**From:** Monte A Jackel <monte@jackeltaxlaw.com>
**Sent:** Sunday, November 20, 2022 9:19 AM
**To:** Comments
**Subject:** [EXT]: PCAOB Rulemaking Docket Matter No. 046
**Attachments:** 2022tnf30-11.pdf; 2019tnf43-9.pdf

Hello. My name and contact information is below. I am submitting comments on PCAOB Release No. 2022-006, Nov. 18, 2022, on proposed new PCAOB auditing standards.

1. I found it very surprising that the manner in which accounting firms, as well as the PCAOB, should evaluate PCAOB rule 3522 (text below), given its vague parameters, is not addressed in an almost 400 page report. See attached article, *Tax Advice and Auditing Don't Always Mix Well,* that I wrote in Tax Notes, Fairfax Virginia, on the topic. Detailed comments and analysis is contained in the article.

2. The main point I make in the foregoing referenced article is that the governing standard for impermissible tax services under PCAOB rule 3522, whether there is a significant purpose of tax avoidance or evasion, is hard to understand and evaluate. Not only do audit firms have their own subjective opinions on the topic, but so does the IRS. The governing IRS regulations do not explain the meaning of the term "a significant purpose" and are more than 20 years out of date. See the attached article, *Small Business Tax Shelters Under the Business Interest Expense Limitation,* Tax Notes, Fairfax Virginia, which addresses the vagueness of the "a significant purpose" standard in evaluating whether a tax shelter exists.

3. PCAOB Rule 3522 references so-called IRS listing notices in determining whether a transaction is a tax shelter which, unless it is

more likely than not the correct treatment, prohibits the tax function of an audit firm from proposing a transaction to that firm's auditors. The Sixth Circuit Court of Appeals in the *Mann* case, 27 F. 4th 1138, 2022, generally held that a particular listing notice was invalid because it was issued without pre-publication public notice and comment under the Administrative Procedure Act. [https://scholar.google.com/scholar_case?case=14005616278713610687&q=Mann&hl=en&as_sdt=4,111,126](https://scholar.google.com/scholar_case?case=14005616278713610687&q=Mann&hl=en&as_sdt=4,111,126). The IRS is fighting this issue out in other circuits and does not agree that the *Mann* court itself in the Sixth Circuit decided the issue of whether the APA in applies to that listing notice in the case of other taxpayers. What sense does it make for a PCAOB rule, 3522, to reference IRS listing notices where it is questionable whether those notices were properly issued under the APA and, thus, invalid?

4. What expertise does the PCAOB have in evaluating whether the audit firm has made the correct judgment about whether an audited transaction does or does not have a significant purpose of tax avoidance? The answer to that question in turn decides whether it is relevant (a) that the same auditing firm brought the transaction to the auditor, or (b) whether the tax treatment of the transaction by the taxpayer is or is not more likely than not the proper treatment, or (c) whether the services related to that transaction is a permissible or an impermissible service.

5. Does or should the PCAOB coordinate with the IRS on these issues? Or is the transaction independently vetted by the PCAOB? Or does the PCAOB accept the auditor's conclusion on this issue without independent investigation? What tax expertise is there at the PCAOB or the SEC to evaluate these transactions without IRS intervention?

6. Much like how Internal Revenue Code section 6110 mandates public disclosure of non-general IRS guidance issued to a particular

taxpayer, such as so-called private letter rulings or IRS legal memorandums, the SOX act needs to be amended to allow public disclosure of these tax determinations by the PCAOB with names and identifying information redacted. Current SOX law prohibits public disclosure in these cases. The law should be changed in the interests of having informed investors of securities and an informed taxpaying public.

## Rule 3522. Tax Transactions

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of, a transaction ....that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws. Note 1: With respect to transactions subject to the United States tax laws, paragraph (b) of this rule includes, but is not limited to, any transaction that is a listed transaction within the meaning of 26 C.F.R. § 1.6011-4(b)(2).["A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."] Note 2: A registered public accounting firm indirectly recommends a transaction when an affiliate of the firm or another tax advisor, with which the firm has a formal agreement or other arrangement related to the promotion of such transactions, recommends engaging in the transaction.

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# Tax Advice and Auditing Don't Always Mix Well

by Monte A. Jackel

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In this article, Jackel explores the public audit regulator rules for tax advice by the same or an affiliated firm, and he examines how those rules are applied by the Big Four in both their tax advising and auditing roles.

## Introduction

Recent news reports have disclosed EY's purported plan to separate its consulting business from its global audit practice.[1] This purported move is, based on public reports, attributable to recent auditing issue errors that have been reported in the news media, and on alleged conflicts of interest and potential violations of the independence rules by EY and some other attest firms both domestically and abroad.[2]

A recent news report said that "The auditor is supposed to be a watchdog for shareholders. But when the audit firm designs, implements, and testifies in court to defend sophisticated tax avoidance strategies for audit clients, they are providing an opinion on their own work. . . . The company has paid for a lap dog, not a watchdog."[3]

These revelations have come with news of cheating on CPA and internal training exams at several major accounting firms,[4] with one article[5] quoting a source saying that "cheating on ethics tests made public recently 'threaten to undermine a profession that sells itself as a trusted protector of the public's interest, from taxpayers to shareholders.'"

These ethics violations and assertions of cheating are particularly surprising to me because in the time I spent at the Big Four[6] after 2002,[7] serious attention was paid to ethics training and attest independence rules. The annual ethics and independence training exams were difficult — perhaps too difficult — as I recall. The training at that time involved watching a video on the subject and then taking the exam. It was usually not possible to fast-forward the video, so on the face of things you had to at least listen to it or let it play. Usually, 70 percent or more correct answers were required to pass.

The training allowed the user to download a written transcript of the video. Without that download, some of the exam questions were so specific to a single point made during the video

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[1] Mark Maurer and Jean Eaglesham, "Accounting Firm EY Considers Split of Audit, Advisory Business," *The Wall Street Journal*, May 26, 2022.

[2] Eaglesham and Ken Brown, "Accounting Firm EY Grapples With Partner Pay, Bear Market in Breakup," *The Wall Street Journal*, June 24, 2022; Matt Robinson, "EY Pays $100 Million SEC Fine Over CPA Ethics Exam Cheaters," *Bloomberg Daily Tax Report*, June 28, 2022; Mary Katherine Browne, "EY to Pay $100 Million for Ethics Exam Cheating," *Tax Notes Federal*, July 4, 2022, p. 97; Dave Michaels, "Ernst & Young Fined $100 Million in Ethics-Exam Cheating Probe," *The Wall Street Journal*, June 28, 2022; Amanda Iacone, "EY Cheating a 'Wake-up Call' as SEC Targets Market Gatekeepers," *Bloomberg Daily Tax Report*, June 29, 2022; Jesse Drucker, "Officials Balked at a Drug Company's Tax Shelter. Auditors Approved It Anyway," *The New York Times*, July 7, 2022.

