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# THE FAILURE OF DISCLOSURE AS AN APPROACH TO SHELTERS

*David A. Weisbach**

PETER Canellos, in his article in this Volume,[1] discusses the response to tax shelters by the highest levels of the tax practitioner community. His article itself is representative of the unusual tradition in the tax bar of public spirited analysis that he discusses. One of the great advantages of practicing and teaching tax law is the high level of interaction between academics, practice, and policymaking. It is a pleasure to be able to comment on his article.

Canellos argues that the combination of properly structured disclosure of and penalties on tax shelters is sufficient to stop or at least slow down the current tax shelter boom. The argument is that the economics of the shelter industry rely on the audit lottery rather than on substantive tax law. Taxpayers compare the probability of being caught and the cost of being caught with the potential tax savings. Under current law, there is no incentive not to buy a lottery ticket in the form of a bogus shelter because the chance of being caught is low and, if one is caught, there is little or no downside in the form of penalties. If we believe courts generally can differentiate between permissible, aggressive tax planning and impermissible tax shelters, we can change these odds without changing substantive law. Disclosure increases the chance of being caught and penalties create a cost to being caught. Properly structured disclosure and penalties should be sufficient and a new substantive disallowance rule is not needed. Moreover, to the extent a substantive disallowance rule, such as a strengthened profit requirement, substance over form requirement, or motive requirement, changes current law, it can only do harm. The relationship between substance and form under current law is nuanced and important. Many ordinary business transactions rely on the subtleties of this distinction. A substantive disallowance rule, by changing the relationship between form and substance, has the potential to play havoc with current law. A substantive disallowance rule, therefore, is not necessary and potentially harmful. Disclosure and penalties are the cure.

I respectfully disagree with this conclusion. Although I believe that disclosure and penalties will do no harm, I also believe that disclosure

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* Professor, University of Chicago Law School. I thank Hal Gann and Cal Johnson for their thoughts on the topics discussed here.

1. Peter Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and Tax Shelters*, 54 SMU L. REV. 47 (2001).



HeinOnline -- 54 S.M.U. L. Rev. 73 2001

and penalties will do little or nothing to stem the current tide of shelters. A strong substantive disallowance rule (which I will also call an anti-shelter doctrine) is necessary and appropriate. Our disagreement may stem from the empirics—we have different views of the quality of current shelters, the strength of current law, and of the abilities of courts. But this disagreement may also mask a more fundamental issue, the appropriate strength of a substantive disallowance rule. Even if Canellos' description of modern shelters, current law, and courts is correct, even if courts would consistently disallow many of the things Canellos would label shelters if they were discovered, current law may be too weak. Perhaps courts should disallow a much broader class of tax planning. I suspect we disagree on this second, more fundamental, issue as well.

Section I discusses the empirics. I do not think courts would disallow many current shelters were they caught nor do I think that disclosure is necessary to catch, or is even about catching and auditing, more shelters. Section II focuses on the more fundamental issue of the appropriate strength of a substantive disallowance rule.

## I. DISCLOSURE IS NOT ENOUGH

Canellos' argument for disclosure is based on the observation that tax professionals and courts can readily distinguish tax shelters from real transactions. The difference, Canellos argues, is multifaceted and not narrowly based on a single test, such as the test proposed by the Treasury Department. Canellos points to four factors that distinguish shelters from other transactions. First, shelters exist principally to reduce taxes. Second, tax shelters are generated and marketed by specialized tax shelter promoters. Third, tax shelters often have accommodation parties. Finally, shelters are often scripted or preplanned (i.e., they have no real economics). Based on these factors, and potentially others, courts and practitioners can readily determine if a transaction is a shelter. If this is true, there is little need to change the substantive law—shelters do not work under substantive law and real transactions are safe.

Why then have we seen the explosion in tax shelters? Because taxpayers are now playing the audit lottery. Find a tax position that is facially plausible but that would never survive real scrutiny. Find a lawyer willing to sell penalty protection in the form of an opinion. And then hope the transaction is never caught. Disclosure and changes to the penalty rules solve this problem by changing the returns to playing the audit lottery.

