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DISRUPTING THE MARKET FOR TAX PLANNING

*David A. Weisbach**

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I. INTRODUCTION

It is a pleasure to comment on Philip Curry, Claire Hill, and Francesco Parisi's article¹ on creating market failures for tax planning. It is rare that I get to comment on an article in which I agree with the basic conclusions and, more importantly, in which I agree with the methodology for reaching those conclusions. Their article provides a number of important and interesting insights and should provide the basis for much future work. I offer some comments and suggestions here.

Although their article is not organized exactly this way, I will break their conclusions into three parts. First, they analyze how to optimally set the line between legitimate and illegitimate tax planning. Second, they discuss whether patents for tax strategies are desirable. Finally, they argue that the government should exploit market failures

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¹ See Philip A. Curry, Claire A. Hill & Francesco Parisi, *Creating Failures in the Market for Tax Planning*, 26 VA. TAX REV. 943 (2007).

to reduce tax planning.

II. LEGITIMATE V. ILLEGITIMATE SHELTERS

In the first part of their article, Curry, Hill, and Parisi discuss how to determine the optimal line between allowable tax planning and disallowed tax shelters, in their language, legitimate and illegitimate tax planning. Although they assume that all tax planning is socially unproductive and wasteful, they conclude that it would not be optimal to eliminate all tax planning.² The reason is that as the government increases the strength of its attacks on tax planning, individuals will incur additional search costs (dissipation costs) as the easy and obvious shelters become illegal. The government needs to balance the additional revenue from reducing tax planning with the additional search costs incurred when the line is moved to reduce the scope of legitimate tax planning. There will be some optimal line, which is likely to stop short of eliminating all tax planning.

There are two aspects of the analysis which are not typical and worth highlighting. First, they treat as the choice variable the line between legitimate and illegitimate tax planning. In the economics literature, this line is usually assumed and the question typically asked is about the taxpayers' decision in light of audit or detection policies. Thus, a typical economics paper will start off by noting that there is a distinction between avoidance and evasion (mapping onto legitimate and illegitimate) and then discuss the report/nonreport decision in light of some penalty structure. Curry, Hill, and Parisi instead treat this line as the choice variable, an approach that I think is valuable as this line is central to policy debates. Second, many legal analyses discuss the best way to draw this line but do not explicitly state the criteria they are using. Curry, Hill, and Parisi want to maximize welfare taking into account both government revenue and taxpayer costs. That is Curry, Hill, and Parisi use an economics approach to answer a question normally addressed only by lawyers. This is, in my view, the right way to approach tax law policy.

Their basic intuition seems to me to be correct, although there are a number of subtleties that are worth further exploration. Their original draft, presented at the Future of Tax Shelters conference, started to model the issue and I think that completing the model should be a priority. Consider some of the complexities. First, the government does not necessarily want to maximize total revenue less

² *Id.* at 949.

dissipation costs, as they suggest. Instead, we usually assume that the government has a fixed revenue constraint, with the money to be spent, say, on a fixed set of public goods. With a fixed revenue constraint and a fixed “tax dissipation function” (how taxpayers react to loophole closing), the answer would be predetermined, so such an approach would not work as a way to think about tax shelters. To make the argument work with a fixed revenue constraint, we have to posit an alternative source of funds that can be used instead of closing tax loopholes. The goal in such a case would be to set the marginal cost of closing tax loopholes equal to the marginal cost of the next source of funds. We might want to use tools such as Slemrod and Yitzhaki’s marginal efficiency cost of funds formulation³ or Slemrod and Kopczuk’s optimal elasticity of taxable income formulation⁴ to think about how to make such a trade-off. The way that I have conceptualized the issue in my writing is to think of loopholes as gaps in the tax base.⁵ We want to balance all of the various methods of broadening the base as well as the overall rate structure. Addressing tax planning is part of this overall set of decisions and is no different, in a general sense, from broadening the base in other ways.