[3] *Id.* Drucker, "Officials Balked," quoting Francine McKenna, lecturer at the Wharton School of the University of Pennsylvania.

[4] *Supra* note 2.

[5] Iacone, "EY Cheating," *supra* note 2.

[6] The Big Four are the global accounting firms Deloitte, EY, PwC, and KPMG.

[7] 2002 is when Congress enacted major SEC legislation. *See* Sarbanes-Oxley Act of 2002. *See* SEC, "The Laws That Govern the Securities Industry," at Investor.gov.



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that, without doing a word search for the item, you would have needed a photographic memory to pass the exam.[8]

The last time there were large-scale public revelations about significantly bad behavior by accounting firms was in 2001-2002. At that time, massive changes were brought about in the Big Four[9] from the enactment of new laws and regulatory guidance after the Enron scandal and the collapse of Arthur Andersen that resulted from that scandal.[10]

## The PCAOB Rules Seem Ineffective

From the ashes of all that came the Sarbanes-Oxley Act of 2002 (SOX),[11] and the birth of the Public Company Accounting Oversight Board (PCAOB). Integral to the operation of SOX is the audit committee of the audited (known as the attest) client.[12]

The PCAOB has rules concerning the independence of auditing firms. Rule 3522[13] states in pertinent part:

> A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to *marketing, planning, or opining in favor of the tax treatment of, a transaction that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws*. . . . With respect to transactions subject to the United States tax laws, [the rule on tax avoidance transactions that needs a more likely than not (MLTN) tax assurance] includes, but is not limited to, any transaction that is a listed transaction within the meaning of 26 C.F.R. section 1.6011-4(b)(2).[14] . . . A registered public accounting firm indirectly recommends a transaction when an affiliate of the firm or another tax advisor, with which the firm has a *formal agreement or other arrangement related to the promotion* of such transactions, recommends engaging in the transaction. [Emphasis added.]

The applicable regulations[15] expand on what is an accounting firm for this purpose:

> Accounting firm means an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization's departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States.

## Tax Transactions That Are Allowed

From the very beginning[16] of PCAOB rule 3522, it suffered from the same infirmity and ambiguity as the term "a significant purpose"

[8] As reflected in my relatively recent experience, I found the IRS Office of Chief Counsel ethics and related training exams much easier to take and pass than those at the Big Four.

[9] Formerly the Big Five before Arthur Andersen collapsed.

[10] Sheryl Stratton, "More Details Emerge on Enron's Tax Strategies," *Tax Notes*, May 27, 2002, p. 1301.

[11] *Supra* note 7.

[12] *See infra* note 17. SOX section 101 established the PCAOB and section 101(c)(2) specifically authorizes the PCAOB to provide rules for the independence of accounting firms in their auditing activities. Except for a single provision in SOX concerning who should sign the corporate tax return, the term "tax" is not otherwise mentioned in the legislation. There is also a provision in SOX expressly excepting proprietary information from public disclosure but nothing specific is said about tax matters. SOX section 105(b)(5)(A) generally exempts the enforcement proceedings of the PCAOB, and matters related thereto, from public disclosure.

[13] Rule 3522 works in tandem with rule 3524, which deals with audit committee preapproval of some tax services (meaning "permissible tax services," which are those services that are not prohibited). Somewhat circular, I know.

[14] "A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."

[15] *See* 17 C.F.R. section 210.2-01 et seq.

[16] PCAOB, Section 3. Auditing and Related Professional Practice Standards, Rule 3522, "Effective Pursuant to SEC Release No. 34-53677, File No. PCAOB-2006-01" (Apr. 19, 2006).



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does in section 6662(d)(2)(C)(ii)[17] today, and since its enactment in 1997.[18] The regulations under the accuracy-related penalty regime, principally reg. sections 1.6662-4 and 1.6664-4, have not been updated since the standard for testing what a tax shelter is was changed from "the principal purpose" to "a significant purpose" in 1997.[19]

In an earlier article in these pages, I said:

> The definition of tax shelter is broad. . . . [it] could include legitimate attempts to reduce a taxpayer's tax burden (almost all business transactions have tax considerations, so it is difficult to draw a line for what is a tax shelter unless all transactions with a tax element are tax shelters but those in which tax avoidance is only an ancillary goal are not) . . . and . . . a 'significant goal' of avoiding taxes does not include an ancillary goal of avoiding taxes. Ancillary most likely means, in this context, not the primary goal of a transaction and not the most important goal of the transaction.[20] [Footnotes omitted.]

The case law concerning "a significant purpose" of tax avoidance only addresses cases that are not close calls, meaning transactions that are undeniably done for tax avoidance purposes.[21] Significant, in this context, acknowledges that the purpose need not be either the predominant purpose or even the most important purpose. Rather, it appears to be limited to an important purpose that is outweighed by nontax purposes that are still meaningful to the taxpayer.

In the course of developing this rule, the legislative history[22] clearly indicates that Congress was aware that business people almost always take tax considerations into account and this fact does not mean that all tax planning is tax avoidance or evasion planning. The real-world problem is that outside clearly abusive situations, it is impossible to delineate transactions in which tax is not merely an afterthought but also important, but not the most important consideration. You would need to be a mind reader to find that out.

That seems to mean that unless the taxpayer can clearly establish that it would have done the transaction regardless of the tax effects, the transaction will be treated as having a significant purpose of tax avoidance. That definition could encompass almost all transactions done in a tax year.

The PCAOB is the body responsible for ensuring that the Big Four are independent of any improper influences. One of the ways the PCAOB endeavors to enforce this is by prohibiting the tax advisory side of an accounting firm from directly or indirectly initiating and then providing tax guidance or advice to the audit side of the firm when a transaction has a significant purpose of tax avoidance, unless the tax advisory side of the firm concludes that it is MLTN that the claimed tax treatment is the proper treatment.

This test is odd given that the regulations under sections 6662, 6664, and 6694, the accuracy-related and preparer penalties,[23] do not provide a safe harbor for tax shelter transactions (those with a significant purpose of tax avoidance), even when the taxpayer or the taxpayer's advisers conclude that the claimed tax treatment is MLTN the proper treatment.[24] That MLTN standard is what is called by the section 6664 regulations the "minimum legal justification" standard. Meeting that standard is necessary to obtain relief under the section 6664 reasonable cause and good faith exception, but it is not conclusive and, thus, is not

[17] "The term 'tax shelter' means — (I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."

