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When Charity Aids Tax Shelters

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I. INTRODUCTION

“Furthermore, one may ask why, if the Government does not like the tax consequences of such sales, the proper course is not to attack the exemption rather than to deny the existence of the ‘real sale’ or exchange.”¹

How to deal with societal vice is always an interesting question. The body politic must first achieve a level of maturity that allows it to formulate a consensus regarding precisely what constitutes “vice.” By its nature, vice is an activity to which some ascribe no harm and others view as inherently harmful. Achieving consensus is therefore no easy task, and then, recognizing that supply would not exist but for demand, and vice-versa, the body politic must determine whether enforcement resources are best directed towards consumers, towards producers, or equally towards both. Here, questions of fairness and efficiency arise. Is it fair, for example, to direct enforcement measures towards the producer when other socio-economic factors prevent the producer from satisfying its needs in a more legitimate manner? Does it make sense to bring enforcement measures solely against the consumer and not at all against the producer of vice? A war on consumers might be absurdly ineffective if the enforcement resources devoted thereto pale in comparison to the enforcement resources devoted to producers.

This article is not about the war on drugs or the campaign against big tobacco, nor does it concern the debate regarding the world’s oldest profession. It is about a tax vice. Tax jurisprudence is quickly approaching a mature consensus that tax shelters constitute a definable societal vice² – something in which many individual taxpayers might participate if given the opportunity, but which is invariably harmful to the whole.³ The question then becomes how

1. *Commissioner v. Brown*, 380 U.S. 563, 580 (1965) (Harlan, J., concurring).

2. Congressional concern regarding tax shelters can be traced to the Tax Reform Act of 1969, 83 Stat. 487 (1969). See Mortimer Caplin, *Tax Shelter Disputes and Litigation With The Internal Revenue Service—1987 Style*, 6 Va. Tax Rev. 709, 712 (1987). In 1984, Congress began to look upon tax shelters as a criminal vice, of sorts. See *id.* at 715 (stating “[the 1984] provisions represent a major shift in emphasis under our tax law, moving away from concepts of voluntary compliance and self-assessment and shifting toward a codification of what might be called ‘Crime and Punishment’.”).

3. For now, a working definition of tax shelter is implicit in the following recent comment relating to financial assets:

[T]here are two kinds of tax benefits that travel with financial assets. The first is intended to encourage specified investment behavior (e.g., investment in business, low-income housing, or public facilities). Taxpayers abuse this kind of benefit when they obtain the benefit in the absence of the investment behavior that Congress sought to encourage. The second kind of benefit is designed to exempt specific persons or entities from taxation under specific circumstances (e.g., the dividends received deduction, the foreign tax credit, and the treatment of exempt organizations). Taxpayers abuse this kind of benefit when they obtain the benefit in the absence of the specified circumstances.

David P. Hariton, *Tax Benefits, Tax Administration, and Legislative Intent*, 53 Tax Law 579,

society should allocate its enforcement resources to eliminate tax shelters. Presently, tax law is disproportionately concerned with directing enforcement resources against “consumers” of tax shelters (e.g., taxable individuals or entities that essentially buy tax benefits) and insufficiently concerned with “producers”(e.g., charities and other “zero-bracket taxpayers”)⁴ that willingly put tax benefits on the market. Some producers, foreign taxpayers, in particular,⁵ are beyond tax law’s jurisdictional reach and that fact explains the lack of enforcement measures against those producers. But this is most certainly not the case for Charity.⁶ Charity has been within regulatory jurisdiction at least since the day it began operating a macaroni factory in competition with taxable entities.⁷ There is not even a purely logistical reason why tax law should ignore Charity’s role in the tax shelter market. If shelters constitute a vice that

580 (2000). As will be explained in greater detail below, a shelter occurs when a taxpayer emulates but does not actually achieve or engage in a status or behavior for which a tax benefit is available, and then claims the tax benefit. See *infra* notes 20-23 and accompanying text.

4. The term “zero bracket taxpayer” generally refers to persons or entities that are exempt from taxation, such as charities, qualified plans, Native American tribal governing bodies, and foreign persons or entities. Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 *Tax Notes* 1775, 1777 (June 21, 1999). Charities and qualified plans are tax exempt by virtue of IRC § 501. Tax exemption of Native American governing bodies is generally provided for in IRC § 7871, which is intended to provide the same tax exemption to such governing bodies as is enjoyed by state governments. See generally, Robert A. Williams, Jr. *Small Steps On The Long Road to Self-Sufficiency for Indian Nations: The Indian Tribal Governmental Tax Status Act of 1982*, 22 *Harv. J. on Legis.* 335, 356-370 (1985). Prior to the 1982 enactment of 7871, the Service declared that Native American tribes, per se, were not subject to federal taxation. See *id.* at 359, citing *Rev. Rul. 67-284*, 1967-2 *C.B.* 55. Foreign persons or entities are taxed by the United States generally only to the extent income can be said to be derived from the United States. See generally, Rufus von Thulen Rhoades & Marshall J. Langer, *U.S. International Taxation and Tax Treaties*, ¶ 1.01-1.02 (2000).

5. Under a Clinton administration proposal regarding corporate tax shelters, foreign parties would incur a tax liability for participating in tax shelter transactions, but if a treaty gave the foreign party tax exemption the tax liability would be collected from the domestic corporate participant. See Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2001 Revenue Proposals 128* (2000) (hereinafter, “FY 2001 Budget Proposal”). Native American governing bodies are not beyond tax law’s jurisdiction, but are instead granted tax exemption as a matter of legislative and executive grace. See Williams, *supra* note 4, at 356-70. Of course, there are complex social and historical reasons why Native American governing bodies are granted exemption from taxation and it may be that taking enforcement actions against such entities would thwart other more important goals. See *id.* The Clinton Administration proposal states that Native American governing bodies would incur a tax liability for participating in tax shelters, but that the liability would be collected only from the corporate participant. See *FY 2001 Budget Proposal*, at 128. In other words, Native American governing bodies would not be subject to enforcement action.

6. The use of the word “Charity” in this article refers only to those organizations exempt from federal income taxation under IRC § 501(c)(3). Throughout this article, I use the word as a pronoun for clarity and ease of comprehension.

7. See, *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3rd Cir. 1950). Mueller is generally credited with providing the impetus for the unrelated business income tax under IRC §§ 511-513, and the feeder provision of IRC § 502.

threatens core values of our taxing system, tax law should focus its enforcement efforts against all participants, not just consumers.

This article therefore introduces a “drug-war” thesis that deems the enforcement focus on consumers insufficient.⁸ When Charity “produces” tax shelters, tax law should not only enforce its displeasure against the consumer, but against Charity as well.⁹ In Part II, the article discusses the normative assumptions that require action against charities that engage in tax shelters if charities are to remain valid. In particular, the article articulates the emergence of a consensus definition of tax shelters, workable in the practical world. That consensus definition forms the basis of the first normative assumption – that tax shelters are readily distinguishable from legitimate transactions that should not give rise to a penalty.¹⁰ It is possible, then, for the law to take action upon the occurrence of such transactions without fear that legitimate transactions will be inadvertently discouraged. The second normative assumption is that tax shelters are always harmful to the tax system. Shelters undermine voluntary compliance and erode the progressive tax rates. Finally, the third normative assumption is that tax exemption is never harmful to the tax system. As a normative matter, tax exemption does not create inefficiency nor unfairness. If society believes these assumptions to be true, then it makes sense that activities that violate the assumptions be prohibited and that such prohibitions be enforced against all who engage in such activities.

In Part III, the article addresses one of the potential objections to a proposal to sanction Charity when it aids tax shelters. The article shows that the end of Charity’s participation in tax shelters – increased capital by which to achieve charitable goals – does not justify the means. This is particularly so since there are better means of accomplishing the end. More fundamentally,

8. In its study of corporate tax shelters, the Department of Treasury conceptualizes illegitimate tax benefits as market commodities produced and consumed by market participants. See Department of Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals, (Purpose)* (1999) (hereinafter, “*The Problem of Corporate Tax Shelters*”). Its articulation of the market conceptualization, though, tellingly omits any reference to producers: As Deputy Secretary Lawrence Summers recently stated, the Administration’s proposals are intended to “change the dynamics on both the supply and demand side of this ‘market’ – making it a less attractive one for all participants – ‘merchants’ of abusive tax shelters, their customers, and those who facilitate the transaction.” See *id.*

9. The Clinton Administration proposal would impose an unrelated business income tax (UBIT) on charities that participate in tax shelters. See *id.* at xvi, 116-117. I argue later that imposing UBIT is ineffective and insufficient. See *infra* notes 134-50 and accompanying text.

10. This is not to say that a distinction between tax shelters and legitimate transactions has yet been sufficiently articulated. Criticisms of current proposals, in fact, focus on the fear that proposed definitions of the phrase “tax shelter” sweep too broadly and thereby threaten legitimate transactions. See Charles W. Shewbridge, II, *Comments on Finance Committee’s Corporate Shelter Discussion Draft*, 88 *Tax Notes* 695, 697 (July 31, 2000) (“The Tax Executive Institute is very much concerned about the ambiguity and expansive scope of the proposed definition of corporate tax shelter.”). Nevertheless, the tax community’s decision to directly address the problem of tax shelters presupposes the ability to distinguish tax shelters from legitimate transactions even though the ability to articulate the distinction has not yet been achieved.

turning a blind eye to Charity's participation in tax shelters will eventually erode the political consensus underlying the grant of tax exemption. The law should act against those particular charities that engage in tax shelter transactions because those charities taint the whole concept of Charity and chip away at the "halo" which justifies tax exemption.

In Part IV, the article discusses the traditional response when Charity aids tax shelters. Almost invariably, Congress reacts by imposing an ordinary tax via the unrelated business mechanism. That is, income derived by Charity via a tax shelter is treated as unrelated and taxed at corporate rates. This approach is insufficient for several reasons, but primarily because it merely restores the status quo without punishing or otherwise discouraging Charity from seeking out new tax shelter transactions. The latter assertion is proven through a brief summary of certain provisions enacted in response to Charity's participation in tax shelters. Then in Part V, the article discusses two present-law theories that would provide theoretical bases from which to adequately respond to Charity's participation in tax shelters. In short, Charity's participation in tax shelters violate the private benefit prohibition and the requirement that Charity's actions not contravene established public policy.

Finally, in Part VI, the article acknowledges and then addresses some of the logistical problems that must be overcome before imposing sanctions when Charity aids tax shelters. A legislative scheme that implements the theory asserted in this article must ensure that Charity is not held vicariously liable for illegitimate tax positions asserted by its trading partners. Charity should be held responsible only for its knowing and intentional assistance to tax shelters. On the other hand, a strict knowledge requirement might effectively prevent enforcement against Charity, since Charity will rarely have sufficient facts from which to conclude that a taxable trading partner will assert an illegitimate tax position made possible by Charity's involvement. The article therefore proposes that Charity be made a participant in present law disclosure requirements. Certain provisions now exist which require tax shelter promoters, for example, to inform investors or otherwise disclose the fact that certain transactions constitute tax shelters. Charity could be made a recipient of such information and required to take certain actions in response to prevent the abuse of an asset, tax exemption, entrusted to its care.

Overall, then, the article asserts that there is no logical reason why a known participant in tax shelters should be immune from enforcement action. Secondly, there are existing theories which address that participant's role in such transactions in a better way than that which is presently relied upon. Finally, the article offers solutions to the logistical objections that might be raised in opposition to the new response to Charity's participation in tax shelters.

II. THE STATUS QUO ANTE: EXPLICATING NORMATIVE ASSUMPTIONS

It seems almost like the ultimate heresy that an entity endowed with a “halo”¹¹ and, in many instances, a large supply of cash and property already exempted from taxation,¹² might willingly participate in tax code manipulations more commonly associated with taxable entities, and presently under attack throughout the tax profession.¹³ Indeed, the phrase “charitable tax shelter”

11. Professor Brody points out that society’s treatment of charitable organizations is largely based upon a romanticized view of the nature of charities:

So far, charities have enjoyed a “halo effect” in our political economy. The rationalized myth of charities as selfless, donative, and volunteer-run deliverers of services to the poor has never entirely been true, but it underlies society’s grant of tax exemption and tax deductibility for contributions. To the extent, however, that this quid depends on the idealized quo, should charity’s core myth change – in a way that becomes visible to the public – society’s willingness to alter the subsidies could also change.

Evelyn Brody, *Hocking The Halo: Implications of the Charities’ Winning Briefs in Camps New-Found/Owatonna, Inc.*, 27 *Stetson L. Rev.* 433, 452 (1997). Indeed, the analysis and proposal set forth in this article are based upon the view that when charities participate in tax shelter transactions, they expose a side of themselves which contradicts the romanticized view and thereby forfeit the justification for tax exemption.

12. As of September 30, 1999, organizations exempt from federal income tax under IRC § 501(c) had \$880 billion in gross receipts and \$1.3 trillion in total assets. Joint Committee on Taxation, *Study of Present-Law Taxpayer Confidentiality And Disclosure Provisions as Required by Section 3802 of The Internal Revenue Service Restructuring and Reform Act of 1998*, Vol. II: *Study of Disclosure Provisions Relating to Tax Exempt Organizations*, 21 (2000). Of the approximately 1.3 million organizations granted tax exemption under IRC § 501(c), “more than half of those organizations, or 776,557 are charitable, educational, religious, and other organizations described in section 501(c)(3).” See *id.* at 18, 20 (Table 1).