Second, Curry, Hill, and Parisi model taxpayer’s costs as search costs. They argue that as the government closes off the obvious loopholes, taxpayers incur additional search costs to find new ones.⁶ Although correct as part of the story, the costs of sheltering are likely to also include structuring or other similar costs. Thus, as the government shuts down the easy to find and use shelters, taxpayers must spend more to find new ones and also more to implement the new ones. For example, newer shelters may involve more complex changes to capital structures, risky investments, etc. Modeling the problem as search costs leads one to think about information flows (hence the discussion of patents in their article). Thinking about other costs of finding and entering into tax shelters suggests alternative avenues for investigation. Thus, the government’s strategies will also involve such items as setting the degree of economic substance or risk that a transaction must have to be legitimate. The government should optimize along all these

³ See Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF STAFF PAPERS 172, 182 (1996).

⁴ See Joel Slemrod & Wojciech Kopczuk, *The Optimal Elasticity of Taxable Income*, 84 J. PUB. ECON. 91 (2002).

⁵ See, e.g., David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 201, 231–41 (2002).

⁶ Curry, Hill & Parisi, *supra* note 1, at 949.

boundaries by setting the marginal benefit equal for each of them (and equal to the marginal cost of funds for other sources of revenue).

Third, later in the article the authors focus on market structure.⁷ This focus might be incorporated into the study of the optimal strength of anti-shelter rules. For example, there might be economies of scale in shelter provision. If so, strategies that focus on different aspects of shelters might not be additive — they might be more than additive. Thus, if sheltering becomes expensive enough, shelter providers might shut down. Understanding the market structure for tax planning will likely be important to understanding the optimal line between legitimate and illegitimate structures.

Fourth, we need some way of operationalizing the approach. We need to get a sense of the optimal strength of attacks on tax shelters. We need to know the tax dissipation function — how taxpayers will react to various approaches. I have suggested previously that the Slemrod and Yitzhaki's marginal cost of funds might be a reasonable approach to the issue, although I am sure there are others. The assumption behind the Slemrod and Yitzhaki formula is that on the margin, all tax reduction strategies have the same cost.⁸ This allows us to use the reduction in tax revenues for a given change in tax rates — the elasticity of taxable income — as a measure of the dissipation and all other costs of a tax rule. Measuring elasticities of taxable income under various tax regimes, although not easy, should be feasible.

III. PATENTS

Patents on tax strategies usually create a strong gut reaction in many that they are entirely inappropriate. Some react negatively to the idea of offering legal protection to something, like a tax shelter, that we should not want to encourage in the first place. Others, often practitioners, react to the “anticommons” effect — that patents on basic tax planning ideas will make it difficult to give everyday tax advice. Imagine a patent on some run-of-the-mill tax strategy. To take a random example, imagine a patent on various techniques used to qualify for a tax-free reorganization or liquidation. This is the kind of advice given everyday by tax lawyers. If these kinds of techniques were patented, it would be perilous to give tax advice for fear of violating a patent. Moreover, assembling the necessary licenses for a complicated tax strategy may be expensive because of the mere costs

⁷ *Id.* at 950.

⁸ Slemrod & Yitzhaki, *supra* note 3, at 172.

of the royalties, the costs of finding all of the patent holders, and the potential for hold-outs. Hence, the reaction that the patenting of tax advice is contrary to the basic structure of the industry today. Note that the two gut reactions point in opposite directions: patents will unduly encourage tax planning and patents will make tax planning impossible. It is possible that both hold true: everyday tax planning may be more difficult while exotic tax shelters may become more rewarding.

It is not clear that tax patents are going away. The original business method patent involved taxes. Neither the patent office nor the courts have given any indication of a reversal of course. We need to move beyond gut reactions to understanding their effect. Curry, Hill, and Parisi take a refreshingly objective approach to the issue. They want to know whether patents increase or decrease tax planning (which, recall, they assume is socially wasteful).⁹ Patents increase the incentive to invest in information by creating property protection for an idea. But at the same time, by creating a monopoly, they potentially reduce dissemination. We cannot say, *ex ante*, which effect dominates. In the normal patent case, where the idea is socially useful, we want to increase the total supply, which means that we hope that the property protection and the incentives it creates for finding ideas outweigh the costs of giving a temporary monopoly once the idea is found. In the tax case, we want the opposite.