[18] Taxpayer Relief Act of 1997, section 1028(c)(2). PCAOB rule 3522 on its face does not prohibit the tax-advising side of the firm from providing advice to the auditing side of the same firm on tax issues that were not initially recommended, directly or indirectly, by the same firm or by another under a formal agreement with that firm. Informal arrangements (via a handshake or the like) are not expressly covered, of course. The SEC also oversees the functions of what is known as the audit committee of the attest client, which is required under SOX, whose key function is to ensure the independence of the attest client and the accounting firm. *See* Office of the Chief Accountant, "Audit Committees and Auditor Independence," which is a pamphlet prepared by the SEC that summarizes those rules.

[19] *See* Monte A. Jackel, "Small Business Tax Shelters Under the Business Interest Expense Limitation," *Tax Notes Federal*, Oct. 28, 2019, p. 607.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] Reg. sections 1.6662-4(d), 1.6664-4(b) through (f), 1.6694-2.

[24] Reg. section 1.6664-4(f).



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a safe harbor from being treated as a tax shelter for federal tax penalty purposes.

As a result of these differing standards, a transaction could be exempt from the PCAOB independence rules because the MLTN standard has been met, but still subject to penalty under the IRC substantial understatement penalty and preparer regimes because other factors weigh against the MLTN conclusion. What sense does that all make?

## Tax Regs and Major Questions

The Supreme Court recently decided a case involving the Environmental Protection Agency.[25] The case has nothing to do with tax, but it could have implications for the future of some tax regulations.[26] In *West Virginia*, the Court applied the so-called major questions doctrine and held that the EPA regulation at issue was invalid. Under that doctrine, regulations of a federal agency are not valid if they would have a major and very significant impact on the public without express congressional statutory authorization to do so.

Tax regulations differ from other agency regulations primarily because there is a general rulemaking grant of authority under section 7805(a).[27] Typical cases involving the validity of tax regulations address whether the regulation is consistent with the statute involved or exceeds that authority, as well as cases involving failure to comply with the Administrative Procedure Act. Tax regulations typically do not involve major questions divorced from either an explicit statutory grant of authority or the general rulemaking authority under section 7805(a). However, if issued under the general rulemaking authority, there could be a major question issue for regulations that impose significant new burdens and duties and that represent a significant change in the law without an express and contemporary statutory grant of authority when the current statutory and regulatory regime is of long standing.

An example of such a regulation could be the so-called partnership antiabuse rule.[28] It is just too early to tell. To me, this means that clarifying the interrelationship problem between federal tax under section 6662(d)(2)(C)(ii) and the SEC, through PCAOB rule 3522, would likely need express congressional authorization, because that type of rule would appear to represent a major question; that is, a question of major import significantly affecting the public without express congressional authorization under a statute (SOX) of long standing.

Perhaps the significance of *West Virginia*, and how it could intersect with tax, would be in the Court's apparent downgrading of the *Chevron* doctrine,[29] to in effect place the application of that doctrine in the analysis of a statute behind the major questions doctrine. Under this approach, the first inquiry would not be whether a statute was ambiguous but, rather, whether the regulation was a major question requiring clear congressional authorization to pass muster.[30] Only if the answer to the first question is that it is not a major question would the analysis proceed to *Chevron*. As *The Wall Street Journal* said in an editorial on the case,[31] "The Court is now placing guardrails on *Chevron* to prevent lower courts from going off the constitutional road."

## Need for Public Disclosure[32]

Unlike IRS letter rulings and similar guidance that is required to be publicly disclosed with

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[25] *West Virginia v. EPA*, No. 20-1530 (2022).

[26] *See* Jonathan Curry, "Supreme Court's EPA Decision Seen as Irrelevant to Tax Regs," *Tax Notes Federal*, July 4, 2022, p. 122; George Will, "The EPA Decision Is the Biggest One of All, and the Court Got It Right," *The Washington Post*, June 30, 2022; Jan Wolfe and Timothy Puko, "Supreme Court Puts Brakes on EPA in Far-Reaching Decision," *The Wall Street Journal*, June 30, 2022; Lee A. Sheppard, "Supreme Court Decides Major Questions Doctrine," *Tax Notes Federal*, July 11, 2022, p. 149.

[27] "The Secretary shall prescribe all needful rules and regulations for the enforcement of [the federal income tax], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."

[28] Reg. section 1.701-2.

[29] *Chevron U.S.A. Inc. v. National Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[30] Editorial Board, "The Supreme Court Restores a Constitutional Climate," *The Wall Street Journal*, June 30, 2022.

[31] *Id.*

[32] On the issue of public disclosure by large corporations generally, see Nana Ama Sarfo, "Microsoft and Cisco Face Shareholder Pressure Over Public Disclosures," *Tax Notes Federal*, July 4, 2022, p. 11. As noted earlier, SOX section 105(b)(5)(A) generally prohibits disclosure of the investigative proceedings of the PCAOB.



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identifying information redacted,[33] there is no legal requirement that the PCAOB routinely make available to the public its review of tax determinations under rule 3522 for accounting firms (with identifying details redacted, of course); nor are the deliberations of the audit committee of the attest client on tax services routinely made public (again, with identifying information redacted).

In point of fact, SOX section 105(b)(5)(A) states:

> All documents and information prepared or received by or specifically for the [PCAOB], and deliberations of the [PCAOB] . . . shall be confidential.

The PCAOB should make those disclosures public, but it appears that the law as it exists today will not permit it. Thus, Congress should amend the law (that is, SOX) to compel disclosure in much the same manner as under section 6110.

The legislative history for section 6110 said, regarding the absence of routine public disclosure of private letter rulings, that this state of affairs:

> Tended to reduce public confidence in the tax laws. . . . The secrecy surrounding [the publication or other availability of] letter rulings generated suspicion that the tax laws were not being applied on an even-handed basis.[34]

The same could be said for the PCAOB and tax matters. It is not a matter of public knowledge whether the PCAOB does an independent review of those tax decisions purportedly made by the accounting firm under rule 3522. Certainly nothing has been reported in either the mainstream news media or the tax media regarding that issue. As noted, that absence of public knowledge on the subject is bad for the tax system (and for those who oversee it) and seems like an area ripe for an investigative report by journalists, particularly given the recent public disclosure of a potential split-up of EY.

As mentioned earlier, the standards of review are not, on their face, consistent between the IRC penalty regulations and the PCAOB independence rules. Although both provisions require a significant purpose of tax avoidance to trigger the applicable rule, the PCAOB rule, on its face, allows a safe harbor for MLTN cases but the IRC does not provide a safe harbor for those very same transactions — only a minimum legal justification standard, which is not a safe harbor. It would not be surprising, because of this inherent ambiguity, if issues fall off (or never make it on) the radar screen of the PCAOB. That result would be damaging to the purpose of the PCAOB in the first place.

### The Decision-Maker

Does the PCAOB rely on the IRS for whether the MLTN standard on a covered transaction has been met, or does the PCAOB make its own determination on the merits, or, further still, does the PCAOB merely rely on an opinion of the auditing firm and limit its involvement to evaluating that opinion? Further yet, does the PCAOB do anything at all on these issues other than rubber-stamp what the accounting firm tells it relating to tax? Does the PCAOB even have the bandwidth to independently evaluate those tax issues?