13. The Clinton administration took up a vigorous campaign against tax shelters in 1999 by way of legislative proposals. See Staff of The Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2000 Budget Proposal* 161-201 (1999). The administration’s FY 2000 proposals were not adopted but were resubmitted as part of the administration’s FY 2001 budget. See *FY 2001 Budget Proposal*, *supra* note 5, at 122-37. A bill designed to attack all forms of tax shelters is pending before Congress. See *Abusive Tax Shelter Shutdown Act of 1999*, H.R. 2255, 106th Cong., 1st Sess. (1999). There has also been a rash of administrative guidance regarding tax shelter transactions. See, e.g., *Rev. Rul.* 99-14, 1999-1 C.B. 835 (relating to “lease-in, lease out” transactions); *Regs.* § 1.7701(l)-3 (regarding the “step-down-preferred” transaction, discussed in *infra* notes 22-31 and accompanying text). At the same time, the judiciary has taken a more active role in upholding the disallowance of tax benefits arising from tax shelters. See *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999); *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999); *Saba Partnership v. Commissioner*, 78 T.C. Memo (CCH) 684 (1999); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3rd Cir. 1998). A broad and extremely helpful theoretical discussion of tax avoidance in general is contained in Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 *Mich. L. Rev.* 365 (1988). A contemporary debate regarding tax shelters and the need for remedial legislation can be found in Kenneth J. Kies, *A Critical Look at the Administration’s “Corporate Tax Shelter Proposals*,” 83 *Tax Notes* 1463 (June 7, 1999), Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 *Tax Notes* 1775 (June 21, 1999), and Joseph Bankman *Challenges Kies to Back Up Assertions with Facts*, 83 *Tax Notes* 1813 (June 21, 1999).

seems oddly oxymoronic when one really thinks about it.¹⁴ According to contemporary usage, the beneficent, “charity,”¹⁵ is antithetical to the pejorative, “tax shelter,”¹⁶ suggesting that the same entity cannot be both charitable and engaged in a tax shelter. Yet the use of an otherwise legitimate charitable organization for tax avoidance purposes is not unknown to history.¹⁷ So just how should tax law respond when Charity, the favorite child of the tax code

14. I have not found the phrase in judicial nor scholarly literature. The phrase, “charitable contribution tax shelter” is used and refers to a transaction described in greater detail below. See *infra* notes 244-54 and accompanying text.

15. “Charities had their origin in the great command, to love thy neighbor as thyself.” *Perin v. Carey*, 65 U.S. (24 How.) 465, 498 (1860) cited in Lars G. Gustafsson, *The Definition of “Charitable” For Federal Income Tax Purposes: Defrocking the Old and Suggesting Some New Fundamental Assumptions*, 33 *Hous. L. Rev.* 587, n.38 (1996). In Western cultures the term “charity” revolves around Judeo-Christian notions of “interpersonal activity through which one individual helps a less fortunate one, or more broadly a community rallies to the aid of those of its members in need.” Laura Brown Chisolm & Dennis R. Young, *Symposium: What is Charity? Implications for Law and Policy (Introduction)*, 39 *Case W. Res. L. Rev.* 653, 654 (1988-89). In the Greek tradition, the term “charity” “focuses on broad-scale contributions to the public infrastructure and to a society’s institutions of education, culture, and other aspects of its general well-being and quality of life.” See *id.* at 654-55.

16. The phrase, “tax shelter” has not always carried exclusively negative connotations. Instead, the phrase “abusive tax shelter” has been used to connote illegitimacy.

Nonabusive tax shelters involve transactions with legitimate economic reality, where the economic benefit outweighs the tax benefits. Such shelters seek to defer or minimize taxes. Abusive tax shelters involve transactions with little or no economic reality, inflated appraisals, unrealistic allocations, etc., where the claimed benefits are disproportionate to the economic benefits. Such shelters typically seek to evade taxes.

Roscoe L. Egger, *Warning: Abusive Tax Shelters Can Be Hazardous*, 68 *A.B.A. J.* 1674 (1982). “It should, but may not, go without saying that the term ‘tax shelter’ is not, in essence one that should have any inherent pejorative connotations. . . . An abusive tax shelter, on the other hand, is formed primarily to obtain tax benefits without regard to the economic viability of the investment.” Robert A. Weiland, *Tax-Exempts and Tax Shelters: Should the Same Person Invest in Both?*, 34 *Cath. U. L. Rev.* 101, 101 n.3 (1984). Today, the term “tax shelter” connotes illegitimacy, even to those who recognize that certain transactions may be legitimate only because of the tax benefits obtained thereby. See, e.g., Arthur B. Willis, et al., *Partnership Taxation* ¶ 19.01[2] (6th ed. 1997). (“Although the term ‘tax shelter’ has acquired an aura of opprobrium, not everything that falls within the description of a tax shelter is disgraceful.”)

17. See, e.g., *Smith v. Commissioner*, 50 T.C. Memo (CCH) 1444 (1985) (Georgetown University entered into a purported partnership in order to generate tax losses for taxable limited partners); *Grove v. Commissioner* 490 F.2d 241 (2nd Cir. 1973) (taxpayer’s contribution of stock in his wholly owned corporation to charitable organization was followed shortly thereafter by complete redemption of contributed stock, resulting in a charitable contribution deduction from the use of untaxed funds). In *Grove*, the taxpayer was successful in employing the charity “as a tax-free conduit for withdrawing funds from the Corporation” for his personal use without incurring tax liability. See *id.* at 242.

after all,¹⁸ participates in a transaction that might reasonably be described as a tax shelter?

Certain normative assumptions important to the resolution of that question should first be made explicit. First, reasonably informed taxpayers can generally agree on what constitutes a “tax shelter,” even if a universal definition remains elusive.¹⁹ It is tempting to leave the issue at that, but my purpose is to

18. In addition to exemption from income tax under IRC § 501, Charities enjoy contributions deductible under IRC § 170, access to below market rate financing under IRC §§ 145-50, exemption from certain employment taxes under IRC § 3306(c)(8), and preferential treatment with respect to pension plans under IRC § 403(b).

19. “There is no consensus definition of a ‘tax shelter’ in the law or legal literature.” Calvin H. Johnson, *What is a Tax Shelter?*, 68 *Tax Notes* 879 (Aug. 14, 1995). Professor Johnson’s “favorite” definition of a tax shelter is “an investment that is worth more after tax than before tax.” See *id.* at 883. Professor Bankman agrees that there is no precise definition of tax shelter. See Bankman, *supra* note 12, at 1776. Instead, he describes characteristics commonly associated with tax shelters:

In general, however, a tax shelter is marked by the following characteristics: (1) the shelter provides a certain tax loss for an investment with little or no risk of economic loss; (2) the shelter involves a domestic corporation and a person in the zero tax bracket. Most commonly, the zero-bracket taxpayer is a foreign person not subject to U.S. tax, but Native American Tribes, domestic companies with unusable net operating losses, and exempt organizations have also been used as zero-bracket taxpayers; (3) the shelter often takes advantage of a flaw in the tax law that allocates income in excess of economic income. The over-allocated income is absorbed by the zero-bracket taxpayer, leaving the domestic corporation with a loss in excess of economic loss; (4) shelters that do not take advantage of the flaw described in (3), above, play on structural flaws involving the taxation of corporate or partnership income, or the interaction of the U.S. tax system with foreign tax systems; (5) the shelter is not designed solely for use by any specific taxpayer but instead marketed to Fortune 500 companies and large closely-held concerns; and (6) the shelter is likely to be shut down by legislative or administrative change soon after it is detected.

See *id.* at 1777. The elusiveness of definition may be waning, however. The two legislative proposals adopt the essence of Professor Johnson’s preferred definition and Professor Bankman’s description:

A corporate tax shelter would be an entity, plan, or arrangement . . . in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A tax benefit would be defined to include a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision A tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis. . .) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. A financing transaction would be considered a tax avoidance transaction if the present value of the tax benefits of the taxpayer to whom financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing.

FY 2001 Budget Proposal, *supra* note 5, at 124. The Abusive Tax Shelter Shutdown Act of 1999 would have defined a tax shelter essentially as any transaction, not resulting in a

construct a prototype for responding to charities that participate in tax shelters. It is therefore necessary to define that which Charity should eschew. As a theoretical matter,²⁰ a tax shelter is a transaction or series of transactions whereby a taxable participant, usually with the help of a charity or other zero-bracket taxpayer, creates the appearance of a status or the illusion of behavior without actually achieving that status or engaging in that behavior.²¹ As a

meaningful change in the taxpayer's economic position, in which the present value of the reasonably expected income is insubstantial in relationship to potential tax benefits. H.R. 2255, 106th Cong., 1st Sess. (1999). "In a financing transaction, any deduction claimed with respect thereto must not be significantly in excess of the economic return for such period realized by the person lending the money or providing the financial capital." See *id.* The bill makes the presence of a zero-bracket taxpayer and the over-allocation of loss evidence of a tax shelter transaction. See *id.*

20. The definition about to be offered is useful in explaining the intended result of a tax shelter, but I later settle upon the more functional definitions offered by Johnson and Bankman, since those describe the qualities indispensable to the theoretical definition in a practically useful manner. See *infra* note 224.

21. See Hariton, *supra* note 3. See also Rosenberg, *supra* note 12. Professor Rosenberg's twelve year old article demonstrated an amazing degree of prescience and analytical acuity with regard to tax shelters. His thesis is essentially as follows:

The tax Code imposes taxes and grants tax benefits by reference to distinct transactions. That is, the completion of a particular transaction signals the accretion of economic wealth, the attainment of a particular status, or the engaging in of a particular behavior to which tax consequences then attach. But it is not the transaction, *per se*, that defines or measures income. Instead, income is measured by the underlying economic accretion, status or behavior. Accurately measuring those underlying factors would be far too difficult. Transactions (*i.e.*, realization events) are therefore looked upon as easily observable substitutes for accurate measurement. Thus, transactions provide reliable indication that a certain accretion or status has been achieved, or that a certain behavior has occurred, and should at that point result in tax consequence. Reliable yes, foolproof no. Though actually occurring (*i.e.*, not a sham), a transaction does not always accurately reflect or signal the accretion, status or behavior which ultimately measures income. Transaction taxation forfeits a degree of accuracy in favor of administrative convenience. To the extent that a transaction, though used as the signal for a certain tax consequence, is not coterminous with the accretion, status, or behavior it is thought to indicate, tax avoidance is possible since the completion of the transaction is nevertheless presumptively viewed as the achievement of the accretion, status or behavior.

See *id.* at 365-384, 445-474. Professor Rosenberg argued that defining tax avoidance (which is, in this context synonymous with tax shelter) by reference to whether tax profit – *i.e.*, the increase in wealth resulting solely from a reduction in tax liability – outweighs economic income is inadequate because there are many provisions that encourage taxpayers to enter into transactions that result primarily in tax profit. See *id.* at 443. The legislative proposals account for this possibility either by specifically exempting those particular provisions, in the case of the Abusive Tax Shelter Shutdown Act of 1999, or, in the case of the Clinton proposal, broadly exempting those provisions designed to encourage such transactions. See *supra* note 9. The Clinton administration proposal is thus closer to Rosenberg's definition, although Rosenberg's has the advantage of elasticity. It may be that tax shelters are properly defined solely by reference to the pursuit of profit, as necessarily implied by the legislative proposals. In case it is not, though, Rosenberg's definition is applicable to the possible existence of a tax

practical matter, the transaction technically meets the requirements of a statute that grants a tax benefit but it does not compose the economic substance underlying the statute. The lack of economic substance, then, is a convenient and fairly accurate signal of a tax shelter transaction.²² The opposite result also constitutes a tax shelter. That is, a tax shelter occurs when a taxpayer disguises its actual status or behavior. In either case, the taxpayer then claims the tax benefit – i.e., a deduction, exclusion, credit, or “any other tax consequence that may reduce a taxpayer’s Federal income tax liability by affecting the timing, character or source of any item of income, gain, deduction, loss or credit”²³ – meant for taxpayers actually occupying, engaging in, or avoiding the intended status or behavior.

The familiar step-down preferred transaction provides a ready example.²⁴ The transaction involves a taxable corporation that forms a real estate investment trust (REIT).²⁵ The REIT issues common stock to the corporate sponsor and “fast-pay” preferred stock to an exempt organization.²⁶ Each stockholder pays \$1000 for its stock. The exempt organization’s stock calls for preferred dividends at above market rates for a relatively short period of time. With the cash transferred in exchange for the common and preferred stock, the REIT makes a \$2000 low-risk qualified investment yielding just enough to pay the dividends on the preferred stock. The aggregate dividends paid to the exempt organization are equal to its initial capital investment, plus a better than market return on capital.²⁷ The result, economically, is the preferred stockholder’s fast recovery of capital and earnings, hence the term “fast-pay.” Thereafter, preferred dividends are reduced to zero percent and the terms of the original issue allow for redemption of the preferred stock at its then low market value. Although the exempt organization’s contribution seems more

shelter which does not involve a clear lack of profit motive.

22. Hence, Professor’s Johnson and Bankman’s definitions, *supra* note 19, have greater practical utility than Professor Rosenberg’s theoretical articulation.

23. Regs. § 1.6111-2T(b)(1).

24. The following example is based upon that set forth by the Treasury Department. See *The Problem of Corporate Tax Shelters*, *supra* note 8, at 149-51. The “step-down preferred” is also known as “fast-pay” and is described in Bankman, *supra* note 13, at 1779.

25. A REIT is essentially an investment entity formally taxed like a C corporation, but in computing its taxable income the REIT may deduct amounts paid as dividends. The general result is that the REIT avoids the corporate level tax. IRC §§ 856-59. For readers who want to know more about the complicated provisions pertaining to REIT’s, see Peter M. Fass, et al., *Tax Aspects of Real Estate Investments* § 3.04 (1997).

26. The exempt investor is most likely to be a pension or profit sharing plan, rather than a charity, although large educational institutions exempt from tax under IRC § 501(c)(3) often hold stock in REITs. The transaction would not differ, though, whether the exempt investor were a charity or a pension or profit sharing plan.

27. Charities act as “accommodation parties who are paid a fee or an above-market return on investment for the service of absorbing taxable income or otherwise ‘leasing’ their tax-advantaged status.” *The Problem of Corporate Tax Shelters*, *supra* note 8, at 17.

like a self-amortizing loan (i.e., debt,²⁸) and the “dividend” payments more like payments against principle and interest, the exempt organization is indifferent to the classification of the payments as “dividends” because it pays no tax in any event. The taxable corporation, on the other hand, prefers the dividend classification because the REIT receives a dividend paid deduction²⁹ and thus eliminates income otherwise taxable at normal corporate rates.³⁰ The foregone corporate tax would have reduced the amount later distributed to the common shareholder. In the meantime, the value of the corporation’s common stock appreciates (because the preferred stockholder’s relative ownership in the REIT’s \$2000 investment decreases as dividends are paid) and, by liquidating the REIT after causing the redemption of the preferred stock,³¹ the corporation realizes that appreciation without any tax liability.³² The step-down preferred constitutes an easily recognizable tax shelter under our theoretical definition because the taxable corporation successfully disguised its true status of debtor and was thereby able to deduct what was essentially both principal and interest payments on a loan from the exempt organization.³³

The second normative assumption is that tax shelters cause harm to a tax system characterized by self-assessment and dependent upon a shared sense of fairness.³⁴ To the extent the grant of a tax benefit is intended to accurately

28. “The fast-pay preferred stock performs economically much like 10-year, self-amortizing debt instrument. That is, payments on the fast-pay preferred stock reflect in part recoveries of the amount originally invested by the exempt participants and in part a market yield on the unamortized portion of the original investment. The economic self-amortization of the fast-pay preferred is conceptually inconsistent with characterizing the full amount of each payment as a ‘dividend’ (and thus income on an investment).” Notice 97-21, 1997-1 C.B. 407. “The net effect of the transaction was to borrow [cash] from the zero-bracket taxpayer and to pay off that taxpayer over ten years, a transaction economically equivalent to a 10-year self-amortizing loan.” Bankman, *supra* note 13, at 1779.

