PREFACE

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On May 17, 2006, government tax experts, leading tax professionals, and academic stars came together for the first time to study state governments' reactions to tax planning by businesses—a phenomenon that intensified greatly in the 1990s, reached its height in the early 2000s, and continues today. It was my honor to chair this day-long program at Georgetown University Law Center, entitled "SALT and Tax Shelters—Policy, Practices and Problems." I am pleased to introduce here the articles prepared by our distinguished presenters for this special edition of *The State and Local Tax Lawyer*. Reflecting the more philosophical nature of some of the symposium topics, in several instances the pieces presented here more resemble an essay than a law review article. As to the currency of the information contained therein, readers should also note that the articles were drafted between March and September 2006.

The idea for a serious, multi-disciplinary look at state tax shelters was the brainchild of my ever-inventive friend and fellow Chicagoan, Phil Tatarowicz of Ernst & Young LLP's national office in Washington, D.C. Phil has chaired the prestigious Georgetown Advanced State and Local Tax Institute for more years than I prefer to think about, and has done more than perhaps any other state tax practitioner to elevate the level of discourse on state and local tax issues.

Credit for making the symposium actually happen belongs to Georgetown University and the American Bar Association Section of Taxation. The efficient staff of Georgetown University Law Center's Continuing Legal Education program, headed by Larry Center, one of the country's best organizers of seminars, brought it all together. At considerable expense to itself, Georgetown also greatly increased the impact of the seminar by inviting the chief counsel of every state tax department in the country to enjoy tuition-free attendance at the seminar and the Georgetown Advanced State and Local Tax Institute, and by underwriting and hosting a closed business and networking function for these top government lawyers.

Stephanie Lipinski Galland, partner at the law firm of Thompson Coburn LLP in Washington, D.C., and chair of the ABA Section of Taxation's State and Local Tax Committee, provided consistent guidance and encouragement. Greg Nowak, partner in the Detroit office of PricewaterhouseCoopers LLP and Editor in Chief of *The State and Local Tax Lawyer*, and Jeff Glickman, a partner in the Atlanta law office of Alston & Bird LLP and production editor of this special edition, have labored mightily to make the insights generated by the symposium available to a wider audience.

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I. FRAMING THE ISSUES

Alex Meleney, principal in the Washington, D.C., national office of Deloitte Tax LLP, kicks off by framing the issues addressed by the symposium's participants.

Meleney observes that current state-level tax shelter programs are largely focused on corporate income taxes and are designed solely to capture the incidental state effects of federal income tax schemes. Tax planning designed to harvest state-only benefits is widespread, however, and Meleney concludes that states will generate little revenue unless they also address state-only tax plans.

As to nonincome taxes, Meleney cautions that federal tax doctrines like "economic substance" and "business purpose" will be difficult to apply to sales and other state and local taxes that are traditionally viewed as "form-driven." And he notes that states must take action, such as increasing state-to-state uniformity, to keep their anti-tax shelter programs from creating major compliance costs and legal risks for business taxpayers.

II. DRAWING THE LINE

Joe Huddleston and Frank Katz, executive director and general counsel, respectively, of the Multistate Tax Commission, Washington, D.C., and Peter Faber, federal and state tax partner in the New York City office of McDermott Will & Emery LLP, attempt to parse legitimate from illegitimate income tax planning.

Huddleston and Katz object to taxpayer reliance on the "simplistic" argument that "it is up to the government to set the rules" and "up to the legislature to go fix its statutes" when taxpayers use those rules to achieve unintended consequences. Lamenting that state courts have failed to define a workable "economic substance" or other test for patrolling unacceptable tax planning, they suggest that a better standard would be "an objective, almost mathematical test," under which a tax-motivated transaction not directly sanctioned by the legislature would be disregarded for state tax purposes "when all other reasons are 'insubstantial' as compared to the tax advantages."

Speaking from the perspective of business taxpayers and the tax lawyers and accountants who counsel them, Peter Faber asks his government colleagues to dispense with pejorative labels, like "tax sheltering" and "aggressive tax planning," and instead to focus on the kinds of transactions that should be prohibited.