If the IRS has an established position on an issue that the PCAOB is reviewing or is supposed to review, can or should the PCAOB make its own determination without regard to what the IRS's views are on either that specific transaction or those types of transactions? If the IRS is doing that kind of review for the PCAOB, this coordination has not been disclosed to the public; at least not anyplace that I can find. In my time at the national office of the IRS Office of Chief Counsel, I never once saw a matter connected in any way to the PCAOB. Are there any?

Why should all this be a mystery? The PCAOB rules, like the Treasury regulations, are silent on this issue. What is the actual practice, if there is any, and why is it not publicly known?

### Conflicts and Forum Shopping

On a practical note. I have practiced at several of the largest accounting firms for parts of three decades now. During that time, there were occasions, not common but not rare either, when the tax advising side of the firm, of which I was a

[33] Section 6110.

[34] Joint Committee on Taxation, "Summary of the Tax Reform Act of 1976," JCS-33-76, at 303 (Dec. 29, 1976).



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part, was negatively inclined on the tax law relating to a transaction for an attest client. Upon learning the initial response from tax, the accounting side of that firm at times responded by pressuring the tax advising side to change its view.[35]

If that did not work and the tax views were baked in on the tax side of the firm by those who were consulted, then the accounting side could, and sometimes did, forum shop within the tax advising side until it achieved a favorable outcome. This did not work each time but in my experience it was the likely outcome in the vast majority of cases in which it arose. After all, business is business and tax is tax.

How does that practice help with auditing function independence regardless of your views on this issue? It doesn't.

## Conclusion

Sunshine in the form of public disclosure is often said to be the best disinfectant. That is as true for the interaction among the PCAOB, tax avoidance transactions, and the very large accounting firms as it ever was.[36]

The PCAOB needs to be mandated by law to police the interactions between the audit and tax advisory functions of the same (or affiliated) accounting firm and to make those interactions public with the appropriate identifying details redacted.

As noted, at least one accounting firm, EY, is said to be thinking of splitting off its consulting business from the rest of the firm. Rules concerning the interaction between tax advising and auditing at the same firm, or of the former same firm, will need to be adopted by the PCAOB to meet the changing circumstances of the accounting firm environment. When that occurs, I hope that the recommendations here are taken into account. ■

[35] OK, change "pressuring" to "lobbying" if that sounds better. Or call it forum shopping because that is what it is. This situation is not unique to the private sector. It is done inside the IRS Office of Chief Counsel and the Treasury Office of Tax Policy as well, but it is called "tax policy" there.

[36] Besides the Big Four, there are many so-called midsized (meaning large but not gigantic) accounting firms at which the same issues are at play.

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# Small Business Tax Shelters Under the Business Interest Expense Limitation

by Monte A. Jackel

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Monte A. Jackel is a tax practitioner who formerly worked for the Big Four and national law firms. He most recently served as special counsel to the IRS chief counsel. He lives in Silver Spring, Maryland.

In this article, Jackel reviews the definition of tax shelter, which is an exception to the Tax Cuts and Jobs Act's small business exception to the business interest deduction limitation under section 163(j).

## I. Introduction

Section 163(j), enacted as part of the Tax Cuts and Jobs Act, is a complex statute intended, generally, to limit net business interest expense to 30 percent of taxable income. Section 163(j)(3) provides an exemption from section 163(j)(1) for some small businesses. An entity that meets the gross receipts test of section 448(c) is generally eligible for this exemption. Under section 448(c)(1), an entity meets this test for any tax year if its average annual gross receipts for the three-tax-year period ending with the preceding tax year does not exceed $25 million. Section 448(c)(2) imposes aggregation rules for this gross receipts threshold.

However, section 163(j)(3) contains an important exception to this small business exemption. This exception provides:

> In the case of any taxpayer (*other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)*) which meets the gross receipts test of section 448(c) for any taxable year, [the limitation on the deduction of business interest] shall not apply to such taxpayer for such taxable year." [Emphasis added.]

Therefore, it is apparent that a small business cannot be a "tax shelter" as so defined and still be exempt from the application of section 163(j).[1]

Section 448(d)(3), which defines the term tax shelter, states in pertinent part:

> The term "tax shelter" has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof).[2]

Tax shelter, in turn, is defined at section 461(i)(3) as:

> any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale . . . any syndicate (within the meaning of section

[1] There are also aggregation rules which require the combining of the gross receipts of some related entities in testing for whether the taxpayer meets the $25 million gross receipts test. For at least one apparent distortion where there is an aggregation of entities having only insignificant overlapping ownership, see Elliot Pisem and David J. Snyder, "A Trap in the Interest Limit's Small Business Exemption," *Tax Notes Federal*, Aug. 26, 2019, p. 1381 (aggregation rule in employee benefit plan provisions can unexpectedly prevent some entities from qualifying for the small business exemption when some other organization, even if not related to the taxpayer or to a related party to the taxpayer, performs "management functions" on a "regular and continuing basis" and where that organization's "principal business" is the performance of those functions on that basis).

[2] Relating to "special rules for farming."



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> 1256(e)(3)(B)), and . . . any tax shelter (as defined in section 6662(d)(2)(C)(ii)).

And at section 6662(d)(2)(C)(ii) as:

> A partnership or other entity . . . any investment plan or arrangement, or . . . any other plan or arrangement, if *a significant purpose* of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." [Emphasis added.]

The definition of tax shelter also includes "syndicates" under section 1256(e)(3)(B), which are defined as:

> Any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable[3] to limited partners or limited entrepreneurs (within the meaning of section 461(k)(4)).

Therefore, any tax shelter, as so defined, will not be eligible for the small business exception to section 163(j), and those small businesses will be subjected to this statute with all of its complexities and discontinuities, including an 11-factor process for computing the interest deduction under section 163(j) of a partnership and its partners.[4] Those computations require a software program to compute efficiently and correctly. Is it appropriate for the IRS to compel small business to that and the other burdens of the statute and regulations? I think not.

It seems greatly unfair, to say the least, to issue final regulations under section 163(j) without first providing some useful guidance on this tax shelter issue. If the IRS believes that it does not have authority to provide separate relief solely for purposes of section 163(j) and does not intend to address this tax shelter issue before it issues final regulations under section 163(j), the regulations should be deferred until general guidance is provided for the term tax shelter. The much more likely alternative is that the IRS will issue the final regulations anyway, promise to address the tax shelter issue later and then, hopefully, not forget about the promise to provide guidance in the near future.