29. See IRC § 857(b)(2)(B).

30. See IRC § 857(a)(1).

31. The redemption essentially takes the form of the exempt holder selling all of its stock back to the REIT. See IRC § 302(b)(3).

32. See IRC § 337(a) (providing that no gain or loss is recognized to the sole corporate parent upon distributions made in complete liquidation).

33. Upon learning of the transaction, the Service took steps to prevent such results in the future. It first issued Notice 97-21, in which it stated its intention to treat the transaction essentially as a debtor-creditor relationship between the two shareholders. See Notice 97-21 1997-1 C.B. 407. The Service later issued comprehensive regulations discussing the manner in which the transaction would be recharacterized to deny the sought after status and accompanying tax benefits. Regs. § 1.7701(l)-3.

34. It is almost universally agreed that perception, per se, (quite independent of reality) of inequity in the tax code is harmful. In his famous treatise, Henry Simons stated:

So, in the study of policy, it is proper to focus attention especially upon those shortcomings of tax methods which give rise to opportunities for systematic evasion. The taxpayer will frequently be able, without impairing his income much, if at all, to order his affairs in such manner as to take advantage of imperfections in the tax system. Where such opportunities are numerous and are open to many taxpayers, fiscal machinery is seriously defective. Nor are the unfortunate consequences merely those of the

measure taxable income, or at least what is within the Code's definition of income at the present moment,³⁵ and thus tax liability, the illegitimate taking of that benefit distorts the measurement and contributes to a perception that some taxpayers pay less than their fair share.³⁶ When tax law inadequately responds to that perception, it undermines the voluntary self-assessment and sense of fairness upon which it is dependent.³⁷ The failure to adequately respond to a tax shelter transaction inevitably erodes the tax base.³⁸ Similarly situated taxpayers will likely structure transactions using the tax shelter technique, for to do

moment. As evasive practices become more and more widespread and reach the attention of the community at large, the task of administration becomes increasingly difficult, merely because of changes in attitudes of persons as taxpayers Administrators may not concern themselves greatly about considerations of justice; but they should be vitally concerned as to whether levies like the income tax are generally felt to be clearly inequitable. This feeling, we venture, is more likely to arise where persons are seen to pay very different taxes for no good reasons.

Henry C. Simons, *Personal Income Taxation*, 108-09 (1938).

35. Certain concessions in the definition of income, such as the deduction provided under IRC § 162 for ordinary and necessary business expenses, are made because they account for costs incurred by the taxpayer in earning or producing income and thus decrease income. Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* 186-87 (1985). Other concessions are made as an indirect form of government spending to achieve a government objective related to a taxpayer's status or behavior. See *id.*; Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures For Fiscal Years 2000-2004*, reprinted in 86 *Tax Notes* 103, 104 (Jan. 3, 2000).

36. One contemporary writer, however, argues that attempting to tailor the Code so that taxpayers believe it to be fair is nothing more than a silly waste of time, and perhaps actively harmful, since public opinion regarding the Code is largely based upon "fiscal illusion." Daniel N. Shaviro, *Uneasiness and Capital Gains*, 48 *Tax L. Rev.* 393, 415 (1993). The argument seems to be that public perception be damned if the tax is, in truth, efficient from an economic perspective. See *id.* at 416. Although it is tempting to confront the argument, my purpose here is merely to set forth generally agreed upon assumptions. Suffice it to say that Professor Shaviro's views are not generally accepted.

37. "[T]he viability of our tax administration system depends to a great extent on taxpayers' perceptions that the system is fair and equitable and is administered in a fair but firm manner. When abusive, illegal, and fraudulent tax shelters are openly touted as proper investments, public confidence in the tax system declines rapidly, producing the likelihood of reduced revenues and voluntary compliance and all that that implies."

See Egger, *supra* note 15, at 1675.

38. See *id.*

otherwise would result in an unfair tax burden.³⁹ The harm caused by tax shelters is therefore a compounding one.⁴⁰

The third normative assumption, and one which is most relevant to the present discussion, is that the existence of charities and the grant of tax exemption to such entities is invariably beneficial and, unlike tax shelter transactions, results in neither unfairness nor erosion of the aggregate income pool from which taxes are levied.⁴¹ That is, the charitable tax exemption does not decrease the aggregate wealth that ought to be available for public use nor impede any of the several debated goals of taxation. Thus, if Haig-Simons income is the ideal tax base and is defined as the algebraic sum of consumption

39. Fairness is normally measured by reference to “horizontal” and “vertical” equity. See generally Louis Kaplow, *Horizontal Equity: Measures In Search of A Principle*, 42 *Nat’l Tax J.* 139 (1989). Horizontal equity is said to embody the command that “equals be treated equally.” See *id.* Vertical equity embodies the notion that the law make appropriate distinctions, i.e., impose different but relatively appropriate tax burdens, between unequals. See *id.* at 141. The problems, of course, are first in determining when two taxpayers are equal, and second, determining whether and when social justice overrides the constraint to treat equals identically and unequals differently. The text uses “unfair burden” to refer to the imposition of higher taxes on two taxpayers identical in all aspects with the exception that one engages in a tax shelter.

40. The Department of Treasury states:

Corporate tax shelters breed disrespect for the tax system – both by the people who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a “race to the bottom.” If unabated, this could have long-term consequences to our voluntary tax system far more important than the short-term revenue loss we are experiencing.

The Problem of Corporate Tax Shelters, *supra* note 8, at iv.

41. This conclusion is as much a result of serious tax philosophy as it is a function of the romanticized notion of Charity. See Brody, *supra* note 11, at 425-53. Tax expenditures, for example, are defined by reference to the “normal income tax structure,” a statutory term of art based on the “ideal tax base,” and the notion that any tax exclusion, exemption or deduction represents a departure from the ideal tax base. See Surrey & McDaniel, *supra* note 35, at 184-88; Staff of the Joint Committee on Taxation, *supra* note 35, at 104. The ideal tax base is essentially defined as all increases in wealth during an annual period, whether immediately consumed or stored for later consumption. See Surrey & McDaniel, *supra* note 35, at 186. Thus, employer-provided educational benefits represent a portion of the ideal tax base, and the exclusion of those benefits under IRC § 127 represents a tax expenditure and therefore a departure from the ideal tax base. See Staff of the Joint Committee on Taxation, *supra* note 35, at 105. Significantly, the grant of tax exemption is not considered a tax expenditure, suggesting that foregoing tax on charitable institutions does not represent a departure from the normal tax base. See Staff of the Joint Committee on Taxation, *supra* note 35, at 107. Surrey & McDaniel, however, assert that the grant of tax exemption should be viewed as a tax expenditure for two reasons. First, some “charities” (hospitals, in particular) operate just like taxable corporations. Surrey & McDaniel, *supra* note 35, at 219. That argument is legitimate, but it really addresses the need to redefine charity, not whether a charity has income in the Haig-Simon sense. The second argument is that charities subsidize private consumption. See *id.* at 219-20. That is essentially an argument for taxing those who ultimately exercise private consumption, not one which proves that charities exercise rights of private consumption.

plus the increase in the value of stored rights (hoarding),⁴² a charitable organization has no income.⁴³ In the Haig-Simons formulation, consumption and hoarding imply the exercise of rights in property to the exclusion of all others.⁴⁴ Consumption, in particular, refers to private use or appropriation, a removal of valuable rights from the public domain.⁴⁵ A charitable organization is essentially a public body and therefore engages in no instances of private consumption or hoarding. Which is to say, a charitable organization neither consumes nor hoards in the Haig-Simons sense.⁴⁶ It is axiomatic, too, that charitable tax exemption is inconsistent with private “ownership” of valuable rights or the appreciation therein.⁴⁷ Instead, rights to capital and appreciation are held in public trust. Tax exemption for charitable organizations, then, takes nothing from the ideal tax base.

Furthermore, the normative tax rate is one which increases with income (i.e., progressive taxation), based on one of two theories revolving around the idea of wealth redistribution. The first is the notion that those who derive the most benefit from society should pay the most. The second is that the burden of taxation should be equally felt amongst taxpayers. Thus, more tax is exacted from higher income taxpayers in order that they will feel the same burden as a taxpayer who pays less tax but who also has less income to spare.⁴⁸ It follows from both theories that those who derive the least benefit should pay the least. Those who derive no benefit from society at all, but universally provide benefit to society, ought to pay no formal tax. Stated with reference to the overall redistributive goal of taxation, a charity redistributes income from individuals

42. The Haig-Simons definition of income is generally viewed as the ideal definition. See Victor Thuronyi, *The Concept of Income*, 46 *Tax L. Rev.* 45 (1990). The formulation was first articulated by Henry Simons, but the definition is referred to as “Haig-Simons” to acknowledge the prior contribution of Robert Haig. See *id.* at 46. See also Simons, *supra* note 34, at 61.

43. In fact, the exemption from tax provided in IRC § 501(c) is not considered a tax expenditure. See Staff of the Joint Committee on Taxation, *supra* note 35, at 107. (“In general, the imputed income derived from [charitable] activities conducted by individuals or collectively by certain nonprofit organizations is outside the normal income tax base.”)

44. See Simons, *supra* note 34, at 49, 89.

45. See *id.*

46. Professor Thuronyi extends this rationale to all entities, arguing that only individuals can have income and that “[a] corporation cannot have income, any more than it can have a blood type.” See Thuronyi, *supra* note 41, at 78. The distinction, though, between taxable and tax-exempt corporations is that a taxable corporation exercises dominion to the exclusion of the public (i.e., consumption) even without later consumption by individuals. Charity (i.e., a tax-exempt corporation) cannot exercise rights in consumption since it cannot hold property to the exclusion of public use.

47. See Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 *N.Y.L. Sch. L. Rev.* 457, 466 (1996).

48. See generally, Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 *Am. J. Tax Pol’y* 221 (1995). Identifying and attacking the different justifications for the use of progressive tax rates.

to other individuals.⁴⁹ Charity exists in a quasi-governmental role to “pass-thru” wealth from the individual⁵⁰ to the public, albeit informally instead of through the formal government treasury. Therefore its exemption from the formal income tax neither erodes the tax base nor otherwise harms the public wealth. The public loses nothing and nobody bears an unfair burden by exemption from taxation granted to charitable entities.

An historical case study suffices to put a fine point on the issue and inform our further discussion. In *Commissioner v. Brown*,⁵¹ representatives of a charity devoted to cancer research approached Clay and Dorothy Brown with a proposition to buy the Browns’ lumber mill corporation.⁵² At the time, the Browns had neither the intent nor desire to sell their business.⁵³ After being informed of the significant tax savings that could be had by use of a “bootstrap sale”—information developed and provided by the Charity’s board chairperson,⁵⁴—the Browns agreed to sell the business. The charity purchased all the stock owned by the Browns in the lumber business and liquidated the corporation. The charity sold a portion of the corporation’s assets and paid a small down payment to the Browns from the proceeds.⁵⁵ The balance was represented by a ten year, non-interest bearing note which, in turn, was secured by a mortgage on the remaining assets.⁵⁶ The charity then leased the remaining assets to a newly formed corporation that continued the lumber mill business (in the same building and with the same personnel as before the transaction) under a management contract allowing the original sellers to act as general manager for the full term of the lease.⁵⁷ The lease payments amounted to 80% of the profits derived from the lumber business.⁵⁸ The charity, in turn, paid 90% of those lease payments over time to the original sellers as payment on the ten-year note.⁵⁹ The charity was not at any risk beyond the lease payments derived from the new corporation. Using the installment method, the sellers successfully reported a portion of each payment as long term capital gain.⁶⁰ Thus, while continuing to own all but title with respect to the property, the sellers were able to withdraw

49. This does not mean that charities necessarily redistribute wealth from rich persons to poor persons. For example a tax exempt-corporation organized for the arts redistributes wealth from personal consumption to a different type of consumption, largely for the benefit of those in the upper economic classes.

50. The individual’s formal tax liability is likewise decreased as a result of her provision of benefit to society, payable via Charity. See IRC § 170.

51. 380 U.S. 563 (1965). The facts discussed in the text are taken from the Tax Court opinion.

52. See *Brown v. Commissioner*, 37 T.C. at 461, 464 (1961).

53. See id. at 464-65.

54. See id. at 465.

55. See id. at 472, 474.

56. See id. at 472-73.

57. See id. at 475-76.

58. See id. at 475, 477.

59. See id. at 477.

60. See id. at 482.

earnings over a ten-year period and have those earnings taxed at preferential capital gain rates, and all at the initiation of the charitable organization.⁶¹ That is, the Brown's were able to assume the appearance of having completed a recognition event – a sale – with respect to a capital asset, without actually engaging in that behavior.⁶² The familiar story would not be complete without noting that at the end of the ten year period, the charity would own the lumber business without ever having paid any of its own funds. It could then liquidate the business completely and apply the proceeds towards cancer research.