I fully support changing the returns to the audit lottery and I commend Canellos and the bar associations for their support in this endeavor. Enhanced penalties and higher opinion standards on lawyers, in particular, may help. But the argument that this approach will stem the shelter boom relies on the courts to recognize and strike down shelters. I have less faith in courts and current law than do Canellos and the bar associations he discusses and, therefore, I do not believe disclosure and related strategies such as changes to the penalty regime are sufficient.

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Courts regularly allow taxpayers to claim benefits from transactions that would fall under Canellos' shelter rubric. These are transactions that have little business purpose, no real economics, are marketed as shelters, and have extraneous parties or steps. *Cottage Savings*,[2] a favorite of the tax bar, is a good example. *Cottage Savings* did not involve a real transaction. Absolutely nothing happened except for tax. The economics of the ACM transaction,[3] an admitted shelter, swamp those of *Cottage Savings*. In fact, it would be difficult to imagine arranging a transaction so that less actually happens. And there was no point to the deal other than to raid the Treasury. The business purpose was precisely zero, not even one-tenth of percent. These transactions were also marketed widely. All the shelter factors except the use of an accommodation parties (which were not necessary) are present. Yet the taxpayer won in *Cottage Savings*.[4]

There are dozens of leveraged lease cases where the courts accepted completely fictional arrangements as real. The leading case is *Frank Lyon*.[5] The facts of this sale-leaseback case are complex, but the bottom line was that in virtually no event would the purported owner of the property recover anything more than its original investment plus six percent interest, and in virtually no event would the purported owner lose money. The purported owner of the property had no involvement in the transaction other than as a lender, but through fictions believed by the court, was able to cast itself as an owner. Maybe sale-leasebacks should be allowed, but the court did not make that policy judgment. Instead, the court was completely fooled by the arrangement. It took a statutory change to limit the shelters allowed by *Frank Lyon* and similar cases and abusive leasing transactions are still common where they fall outside the statutory rules.[6]

The courts also have a mixed record dealing with straddle losses, again requiring congressional action to fix. For example, in *Smith*,[7] the court found all of the factors required to claim a loss could be present in typical straddle transactions. It found that property was acquired by the taxpayer, a closed and completed transaction occurred in the taxable year, the taxpayer had basis in the property, and the amount realized was ascertainable. Therefore, the elements necessary to claim a capital loss were present in closing one leg of a commodity straddle position. The court further held that the transactions were neither shams nor devoid of

2. Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991).
3. ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998).
4. The tax bar frequently defends the result in *Cottage Savings* with the argument that the losses in that case were real economic losses. This defense falls short. The tax law must police the use of realization to claim losses because taxpayers can choose to defer realization of gains. A regime where taxpayer could simply check a box to claim losses or gains without real economic changes would be a disaster. That is, because gains tend to be deferred under the realization rule, we must design the realization rule to ensure that losses cannot freely be accelerated. The tax law should require some real economic cost for a taxpayer to claim a loss. The result in *Cottage Savings* undermines this basic structure of the realization rule and, therefore, cannot be defended as an appropriate result.
5. Frank Lyon Co. v. U.S., 435 U.S. 561 (1978).
6. *See* I.R.C. § 469 (1994).
7. 78 T.C. 350 (1982), *aff'd without op.*, 820 F.2d 1220 (4th Cir. 1987).

economic substance based in part on the fact that futures contracts are binding on the parties. Although the court ultimately held against the taxpayer, the court did not understand the nature of these transactions. The vast majority of straddles prior to the enactment of section 1092 were pure tax creatures, as fake as the most blatant of modern corporate shelters. There was no business purpose, and no economics, and they were widely marketed by promoters. Under Canellos' concept of shelters, straddles should never have been allowed. Congress eventually had to enact legislation to stop these shelters.[8]

In *NIPSCO*,[9] the taxpayer set up a shell subsidiary in the Netherlands Antilles and borrowed money in the European markets through the subsidiary. By running the money through the Netherlands Antilles, the taxpayer avoided withholding taxes. While the transaction involved a real borrowing, the entire structure of the transaction was purely tax driven. A few pieces of paper filed with the government of a Caribbean island, paper that had no effect on the underlying transaction, allowed the taxpayer to avoid taxes. These transactions were marketed by shelter promoters, involved extraneous parties and steps, were completely wired in the sense that they did not change the economics of a transaction that would otherwise have occurred, and were entered into solely to reduce taxes. Every tax shelter factor was present. Like *Frank Lyon* and *Smith*, *NIPSCO* had to be reversed through legislation.[10]