The section 163(j) proposed regulation[5] preamble merely states that:

> Consistent with section 163(j)(3), these proposed regulations would provide that taxpayers that meet the gross receipts test of section 448(c) are not subject to the section 163(j) limitation. Eligible taxpayers are those, *other than tax shelters under section 448(a)(3)*, with average annual gross receipts of $25 million or less, tested for the three taxable years immediately preceding the current taxable year. [Emphasis added.]

## II. History of the Tax Shelter Definition

Below is a brief but necessary history of the definition of tax shelter as defined for section 163(j)(3).

### A. Syndicate Tax Shelters

The starting point for this historical analysis is the treatment of farming syndicates, which were denied specific tax benefits relating to farming under the code. Before the Tax Reform Act of 1976,[6] both active farmers as well as what were called "farming syndicates" were permitted to take advantage of several beneficial rules in the code for farming, such as the prepayment of

[3] The term "allocable" has been interpreted by the IRS as "allocated," so that the enterprise must have losses for the year, and more than 35 percent of the losses are allocated to limited partners or limited entrepreneurs. *See* LTR 9335041, LTR 9415005, LTR 9535036, and LTR 9407030. These rulings, as well as reg. section 1.448-1T(b)(3), make it clear that losses have to be allocated for a tax year to be a syndicate. All of these rulings refused to rule on the section 6662(d)(2)(C) definition of tax shelter citing the applicable no-rule revenue procedure. The current no-rule revenue procedure, Rev. Proc. 2019-3, 2019-1 IRB 130, section 3.02(2), also says no ruling will be given for whether there is a principal purpose of tax reduction. Although not mentioning significant purpose, a request for a ruling under current law section 6662(d)(2)(C) would most likely also be denied. For other background on this issue, see AICPA letter to the IRS on small business relief from the definition of tax shelter (Feb. 13, 2019); Angela W. Yu and Daniel J. Paulos, "New Limitation on Business Interest Expense Deductions," *Tax Notes*, May 13, 2019, p. 993; Stephanie Cumings, "IRS Should Spare Syndicates From Tax Shelter Rule," *Tax Notes*, Feb. 18, 2019, p. 811; and Libin Zhang, "Links to the Past: Old Exceptions to New Interest Deduction Limitations," *Tax Notes*, January 21, 2019, p. 271.

[4] The proposed regulations included an 11-factor test to apply section 163(j) to partnerships and partners. It is my understanding that the final regulations will also include this 11-factor test.

[5] REG-106089-18.

[6] P.L. 94-455.



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expenses, elimination of the need to keep inventories, and the conversion of ordinary income to capital gain in some cases. These syndicates were formed using either local law limited partnerships or as an agency relationship with a management contract and the use of nonrecourse financing. The stated reason for imposing limitations on these farming syndicates was that:

> Such special farm tax rules should be severely curtailed for farming syndicates in which a substantial portion of the interest is held by taxpayers who are motivated, in very large part, by a desire to shelter other income, rather than by a desire to make a profit in the particular farming operation.[7]

Section 464(c) at that time first defined the term farming syndicate. As stated by the 1976 blue book[8]:

> A "farming syndicate" is defined as including (1) a partnership or other enterprise . . . engaged in farming if, at any time, any interest in the partnership or other enterprise has been offered for sale in an offering required to be registered with a Federal or State agency having authority to regulate the offering of securities for sale, [and] (2) a partnership or other enterprise . . . engaged in the trade or business of farming if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs. [Footnotes omitted.]

Because of its focus on syndicated farming partnerships or other limited liability arrangements in which the owners are not active in the farming business, the statute from inception contained exceptions to this tax shelter rule if the individual owner was actively involved in the operation or management of the farm. (The provisions of section 464(c) were moved to the end of section 461 as then-section 461(j)[9] as part of the Tax Technical Corrections Act of 2014.[10])

Then there was the enactment of mark-to-market rules under section 1256 in 1981 as part of the Economic Recovery Tax Act of 1981.[11] The 1981 blue book[12] describes the tax shelter exception to hedging transactions under section 1256(e)(3), under which hedging transactions are an exception to those mark-to-market rules in the first instance under section 1256(e)(1). That section uses the term "syndicate" to mean a tax shelter defined as:

> A syndicate means any partnership or other entity . . . if more than 35 percent of the entity's losses during the taxable year are allocable to limited partners or limited entrepreneurs.

The limitation on tax shelters for this purpose does not apply when an individual actively participates in the management of the enterprise. Of particular interest, the 1982 blue book stated[13]:

> The Act delegates to the Treasury the authority to determine whether certain other interests [other than actively participating interests] should be treated as active interests. The Treasury may allow an interest to be treated as an active interest if it determines that an interest should be treated as held by an individual who actively participates in the management of the entity and that neither the entity nor the interest are used (or will be used) for tax-avoidance purposes.

Next, the 1984 act[14] added a restriction on the prepayment of expenses generally by tax shelters as defined under section 461(i)(3). This was done to prevent the acceleration of deductions by high-

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[7] Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1976," JCS-33-76, at 46 (Dec. 29, 1976) (1976 blue book).

[8] *Id*.

[9] Now section 461(k) entitled "farming syndicate defined."

[10] P.L. 113-295 section 221.

[11] P.L. 97-34 section 503.

[12] JCT, "General Explanation of the Economic Recovery Tax Act of 1981," JCS-71-81, at 300, 301 (Dec. 29, 1981) (1981 blue book).

[13] JCT, "General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982," JCS-38-82, at 219, 301 (Dec. 31, 1982) (1982 blue book).

[14] The Deficit Reduction Act of 1984, P.L. 98-369, section 91.



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bracket taxpayers. As stated by the 1984 blue book in defining tax shelters under section 461(i)(3)[15]:

> Under the Act, a tax shelter means (1) a partnership or other enterprise . . . in which interests have been offered for sale, at any time, in any offering required to be registered with a Federal or State agency; (2) a partnership or other enterprise if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs (generally investors who do not actively participate in the management of the enterprise); or (3) any partnership, entity, plan, or arrangement which is a tax shelter within the meaning of section 6661(b) [see below] (i.e., the principal purpose of which is the avoidance or evasion of Federal income tax). . . . In determining whether an investment constitutes a tax shelter, Congress intended that consideration will be given to whether there is a reasonable and significant expectation that either (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset Federal income taxes on income from other sources in that year. Significant weight will be given to the expectations described in the offering materials . . . [or] to the percentage of total expenses of the entity, plan, or arrangement that are prepaid expenses.

Finally, the 1986 act[16] enacted section 448 to limit the use of the cash method of accounting by, among other entities, a tax shelter as defined at section 448(d)(3) as having the same meaning as in section 461(i)(3), described immediately above. Section 448(d)(3) defines tax shelter for purposes of section 448(a)(3), which is referenced in section 163(j)(3) as providing the kick-out of tax shelters from the small business exception to section 163(j)(1)'s limitation on the interest deduction.