The successful conduct of the bootstrap sale in *Clay Brown* exemplifies the first two assumptions and creates a serious challenge to the third. Even during its heyday, the charitable bootstrap was candidly recognized as a tax shelter. The supposed harm was the conversion of what should have been treated as ordinary income into capital gain income.⁶³ Given an understanding of the policy underlying the capital gains preference, it is easy to see how the taking of the capital gains benefit in the bootstrap transaction distorts the ideal tax base. The capital gains tax rate is designed principally to alleviate two problems. The first, bunching, refers to the realization in one year of appreciation occurring over several years and thereby requiring a taxpayer to pay tax at a suddenly higher rate than that which is accurate, assuming a taxpayer's average rate over time is most accurate.⁶⁴ The reduction in tax rate for capital gain is said to alleviate that sudden spike and thereby ameliorate

61. See *id.* at 483-84.

62. That the Supreme Court eventually upheld the transaction as a true sale does not negate the conclusion that the transaction amounts to a tax shelter under the definition adopted in this article. See *supra* notes 19-23 and accompanying text. Indeed, one of the requirements for a tax shelter transaction is that the taxpayer successfully attain the label attached to a transaction without actually achieving the underlying status or engaging in the behavior for which the label is a convenient shorthand and to which the tax benefit attaches. See *id.* In fact, contemporary judicial opinions and legislative proposals acknowledge, explicitly or implicitly, that a taxpayer has actually engaged in a transaction, the label of which triggers tax benefit. Contemporary judicial opinions and legislative proposals go further by disallowing the tax benefit when the transaction, or the label thereof, does not accurately signal the achievement of a status or the engagement in a certain behavior to which the sought-after tax benefit attaches. See *supra* note 12 and the cases and legislative proposals cited therein.

63. Writers of the era generally agreed that achieving a "sale" transaction in such cases was misleading to the extent such achievement triggered the benefits of capital gains taxation. See James A. Moore & David H.W. Dohan, Sales, Churches, and Monkeyshines, 11 *Tax L. Rev.* 87, 87 (1955-56); Geoffrey J. Lanning, Tax Erosion and The "Bootstrap Sale" Of A Business, 108 *U. Pa. L. Rev.* 623, 623 (1960). Even contemporary authors note that a "sale" was achieved, but in name only. See Suzanne Ross McDowell, Taxing Leveraged Investments of Charitable Organizations: What is the Rationale?, 39 *Case W. Res. L. Rev.* 705, 709 (1988-89) ("The seller treated the sale price as a capital gain, and continued to operate the business."). But, as discussed below, the harm was not embodied in the conversion of ordinary income to capital gains income, since that result is condoned by Congress and could be achieved without Charity's involvement. See *infra* notes 69-76 and accompanying text. The real harm was the avoidance of the corporate level tax on income earned at the corporate level. See *id.*

64. See Noel B. Cunningham & Deborah H. Schenk, The Case For a Capital Gains Preference, 48 *Tax L. Rev.* 319, 328-330 (1993).

whatever unfairness results from progressive taxation.⁶⁵ Lock-in is closely related and refers to the disincentive to engage in a sale or disposition of a capital asset because the nonrecurring gain will result in a sudden increase in tax liability.⁶⁶ The lock-in concern is broader, though, in that it references not only the burden on the individual taxpayer, but society as well. Society is burdened by the immobility of capital from one investment to another caused by the high tax “exit fee.”⁶⁷ The reduction in tax rate for capital gain is said to alleviate that societal burden. Thus, the capital gain tax rate is conditioned upon the actual divesting of capital from its owner and the owner’s severing and taking the appreciation therefrom. In a charitable bootstrap transaction, the progressive tax rates are compromised to the seller’s benefit, but the societal benefit from that compromise is nonexistent or is at best deferred for some years after the progressive rates are relaxed. The seller neither realizes unexpected “bunched” gain justifying the deviation from progressive rates, nor has she forsaken the lock-in phenomenon and its negative effects on society.⁶⁸

But the seller’s taking of the capital gains preference is not a harm unique to Charity’s involvement in the transaction.⁶⁹ The seller could have legitimately obtained that benefit without Charity’s involvement. Which is to say that whatever distortion results from the capital gains preference is one which Congress allows without regard to whether the buyer is a charitable organization.⁷⁰ Nothing prevented the seller from taking a note from a taxable buyer and reporting the taxable portion of each payment as capital gain, while also continuing to manage the company under a management agreement.⁷¹ Indeed, the law seems to explicitly authorize the purchase of a business using earnings from that business, and the seller’s treatment of the proceeds as gain from a capital asset.⁷² Hence, Charity is not engaging in a tax shelter to the

65. See *id.*

66. See Cunningham & Schenk, *supra* note 64, at 344-351.

67. See *id.*

68. See Lanning, *supra* note 63, at 693-697.

69. This point seems lost in much of the literature. Much of the literature assumes the harm to be manifested by the seller’s conversion of what looks like ordinary income – the corporate profit ultimately used to finance the purchase – into capital gain. See Lanning, *supra* note 63, at 692-697; See also Moore & Dohan, *supra* note 63; Note, *Bootstrap Acquisitions: The Next Battle*, 51 *Iowa L. Rev.* 992 (1966).

70. Scholars readily admit the unstable theoretical basis upon which a capital gains preference rests. See, e.g., Cunningham & Schenk, *supra* note 64, at 320.

71. Seller could sell the stock in his corporation to buyer and buyer could give seller a note for the purchase price with the intent to pay the note from corporate distributions. See William H. Kinsey, *Bootstraps And Capital Gain – A Participant’s View of Commissioner v. Clay Brown*, 64 *Mich. L. Rev.* 581, 582. Seller could treat the profit as capital gain even though the payments are made from ordinary corporate profit. See *id.*

72. For a modern discussion of the legitimate use of bootstrap sales, see Robert I. Keller, *Returning to Form: Untangling the Tax Jurisprudence of Bootstrap Acquisitions*, 16 *Va. Tax Rev.* 557 (1997). One accepted bootstrap sale involves a buyer who forms a corporation. The new corporation buys the stock of a target corporation, making a small down payment and giving a note for the remainder. The purchasing corporation liquidates the target corporation and takes the assets with no tax consequences and a carryover basis. See IRC § 332; IRC § 334. The

extent the seller achieves capital gains treatment. However much a misnomer the term “sale” is with regard to the bootstrap transaction, Congress intended to treat the transaction as such and to grant the capital gains preference in response.⁷³ In cases not involving a charitable buyer, however, the proceeds by which the seller provides financing are first subjected to ordinary tax as profit earned at the corporate level.⁷⁴ A corporation may thus finance the purchase of its own stock, but only with money previously taxed at ordinary rates. The shelter and, in fact, the harm unique to Charity’s participation in bootstrap transactions is the disguising of corporate profit, from which a tax is normally extracted and financing is later provided. Charity helps make it appear that earnings never arrive in corporate solution but instead the corporation is merely distributing previously taxed capital.⁷⁵ The seller is thereby able to provide financing (which ultimately redounds to the seller’s benefit) using untaxed profit.⁷⁶ Charity has thus aided in disguising the corporation’s realization of profit.

It wasn’t just miserly government tax collectors who recognized harm caused by the charity’s knowing involvement in *Clay Brown*.⁷⁷ Congress,⁷⁸

liquidating corporation will have no gain from the distribution. See IRC § 337. The new corporation uses the income from the operation of the liquidated corporation’s previous business to pay the remaining purchase balance in installments. The seller gets capital gain treatment, while the sole shareholder of the new corporation avoids current tax liability on the proceeds used to purchase liquidating corporation. See Kinsey, *supra* note 71, at 581-82.

73. Which conclusion serves only to bolster arguments that the capital gains preference cannot be theoretically justified. See generally, Cunningham & Schenk, *supra* note 64.

74. See Keller, *supra* note 72, at 562-567.

75. The amount paid to Charity as rent in a charitable bootstrap transaction is deducted against earnings, resulting in little or no corporate level tax.

76. Cf. *Grove v. Commissioner* 490 F.2d 241, 246-47 (2nd Cir. 1973) (taxpayer was successful in employing the charity “as a convenient conduit for withdrawing funds from the Corporation for his personal use without incurring tax liability.”).

77. The government suspected but ultimately misperceived the real harm in *Clay Brown*. The real thrust of the opinion in *Clay Brown* was not that the Charity did not cause any harm. Rather, the seller could have obtained capital gains treatment with the same transaction but without Charity’s involvement. The government misperceived the harm and therefore sought an inappropriate remedy. See *Commissioner v. Brown*, 380 U.S. at 563, 579 (1965). The Court stated “the Commissioner’s position here is a clear case of overkill if aimed at preventing the involvement of tax-exempt entities in the purchase and operation of business enterprises . . . and if the Commissioner’s approach is intended as a limitation upon the tax treatment of sales generally, it represents a considerable invasion of current capital gains policy.” See *id.*

78. The Congress expressed general disapproval of such transactions prior to *Clay Brown*. The legislative history regarding the Revenue Act of 1950 suggested the general impropriety of a charity’s participation:

There are three principal objections to the lease-back arrangements where borrowed funds are used. First, the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its exemption, since the only contribution it makes to the sale and lease is its tax exemption. Therefore, it appears reasonable to believe that the only reason why it receives the property at no expense to itself is the fact that it pays no income tax on the rentals received.

courts,⁷⁹ commentators⁸⁰ and even charities candidly understood the charity to be aiding and abetting in a malevolent transaction and yet the charity suffered no penalty. Consider the following remarks made by one writer of the time:

In effect Charity is selling a portion of its tax exemption. That is particularly apparent where an excessive price can be proved to the court. Of course, the income available to pay the notes is much larger if it is tax-free, and the high price was set because it was anticipated that Feeder would be held exempt by virtue of nominally paying its income over to Charity. Even where an excessive price cannot be proved, there is the very substantial advantage of more secure and more rapid payment of the notes out of tax-free income. During the whole period of the pay-off to Owner, funds which were given tax exemption so that they could be used for charitable and public purposes are going directly into Owner's pocket. And the tax advantages of having made a "sale" are granted on the assumption that there has been a substantial present change in Owner's economic relationship to the business. But Owner continues to run the business and

The second objection to the lease-back is that it is altogether conceivable that if its use is not checked, exempt organizations may own the great bulk of commercial and industrial real estate in the country. This, of course, would lower drastically the rental income included in the corporate and individual income-tax bases.

A third reason for proposing the taxation of lease-backs is the possibility which exists in each case that the tax exempt organization has in effect sold part of its exemption.

S. Rep. No. 81-2375, at 31 reprinted in 1950 U.S.C.C.A.N. 3053, 3084. The Revenue Act of 1950 resulted in the enactment of the "Business Lease" provision. See IRC § 514 (1954). In general, that provision taxed as unrelated business income rentals received from property if the property was financed with borrowed funds. A significant exception, however, applied if the lease term was for five years or less (the short term lease exception). See IRC § 514(c)(1) (1954). Thus, charities continued to obtain the benefits of *Clay Brown* transactions for themselves and owners of taxable business simply by limiting the lease term to five years or less. See McDowell, *supra* note 63, at 710-11. In finally closing the short term lease loophole, the Congress stated:

During the past several years a device has been developing which exploits weaknesses in the taxation of unrelated business income of tax-exempt organizations. The net effect is the use of the tax exemption to reduce taxes for owners of a business by converting ordinary income to capital gain and eventually to the acquisition of the business by a tax-exempt organization entirely out of the earnings of that business.

S. Rep. No. 91-552, at 62 (1969), reprinted in 1969 U.S.C.C.A.N. 2027, 2091.

79. See *Commissioner v. Brown*, 380 U.S. 563 (1965).

80. See Kinsey, *supra* note 70 (author, counsel to the taxable participant in *Clay Brown*, nevertheless acknowledges that Charity's involvement should be addressed); Note, Tax Problems of Bootstrap Sales to Exempt Foundations: A Comprehensive Approach, 18 Stan. L. Rev. 1148 (1966); Note, Bootstrap Acquisitions: The Next Battle, 51 Iowa L. Rev. 992 (1965-66); Note, A Charitable Armageddon: *Commissioner v. Clay Brown*, 13 U.C.L.A. L. Rev. 167 (1965-66).

to receive its profits much as he always did. In brief, it can only be the public who ultimately pays for the pleasant arrangement between Charity and Owner.⁸¹

The universal though not quite accurate⁸² recognition of harm caused by the “selling” of the tax exemption thus brings into focus Justice Harlan’s question asked in response to the *Clay Brown* transaction: why not attack the exemption?⁸³ It is, of course, precisely the tax exemption and Charity’s willing participation that made possible the transaction. And by contemporary thought, the presence of Charity in what seems or proves to be a nonsensical transaction is considered evidence that the transaction is a tax shelter.⁸⁴ Given universal recognition of fundamental harm and Charity’s responsibility therefor, is the present approach sufficient? Is it sufficient that what might be viewed as theft of public wealth⁸⁵ is rectified by the mere recouping of that benefit from the taxable party, while the charitable citizen who aided and abetted in that theft simply walks away untouched by any consequence?⁸⁶ It might be argued that Charity’s intention to devote whatever gain arises from the transaction to charitable purpose justifies the lack of any real imposition – a sort of ends justifying the means argument. Or should the grant of tax exemption be viewed as the public’s expression of an almost religious faith, to be violated only on pains of substantial penalty? And if the latter approach is preferable, how shall the penalty be administered? How can such a prohibition be practically enforced

81. See Lanning, *supra* note 63, at 637. The author’s reference to a “feeder” concerns an organization that engaged in a regular commercial enterprise but, under prior law, was exempt from taxation because all of its income was dedicated to charity. See, e.g., *Roche’s Beach, Inc. v. Commissioner*, 96 F.2d 776 (2nd Cir. 1938) (holding that the corporation which operated a beach resort was tax-exempt since all of its income was paid to a charitable foundation). A “feeder” organization is no longer entitled to tax exemption. See IRC § 502.

82. The writer focuses on the seller’s treatment of the proceeds as capital gains and ignores the avoidance of the corporate level tax. We have seen that the real harm attributable to Charity’s involvement was the avoidance of corporate tax. See *supra* note 69-78 and accompanying text.

83. See *Brown*, 380 U.S. at 580.

84. See *The Problem of Corporate Tax Shelters*, *supra* note 8, at 16-17. (“Another significant characteristic found in many, but not all, corporate tax shelters is the participation of tax-indifferent parties [such as charitable organizations]”).

85. “One might analogize tax avoidance to robbery from the public fisc.” Rosenberg, *supra* note 13, at 444.