Faber acknowledges that the "mass marketing of tax strategies that consisted of artificial transactions designed solely for the purpose of inventing a tax deduction or credit" by the private sector (*i.e.*, law firms, accounting firms and independent promoters) have invited attack. But, he laments, courts have distorted the "business purpose" and "economic substance" doctrines in a manner that suggests that "a perfectly legitimate business transaction . . . is improper if the decision as to its form is motivated solely by tax considerations."

As an example of why we need to rethink where to draw the line between legitimate and improper tax planning, Faber posits that a business owner just getting started may legitimately use a tax-favored legal structure, such as an LLC or S corporation or separate entity to hold property, or a beneficial capital structure involving mostly debt. That being the case, says Faber, there is no reason why a

taxpayer who adopts "a tax inefficient structure at the outset, should not be able to reorganize into a more efficient structure even if the sole reason for doing so is to lower its tax burden." Yet states have attacked such plans as illegitimate.

III. WHAT ARE STATES DOING TO ADDRESS TAX SHELTERING?

In her article, Marilyn Wethekam, partner in the Chicago law firm of Horwood, Marcus & Berk Chartered, details the legislative, regulatory and litigation tools that states have put in place.

Since current state programs largely piggyback the federal income tax anti-tax shelter rules, Wethekam begins by reviewing the principal federal tax doctrines used by the courts to patrol aggressive federal income tax planning. She then recounts the interesting history of the federal tax shelter rules that initially targeted the individual taxpayers who bought mass-marketed tax reduction programs, and then, starting in 1984, evolved to their current focus of requiring registration and investor-list keeping by promoters, return disclosure by participating taxpayers, and increased penalties for all.

Wethekam observes that the anti-tax shelter programs put in place by the states to date are limited to state income taxes and generally take one or more of four approaches: (1) require taxpayers to add back deductions for certain expenses, principally royalties and interest related to intangible holding companies; (2) require registration, disclosure, or penalties for tax shelter promoters and participants; (3) disallow or disregard transactions lacking "economic substance" or "business purpose," often without providing definitions for those terms; and (4) allow "amnesty" to taxpayers who pay up voluntarily.

In addition to summarizing the Multistate Tax Commission's proposed model statutes, one of which would mandate a 51-state spreadsheet disclosing "inconsistent filing positions," she describes the terms of the anti-shelter programs adopted in California, Illinois, New York, Connecticut, Minnesota, North Carolina and West Virginia. Wethekam also reviews the principal litigation positions used by the states to attack trademark, trade name, and intellectual property holding companies (intangible holding companies or IHCs) and other "tax shelters," for example, "nexus" for IHCs and REITs; forced combination for IHCs and distribution companies; and lack of "economic substance" and "business purpose" in the creation and operation of IHCs.

Nonie Manion, audit chief of the New York State Department of Taxation and Finance, and Mike Duffel and Michael Infantino, director of out-of-state multistate field operations and associate attorney, respectively, at the California Franchise Tax Board, describe "unprecedented" coordination of audit activity aimed at "abusive tax avoidance transactions" (ATATs). Significant among these are the "IRS September 2003 ATAT Memorandum of Understanding" and similar agreements signed by the IRS and 43 states in 2003 and 2004, by which the IRS and the states have agreed to share information regarding ATATs. Also reviewed is the Multi-State Tax Shelter Database, created by California and New York and housed in the New York department, which has shared tax shelter information with more than 40 tax agencies since December 2004.

Manion, Duffel, and Infantino also describe further state steps to detect and shut down ATATs, including the creation of separate tax shelter discovery units within their audit bureaus and more aggressive assertion of penalties. They also report that states are using technology and data warehousing to "ferret out" ATATs from media reports, income tax sheltering seminars, and websites, as well as from records of insurance settlements, charitable contributions, and lottery winnings.

IV. HOW CAN STATES BE MORE EFFECTIVE?

Harley Duncan, executive director of the Federation of Tax Administrators in Washington, D.C., and Bill Fox, professor of business and economics, as well as director of the Center for Business and Economic Research, at the University of Tennessee in Knoxville, identify the principal state strategies used to combat state income tax shelters and tax planning. In their article, they comprehensively evaluate these strategies in terms of their revenue impact, state administrative and taxpayer compliance costs, and "economic efficiency," that is, their impact on real world business activity.