### B. Principal Purpose Tax Shelter

The initial enactment of the penalty for substantial understatement occurred under then-section 6661 as part of the 1982 Tax Equity and Fiscal Responsibility Act.[17] Regarding the special rules for tax shelters at that time, the 1982 blue book states that neither corporate nor noncorporate taxpayers could avoid the penalty unless:

> With respect to tax shelter items, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. For this purpose, a tax shelter is a partnership or other entity, plan or arrangement the principal purpose of which, based on objective evidence, is the avoidance or evasion of Federal income tax. Congress believed that if the principal purpose of a transaction is the reduction of tax, it is not unreasonable to hold participants to a higher standard [more likely than not] than ordinary taxpayers [substantial authority]. Congress was also aware, however, that no reasonably informed business decision is made without regard to its tax effects.

It can therefore be seen that, when first enacted into law, the definition of tax shelter (the principal purpose of tax avoidance or evasion) was tied directly into the level of legal assurance the taxpayer could establish regarding the likelihood of prevailing on the merits of the transaction (more likely than not), when the taxpayer eventually lost on the merits of the particular transaction (otherwise, there would be no understatement of tax).

The initial statute also acknowledged that it was reasonable to take tax effects into account. However, it was not difficult to make such a

[15] JCT, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," JCS-41-84, at 281 (Dec. 31, 1984) (1984 blue book).

[16] Tax Reform Act of 1986, P.L. 99-514, section 801.

[17] P.L. 97-248 section 323(a).



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statement: When the IRS had to establish that "the principal purpose" was tax avoidance, that purpose therefore had to exceed any other purpose in importance,[18] and the taxpayer could avoid the penalty if the taxpayer could establish that it was "more likely than not" that he would prevail on the merits.

Next, in 1984 Congress imposed restrictions on the prepayment of expenses by tax shelters under section 461(i), as noted earlier. The 1984 blue book[19] defines tax shelter as both a syndicate and "a partnership or other arrangement where the principal purpose was tax avoidance." "The principal purpose" test is still reflected at reg. section 1.6662-4(g) even though that regulation section was last amended in 2003, way past the date in 1997 when section 6662 was changed from the principal purpose to "a significant purpose" and the date in 2004 when the more likely than not exception for noncorporate tax shelter transactions was repealed (see below).

Next, again as noted earlier, the 1986 act brought changes to the use of the cash method of accounting by enacting new section 448. The 1986 blue book[20] references section 461(i), relating to the definition of tax shelter, for purposes of imposing limitations on using the cash method of accounting.

Next, tax legislation enacted in 1994[21] eliminated the more likely than not exception for corporations participating in tax shelters because:

> There appears to be a growing number of aggressive tax shelter transactions involving corporate taxpayers.

That change in the law created the disconnect between the level of taxpayer assurance for success on the merits and the definition of tax shelter under section 6662 (and the other sections incorporating the section 6662 definition of tax shelter). At that time, even if a corporate taxpayer could establish that it was more likely than not to prevail on the merits, there was no automatic exemption to the accuracy-related penalty if the taxpayer ended up losing on the merits. The level of taxpayer assurance at that time became merely a factor in the reasonable cause defense to the penalty under section 6664.[22]

However, at least at that time it was still necessary for the principal purpose of a transaction to be tax avoidance or evasion for it to be a tax shelter although there was no direct connection any longer between a corporate taxpayer, its level of assurance on the merits of a transaction, and what is a tax shelter for purposes of the penalty. The remaining linkage of level of assurance on the merits and what is a tax shelter was broken in 2004[23] when the exception for more likely than not was eliminated for all noncorporate taxpayers as well.

Finally, the 1997 act[24] brought changes to the tax shelter registration rules of section 6111 and related sections and changed the definition of the term tax shelter itself in section 6662. The 1997 blue book[25] reflected a change in section 6662(d)(2)(C) from the principal purpose to a significant purpose in defining the term tax shelter. The reason given for the change was to conform to the tax shelter registration requirements then in effect and as imposed by the 1997 act. No explanation is given in the 1997 blue book as to what the new standard meant.[26]

At that time in 1997, a corporate taxpayer could have a more likely than not chance of success on the merits of a transaction, but the transaction could still be a tax shelter if there was a significant purpose rather than the principal purpose of tax avoidance or evasion regarding that transaction. Because significant purpose was clearly a lower standard than the principal purpose, corporate taxpayers could have a better chance of winning than losing in court, but the

[18] Reg. section 1.6662-4(g)(2)(i) ("The principal purpose . . . [exists] if that purpose exceeds any other purpose.").

[19] 1984 blue book, *supra* note 15, at 281.

[20] JCT, "General Explanation of the Tax Reform Act of 1986," JCS-10-87, at 479 (May 4, 1987) (1986 blue book).

[21] S. Rep. 103-412 (Nov. 22, 1994), commenting on P.L. 103-465, section 744(b)(1).

[22] The regulations under sections 6662 and 6664 reflect this state of the law and have not been updated to reflect the 2004 act change that eliminated the more likely than not exception for tax shelters of all taxpayers.

[23] P.L. 108-357 section 812.

[24] Taxpayer Relief Act of 1997, P.L. 105-34, section 1028.

[25] JCT, "General Explanation of Tax Legislation Enacted in 1997," JCS-23-97, at 224 (Dec. 17, 1997) (1997 blue book).

[26] Finally, P.L. 108-357 section 812, tax legislation enacted in 2004, eliminated the noncorporate taxpayer exception to tax shelters under section 6662(d)(2)(C) without any explanation other than stating that Congress intended this change.



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transaction could still be a tax shelter and there would be no immunity from the penalty if the taxpayer ended up losing on the merits, a very illogical result.

### C. Case Law Treatment

The section 6662 definition of tax shelter has been cited in case law since the change in 1997,[27] but those cases were so blatantly tax shelters that they provide no or little useful guidance on where the line is for a significant purpose compared with the principal purpose. The significant purpose of a transaction can be tax avoidance or evasion regarding almost any transaction with a tax element, even a small one, depending on how you look at the term "significant." It is not even clear whether significant is measured quantitatively or qualitatively.[28]

What is clear from the case law is that you do not need a mass-marketed, cookie-cutter structured transaction to have a tax shelter under the significant purpose standard of section 6662.