86. The Treasury Department acknowledges that charities and other zero-bracket taxpayers should be held accountable for aiding a tax shelter:

A tax-indifferent party has a special status conferred upon it by operation of statute or treaty. To the extent such person is using this status in an inappropriate or unforeseen manner, the tax system should not condone it. Imposing a tax on the income allocated to tax-indifferent persons could be used to eliminate the inappropriate rental of their special tax status, eliminate their participation in corporate tax shelters, and thus eliminate the use of tax shelters that arbitrage their tax-preferred treatment.

The Problem of Corporate Tax Shelters, *supra* note 8, at 115. The Treasury nevertheless proposes a remedy that fails to create a disincentive for charities. See *infra* notes 130-48 and accompanying text.

without, in effect, making Charity its brother's keepers? That is, by what method can the law hold Charity responsible for the illegitimate tax positions assumed by taxable trading partners? Let us briefly address the "ends justify the means" argument, prove that the latter approach is preferable – that government ought to attack the exemption when Charity aids a tax shelter – then consider the possible legal theories from which an attack might be sustained and the methods by which theory can be implemented in practice.

III. THE NEED FOR INTERVENTION: THE END DOES NOT JUSTIFY THE MEANS.

The notion implicit in Justice Harlan's exasperated question – why not attack the exemption? – is that substantively the law neither objected nor responded to Charity's involvement in tax shelters.⁸⁷ Before addressing the continuing accuracy of that notion,⁸⁸ it is appropriate to consider whether the law ought to be indifferent to such involvement. The question might be answered by comparing the benefit derived by exempting Charity from tax⁸⁹ with the harm caused by Charity's occasional folly in engaging in a tax shelter transaction.⁹⁰ Had the charity in *Clay Brown* been subject to judicial action, or had charities in general been faced with proposed legislation sanctioning involvement in tax shelters, they might have argued that such transactions result in more assets being devoted to beneficial use and therefore should not result in a sanction.⁹¹ Undoubtedly, that is always the case. Charity is invariably paid

87. *Clay Brown*, as the government prosecuted the case, was exclusively about a taxpayer's illegitimate taking of the capital gains preference. See supra note 77. Prior to *Clay Brown*, however, the objection to such transactions appeared to be based exclusively on the fear that exempt organizations would grow too large by "selling" their exemption. See S. Rep. No. 81-2375, at 31 reprinted in 1950 U.S.C.C.A.N. 3053, 3084 (quoted supra note 78). There was no apparent concern that Charity's participation was fundamentally inconsistent with the notions supporting the grant of tax exemption. See *id.*

88. The 1969 enactment of the unrelated debt financed income provision, in what is now IRC § 514, was ostensibly aimed at the taxable participant's conversion of ordinary income to capital gains – the issue specifically addressed in *Clay Brown*. See Tax Reform Act of 1969, 83 Stat. 487 (enacting IRC § 514); See also S. Rep. No. 91-552, at 62 reprinted in 1969 U.S.C.C.A.N. 2027, 2091 (discussing the reasons for enacting IRC § 514). In the next section, I show why the law nevertheless remains effectively indifferent to Charity's participation in tax shelters.

89. According to one estimate, in 1996 nonprofit organizations spent \$460 billion providing charitable services, with health care and educational institutions accounting for 83% of that figure. See Lester M. Salamon, *America's Nonprofit Sector: A Primer* (2d ed. 1999).

90. One reporter estimates aggregate 1999 losses from corporate tax shelters at approximately \$10.6 billion, but admits that the estimate is hard to verify. See Martin A. Sullivan, *A Revenue Estimate for Corporate Tax Shelters*, 85 Tax Notes 981 (Nov. 22, 1999).

91. Because there has never been a proposal attacking tax exemption, one can only speculate as to how the charitable community might respond. Assuming, though, that even charities that would never consider engaging in a tax shelter transaction would nevertheless object to any rule that might conceivably jeopardize exempt status, I can think of only two arguments by which Charity might make to try to thwart such a rule. First, Charity could argue that the benefits it provides to the public are so great that the harm caused by Charity's

a fee for its participation⁹² and, assuming Charity complies with statutory mandates, the gain derived necessarily increases the benefit to charitable goals.⁹³

The precise assertion, then, is that the law shouldn't attack the exemption if the revenue loss resulting from the tax shelter is compensated by a greater amount transferred to public purposes.⁹⁴ Accordingly, to the extent Charity is supplanting or supplementing government in the provision of public goods or services, societal well-being is not harmed by Charity's participation in tax shelters. Under this approach, Charity's participation in tax shelters does not become harmful until the government's revenue loss exceeds the value of goods and services otherwise provided by Charity.⁹⁵ This purely empirical approach, though, is ultimately a fool's refuge for two reasons. First, the detriment to society will always be understated, since the essential nature of a tax shelter is disguise and illusion.⁹⁶ To the extent the disguise or illusion is

participation in tax shelters is negligible and not worth the added complexity of new legislation. I address and reject this argument in the text. Second, Charity might argue that its involvement in tax shelter transactions is so infrequent that the government's monitoring cost for new legislation aimed at Charity would far exceed the costs from those infrequent occasions. To that, I adopt Professor Weisbach's assertion that "uncommon transactions that are taxed inappropriately become common as taxpayers discover how to take advantage of them." David A. Weisbach, *Formalism in the Tax Law*, 66 U. Chi. L. Rev. 860, 869 (1999).

92. See *The Problem of Corporate Tax Shelters*, supra note 8, at vi.

93. One writer notes a similar argument with regard to the imposition of corporate tax on charities that engage in noncharitable trades or businesses: "Critics of the UBIT respond that all returns from unrelated business must ultimately be spent on their related activities and that this justifies exemption for the unrelated business." Henry B. Hansmann, *Unfair Competition and The Unrelated Business Income Tax*, 75 Va. L. Rev. 605, 624 (1989).

94. Such an argument was made in response to proposals to limit the tax benefit arising from sale-leaseback transactions involving tax exempt organizations. See William L. Vallee, Jr. *Sale-Leaseback Transactions By Tax Exempt Entities and The Need for Congressional Guidelines*, 12 Fordham Urb. L.J. 349, 351, 354 n.24 (1983-84) (arguing that "although causing a revenue loss, [sale-leaseback transactions] are a useful device for providing certain tax-exempt entities with the financial means to maintain services in the face of rising costs and the withdrawal of federal funding."). Sale-leaseback transactions are a type of tax shelter transaction under which a taxable party purchases a building with funds borrowed from a tax exempt organization and then leases the building back to the entity under a net lease arrangement (i.e., an arrangement that requires the lessee to pay all maintenance costs in addition to rent equal to buyer's payments on the purchase money note). In terms of our definition, by achieving the status of "borrower" and "owner" for tax purposes (without really occupying the position of "borrower" or "owner" in a true economic sense), the taxable participant can claim interest expense and depreciation deductions.

95. See Dennis Zimmerman, *Corporate Title Sponsorship Payments to Nonprofit College Football Games: Should They Be Taxed?* (Congressional Service Report) 5 Exempt Org. Tax Rev. 438 (1992) (asserting that whether a charitable organization should be taxed on unrelated business should be determined by comparing the economic benefit derived from allowing charities to engage in those activities without taxation with the revenue loss to the government).

96. "It is difficult to estimate the federal government's revenue loss from corporate tax shelters. One reason is that the tax shelter transactions are shrouded in secrecy to prevent detection by the IRS – and in the case of shelter promoters – to prevent detection by competitors and by taxpayers who are not paying clients. Another reason is that it is difficult for the IRS to

successful (in the sense that the transaction is never challenged, nevermind exposed and addressed *ex post facto*), the quantitative detriment to society via revenue loss will necessarily be understated.⁹⁷ Indeed, confidentiality is a frequent condition of tax shelter marketing and that condition necessarily results in an understatement of the quantitative revenue loss.⁹⁸ Second, even assuming the detriment is small by economic measure, the assumption would not justify tolerance of Charity's participation in tax shelters. A cost-benefit analysis, such as is implied by comparing detriment to benefit, assumes a cost necessarily incurred. If, in fact, the cost is necessarily incurred, it is appropriate to ask whether the cost is so small relative to the benefit that the law should be unconcerned. But if the cost is unnecessarily incurred, cost-benefit analysis is irrelevant. Increasing the monies devoted to charity could certainly be better accomplished, as opposed to formal indifference to charitable tax shelters, by direct government grants to charitable organizations or directly to beneficiaries.⁹⁹ At least this would accomplish the goal implicit in the actions of charities that engage in tax shelters without the manifest harm of tax shelters. Hence, the end from Charity's viewpoint – increased financial assets devoted to charitable causes – cannot justify the means – contributing to the erosion of the tax system and the assumption underlying the grant of tax exemption. The intentional indulgence of unnecessary cost, per se, is sufficient to rebut the assertion that the end justifies the means.

The preceding discussion exposes the fallacy of the end justifying the means argument – the quantitative means can never be accurately measured and are justified by the end, if at all, only when there is no better alternative. If there

identify tax shelters even when they were used by corporations in tax years under audit. The impact of a tax shelter may appear on only a few lines of a return that is as thick as a telephone book and as complex as a textbook on advanced physics." Sullivan, *supra* note 90, at 981.

97. But see *University Hill Foundation v. Commissioner*, 51 T.C. 548 (1969), *rev'd* 446 F.2d 701 (1971) (charitable foundation's participation in 24 charitable bootstrap sales over a fourteen year period resulted in revenue loss in excess of \$10 million – not including the revenue loss from the seller's claiming of capital gains tax rate preference; amount paid to charitable purpose over same time period was approximately \$2 million.)

98. See *The Problem of Corporate Tax Shelters*, *supra* note 8, at 20-22.

99. Congress accepted this argument when it enacted rules under IRC § 168(h) designed to limit the tax benefit available to taxable entities who engage in sale leasebacks with exempt entities:

[T]he committee believes that Federal aid to tax-exempt entities (above and beyond their tax exemption) should be made by appropriations rather than by tax benefits transferred through tax system. The tax benefits in leasing are open-ended and hence uncontrollable in amount and composition, whereas appropriations are limited and adjustable to current priorities from year to year. Moreover, tax benefits appear in the Federal budget only as reduced tax collections, unassociated with any particular public purpose. Thus, with Federal aid conveyed through the tax system, it is very difficult to discover what tax-exempt purposes have been federally assisted, by how much they have been assisted, and whether the assistance has been rendered in ways consistent with other objectives of public policy.

H.R. Rep. No. 98-432, at 1141 (1984) reprinted in 1984 U.S.C.C.A.N. 697, 815.

are other fairer and more efficient means to an end, the uncertain, unfair and inefficient means ought to be avoided. The unfairness and inefficiency of indifference to Charity's role in tax shelters arise from the corrosive effect such transactions have on the tax base and progressive tax rates, and the distorting effect such transactions have on potential sellers' preferences as between taxable and tax exempt buyers of market assets.¹⁰⁰ Indulging this compounding effect contradicts the normative assumptions identified earlier. Two of our normative assumptions hold that tax shelters erode the tax base, create unfairness as between individual taxpayers, and breed disrespect for a tax system dependent upon a sense of fairness.¹⁰¹ Consequently, tax shelters are not to be tolerated. The third assumption holds that charitable tax exemption does no harm whatsoever. But Charity's unchallenged participation in tax shelters violates that assumption. If those normative assumptions are to be violated, the decision to violate them should be in response to a situation requiring a choice between lesser evils. That is certainly not the case with regard to Charity's participation in tax shelters.

There is, perhaps, an even more fundamental reason why the government should not be indifferent to Charity's participation in tax shelters. That reason can be succinctly articulated. Charity, for all its positive connotations, has already been so bastardized that one must cynically wonder whether it is worthy of the religious reverence and higher values that justify tax exemption.¹⁰² With relatively simple planning under the present system, for example, Charity can engage in any type of business it pleases,¹⁰³ distribute the

100. With regard to the effect of not having the unrelated business income tax as it relates to tax avoidance, one writer states:

In the absence of the [unrelated business income tax], the value of an otherwise taxable business would be higher in the hands of an exempt nonprofit than it would be in the hands of ordinary taxable entrepreneurs or shareholders. Thus, there would be potential gain from the sale of a business to a nonprofit equal to the discounted present value of all the future taxes that the business would otherwise pay. Leveraged financing should therefore be readily available for such a purchase, and nonprofits would likely often borrow a very large fraction, and in many cases perhaps close to 100%, of the capital needed for the acquisition of an unrelated business. The increased net income resulting from tax avoidance would provide the return necessary to cover the increased agency and transaction costs involved in such highly leveraged financing. As a consequence, even nonprofits with modest net assets could hold large portfolios of business firms.

Henry B. Hansmann, *Unfair Competition and The Unrelated Business Income Tax*, 75 Va. L. Rev. 605, 622 (1989).

101. See *supra* notes 19-40 and accompanying text.

102. For a history of the definition of the term "charity" for tax purposes, see Lars G. Gustafsson, 33 Hous. L. Rev. 587 (1996).

103. A charity that engages in a business unrelated to the purpose for which it was granted tax exemption is subject to normal corporate tax rates with respect to that unrelated business. See IRC § 511. If the unrelated business is substantial, relative to those activities that are related to the charitable purpose, the charity may lose its tax exemption. Regs. § 1.501(c)(3)-1(c); *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279, 283 (1945). ("[T]he presence of a single [noncharitable] purpose, if substantial in nature, will destroy

economic equivalent of profit¹⁰⁴ to, and make millionaires of, its stewards all without ever forfeiting tax exemption. This is to be contrasted with the notion of Charity as characterized by selfless love of humanity and disdain of the profit motive. It is perhaps an idealized goal that Charity should have no bounds. But that which constitutes Charity ought to have bounds, lest true Charity lose its revered status. If, as is the present case, Charity may sometimes include greed, fraud, secrecy and illusion such as is concomitant with the idea of tax shelters, then the law really has no bounds on its definition of Charity.¹⁰⁵ Hence, the question of whether Charity should be permitted to engage in tax shelters without sacrificing its status ultimately begs the question, what is Charity. One cannot prove that Charity is this activity or that, for ultimately the answer rests upon value judgment, not empirical proof.¹⁰⁶ But society ought to possess the ability and intellectual wherewithal to identify that which most certainly is not Charity, if not by broadly applicable definition then by particularized recognition. In fact, society has done so. Charity is neither criminal behavior¹⁰⁷ nor racial discrimination.¹⁰⁸ Those latter conclusions are implicitly, if not explicitly, based upon the enforcement of accepted normative assumptions: crime and racial discrimination harm society. Likewise, the enforcement of the normative assumptions relating to tax policy require that Charity be not a tax shelter participant.