In *Chamberlin*,[11] a closely held corporation issued a non-taxable stock dividend of preferred stock. Two days later as a result of lengthy prior negotiations, virtually all of the shareholders sold the preferred stock to two insurance companies for cash, claiming capital gains. It was contemplated that the preferred stock would be redeemed within seven years. Effectively, the corporation sent cash to its shareholders by passing it through an insurance company and by adding this extra step, converted ordinary income into capital gain. This fits all of the shelter factors. There was no purpose to this arrangement other than conversion. The insurance companies acted as ready accommodation parties. I have no idea whether the transaction was marketed by shelter promoters, but clearly, it could have been and is similar to the transactions that are today marketed by promoters. And the deal was completely wired, so that there was little or no chance that the accommodation parties would, in the end, have a real interest in the corporation. But the court agreed with the taxpayer. And once again, Congress had to intervene because the result was so patently ridiculous.[12]

I could go on for pages describing the silly results in cases such as

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8. *See* I.R.C. § 1092.
9. N. Ind. Pub. Serv. Co. v. Comm'r, 105 T.C. 341 (1995).
10. *See* I.R.C. § 7701(l).
11. Chamberlin v. Comm'r, 207 F.2d 462 (6th Cir. 1953).
12. *See* I.R.C. § 306.

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*Woods Investment, Esmark, Beck Builders, Chisholm*[13] and others. There is a long line of jurisprudence in the tax law to the effect that taxpayers are allowed to structure transactions to minimize taxes and are allowed to rely on the law as it is written. For every case looking to substance over form or business purpose over tax motive, there is an equal and opposite case respecting a transaction that fits Canellos' description of shelters. There are good arguments that the decisions in many of these cases were correct and good arguments that they were incorrect. I do not think, however, that a debate about the merits of each individual case would be helpful. Maybe a few would get switched from the "decided wrong" category to the "decided right" category or vice versa. (Even debating this is difficult without a theory of tax avoidance, which Canellos does not provide and which I will not discuss until the next section.) But I think a perusal of the cases shows that courts are often quite literal in their interpretation of the tax law, and if someone finds a winding path through dozens of complex, interacting code provisions that leads to a tax goodie, all the better for the taxpayer. I do not believe we can rely on courts and current law to police shelters.

My experience with tax practitioners is similar to my reading of the case law. Many transactions never make it to court. Instead, they require immediate reversal by Congress or the Treasury Department because the results they produce are so ridiculous. Yet good practitioners from respected firms, not just tax promoters crawling out from under rocks, offer opinions on these deals. For example, leveraged *Morris Trust* transactions allowed cash sales of businesses without tax. These transactions were given strong opinions by serious practitioners, but were later disallowed (prospectively) with support from the major bar associations.[14] Reverse MIPS, which never were offered because the Treasury issued a ruling prior to their introduction, would have allowed equity to be treated as debt, at least if one is to believe the opinions of top level practitioners.[15] The current President of the ABA recently defended in print the *UPS* transaction, a transaction involving a sham off-shore subsidiary that surely falls into Canellos' description of tax shelters (and if it does not, the case is relatively easy that disclosure is not enough).[16] Joe Bankman, last year, described a loss importation shelter, in which, through a complex scheme with a trumped-up business purpose, artificial losses were generated off-shore and then essentially sold to corporations to use against their tax liability.[17] Once again, good practitioners were giving

13. *See* Woods Inv. v. Comm'r, 85 T.C. 274 (1985); Esmark Inc. v. Comm'r, 886 F.2d 1318 (7th Cir. 1989); Henry C. Beck Builders Inc. v. Comm'r, 41 TC 616 (1964); Chisholm v. Comm'r, 79 F.2d 14 (2d Cir. 1935), *cert. denied*, Helvering v. Chisholm, 296 U.S. 641 (1935).

14. *See* I.R.C. § 355(e).

