guys didn't know anything about that rule that the IRS put out. What they understood was they better pay attention to what the hell is going on. So that's why the meeting happened.

And then the professional shows up and explains to them that even though this might work -- and I thought it did, actually; I thought transaction could work -- they still faced this risk because of this tax procedure and they made a judgment not to do it. I think that's just terrific.

So you have a lot of things coming together right there. You have the whole Sarbanes-Oxley, Enron, Arthur Andersen's situation over here. You have the IRS increasing its enforcement.

And what we've got to do is have a balanced and thoughtful enforcement program. We are where we are. We can all sit around here and say give the IRS zillions of dollars to do this. It ain't going to happen. It's not going to happen.

On the collection stuff that Len wanted to raise here I was on record, and Don Alexander knows this, ten years ago going up to the Congress and testifying as a private citizen where I said look, in a perfect world, Congress, this is nuts, that you ought to provide enough money for the IRS to do its job. But if you decide that you're not going to do that, well, the IRS ought to be free to try some other ways to get at things. That's all we're talking about. So we've got to be smarter about what we're doing here and we're trying a lot of different things. And if you pay attention closely you'll see. We're experimenting an awful lot and a lot of this is working.

QUESTION: Can I ask a question of research methods. Let's assume that things have calmed down for now and people are not doing some of the more aggressive shelters but maybe you lose Son of Boss or maybe just your attention's elsewhere and five years from now they're marketed again.

Do we have anything in the works research-wise that would allow the IRS to catch on earlier? I've gone to these research conferences and heard people talking. They're going to have neural nets and crunching the partnership returns to look for patterns. We know that

the credit card companies can do that. They know when somebody's using your card and shouldn't be. So where is the IRS on some more modern methods of detecting things they didn't know they were looking for?

MR. TODER: There are activities going on within the research group in the IRS and they were going on when I was there by some fairly sophisticated computer types and artificial intelligence people. One thing that is interesting that you refer to was mentioned at the conferences was something called a K-1 link project, which is only made possible by the fact that within the past few years the K-1 data were electronically transcribed. What that is is a tool that shows the relationships between individual taxpayers, partnerships, S-corporations, trusts, and other entities.

What turns out to be the case is that in a lot of the compliance problems an individual may be reporting their income perfectly on their return, a partnership might be reporting their income perfectly on the return, but what the abuse is that through links between partnerships, individuals, S-corporations, and whatever money is flowing between returns and gains and losses are being allocated in such a way that somehow the loss ends up in the hands of the high-bracket taxpayer and the gain ends up in the hands of an offshore entity or another tax-indifferent entity.

This tool has actually enabled examiners who have looked to identify a lot of things. Now, that doesn't mean those transactions are bad transactions; it means they're potentially bad transactions. But I do believe there is a lot that could be done with proper investment in research resources that would enable the IRS to be more efficient in identifying suspicious transactions. That would be a good thing and things are being done in that line.

You still have to go audit them; you still have to do other things. You have listed transactions, which are wonderful and a great progress, but not everybody lists their transactions. Steve.

QUESTION: Steve Rosenthal. I wonder if technology can be used, as you suggest, to benefit the IRS which is in part a corollary to changing technology in terms of marketing allowed tax shelters to expand and develop a great deal.

I remember reading an article maybe a dozen years ago by Gene Steuerle on mutual funds having large computers and they ought to be able to calculate gains and losses for their shareholders. So why shouldn't those mutual funds with the large computers provide that information both to their shareholders and, perhaps, to the government?

That kind of thinking to try to capture technological improvements I would have thought would be quite beneficial to the extent the government could ever catch up. But perhaps government operates under other constraints in the use of information that the private sector does not operate or something of that sort. But I wonder are there efforts, more generally speaking, from an enforcement standpoint to take advantage of changing times and technologies to help the government out?

MR. TODER: The answer to that question is yes, everything is yes, but not enough. It's certainly the case that tax shelters are being marketed through the electronic medium these days and the marketing is done in such a way that you could probably go to Google and find some tax shelters but that's not really the state of the art.

The way they're being marketed is through ways of contacting people where it's difficult to identify who the marketer is. They cover up their tracks so it's almost like a private communication over the Internet toward to the targeted people. There are ways that the IRS technologically can combat that and do a better job of identifying those kinds of marketing transactions.

I don't know the details of it. You mentioned constraints and there are all sorts of constraints in operating in government more efficiently and that's just a large topic. I don't think it's helpful for me to get into details of whether something could be done more efficiently managerially or how but that certainly is an issue that the IRS has to face.