The result of Charity's participation in tax shelters – more capital devoted to charitable goals – does not justify the harm caused thereby. The goal would be better achieved via direct grants to Charity or even to those normally served by Charity.¹⁰⁹ Moreover, Charity should not be defined only by its good result. As a concept, charity ought also to be defined by the manner in which

the exemption.) But even though the trade or business is subject to taxation, it nevertheless enjoys a publicly funded advantage caused by the spill-over of goodwill and other intangibles from the organization's tax exempt (i.e., publicly funded) activities.”

104. Revenue sharing arrangements, under which an employee is paid a percentage of Charity's net revenue are now permissible if properly structured. See Prop. Regs. § 53.4958-5 (August 4, 1998).

105. I will admit to indulging in a small degree of hyperbole here. For it is ultimately a debatable question whether tax shelters and those who engage in such transactions ought to be described by reference to words that imply immorality and I do not wish to tackle such a broad philosophical question here. See *Gregory v. Helvering*, 69 F.2d 809, 810 (2nd Cir. 1934) (“Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.”) *aff'd* 293 U.S. 465 (1935).

106. See generally Lars G. Gustafsson, *The Definition of “Charitable” For Federal Income Tax Purposes: Defrocking the Old and Suggesting Some New Fundamental Assumptions*, 33 *Hous. L. Rev.* 587 (1996).

107. See, e.g., Rev. Rul. 75-384, 1975-2 CB 204.

108. See *Bob Jones University v. United States*, 461 U.S. 574 (1983).

109. In fact, the trend is toward direct grants to persons who might otherwise be Charity's beneficiaries. See Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 *Tenn. L. Rev.* 687, 688 (1999) (stating, “[i]n recent years, however, Congress has increasingly shifted its focus from helping the charitable sector to helping individuals in need of specific social services.”)

that result is achieved. If that is so, Charity should not engage in certain actions – crime, discrimination, nor even tax shelters.

IV. UBIT AS THE PROTOTYPICAL RESPONSE: CHASING OUR OWN TAIL

Clay Brown represents Charity's loss of innocence. Theretofore, Charity had "survive[d] with the luster of its public service emblem untarnished."¹¹⁰ Charity enjoyed a relatively unregulated existence as far as the Code was concerned.¹¹¹ Since *Clay Brown*, Charity – like he who had once tasted of the forbidden fruit – has been subject to ever more regulation, as Congress continually reacts on a case-by-case basis to new manifestations of a singular problem. The particular reaction to *Clay Brown* was the expansion of the unrelated business income tax¹¹² (UBIT) and that reaction has served as the model for most subsequent Congressional responses to Charity's participation in tax shelters.¹¹³ It is as though Charity's occasional but regular participation

110. *University Hill Foundation v. Commissioner*, 51 T.C. 548, 573 (1969) rev'd 446 F.2d 701 (1971).

111. There are three explicit statutory rules applicable to charities. The first is the prohibition against private inurement, first enacted in 1909. Tariff 1909, Ch. 6, § 38, 36 Stat. 11, 113 (1909) (current version at IRC § 501(c)(3)). The second rule, which prohibits Charity's "substantial" involvement in attempts to influence legislation was added in 1934. Revenue Act of 1934, ch. 277, § 101(6), 48 Stat. 680, 700 (1934). The third rule, added in 1954, is that Charity may not participate or intervene in political campaigns on behalf of or in opposition to a candidate for public office. Revenue Act of 1954, ch. 736, § 501(c)(3), 68A Stat. 163 (adding the prohibition against intervening in political campaigns). The unrelated business income tax was added in 1950. Revenue Act of 1950, ch. 994, § 422, 64 Stat. 906, 947-50 (1950).

112. See IRC § 514, added by the Tax Reform Act of 1969, § 121(d), 83 Stat. 487, 543-48 (1969). IRC § 514 would have classified the rent payments as "unrelated debt-financed income" and thus unrelated business taxable income under IRC § 511.

113. One exception to this general pattern is found in IRC § 170(f)(10) recently enacted by the Tax Relief Extension Act of 1999. See 113 Stat. 1860, 1936 (1999). In Notice 99-36, the Service described the prototypical transaction addressed by IRC § 170(f)(10):

[A] charitable split-dollar insurance transaction involves a transfer of funds by a taxpayer to a charity, [and the donor claiming a charitable contribution deduction equal to the amount of the transfer] with the understanding that the charity will use the transferred funds to pay premiums on a cash value life insurance policy that benefits both the charity and the taxpayer's family. Typically, as part of this transaction, the charity or an irrevocable life insurance trust formed by the taxpayer (or a related person) purchases the cash value life insurance policy. The designated beneficiaries of the insurance policy include both the charity and the trust. Members of the taxpayer's family (and, perhaps, the taxpayer) are beneficiaries of the trust.

In a related transaction, the charity enters into a split-dollar agreement with the trust. The split-dollar agreement specifies what portion of the insurance policy premiums is to be paid by the trust and what portion is to be paid by the charity. The agreement specifies the extent to which each party can exercise standard policyholder rights, such as the right to borrow against the cash value of the policy, to partially or completely surrender the policy for cash, and to designate beneficiaries for specified portions of the

in tax shelters, and Congress' response, have both become matters of unthinking routine rather than appropriate moments for rethinking the normative assumptions underlying tax exemption – particularly the assumption that Charity does no harm – and Congress' method of policing those assumptions.

IRC sections 168(g), 514(c)(9), 337(d), and 1245(b)(3) are typical responses to Charity's participation in tax shelters. A brief description of each provision follows in order to highlight problems common to the present approach. IRC section 168(g) attacks the sale-leaseback transaction¹¹⁴ by denying the accelerated cost recovery deduction to the taxable participant. In a sale-leaseback, Charity sells depreciable property to a taxable buyer who oftentimes finances the purchase.¹¹⁵ Immediately thereafter, Charity leases the property, usually under a net lease arrangement, from the buyer.¹¹⁶ The buyer uses the depreciation deduction to offset (i.e., shelter) other income. Under section 168(g), more of the taxable participant's income is subject to current taxation because the buyer/lessee is allowed a smaller depreciation deduction.¹¹⁷ The section 168(g) rule does not apply, however, if the property involved in the sale-leaseback creates unrelated business taxable income.¹¹⁸ That is, if the

death benefit . . . Although the terms of these split-dollar agreements vary, the common feature is that over the life of the split-dollar agreement, the trust has access to a disproportionately high percentage of the cash-surrender value and death benefit under the policy, compared to the percentage of premiums paid by the trust.

1999-26 I.R.B. 3 (June 28, 1999). See also, S. Rep. No. 106-2077, at 72 (1999). (Senate Finance Committee Report regarding IRC § 170(f)(10)). IRC § 170(f)(10) not only denies the charitable deduction to the donor, but also imposes an excise tax on Charity equal to the amount of premiums Charity pays. Thus, unlike UBIT, the tax under IRC § 170(f)(10)(F) does more than merely recoup the tax avoided by the taxable participant.

114. See generally William L. Vallee, Jr. *Sale-Leaseback Transactions By Tax Exempt Entities and The Need for Congressional Guidelines*, 12 *Fordham Urb. L.J.* 349 (1983-84). The abusive impact of sale-leaseback transactions was described by the Treasury in its testimony before Congress:

During the early 1980's, a number of charitable organizations again became involved in leasing transactions with taxable entities. Due to the investment tax credit and accelerated depreciation, certain types of property were subject to a negative tax, generating credits or losses that would offset income from other investments. Because tax exempt organizations could not benefit from these incentives directly, a number of exempt organizations . . . sold part of their assets to taxable businesses that could make use of the tax incentives and would then lease the property back on a long-term basis.

Unrelated Business Income Tax: Hearings Before The Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, 100th Cong., 1st Sess. 31 (1987) (Statement of O. Donaldson Chaption, Deputy Assistant Secretary (Tax Policy), U.S. Department of Treasury) (hereinafter, "Hearings").

115. See Vallee, *supra* note 114, at 352-355.

116. See *id.*

117. In general, IRC § 168(g) requires the buyer to take depreciation deductions over 40 years. IRC § 168(g)(2)(C).

118. See IRC § 168(h)(1)(D).

property is used in a non-charitable activity, the activity will generate income not exempt from taxation.¹¹⁹ The imposition of UBIT allows the government to impose the regular corporate tax and thereby recoup the revenue otherwise avoided by the taxable participant.

IRC section 514(c)(9) operates for a similar purpose in the partnership context by imposing the UBIT on tax exempt educational institutions that participate in partnerships owning debt-financed real property.¹²⁰ In general, the UBIT will apply if a partnership effectively over-allocates income to Charity.¹²¹

119. See IRC § 513(a) (defining “unrelated trade or business”).

120. For a very good discussion of this extremely complicated provision, see William B. Holloway, Jr. Structuring Real Estate Investment Partnerships With Tax-Exempt Investors, 87 Tax Notes 1517 (June 12, 2000).

121. In its testimony before Congress regarding the over-allocation of depreciation deductions to a taxable participant, the Treasury gave the following example:

[A]ssume that a taxable entity and [a] tax-exempt organization form a partnership to acquire property for \$1 million, that all depreciation deductions are allocated to the taxable partner, and that any gain on the sale of the property is allocated to the taxable partner to the extent of his depreciation deductions and then divided equally between the partners. Assume that the property is sold after 20 years. Under current law, the partnership would be required to use 40-year straight line depreciation and thus the taxable partner would have taken depreciation deductions of \$500,000 by the time of the sale. If 40-year straight line depreciation is an accurate measure of true economic depreciation, then in theory the building would be sold for \$500,000 (\$1 million less \$500,000 depreciation) and no gain would be realized. In that case, the entire sales proceeds would be allocated to the tax-exempt partner and the taxable partner would have suffered a true economic loss of \$500,000. In practice, however, because of inflation and because 40 years may not represent true economic depreciation for some buildings, the building could be expected to be sold for more than its basis. Thus, for example, if the building was sold for \$1 million, the gain of \$500,000 would be allocated to the taxable partner. In this case, the taxable partner would have received the benefit of deducting depreciation allowances in the early years which would be offset by gain deferred until the later years. Because there is a common expectation that real estate will not decline, in nominal value, the gain on the property will equal or exceed depreciation deductions.

Hearings, *supra* note 114, at 52. The taxable partner’s taking of all depreciation deductions essentially results in more income being allocated to the exempt organization. That allocation is disproportionate to the extent it exceeds allocations of losses. The example appears to be based on a transaction in which Georgetown University contributed depreciable debt-financed property to a partnership and then sought to allocate the depreciation to the taxable partners. See *Smith v. Commissioner*, 50 T.C. Memo (CCH) 1444 (1985). The court sidestepped the partnership allocation issue by simply deciding that the partnership never actually owned the property. See *id.* Under Subchapter K as presently written, the allocations would not have been considered insubstantial (i.e., the allocations would have been respected and the tax benefit allowed) because the assumption that the property’s fair market value will be higher than basis and therefore result in gain to the taxable participant is precluded by the “fair market value equals basis” presumption. See Regs. § 1.704-1(b)(2)(iii)(c) (flush language). IRC § 514(c)(9) would essentially recapture the sheltered tax by imposing UBIT on the exempt organizations allocable share of income from the property.

The effective over-allocation of income, of course, is the economic equivalent of transferring losses unusable by Charity to taxable participants. By allocating more income to Charity, rather than taking its proper share of income, the taxable partner shelters income and pays less tax.¹²² The UBIT essentially recaptures the avoided tax from Charity and restores to the government revenue avoided by the taxable participant.¹²³

IRC section 337(b) and (d), the latter as implemented by Treasury Regulations section 1.337(d)-4, operate in the corporate context to prevent the circumvention of the *General Utilities* repeal.¹²⁴ The transactions to which IRC section 337(b)(2) and Treasury Regulations section 1.337(d)-4 are aimed involve the distribution of appreciated assets by a controlled corporation. If the appreciated assets are distributed to the controlling corporate shareholder, no gain is recognized by the liquidating corporation and the recipient corporation takes a carryover basis, and gain is merely deferred.¹²⁵ If the appreciated assets are distributed to a charitable organization, however, the gain will be entirely foregone since the charitable organization will likely report no gain on the later disposition of the property.¹²⁶ That is, the gain will be sheltered by the organization's tax exemption. IRC section 337(b)(2) prevents this result by treating the transaction as though the assets were first sold for their fair market value, resulting in a taxable event for the liquidating corporation, and then distributed to Charity. In effect section 337(b) and Treasury Regulations section 1.337(d)-4 accelerate the tax the shareholders would have indirectly paid if they had sold their stock to a taxable purchaser. The deemed sale does not occur, however, if the charitable recipient will use the assets in an unrelated trade or business. Yet again, imposing the UBIT allows the government to recoup revenues otherwise lost.

IRC section 1245(b)(3) and (7) operate in conjunction with UBIT to prevent what is essentially the "conversion" of ordinary income into capital gains income via the use of Charity. For economic policy reasons, taxpayers are allowed depreciation deductions that exceed the actual economic decline in an

122. Cf. Rev. Rul. 99-43, 1999-42 I.R.B. 506 (over-allocation of income from the discharge of indebtedness to an exempt taxpayer (exempt from tax on discharge of indebtedness income by virtue of IRC § 108(a)(1)(B)) resulted in reduced tax liability to taxable partner and therefore was disregarded.)

123. IRC § 514(c)(9) would essentially recapture the sheltered tax by imposing UBIT on the exempt organization's allocable share of income from the property.

124. In *General Utilities & Operating Co. v. Helvering*, a corporation was not required to recognize gain upon the distribution of appreciated property to shareholders. 296 U.S. 200 (1935). The *General Utilities* ruling was reversed by the Tax Reform Act of 1986 and now corporations must generally recognize gain (but not loss) on the distribution of appreciated property. See IRC § 311(b).