Specifically, Duncan and Fox assess the merits and pitfalls of combined reporting, throwback, amnesties, state rules for pass-through entities, federal-like registration, disclosure, and penalty regimes, increased state audit and enforcement efforts, state rules to offset "entity isolation" planning techniques, and alternative structures such as gross receipts and net worth taxes. They conclude that state administrators need more "precision in the thought process" both in identifying the problems they face and in devising solutions.

Citing numerous studies, Duncan and Fox conclude that mandatory combined reporting raises revenues; throwback rules have little effect, or a distortive one; amnesties have been overused and have diminishing benefits; and more recent registration and disclosure schemes can generate one-time revenues but will not generate longer-term benefits without much greater state enforcement. Targeted anti-entity isolation rules, recently passed by a number of states, help stem the loss of revenues, but will likely engender new forms of taxpayer planning to get around them. Alternative tax structures, they add, can bring increased revenues and greater stability to the state's business tax structure, but gross receipts taxes raise serious policy concerns such as pyramiding.

V. THE ROLE OF TAX OPINIONS IN TAX PLANNING

Hollis L. Hyans and Amy F. Nogid, partner and counsel, respectively, in the New York City office of Morrison & Foerster LLP, address the challenges confronting the tax practitioner who has been asked by his client to render a tax opinion. Noting a sea change in the nature of opinions being given today compared to just ten years ago, Hyans and Nogid begin with a fascinating history of federal and state government, professional organization and state attempts to regulate the content of tax opinions, culminating in 2005 amendments to Treasury Department Circular 230 (which applies, *inter alia*, to any written tax advice rendered with respect to a transaction having as a "significant purpose" the "avoidance" of federal income tax).

Not only do the courts lacks consensus as to the level of assurance necessary to avoid disregard of the transaction or penalties ("reasonable possibility of success," "more likely than not," etc.), but, they say, the courts—and hence the taxing authorities—are confused on the more fundamental issue of how to interpret taxing statutes, that is, how far beyond the literal words of the statute should they look to find the legislature's "intent." Hyans and Nogid note and highlight four distinct interpretation methods or "philosophies," that is, "literalist–textualist," "intentionalist," "purposist," and "practical reason."

Hyans and Nogid summarize the main court decisions applying the "business purpose," "economic substance," and "sham transaction" tools principally relied upon by the courts to overturn aggressive income tax planning. Unfortunately, the authors note, the courts cannot agree on the meaning of either term, or on the extent to which a taxpayer's motivation to save taxes should taint a transaction that would otherwise pass muster. And recent state attempts to codify and "objectify" these doctrines have so far provided little clarity.

What is the tax practitioner to do? Admirably, Hyans and Nogid do not throw up their hands, but offer a number of concrete, if difficult, suggestions. Until state courts provide guidance, they say, lawyers and accountants must live with the reality that opinions written today may be judged by "standards not yet clarified and legal precedent not yet issued."

VI. WHAT DOES THE FUTURE HOLD?

Joseph Bankman, professor of law and business at Stanford Law School, has spent years studying and writing about federal income tax shelters and was the first academic to put a price tag on the U.S. Government's annual revenue loss from tax shelters ($10 billion in 1988). In his article, Bankman undertakes "an overview of where we are with respect to the [state income] tax shelter problem and the greater issue surrounding state taxation of income from capital."

Bankman acknowledges the difficulty of finding a global solution to the decline in state income tax revenues, among other reasons because of the lack of uniformity of state income taxes, constitutional limitations on the states' tax reach, and competition among the states that tends to create and perpetuate loopholes. He contends that the states, as well as the federal government, have pretty much dried up the "shelter market as it existed a decade ago," but that he is "less optimistic as to whether we can prevent aggressive tax planning aimed at reducing state . . . revenue from capital."