MR. KORB: Let me just make a point. You didn't say anything about computers. A large reason we had this new tax shelter phenomenon is the existence of computers. There's a direct link there.

Again, there are probably people old enough in this room who remember back in the old days they had something called the Rule of 78s, which was a hokey way to compute interest. Well, the reason was you could do it on a sheet of paper. You could pull out your accountant's pad and actually manually compute it. That was before computers. Once computers really became widespread in corporate finance that's one of the reasons that these things are created and the marketing is what took it to the next level.

MS. NOVACK: And they could design the derivative that allowed you to have no real risk and it was much cheaper. You could design them for the guy who only had a certain amount in gains.

MR. KORB: One thing you ought to keep in mind, I always felt this way in practice and I see it too, is one thing you want to avoid is really going to the mat with those guys because if I have the authority to designate a case for litigation that means that case is going to litigation. And if we decide that case is really important we have access to incredible ways of proving our case. We have all the computer tools that everybody else has. So what you're gambling on is that you won't be the one and that's not a good gamble.

MS. NOVACK: And, of course, there's a political decision there because there's been discussion for years about having the security firms to the extent they had the information provide basis information. Of course, they don't want to provide basis information because basis is never ever audited so the compromise is we will report sales.

I see routinely from the tax court nonfiler cases with people

who have enormous amounts of sales and haven't filed. I think they're crazy. They could file and make up a basis like everybody else. No, it's true; I see them. What the IRS does is come in and say we don't believe you have any basis. But this is a chronic problem and GAO has looked at it and Congress has looked at it and politically there has not been the will to solve that.

MR. TODER: There actually is a company that was trying to market to the IRS that does have for publicly-traded stocks electronically basis. It's available. Of course, you still don't know if the taxpayer's telling the truth about when he or she bought the security but if you have the date right with that method you can get basis. Whether that works or how well I don't know.

MS. NOVACK: So for the honest taxpayer it's much easier than it used to be. If you simply require the securities firm to report basis to the extent that they know it then if somebody wants to cheat they have to keep moving their portfolio so you make it a little harder.

Any other questions?

QUESTION: I'm Ethan Yale. I'm wondering if we're likely to see any LILO or SILO litigation. I know that these deals were largely put out of business by the October '04 legislation and a lot of people were racing to get deals done right before that legislation was codified.

The transactions either dating back to the 1999 revenue ruling from then through the date when you could no longer do those transactions, which was prospective, are any of those cases likely to be litigated?

MR. KORB: He raises page 10. Look at the indicia of new style corporate tax shelters here. Number 1, generation of losses for tax purposes but not for book purposes.

MS. NOVACK: Which is why you make them public?

MR. KORB: That's right and that's a good tool. Well, not public. Let's walk before we can run. Having the M-3 is now going to at least have sunlight shone on it inside the audits. More importantly, think about it. Now somebody's going to have to fill that piece of paper out. So every time they do one of these the way this should work is they say wait a second here. Now, if we do it this way here's what we're going to have to show. Is this really what we want to do? This M-3 is another really good idea.

MS. NOVACK: But conforming the tax and book has the advantage for inflated earnings too.

MR. KORB: There are 535 guys up on the Hill who have to deal with that.

MS. NOVACK: And they won't want to do it but I'm just saying there really is this structural problem. I know you're against an anti-abuse rule but there's this structural problem because they are different.

MR. KORB: It's in the tax code. I'm not defending it. I'm just saying it's there.

SPEAKER: Given the numerous ways, and I'm not an accountant, of measuring book income, it seems that we do need to have a rule for tax income.

MR. KORB: Larry, What about the AMT? Remember that time period where we had the book tax difference for the AMT? We did that for three years and then we switched to something else. There's some history there and people can look back and see how that worked.

MS. NOVACK: And it didn't work well.

MR. KORB: What I thought we should have done is one year you have one, next you have another, and then you switch back to the first one.

SPEAKER: But I agree with you that the M-3 is the key in getting those differences identified.

MR. KORB: But it's not just a tool for us to spot transactions; it's a prophylactic tool. It's a tool to make people think about whether they want to do something because they may have to disclose it. They may have to weigh it out. And hopefully there's going to be enough of that that's going to help.

MS. NOVACK: I want to thank Mr. Toder, Mr. Korb, and Mr. Solomon, who has left. I just think they were great today and they still haven't given us the secret of those that we haven't done. Thank you so much.

(Whereupon, the PROCEEDINGS were adjourned.)

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