125. See IRC § 334(b).

126. See IRC § 501(c)(3); see also, IRC § 512(b)(5) (unrelated business taxable income does not include gain from disposition of non-inventory property or property not held primarily for sale to customers in the ordinary course of business).

asset's value.¹²⁷ If the asset is later sold at a gain (i.e., fair market value exceeds adjusted basis), the selling taxpayer must report a portion of the gain otherwise taxable at capital gains rates as ordinary income.¹²⁸ In this manner, the Code recoups the tax benefit resulting from accelerated depreciation. That benefit is best described as the payment of less tax at the ordinary rate, under the assumption that the asset actually declined in value by the amount of the accelerated depreciation deduction. To the extent the asset is sold at a gain, that assumption is proven false and the government is "owed" the foregone tax. If the gain is taxed at capital gains rate, because of the operation of IRC section 1231, the government does not fully recoup the undeserved benefit.¹²⁹ Thus, IRC section 1245 imposes ordinary income rates on the gain to the extent that gain is attributable to previous depreciation deductions. The section 1245 rules provide an exception, however, when property is distributed to a controlling corporation. In such cases, the controlling corporation will return the undeserved amount when it sells or disposes of the property. If the controlling corporation is a charitable organization, however, the government may never recoup the undeserved benefit because the gain, if any, upon the subsequent disposition of the property will be exempt from tax.¹³⁰ IRC section 1245(b)(3) therefore requires recognition of ordinary gain, not to exceed previous depreciation allowed, when the property is distributed to a charitable organization.¹³¹ For the same recuperative reasons previously noted, recognition is not required if the charitable organization's use of the property results in the UBIT.

Finally, the question of how the law should respond when Charity aids a tax shelter arises implicitly, if not explicitly, in contemporary discussions with regard to tax shelters. Under the Clinton administration's proposal, Charity's income from participation in a tax shelter transaction would be classified as UBIT.¹³² A separate proposal would deny the taxable party the tax benefit arising from a tax shelter transaction and make Charity's involvement evidence

127. See generally, Jeff Strnad, *Tax Depreciation and Risk*, 52 SMU L. Rev. 547, 547 (1999) ("Although some parts of U.S. law aim to replicate economic depreciation, tax depreciation is normally allowed at a rate that is faster than economic depreciation.").

128. See IRC § 1245(a).

129. "The taxpayer who has taken excessive depreciation deductions and then sells an asset, therefore, has in effect converted ordinary income into a capital gain." S. Rep. No. 1881, 87th Cong., 2nd Sess. 95 (1962).

130. See IRC § 512(b)(5) (unrelated business taxable income does not include gain from disposition of non-inventory property or property not held primarily for sale to customers in the ordinary course of business).

131. The tax avoidance effect will most likely arise when Charity itself is attempting to avoid taxation. For example, Charity might create a wholly owned subsidiary to engage in an unrelated trade or business. To zero-out the subsidiary's gross income, the Charity could contribute a depreciable asset to the subsidiary. The subsidiary can use accelerated depreciation deductions to shelter its taxable income. Later, the subsidiary can be liquidated into its charitable parent and, in the absence of IRC § 1245(b)(3) essentially pay no taxes on the unrelated business.

132. See *The Problem of Corporate Tax Shelters*, supra note 8, at 116; FY 2001 Budget Proposal, supra note 13, at 127-28.

that the transaction is indeed a tax shelter.¹³³ Both approaches are rather consistent in their approach of merely chasing and then recouping the government's lost revenue, although the second is a bit more lenient from Charity's standpoint.

By now, then, the pattern should be all too, and rather painfully familiar. When Charity aids in the unintended grant of a tax benefit, the Code essentially follows the money and, at the point the money rests with the charitable organization, imposes tax at ordinary rates via the UBIT provisions. This approach raises at least two substantive objections and two related procedural objections. First, since the money ultimately taxed originates with the taxable participant, the UBIT imposition is economically moot with regard to Charity.¹³⁴ That is, no real tax or other toll is imposed on Charity. Rather, Charity's return from its participation is reduced and the opportunity for further such participation is eliminated since the imposition of UBIT means the plan is no longer attractive to the taxable participant. The UBIT imposition is economically a mere restoration of the status quo. If Charity were simply an innocent bystander, such an approach might be appropriate. The transaction's occurrence, in such cases, could not reasonably be viewed as an appropriate occasion on which to impose upon Charity's tax exempt status. Charity's actions would have neither contributed to a distortion of income nor could Charity's actions be traced to the imposition of an unfair burden on another taxpayer. Charity, consistent with its halo, ought to be ready and willing to assist the tax collector in recouping illegitimate tax benefits and that is the sole effect of imposing UBIT. To otherwise work an imposition on Charity's tax exemption, though, serves no purpose but to aggravate the harm to both the public in general and charities in particular.

History proves, unfortunately, that Charity is oftentimes more than an innocent bystander. When, instead, Charity aids and abets a tax shelter, merely recouping the tax benefit without impacting the tax-exempt status is singularly unproductive.¹³⁵ A mere recoupment does nothing to alter Charity's motivations for engaging in the transaction in the first place, and thus provides no protection from future harm caused by Charity's participation in new tax shelters. The imposition of UBIT is ultimately a tax on the taxable participant's income, just as is the mere denial of the sought-after tax benefit, particularly since the role of Charity is generally that of a money launderer. That is, the taxable participant's income is passed through Charity in order to change its character,

133. See Abusive Tax Shelter Shutdown Act, H.R. 2255, 106th Cong. § 3 (1999).

134. "Tax-indifferent parties often are interposed into corporate tax shelter transactions to absorb taxable income from the transaction, leaving offsetting deductions or losses to be used by a taxable corporate participant." *The Problem of Corporate Tax Shelters*, supra note 8, at 115.

135. After Congress enacted the Business Lease provisions in 1950, for example, University Hill Foundation simply planned around the specific rules by limiting future leases to five years or less and continued participating in charitable bootstraps until it finally lost in court more than 20 years later. See *University Hill Foundation*, 51 T.C. 548 (1969) rev'd 446 F.2d 701 (9th Cir. 1971).

or decrease taxable income (by understatement of gain, or overstatement of loss) to the taxable party.¹³⁶ Imposing UBIT does nothing to Charity because it puts at risk none of its own funds and ultimately none of its funds are affected by the tax.¹³⁷ In substance, and despite the lessons of history, imposing UBIT treats Charity as though it is invariably an innocent bystander to tax shelters when quite the opposite is often true. Thus, the present approach to Charity's participation in tax shelters may thwart the money-laundering goal and thereby put an end to a particular tax shelter. But the imposition of UBIT does nothing to address Charity's responsibility for that particular tax shelter transaction, nor does it provide an effective deterrent to Charity's involvement in new tax shelters.¹³⁸

The foregoing analysis should not be surprising considering the objectives of the UBIT. From its inception, UBIT has been neither a preventive nor a punitive measure.¹³⁹ Ultimately, the imposition of UBIT is a restorative

136. In a sale-leaseback for example, the taxable buyer is merely funneling money into a depreciable charitable asset to obtain the depreciation deduction not otherwise available to the charitable seller/lessee. See *supra* notes 114-17 and accompanying text. In the charitable bootstrap sale, the taxable payer is "paying" earnings to itself after those earnings have been funneled through the charitable buyer in order to purge the corporate tax. See *supra* notes 63-65 and accompanying text. In a partnership involving taxable and charitable partners, the taxable partner would be able to avoid tax by over-allocating income to the charitable partner if IRC § 514(c)(9) were not enacted. And finally, without IRC § 337(b), shareholders could use an exempt organization to withdraw appreciation untaxed at the corporate level.

137. UBIT is imposed, of course, only on net gain. See IRC § 512(a)(1). In most, if not all such tax shelters, Charity will not have put any of its assets, at risk but instead will be "trading" on its tax exemption. See *Commissioner v. Clay Brown*, 380 U.S. 563, 580 (Harlan, J., concurring) ("since its exemption is unlimited, like the magic purse that always contains another penny, the [charitable organization] gave up nothing by trading on it."). "The Treasury Department believes that the current nothing ventured, nothing gained attitude, coupled with little downside risk to many participants has, in part, led to the proliferation of corporate tax shelters." *The Problem of Corporate Tax Shelters*, *supra* note 8, at 118.

138. The Clinton administration's proposal recognizes the appropriateness of penalizing the exempt organization as opposed to merely restoring the status quo:

Proposals to deter the use of corporate tax shelters could provide sanctions or remedies on these parties as a penalty for engaging in inappropriate behavior. More importantly, such remedies or sanctions would lessen or eliminate the economic incentives for these parties to participate in sheltering transactions, thus having a dampening effect on the transactions themselves to the extent they are facilitated by the participation of these parties. Finally, the potential for remedies or sanctions on all participating parties will multiply the number of eyes that will scrutinize a transaction for its integrity.

The Problem of Corporate Tax Shelters, *supra* note 8, at 112. Still, the imposition of the UBIT hardly serves that purpose.

139. The problem at which the tax on unrelated business income is directed is primarily that of unfair competition In neither the House bill nor your committee's bill does this provision deny exemption where the organizations are carrying on unrelated active business enterprises, nor require that they dispose of such businesses. Both provisions merely impose the same tax on income derived from an unrelated trade or business as is borne

device that merely eliminates the unintended advantage Charity has relative to taxable entities in an identical commercial transaction.¹⁴⁰ Consider again, for example, the bootstrap transaction in *Clay Brown*. The sale to a taxable purchaser, as opposed to Charity, could have been structured to avoid one, but not both levels of tax normally applicable to corporations and shareholders.¹⁴¹ The unique advantage of bootstrap sales to Charity is that both levels of tax can be avoided, because Charity is tax exempt, and the buyer can realize a greater and faster return. The real effect of UBIT is therefore only to eliminate the market distortion caused by tax exemption.¹⁴² That distortion manifests itself in an actor's preference for engaging in transactions with Charity rather than taxable entities. Without intervention, Charity could conceivably eliminate taxable buyers' ability to obtain market resources because taxable buyers could not offer as attractive a return as Charity.¹⁴³ Whenever it is imposed, then, UBIT does nothing more than eliminate the competitive advantage or market distortion unintentionally caused by tax exemption. UBIT restores an appropriate status quo but does not address Charity's willing distortion of that status quo nor its self-interested motivation to do so in future cases.

The second substantive objection to the present approach is a bit less pragmatic and much more philosophical. Failing to address Charity's involvement in the transaction allows for a present harm separate and apart from the erosion of the tax base – the degradation of the political and social consensus that justifies tax exemption. To the extent Charity aids and abets a tax shelter, and does so without consequence, it tarnishes the halo that justifies granting tax exemption not just to the particular charity involved, but to all charities.¹⁴⁴ There will thus come a time when Charity's occasional but regular folly of engaging in tax shelters will define Charity, however inaccurate that definition may be. In effect, such actions constitute a substantive attack on society's understanding of the charitable concept and that attack should not be allowed to persist without response, lest the problem grow to such an extent that an inevitable, but long-delayed response manifest itself by a wholesale elimination of the charitable tax exemption.

Two procedural objections are undoubtedly apparent with respect to the use of UBIT to attack Charity's participation in tax shelters. First, the imposition of UBIT, particularly on a case by case basis, adds to the already

by their competitors. In fact, it is not intended that the tax imposed on unrelated business income will have any effect on the tax-exempt status of any organizations.

S. Rep. No. 81-2375, 81st Cong., 2nd Sess. at 3081 (1950) reprinted in 1950-2 C.B. 483, 504-05

140. See *id.*

141. See *supra* notes 69-70 and accompanying text.

142. For a broad-ranging summary of market distortions caused by the tax treatment of charities, see Charles T. Clotfelter, *Tax Induced Distortions in the Voluntary Sector*, 39 *Case W. Res. L. Rev.* 663 (1988-89).

143. See *supra* note 99 and accompanying text.

144. See Brody, *supra* note 11 and accompanying text.

significant degree of complexity and transaction costs contained in or resulting from the Code. The anti-avoidance goal of IRC section 514(c)(9), for example, presents formidable challenges to the human capacity to comprehend substance and monitor compliance. Indeed, the detailed requirements of that provision are imposed as an addition to the already complex substantial economic effect rules of IRC section 704(b).¹⁴⁵ They require not only present compliance, but prospective compliance as well. That is, all current and all *possible* allocations under the partnership agreement must comply with the “fractions rule” if the UBIT “penalty” is to be avoided.¹⁴⁶ The second objection applies just as much to the overall approach to tax shelters. Tax shelters result, perhaps, from over-particularized rules. Such rules attempt to address the entire universe of transactions that fall within a certain illegitimate purpose.¹⁴⁷ In doing so, they impose inflexible definitions. That inflexibility works both ways. It imposes complexity and transaction costs on taxpayers whose transactions are entirely unconcerned with illegitimate tax avoidance.¹⁴⁸ On the other hand, a transaction might be fraught with illegitimate tax avoidance indicators and yet the inflexibility of the over-particularized rule leaves the public without remedy.¹⁴⁹ Congress’s historical reaction in the latter instance has normally been to impose yet another particularized rule, as though the unaccounted-for transaction was the only one possibly omitted from the first rule. The result, with respect to both procedural objections, is a predictable cycle characterized by spiraling complexity and endless detail.¹⁵⁰ The analogy of a dog chasing its own tail is

145. See IRC § 514(c)(9).

146. The “fractions rule” requires that, in a partnership having both taxable and nontaxable partners and which holds debt-financed property, allocations to the nontaxable partner “cannot result in that partner having a percentage share of overall partnership income for any partnership taxable year greater than that partner’s overall partnership income or loss for the taxable year in which that partner’s share of overall partnership loss will be the smallest. Regs. § 1.514(c)-2(b)(1)(i). The fractions rule must be complied with “both on a prospective basis and on an actual basis for each taxable year of the partnership.” Regs. § 1.514(c)-2(b)(2)(i). Thus, the partnership must determine the charitable partner’s potentially smallest loss share and then determine whether it is possible that an allocation of income throughout the life of the partnership might possibly exceed that smallest loss share.

147. “[R]ules are not good at regulating infrequent transactions because their content must be determined *ex ante*. If there are 1000 possible rare transactions, and only 10 actually will occur absent the opportunity to evade taxes, rules must anticipate all 1000 transactions and do so accurately.” David A. Weisbach, *supra* note 91, at 870 (1999).