A significant case in this area is *Valero Energy*.[29] This case dealt with the applicability of the exception to the federally authorized tax practitioner privilege involving the promotion of a tax shelter, when section 7525(b)(2) expressly references section 6662(d)(2)(C)(ii) for that purpose. In this case, the taxpayer directly solicited advice from a large accounting firm (Arthur Andersen) concerning foreign currency losses; the court noted that the advice given by the accounting firm did not relate to an "advertised prepackaged tax shelter" product, which the taxpayer argued was necessary to have a tax shelter:

> While Congress left promotion [of a tax shelter] up to judicial interpretation, it took care to define tax shelter by explicit reference to another section of the tax code. For purposes of the exception, a tax shelter is "(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." 26 U.S.C. section 6662(d)(2)(C)(ii). Nothing in this definition limits tax shelters to cookie-cutter products peddled by shady practitioners or distinguishes tax shelters from individualized tax advice. Instead, the language is broad and encompasses any plan or arrangement whose significant purpose is to avoid or evade federal taxes. . . . This definition of tax shelter is broad and could, as [taxpayer] points out, include some legitimate attempts by a company to reduce its tax burden. But it is not our place to tinker with the unambiguous definition provided by Congress. And even under this definition, tax shelters are not boundless. Only plans and arrangements with a significant — as opposed to an ancillary — goal of avoiding or evading taxes count.

What is clear from this excerpt from the court's opinion is that: (1) the definition of tax shelter is broad (that is an obvious statement); (2) the definition of tax shelter could include legitimate attempts to reduce a taxpayer's tax burden (almost all business transactions have tax considerations, so it is difficult to draw a line for what is a tax shelter unless all transactions with a tax element are tax shelters but those in which tax avoidance is only an ancillary goal are not); (3) if the definition of tax shelter is overbroad, it is up to

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[27] *Nevada Partners Fund LLC v. United States*, 714 F. Supp. 2d 598 (S.D. Miss. 2010) (complex structured financial products trade); *United States v. Textron Inc.*, 507 F. Supp. 2d 138 (D.C.R.I. 2007) (SILO transaction); *Enbridge Energy Co. v. United States*, 553 F. Supp. 2d 716 (S.D. Tex. 2008) (Midco transaction); *Salem Financial Inc. v. United States*, 102 Fed. Cl. 793 (Ct. Cl. 2012) (STARS transaction); *Alpha I LLP v. United States*, 93 Fed. Cl. 280 (Ct. Cl. 2010) (son-of-BOSS); *Raifman v. Commissioner*, T.C. Memo. 2018-101 (marketed stock monetization loan strategy); *AD Investment 2000 Fund LLC*, T.C. Memo. 2015-223 (son-of-BOSS); *Our Country Home Enterprises Inc. v. Commissioner*, 145 T.C. 1 (2015) (split-dollar transaction substantially similar to a listed transaction); *Gerdau MacSteel Inc. v. Commissioner*, 139 T.C. 67 (2012) (contingent liability loss duplication transaction); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161 (2009) (digital option spread transaction); *Stobie Creek Investments v. United States*, 82 Fed. Cl. 636 (Ct. Cl. 2008) (son-of-BOSS); *Jade Trading LLC v. United States*, 80 Fed. Cl. 11 (Ct. Cl. 2007) (son-of-BOSS); *Palm Canyon X Investments LLC v. Commissioner*, T.C. Memo. 2009-288 (son-of-BOSS); and *Santa Monica Pictures LLC v. Commissioner*, T.C. Memo. 2005-104 (loss duplication). *See also* Sheryl Stratton, "Accountant-Client Privilege: Unclear From the Start," *Tax Notes*, July 6, 1998, p. 7 ("The broad definition of tax shelter [in section 7525 and thus in section 6662] as it stands could literally mean anything.").

[28] Meaning it is not clear whether "significant" is any tax reduction of a meaningful dollar amount although it is a low percentage of the reasons for entering into the transaction compared with the nontax reasons, or whether significant means a high percentage (up to 50 percent) of the reasons for entering into the transaction compared with the nontax reasons. Or both.

[29] *Valero Energy Corporation v. United States*, 569 F.3d 626 (7th Cir. 2009).



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Congress, and not the courts, to correct the problem; and (4) a "significant goal" of avoiding taxes does not include an ancillary goal[30] of avoiding taxes. Ancillary most likely means, in this context, not the primary goal of a transaction and not the most important goal of the transaction. But that type of definition indicates a transaction that does not have tax avoidance as the principal purpose.[31] These factors are not worth much in providing useful guidance in real world business and investment scenarios.

## III. A Possible Path Forward

There is a potential solution to the section 163(j) tax shelter problem, at least under section 1256(e)(3)(C) for deemed active management by the taxpayer as an exception to the syndicate tax shelter kick-out to the hedging transaction exception to the mark-to-market rules.

As noted, when an individual actively participates in the management of the entity, the interest held by the individual is treated as not being held by a limited partner or limited entrepreneur and, thus, not a syndicate tax shelter. In that way section 1256(e)(3)(C)(v), as explained earlier, grants regulatory authority to exempt some interests from being a syndicate tax shelter if tax avoidance is not a factor in the transaction and the IRS determines it is appropriate to treat the holder as if it is an actively participating individual, even though the taxpayer is not active.

It will not be easy to write a rule exempting nontax avoidance syndicates when there is no active participation. However, some limited participation entities should not be treated as tax shelters to those holders even if they generate losses. If that were not the case, why authorize regulations to deal with that precise issue, as section 1256(e)(3)(C)(v) does? Because neither the TCJA legislative history nor the TCJA blue book[32] discusses the reason why passive investments that can generate losses attributable to a trade or business should be exempt from section 163(j) if it is a small business entity, this line drawing will not be easy.

It seems that given that only trade or business interest expense is subject to section 163(j), passive investors should be exempt from its application and only subject to the investment interest limitations of section 163(d). This argues for writing a rule exempting passive participants in syndicates from being tax shelter participants under the rules of section 1256. But the proposed regulations under section 163(j)[33] do not follow this approach, applying both the trade or business limitation of section 163(j) at the partnership level and the investment interest limit of section 163(d) at the partner level. The proposed regulation preamble states:

> It should be noted that, with respect to passthrough entities, including S corporations, engaged in trades or businesses that are not passive activities and with respect to which certain owners of the passthrough entities do not materially participate for purposes of section 469, as described in section 163(d)(5)(A)(ii) and as illustrated in Rev. Rul. 2008-12, the rules of section 163(j)(4) will apply to business interest expense allocable to such trades or businesses of those passthrough entities if those entities are otherwise subject to section 163(j). To the extent business interest expense of a passthrough entity is not limited under section 163(j), such business interest expense may still be limited by section 163(d) at the passthrough entity owner level in these situations. With respect to partnerships, to the extent that such business interest expense is limited under section 163(j)(4) and becomes a carryover item of partners who do not materially participate with respect to such trades or

[30] The *Oxford Dictionary of English* defines "ancillary" as providing necessary support to the primary activities or operations of an organization or system, or in addition to something else but not as important.

[31] "If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose." Reg. section 1.269-3(a)(2) (flush language).

[32] JCT, "General Explanation of Public Law 115-97," JCS-1-18 (Dec. 2018).

[33] REG-106089-18.