15. *See* I.R.S. Notice 94-48, 1994-01 C.B. 357.

16. *See* David Lupi-Sher, *As Briefs are Filed, Practitioners Question Decision in* UPS *Case*, 89 TAX NOTES 200, 203 (Oct. 9, 2000) (quoting Pamela Olson).

17. *See* Joseph Bankman, *The New Market for Corporate Tax Shelters*, 83 TAX NOTES 1775 (1999).

opinions on these transactions. Plenty of practitioners also offered opinions on step-down preferred and liquidating REIT transactions. The list of transactions, like the list of cases, is almost endless. If Canellos intends to rely on the tax bar to help police the shelter mess, he is looking in the wrong place.

If Canellos thinks the tax bar can tell good deals from bad, why are they giving support to such junk? The reason the tax bar gives support to this junk goes back to the case law. Many of these transactions work under current law. This means that they do not rely on the audit lottery. Disclosure and penalties would not stop them. Indeed, some of these deals were public. To stop these shelters we need to change the substantive law, not just rely on disclosure and penalties.

The basic economics of corporate shelters also makes it hard to believe that any sizeable percentage rely on the audit lottery. Few companies want to reduce earnings even if doing so produces real tax savings. Therefore, most shelters produce tax losses but not book losses. These shelters will show up as Schedule M adjustments. While Schedule M's can be long and complex, shelters of reasonable size are likely to be spotted.

If Schedule M's are insufficient, the IRS can readily require better record keeping or revise the Schedule M to allow better scrutiny. This, of course, leaves private companies and individuals who do not file Schedule M's, but my impression is that the vast majority of shelter activity takes place in the public company context. The basic point, however, applies even in the private company context: we do not need legislation or new regulations to address the problem of discovery of shelters during audits; changing tax forms or record keeping requirements would suffice.

Disclosure, instead, is about letting the policy makers in Washington find out about shelters more quickly. Disclosure lets the policy makers evaluate shelters sooner and decide whether the law needs to be changed to prevent them. The stories of tax shelter descriptions arriving at the Treasury in plain brown envelopes reflect why this type of disclosure is needed. But the Treasury only needs to know about shelters to the extent that they plausibly work under current law. (The Treasury need not waste time on shelters that blatantly do not work.) The benefit of disclosure comes only if the government is willing to change, or at least clarify, the law. Therefore, we should compare disclosure and frequent changes to the law with a broad substantive disallowance rule. Here, Canellos and the bar associations are on weak ground. As Joe Bankman pointed out several years ago, the government regularly shutting down shelters actually feeds the shelter market because it creates a demand for the services of tax shelter providers.[18] In addition, frequent changes that shut down shelters impose costs on other taxpayers in the form of enormous

18. *See id.*

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complexity. The combination of disclosure and frequent changes is inferior to a broad substantive disallowance rule.

Perhaps our reading of the cases (and practitioner opinions) reflects more than a mere disagreement about the quality of the decisions. We may simply draw the line between aggressive tax planning and shelters in different places. For example, Canellos indicates that he thinks the transactions illustrated in *UPS*, *Winn-Dixie*, and *Compaq*[19] are in the hinterland between merely aggressive transactions and tax shelters while I think these transactions were clearly in the shelter camp. And Canellos takes a relatively benign view of financial products (call them an interstitial class between real transactions and shelters) while I view much financial planning as inappropriately and inefficiently tax driven. Maybe Canellos thinks that the transactions exemplified in *Cottage*, *Smith*, *Frank Lyon*, *NIPSCO*, *Chamberlin*, and other similar cases were all also perfectly fine, in which case he is right to conclude that, given this baseline, there is no need to change substantive law. Perhaps, then, we disagree about the appropriate strength of anti-shelter doctrines. I turn to this issue now.

## II. THE CASE FOR A STRONG ANTI-SHELTER DOCTRINE

Let me begin the case for a strong anti-shelter doctrine by putting aside two issues. First, some have argued that the tax law is best implemented through a strict rule-bound system.[20] Neither Canellos nor most bar associations take this position, and I agree with them. The tax law is best implemented through a combination of rules and standards that can override the rules in situations where strict application of the rules produces perverse results. As I have argued previously, this is the most cost-effective method of implementing the tax law. Overriding standards allow rules to cover most common situations without the complexity that would come from ensuring perfect application in all cases.[21] The question is the appropriate strength of those standards, not whether standards of this type have a place in the tax law.