As Curry, Hill, and Parisi emphasize, the net effect is theoretically indeterminate. Nevertheless, given the long existence of the patent system, it is reasonable to assume that the best guess is that patents increase the supply of ideas. Whether this extends to tax patents depends on the particular cost structures in the industry (of tax advice).

One of the key features of the tax advice industry is that it is relatively inexpensive to create new tax ideas, at least compared with the costs of creating ideas in many areas. The costs of creating a very innovative tax strategy is likely to be at least one and maybe two orders of magnitude less than the costs of, say, finding a new drug. The implication is that inventors do not need a lot of incentives to come up with new ideas. They will arise without patents. On the other hand, the possibility of exclusion means that patents may significantly increase the reward to being first. In the normal (socially valuable ideas) case, the balance is likely to lead to the conclusion that patents are not helpful in these circumstances. Without patents, the

⁹ Curry, Hill & Parisi, *supra* note 1, at 953.

ideas will be developed anyway, the benefits of acceleration likely to be small, and the costs of exclusion the same as in other areas. In the tax case (socially wasteful ideas), we might then want patents: the benefits of exclusion may exceed the costs of incentives.

Low cost of development is also what leads to the potential anticommons problem — whatever you find is very likely to have been found by someone else. Many industries live with this problem, so, tax lawyers, welcome to the club. You have got nothing special to complain about. Moreover, to the extent that the anticommons problem reduces tax reducing strategies, it is a good thing. On the other hand, the anticommons problem may reduce compliance, in which case tax patents would be undesirable. Remember that the original business methods patent case, *State Street*,¹⁰ involved tax compliance — it was about a method of making reverse 704(c) allocations in a hub and spoke mutual fund system. Many complicated and potentially patentable tax ideals may also be about compliance: think about the record keeping complexities of many tax rules, such as the UNICAP rules or rules for interest allocations. It is easy to imagine innovative compliance mechanisms deserving of patents. One possibility could be a return to the days when the patent office examined whether patents were socially desirable before granting them.

A second factor is that patent holders would have no easy way to determine when someone else is violating the patent — tax returns are secret. On the other hand, if the tax advisor is potentially subject to malpractice for advising a client to enter into a patented strategy, even a remote possibility of enforcement may be enough.

Third, we need to understand the likely scope of the patents, a matter likely to be resolved only through litigation. If the scope is interpreted narrowly, substitutes may be readily available, reducing the ability of the patent holder to earn profit and also to restrict supply.

Fourth, we need to understand the effect of tax patents on how tax ideas get disseminated. Right now, there is a fairly robust discussion of ideas at conferences, in articles, and among professionals. Although undoubtedly some techniques are closely held, I have the impression that most top level professionals know what the leading techniques are. Patents may change that dynamic, although it is not obvious in which direction. One possibility is that

¹⁰ *State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998).

there will be less sharing as the possibility of patents makes sharing costly. On the other hand, basic ideas might be shared more widely to establish clear evidence that they are not new and, therefore, cannot be patented. If so, the threat of patents may actually increase dissemination of tax ideas.

There is much work to be done to understand these effects. Moreover, other industries might be quite similar to the tax advice industry but are producing a socially valuable product. Whatever conclusions we draw about tax patents may have implications for those other industries and vice versa. Thus, if the speculation that tax patents may possibly reduce innovation is correct (which would mean that we want patents in tax), it would also mean that we would not want patents in similar areas.

Finally, I was struck by Curry, Hill and Parisi's suggestion that the government purchase some key tax patents and refuse to grant royalties.¹¹ This idea seems very clever, although the government, in such a case, could always simply prohibit the strategy by law rather than by owning the patent. Perhaps a more promising route is for a nonprofit who cares about tax compliance, to patent some tax ideas. For example, Citizens for Tax Justice could hire a few good tax lawyers to invent some strategies and patent them. It could then hold the patents tightly, thereby preventing a variety of tax shelters.