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> businesses, those items will be treated as items of investment interest expense in the hands of those owners for purposes of section 163(d) once those carryover items are treated as paid or accrued in a succeeding taxable year. The Treasury Department and the IRS have concluded that this is the result of the statutory rules contained in section 163(d)(4)(B) and (d)(5)(A)(ii) and, therefore, no additional rules are needed in regulations to reach this result.

As for section 6662(d)(2)(C)'s tax shelter definition, there would need to be some guidance issued by the IRS providing that some arrangements do not have "a significant tax avoidance purpose" to be exempt from section 163(j) if the taxpayer otherwise qualifies as a small business. This line drawing will be difficult, but it is a necessary job and is long overdue.[34]

Reg. section 1.6662-4(g)(2) defines the term tax shelter generally and provides context for what the principal purpose of tax avoidance means. The regulation states in pertinent part:

> Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter. . . . The principal purpose of an entity, plan or arrangement is not to avoid or evade Federal income tax if the entity, plan or arrangement has as its purpose the claiming of . . . tax benefits in a manner consistent with the statute and Congressional purpose.

This seems to mean that if the transaction passes muster under the economic substance doctrine,[35] at least the principal purpose of the transaction is probably not tax avoidance,[36] but tax avoidance could still be a significant purpose given the ambiguity of the term. The same is true for transactions with no tax elements whatsoever, if those transactions actually exist (other than, perhaps, the receipt of cash compensation for services with no restrictions is gross income).

But in between these two extremes lie transactions that have both tax and business elements. Do tax shelters cover transactions only when it can be proved (1) that the taxpayer would not have entered into the transaction without the tax benefits? Or does it mean that (2) if the taxpayer would have entered into the transaction regardless of whether there are tax benefits, only then is it possible not to be a tax shelter, but (3) even in the latter cases, it still could be a tax shelter? If the last statement is true, all tax planning could be bad, which is clearly not the case and would be inconsistent with statements made in the 1982 blue book,[37] when the accuracy-related penalty was initially enacted, that all reasonable businessmen take tax considerations into account.

Section 7701(o) requires a substantial nonfederal income tax purpose for the transaction to have economic substance. But even in that case the "substantial business purpose" could be very real but less important than the sought-after tax benefits. How "substantial" does the business purpose have to be to avoid being treated as a tax shelter when a significant purpose of tax

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[34] As it has for years, the latest Treasury-IRS priority guidance plan update (Sept. 2, 2019) promises guidance on issues under sections 6662, 6662A, and 6664, and it references Notice 2005-12 as interim guidance. However, Notice 2005-12 does not discuss making any changes to the definition of tax shelter under section 6662.

[35] Section 7701(o).

[36] But as can be seen from the quoted excerpt, the regulations even hedge on that point.

[37] *See supra* note 13.



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avoidance will potentially result in the assertion of accuracy-related penalties under section 6662?[38]

The penalty provisions under sections 6662 and 6664 do not provide a solution either — at least not as the regulations are presently drafted. Substantial authority will not provide a defense to a tax shelter item.[39] Nor will a reasonable basis position and disclosure to the IRS.[40] Nor even will a more likely than not position on the merits.[41] Thus, the current regulations imply that one can have a tax shelter even though the legal position supporting the taxpayer's treatment is greater than 50 percent.

The economic substance case law is all over the map in terms of quantifying when the doctrine will be applied and what tests to apply in determining whether a transaction has economic substance.[42] The 2010 blue book notes[43] that "if the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed." The note then follows with a list of tax credits that do not violate the doctrine "in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was designed to encourage." This language mirrors the language in reg. section 1.6662-4(g)(2), quoted earlier, that the principal purpose of a transaction is not tax avoidance if the transaction "has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose." The language also mirrors the language in the 1984 blue book on the prepayment of expenses, also discussed earlier.

However one wants to argue this, Congress has not provided an express exception to the substantial understatement penalty tax shelter regime for transactions found to possess economic substance and not found lacking under the other common law antiabuse doctrines. But future regulations or other guidance should at least provide a presumption in the taxpayer's favor in that type of case, when the transaction would not be invalidated based on sham, substance, or step transaction principles.

Even if that is done, to provide an ability for small business taxpayers to assess whether they are tax shelters for purposes of section 163(j), rules should provide that when it is "more likely than not" that a transaction would not be invalidated under economic substance or the other common law doctrines, or any other statutory[44] or regulatory[45] antiabuse rules, the transaction should not constitute a tax shelter under section 6662(d)(2)(C). The IRS should be able to rebut this presumption with evidence of a tax avoidance motive.

I think that is the best we can do under the circumstances absent a statutory change from Congress. That is badly needed but very unlikely. ■

[38]It would seem odd that a taxpayer could prevail on the merits of an economic substance challenge, and, thus, not be subject to the lack of economic substance penalty under section 6662(b)(6) but still be subject to the substantial understatement penalty under section 6662(b)(2) if the taxpayer did not prevail on a challenged transaction for reasons other than lack of economic substance or failing to meet the requirements of any similar rule of law because the transaction is still treated as a tax shelter under section 6662(d)(2)(C).

[39]Reg. section 1.6662-4(g).

[40]Reg. section 1.6662-4(e)(2).

[41]Reg. section 1.6664-4(f)(2), (f)(3). Note that the regulations under sections 6662 and 6664 are out of date because they still reference "the principal purpose" tax shelter definition and continue to treat corporate and noncorporate tax shelter participants differently, which is no longer the case since the tax legislation in 2004.

[42]JCT, "General Explanation of Tax Legislation Enacted in the 111th Congress," JCS-2-11, at 369-382 (Mar. 2011) (2010 blue book).

[43]*Id*. at 378. For a recent case that may have missed the application of the codified doctrine and the so-called tax credit exception discussed in the text, see *Cross Refined Coal LLC v. Commissioner*, No. 19502-17 (Aug. 29, 2019, bench opinion), which concerned a transaction that apparently occurred in 2010, predating the codification of the economic substance doctrine in section 7701(o), wherein the Tax Court found for the taxpayer in determining whether a valid partnership had been formed to invest in coal refining and to obtain the section 45 credit for the refining activities. The court followed *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), distinguished *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012), and held that in determining profit sharing, the analysis must take into account the tax credit itself, the purpose of which was to encourage investment in the credit activity. The court did not cite or mention either the check-the-box regulations or reg. section 1.701-2, and it also did not cite or discuss section 7701(o). The investments into the partnership occurred no later than March 1, 2010, and section 7701(o) is effective for transactions after March 30, 2010. *See also* Eric Yauch, "Energy Credit Scheme Lacked Economic Substance," *Tax Notes Federal*, Sept. 30, 2019, p. 2326 (discussing the *Alternative Carbon* case, No. 2018-1948 (Fed. Cir. 2019)), where the court found a transaction lacked economic substance and determined that the taxpayer's position lacked reasonable cause without discussing whether it was a tax shelter.

[44]Section 269.

[45]Reg. section 1.701-2.



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