Second, we should not be distracted by attempts to codify a substantive disallowance doctrine. Canellos argues that the distinction between shelters and other transactions is multifaceted and not reducible to a single formula. I generally agree with him on this, although one can imagine giving more (or less) content to anti-shelter doctrines than does current law. Thus, we can agree that Treasury's recent attempt to codify anti-shelter doctrines may be doomed even if we disagree about their appropriate strength. But regardless of whether they are best implemented as a

19. United Parcel Serv., Inc. v. Comm'r, 78 T.C.M. 262 (1999); Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254 (1999); Compaq Computer Corp. v. Comm'r, 113 T.C. 363 (1999).

20. *See, e.g.*, Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHIC. L. REV. 859 (1982).

21. *See* David Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860 (1999).

rule or a standard, we can and should think about the strength of anti-shelter doctrines.

With these two issues put aside, we can turn to the question of the appropriate strength of anti-shelter doctrines. I think it is clear that current doctrines are too weak. The most straightforward evidence is the growth of a large, profitable tax shelter industry under current standards. The shelters promoted by this industry waste resources and distort transactions. Resources are transferred from individuals who do not shelter to those who do shelter, creating no net gain. In addition, the transfer takes resources, such as lawyer and banker time and the costs of distorted transactions, which go entirely to waste. The activity is non-productive. If it is possible, it should be eliminated, just like we might want to eliminate other entirely wasteful activity.

There is nothing in this logic to distinguish a special class of transactions labeled "shelters" from all other tax planning. Most tax planning is wasteful activity and we should not be shy about restricting it severely. Although not strictly an externality under textbook definitions, externalities can serve as a useful analogy. Individuals see a benefit to tax planning, but do not consider the costs imposed on others through their tax planning (higher taxes). Therefore, individuals have an incentive to engage in too much of it. The standard solution to an externality is to force individuals to consider the social as well as private effects of an activity, say through a tax. The external costs of a tax planning are equal to the taxes imposed on others, which is equal to the taxes saved through the tax planning. That is, if we were to internalize the cost of tax planning, we would force taxpayers to pay an amount equal to the taxes they save. Therefore, the optimal policy would be to eliminate tax planning altogether.[22]

We, of course, cannot do this because we generally cannot determine what the individual would have done absent planning. Completely eliminating tax planning would be costly.[23] If there is some cost to eliminating tax planning, we may not want to go that far. We must balance the marginal benefit of reducing tax planning through stronger anti-shelter doctrines with the marginal cost of these doctrines. But the starting point of analysis should be the goal of eliminating virtually all tax planning and the limitation should be based only on the potential costs of doing so. We should not be shy about very strong anti-tax planning doctrines.

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22. There may be some activities of tax lawyers that are welfare enhancing. Interpreting the law to ensure compliance and instructing clients on the sometimes bizarre requirements the law imposed to get a contemplated benefit are likely to be beneficial. But very little of what tax planners do falls into this category.

23. If we cannot perfectly identify tax planning, attempts to stop it will impose deadweight loss. The reason is that taxpayers will alter their behavior to avoid the anti-shelter doctrines. For a discussion of this point and other subtleties created by imposing anti-shelter doctrines, see David Weisbach, *An Economic Analysis of Anti-Tax Avoidance Doctrines, Univ. of Chic. Law and Econ. Working Paper* 99 (2d Series) (2000).

HeinOnline -- 54 S.M.U. L. Rev. 80 2001

If current law were adequate for so many years, why should we consider changing the law now? The reason is that clearly something has changed with the rise of the current shelter boom. Although we do not know for sure, the increasing sophistication of tax lawyers and promoters, the rise of derivatives, and the globalization of markets all seem to have created vast new opportunities for sheltering income. Shelters are cheaper and safer than ever before. The tax law needs to be adjusted to take into account this new reality.