I do not yet have a well-informed view on tax patents, except that (i) the issue seems complicated and (ii) they may be here to stay, so that secondary issues such as their scope and which ideas can be patented, may be where the action is. Once we get over the fact of tax shelter existence, we can begin to work to ensure that they are socially valuable: to make them encourage or at least not hurt compliance, but discourage or at least not increase sheltering.

IV. THE TAX SHELTER MARKET

The heart of Curry, Hill, and Parisi's article is the idea that the government can reduce tax sheltering by creating or exploiting market failures.¹² This is a very interesting and, as far as I know, original idea. The analysis of tax patents naturally falls within this category, but it is much broader than patents alone. The authors take the usual list of market failures and see how they might apply in the tax context.

Curry, Hill, and Parisi go through all of the well-known reasons

¹¹ Curry, Hill & Parisi, *supra* note 1, at 953.

¹² *Id.* at 961.

for market failure. Because they try to be complete, it is not the case that each of these failures has an equal likelihood of applying in the tax context. Thus, creating a lemons market does not seem likely to help, at least for corporate tax shelters where the taxpayers tend to be well advised. On the other hand, it might work in the individual tax shelter market, where individuals may have a harder time discerning quality. Misallocating risk, however, may work well in the corporate context, where the threat of sanctions on a tax advisor may substantially increase the effective risk aversion used when evaluating a strategy. Without taking a view on the merits of the recent indictments of tax advisors (mostly from KPMG), the threat of such indictments might be a way to inject a significant dose of risk aversion into the tax shelter market. Pressure on accounting firms with respect to their approval of accounting benefits for tax shelters may work for similar reasons — find a weak point in the chain of production where imposition of risk is likely to be very costly and put the threat of sanctions there.

One suggestion not pursued by Curry, Hill, and Parisi is preventing price discrimination. This prevents someone with an exclusive idea from fully capturing the benefits, thereby restricting supply to the monopoly supply. Limitations on charging fees based on a percent of tax savings can be seen in this light.

Curry, Hill, and Parisi point to four examples to illustrate their theories: the check-the-box regulations,¹³ interest tracing (as opposed to pro rata allocation),¹⁴ Circular 230,¹⁵ and the Thompson/McNulty memo.¹⁶ The check-the-box regulations and interest tracing, they argue, show that the government does not attempt to eliminate all tax reducing strategies, instead sometimes blessing them. Examples of this sort abound. The government lets taxpayers engage in tax reducing strategies all the time, with some of them producing significant revenue losses. It is difficult, for example, to estimate the revenue loss associated with tax havens, but if we wanted to eliminate them or at least significantly reduce their number, it would not be hard: the United States can have significant influence on the behavior of small, defenseless nations if it wants. My main comment is that it is difficult, however, to know whether holding back in such areas is a result of political failures (or more generally, political calculations),

¹³ *Id.*

¹⁴ *Id.* at 962.

¹⁵ *Id.* at 963.

¹⁶ *Id.* at 964.

optimal tax policy, or just a mistake. Although I agree with Curry, Hill, and Parisi about the optimality argument, I do not know what to make of any particular example. On the other hand, the pervasiveness of tax planning and the corresponding limited attempt to reduce it by the government may be an indication that the costs of reducing tax planning are not worth the additional revenue that would be raised, consistent with Curry, Hill, and Parisi's suggestion.

Their market disruption examples fare better. Circular 230 and the Thompson/McNulty memo seem like clear examples of market disruption. Similarly, the rules regarding contingency fees seem aimed at making pricing less efficient. There are likely to be other examples. Thus, uncertainty may help disrupt sheltering. Anti-abuse rules have this feature — they have uncertain content, potentially forcing taxpayers to be more conservative than they would be if they had clear boundaries. Similarly, refusing to provide rules in some areas may be an example of the same strategy. Thus, the lack of rules in the debt/equity area or with regard to what is a constructive sale may prevent aggressive behavior. Rules against tax insurance may be a way of preventing signaling of quality, thereby creating adverse selection. Given the variety of examples of market disruption, I get the sense that the government already understand the point. Curry, Hill, and Parisi do the job of framing it and generalizing it. Their article is a worthy contribution to the literature.