The professor does not explicitly draw the line between permissible and impermissible tax planning, but distinguishes between three categories of planning along a "continuum" that "raise different issues" and therefore demand different responses. A "tax shelter" (at least one that reduces the tax on capital) is:

> [A] transaction that (1) reduces the tax on capital; (2) in a manner that is consistent with (or purports to be consistent with) the literal language of a statute (regulation); (3) but is strongly inconsistent with any notion of legislative (administrative) intent or purpose; and (4) that has little or no non-tax business purpose.

He uses a different term—"quasi-tax shelter" or "aggressive jurisdictional planning"—to describe the typical intangible holding company (IHC), and yet another phrase—"jurisdictional tax planning"—to describe techniques such as locating physical property in a low tax state.

Tax shelters defined thus narrowly "were primarily aimed at reducing federal taxes but substantially reduced state taxes as well," and have largely been vanquished by court decisions applying the economic substance and business purpose doctrines and by anti-shelter programs adopted by the federal and state governments to date, for example, mandatory registration and disclosure, amnesties coupled with increased penalties, Circular 230 changes, and the criminal prosecution of accounting and other firms involved in their offering. Bankman suggests that only the largest states should devote resources to finding and auditing such "tax shelters," and that the rest should either "free ride" on federal efforts, contract out enforcement to the larger states, or, less desirably, share information and coordinate case-by-case efforts in the manner described by Manion, Duffel, and Infantino.

But "tax shelters" thus defined "comprise only a small part of the reason state corporate tax collections are down," in Bankman's opinion. The real cause is "the increased mobility of capital," he says, and state revenue declines are likely caused primarily by interstate tax competition, quasi-tax shelters in the form of intangible holding companies, and international tax competition that reduces the federal–state tax base.

The quasi-tax shelter IHC is different from a tax shelter, says Bankman, since it "can arguably fit within the spirit, as well as the letter, of the law" and "there is an easy legislative fix." As a result, he says, states "have not been able to win the battle against intangible holding companies through litigation." (Curiously and without further explanation, Bankman also calls the IHC "the form of tax minimization that is most egregious and most easily challenged in court.") If state policymakers want to limit IHCs, he says, the practical responses are combined reporting and expense disallowance rules.

Bankman clearly believes that interstate tax competition has played a large, perhaps the largest, role in the decline of state corporate income tax revenues and that "despite the best efforts of state tax officials, competition will make the corporate tax harder and harder to implement." At the same time, he acknowledges that similar predictions he and others have made about the role of international tax competition in the decline of federal income tax revenues have not come to pass (federal revenues in the past few years are "up considerably," he notes) and that "predictions of ruinous state tax competition may be similarly overrated."

VII. CONCLUSION

One reason this symposium's practical and multi-disciplinary look at tax planning and tax shelters has not happened before is that government and business representatives have been polarized around different notions of when tax planning is "illegitimate." As these articles reveal, the term "tax shelter" is used quite differently depending on who's speaking, from the benign, that is, all tax planning

designed to reduce tax liabilities, to the malevolent, that is, illegal evasion of taxes. The size of the state tax planning–shelter "problem," and therefore the resources that a state should devote to solving it, depend a lot on how one defines what is proper and what is not.

Another is that government and business representatives have been somewhat paranoid on the topic. State tax officials fear that objective discussion of audit plans and techniques will give business taxpayers a "roadmap" to tax avoidance. Corporations and tax advisers worry that shining the bright light of analysis on state tax planning will create unfair public pressure to give up clearly legitimate tax restructuring. Sarbanes-Oxley and the SEC's opaque implementation of that law have scrunched the term "tax shelter" into a four-letter word. As a result, corporate America has increasingly eschewed even fairly uncontroversial tax restructuring projects, with a concomitant loss of income for tax advisers and shelter promoters, at least for the time being.

This special edition of *The State and Local Tax Lawyer* assembles in one place some of the best analytical work done on the various aspects of this controversial and important topic. Even though the articles contain few definitive conclusions, they argue persuasively for the proposition that more of such careful and respectful analysis will narrow the areas of disagreement about the kinds of tax planning that should be restricted and will encourage the states to develop more focused and more uniform approaches to illegitimate tax planning that can be embraced by the business community.