If we can talk in terms of presumptions, if only to organize our thoughts, I think this establishes a prima facie case for stronger anti-shelter doctrines. The objections to stronger anti-shelter doctrines cannot overturn this presumption. One objection is that a strong anti-shelter doctrines would interfere with the right to tax plan. But this right can be reduced, limited, or completely taken away by Congress whenever it feels like it. Congress can overrule each and every case establishing such a right with the stroke of a pen. And as a policy matter, the scope of the right to tax plan has to be part of the question rather than an assumed answer. Along the same lines, stronger anti-shelter doctrines would not, by definition, impede on legitimate tax planning because the scope of legitimate tax planning is the question on the table.

A more serious objection to anti-shelter doctrines is that they would create great uncertainty. But the argument is usually just left at that, as if it were self-evident that uncertainty is a bad thing that should be avoided at all costs. But this is not the case. First, note that even if uncertainty is bad, there is a trade-off between the good of a substantive disallowance rule and the bad of uncertainty, and it is not clear that the race should necessarily go to uncertainty. In addition, businesses deal with uncertainty all the time, and it is not clear why tax uncertainty is any worse than uncertainty about, say, the weather or about the standard of due care under a negligence rule. Finally, uncertainty about the tax law may not even be bad. There is a lot of literature about the effects of uncertainty in the tax law and in other areas of law. The general thrust is that uncertainty generally does not have uniformly bad or good effects and that we should have no presumption that reducing uncertainty (even for free) is a good thing.[24] None of this literature has been incorporated into the tax shelter debate. While uncertainty may play a role in the debate over anti-shelter doctrines, the assumption that it is a strong argument against these doctrines is false. We cannot say that uncertainty is necessarily bad and cannot say that we should not impose significant uncertainty if it is needed to implement strong anti-shelter doctrines.

Yet another objection is that the government sometimes uses the tax law to create incentives and a strong substantive disallowance rule would

24. *See, e.g.*, Richard Craswell & John Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. Econ. & Org. 279 (1986); Joseph Stiglitz, *Self-Selection and Pareto Efficient Taxation*, 17 J. Pub. Econ. 213 (1982); Suzanne Scotchmer & Joel Slemrod, *Randomness in Tax Enforcement*, 38 J. Pub. Econ. 17 (1989).

get in the way of these incentives. This objection seems relatively trivial to me. A strong substantive disallowance should take into account congressional intent and it should not be difficult to identify those places where the government intended certain transactions to be subsidized. A strong presumption against finding an intent to subsidize a transaction will force Congress to be clear and prevent creative statutory interpretation.

Canellos raises a more nuanced objection to strong anti-shelter rules. He argues that the relationship between form and substance is subtle and that stronger anti-shelter doctrines may disrupt this relationship. For example, the willingness to disregard a temporary subsidiary created only to merge into a target allowed the creation of the reverse subsidiary merger form in the United States. Germany did not have this form of merger because of its refusal to disregard form. Canellos is right about the need to be careful about the distinction between form and substance, but I do not think a stronger, even a much stronger, anti-shelter doctrine would affect these transactions very much. The transactions Canellos is worried about have business purposes and expose the taxpayer to risk. The results claimed in these transactions are also justifiable. They have little to worry about from strong anti-shelter doctrines. And if strong anti-shelter doctrines do catch a few transactions that we might otherwise allow, it is hard to see the harm. Taxpayers are very good at pointing out the injustices of the tax system to Congress and the Treasury, and the tax rules can be and frequently are changed to eliminate the problems.

There are other objections to a strong anti-shelter doctrines, but the point here is not to provide the definitive statement in support of such a doctrine. Instead, I wish merely to suggest that the case for such a doctrine is persuasive. Even if Canellos is right about how courts decide shelter cases, I still disagree that disclosure and penalties are enough. Many things that he labeled aggressive tax planning under current law should be disallowed under a better law. This type of activity produces no social benefit, wastes resources, and would not be that costly to reduce.

Much more could be said on the topic of tax shelters. I have not even touched on the appropriate content of anti-shelter doctrines. Incentives on the tax bar and ethical standards deserve attention. The allocation of the power to interpret statutes between courts and the Treasury must be studied. My goal here is only to establish that disclosure and penalties alone are not sufficient and that there is a good case for strong anti-shelter doctrines.

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