148. See generally, Arthur A. Feder and Joel Scharfstein, *Leveraged Investments in Real Property Through Partnerships By Tax Exempt Organizations After the Revenue Act of 1987 – A Lesson in How The Legislative Process Should Not Work*, 42 *Tax Law.* 55 (1988) (discussing what the authors view as unnecessary compliance burdens created by IRC § 514(c)(9)).

149. See Weisbach, *supra* note 91, at 871. (“[R]ules apply to their complete domain even if at the borders they are inaccurate. This type of inaccuracy makes an easy target for tax planning, which both loses revenue and distorts transactions.”)

150. A good example involves a charity that operates a taxable enterprise via a subsidiary and attempts to shelter the income from UBIT’s anti-sheltering intent. UBIT, of course, was ultimately imposed to tax noncharitable activities escaping taxation under the shelter of tax exemption. To avoid UBIT, Charity could conduct unrelated activities via a subsidiary.

finally appropriate. The dog may catch its tail once in awhile but it can hold on for only a brief moment. And when he lets go, the chase starts all over again.

The objections to the use of UBIT as the prototypical response to Charity's participation in tax shelters prove the need for a better approach. A better approach is suggested by contemporary proposals related to taxable participants in tax shelters. Those proposals generally call for an articulated anti-tax shelter standard applicable to taxable participants and designed to address a broad range of transactions having common characteristics though distinguished by diverse facts and circumstances.¹⁵¹ There should be a similar standard specifically related to Charity's participation in tax shelters, accompanied by an effective penalty for violations of that standard. One current proposal imposes UBIT when Charity assists a taxable person in violating the broad anti-shelter standard.¹⁵² That approach, however, only generalizes a remedy already shown to be ineffective in particular situations, since UBIT merely recoups what the taxable person should have paid and has no effect on Charity. Perpetuation of the present approach leaves an indispensable party to an illicit transaction free to search out yet another tax shelter opportunity. What is required, instead, is a standard-based prohibition supported by an effective deterrent.

V. TOWARDS AN EFFECTIVE RESPONSE: THE PRIVATE BENEFIT AND PUBLIC POLICY DOCTRINES

Charity is never precisely defined in tax law.¹⁵³

If the activities were conducted directly by the charity, the income would be unrelated business taxable income. See IRC § 511. Likewise, operation of the enterprise via a subsidiary results in a corporate tax on the subsidiary. But if the charity caused the subsidiary to pay rent for the use of the charity's fixed assets and the rent is approximately equal to the subsidiary's gross earnings, the subsidiary can "zero-out" its income and avoid the corporate tax altogether. The Charity could thus avoid the anti-sheltering intent of UBIT. In further response to such transactions, though, the Code chases the money and imposes the ordinary corporate tax (via the UBIT provisions) on the rents received by the charity from a controlled corporation. See IRC § 512(b)(13); See also Unrelated Business Income Tax: Hearings Before The Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, 100th Cong., 1st Sess. 30 (1987) (Statement of O. Donaldson Chapton, Deputy Assistant Secretary (Tax Policy), U.S. Department of Treasury) ("The controlled subsidiary rule was imposed to discourage charitable organizations from 'renting' part of their physical plants to taxable subsidiaries, thereby reducing or eliminating the [unrelated business] taxable income of the subsidiaries.").

151. See Abusive Tax Shelter Shutdown Act, H.R. 2255, 106th Cong., 1st Sess. (1999); FY 2001 Budget Proposal, *supra* note 13, at 124-128.

152. See FY 2001 Budget Proposal, *supra* note 13, at 127-28.

153. The closest thing to a formal tax definition of "charity" is found in Regs. § 1.501(c)(3)-1(d)(2) which states:

The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term include: Relief of the poor and distressed or of

That is, the affirmative requirements for tax exemption are not specifically articulated.¹⁵⁴ To the extent Charity is defined, it is primarily by negative implication. Thus, Charity may not distribute profit to its stewards,¹⁵⁵ though that prohibition appears waning;¹⁵⁶ it may not operate for “private benefit,”¹⁵⁷ nor engage in political activity,¹⁵⁸ and it must function in a manner that does not violate “clearly established public policy.”¹⁵⁹ Otherwise, the definition of Charity is by reference to historical standards, as opposed to precise

the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

The judicial approach to the task of defining “charity” has been one whereby the trust law definition of charity is incorporated into tax law. See Lars G. Gustafsson, *The Definition of “Charitable” For Federal Income Tax Purposes: Defrocking The Old and Suggesting Some New Fundamental Assumptions*, 33 *Hous. L. Rev.* 587 (1996). Some commentators have decried that approach and have instead set forth what might fairly be described as socio-economic theories of charity for purposes of tax exemption. See Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 *B.C. L. Rev.* 501 (1990) (proposing that charity, for purposes of tax exemption, is the act of engaging in altruistic economic behavior); see also John D. Colombo & Mark A. Hall, *The Charitable Tax Exemption* (1995) (proposing that charity is altruistic economic behavior, but defining “altruism” differently from Professor Atkinson’s definition); Nina J. Crimm, *An Explanation of The Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 *Fla. L. Rev.* 419 (1998) (proposing that “charitable” for purposes of tax law is the provision of pure and mixed “public” goods and services).

154. The regulations define “educational” and “scientific,” but not all educational or scientific purposes are charitable. See Regs. § 1.501(c)(3)-1(d)(3), (4).

155. See IRC § 501(c)(3) provides charitable tax exemption for:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve [sic] the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

156. For an in-depth discussion of the history and future of the prohibition against profit distribution see Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 *Va. Tax Rev.* 575 (2000).

157. See Regs. § 1.501(c)(3)-1(d)(1)(ii) (“An organization is not organized or operated exclusively for [charitable purposes] unless it serves a public rather than a private interest.”)

158. See IRC § 501(c)(3), quoted *supra* note 155.

159. See *Bob Jones University v. Commissioner*, 461 U.S. 574, 1591 (1983).

articulation.¹⁶⁰ As an affirmative matter, Charity is essentially what it has always been thought to be.¹⁶¹ The failure of precise definition, though, is not fatal. Quite the opposite is true. Ultimately precision is the cause of tax shelters and imprecision will be the cure.¹⁶² It is only an imprecise yet recognizable conceptualization of charitable tax exemption that will redress Charity's participation in tax shelters, and perhaps all other deviations from the notions justifying tax exemption. In this section, then, the analysis focuses on how the broad conception of Charity excludes such participation. The section begins with the prohibition against private inurement, the statutory doctrine that bars Charity from distributing profit.¹⁶³ It then addresses the only affirmatively stated requirement for tax exemption – that Charity's activities must be primarily directed towards achieving “exempt purposes.”¹⁶⁴ Neither of these first two requirements is sufficient to prevent Charity's involvement in tax shelters. Both are relatively fixed, quantitative doctrines that do not allow for an evolutionary standard fairly responsive to an evolved form of qualitative abuse.¹⁶⁵ Two of the three remaining doctrines, private benefit and clearly established public policy,

160. See Gustafsson, *supra* note 107; see also Nina J. Crimm, *An Explanation of The Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 Fla. L. Rev. 419, 425-427 (1998).

161. I don't mean to be facetious here, but my purpose is only to show that whatever the definition of charity may be, it certainly does not include participation in tax shelters. For attempts at affirmatively defining charity see *supra* note 153, and sources cited therein.

162. See Weisbach, *supra* note 91, at 875-882 (discussing the advantages of broad tax standards as opposed to complex particularized rules).

163. See IRC § 501(c)(3), quoted *supra* note 155.

164. See Regs. § 1.501(c)(3)-1(c)(1). IRC § 501(c)(3) limits tax exemption to those organizations “exclusively” engaged in charitable activities. The word “exclusively,” however has been interpreted to mean “primarily.” See *id.* See also *World Family Corporation v. Commissioner of Internal Revenue*, 81 T.C. 958 (1983) (“Although section 501(c)(3) uses the words ‘operated exclusively,’ an organization will be regarded as satisfying the operational test if it engages primarily in activities which accomplish one more exempt purposes in section 501(c)(3).”).

165. The ultimate concern of the private inurement prohibition is the diversion of resources from charitable beneficiaries in favor of individual private gain. See Jones, *supra* note 156. That doctrine, applies, though, only when private gain is diverted to “insiders” (those who exercise power of ownership with respect to the entity). See *United Cancer Council, Inc. v. Commissioner*, 165 F.3d 1173, 1176 (7th Cir. 1999) (insider is director or trustee, chief executive officer, chief financial officer, or other high level manager). The primary purpose requirement, too, is ultimately concerned with whether, on the whole, the good that Charity does so outweighs any other effects that tax exemption is justified. My premise is that even if resources are not diverted to individual gain and even if the organization is “primarily” charitable, the participation in tax shelters should still be precluded. The private inurement and primary purpose doctrines do not legitimately support such a notion.

are evolutionary¹⁶⁶ and thus legitimately respond to Charity's evolving participation in tax shelters.

A singular finding of fact, of sorts, is necessary before addressing the theoretical justifications for prohibiting charitable tax shelters. Contrary to early notions, an attack against Charity's participation in tax shelters cannot be sustained on the notion that Charity is paying an above market rate in any particular tax shelter transaction.¹⁶⁷ In neither the fast-pay, bootstrap nor leaseback transactions, for example, is it logical to assume that Charity is lending money at below market rates, (in the case of the fast-pay transaction), or paying an above market purchase or rental price (in the case of a bootstrap or leaseback transaction). The economic benefit necessitating Charity's involvement is solely a tax gain. That is, Charity's tax-exempt status allows the

166. Two scholars deride the fact that "courts and commentators find themselves repeatedly forced to rest on the unilluminating platitude that 'charity is an evolving concept which must be allowed to change and expand in response to the needs of society.'" See Columbo & Hall, *supra* note 153, at 38 citing John P. Persons, et al., *Criteria for Exemption Under Section 501(c)(3)*, in *Research Papers Sponsored By The Commission on Private Philanthropy and Public Needs*, at 1909 (U.S. Dep't. of the Treasury, ed. 1977). I rather think that the whole of law, particularly tax law (though I admit to being partial) is evolutionary.

167. See *supra* note 81 and accompanying text. On at least one occasion, even Congress has explicitly assumed such a result:

A third reason for proposing the taxation of lease-backs is the possibility which exists in each case that the tax exempt organization has in effect sold part of its exemption. This can occur either by the exempt organization paying a higher price for the property or by charging lower rentals than a taxable business could charge. Proof, of course, is difficult to obtain because the purchase price, or rental charge which a taxable business would agree to pay, is unknown. In the case of ordinary investments there is no reason why an exempt organization could be expected to make an offer which would be much better, if any, than that which would be made by a taxable business. However, in the case of the lease-back arrangements the sellers seem to take the position that they will not sell at all unless they receive better terms than a taxable business can offer, and the exempt organization, because of its tax-free status, can afford to pay the higher price and still make a profit on the transaction.

S. Rep. No. 2375, 81st Cong., 2nd Sess. 31 reprinted in 1950 U.S.C.C.A.N. 3053, 3084. The dissent in *Clay Brown* accepted the assumption as well:

Indeed, this supposition [that Charity is paying too much or charging too little] is highly likely, for the Institute was selling its tax exemption, and this is not the sort of asset which is limited in quantity. Though the Institute might have negotiated in order to receive beneficial ownership of the corporation as soon as possible, the Institute, at no cost to itself, could increase the price to produce an offer too attractive for the seller to decline. Thus, it is natural to anticipate sales such as this taking place at prices on the upper boundary of what courts will hold to be a reasonable price – at prices which will often be considerably greater than what the owners of a closed corporation could have received in a sale to buyer who were not selling their tax exemption.

Commissioner of Internal Revenue v. *Clay Brown*, 380 U.S. 563, 588 (1965) (Goldberg, J. dissenting).

taxable participant to avoid a tax cost and thereby obtain a premium not available elsewhere.¹⁶⁸ The avoidance of that tax cost is uniquely available through the use of Charity. Thus, the taxable participant is in no position to demand, and Charity need not pay, an inflated price. Moreover, Charity's tax exemption, and therefore the taxable participant's premium, is unnecessarily jeopardized when Charity pays an inflated price. Payment of an inflated price would implicate and likely violate the prohibition against private inurement or private benefit. The taxable participant therefore has an economic interest in ensuring that Charity pay no more than market rate. If, indeed, charitable tax shelters were really a function of a higher than market payment, the answer would be readily apparent; the private inurement or private benefit doctrines would be adequate enforcement tools.¹⁶⁹ The taxable participant's economic yield is instead entirely dependent upon Charity's reasonable, rather than unreasonable, payment.

The foregoing discussion, then, eliminates the prohibition against private inurement as a basis for attacking charitable tax shelters. That prohibition requires two findings. The first is that the taxable participant be an "insider" with respect to the charitable participant.¹⁷⁰ The second is that the Charity transfer wealth unnecessarily to the insider.¹⁷¹ The second requirement manifests itself, as a general matter, when Charity makes an unreasonable payment.¹⁷² The tax shelter purpose would fail completely in such

168. In the fast-pay tax and bootstrap shelters, Charity allows the taxable participant to avoid the corporate tax. See *supra* notes 24-33 and accompanying text (with regard to fast-pay) and notes 51-68 and accompanying text (with regard to bootstrap sales). In a leaseback transaction, Charity allows the taxable participant to avoid the corporate or individual tax. See *supra* notes 114-19 and accompanying text. In a partnership owning debt financed property, Charity's participation likewise allows a taxable participant to avoid tax. See *supra* notes 120-23 and accompanying text. Although Congressional statements most often assume Charity pays too much or charges too little, on another occasion Congress has accepted that Charity probably pays less than market rate:

The committee believes that reform of the tax law is essential, insofar as it relates to property used by tax-exempt entities under a lease, a lease formulated as a service contract, or other similar arrangements. When tax-exempt entities use property under these arrangements, they pay reduced rates rents that reflect a pass-through of investment tax incentives from the owner of the property. Tax-exempt entities thereby benefit from investment incentives for which they do not qualify directly, and effectively gain the advantage of taking income tax deductions and credits while having no corresponding liability to pay any tax on income from the property.

H.R. Report No. 432, 98th Cong., 2nd Sess. 1138 (1984), reprinted at 1984 U.S.C.C.A.N. 697.

169. See *id.*

170. See *United Cancer Council, Inc. v. Commissioner*, 165 F.3d 1173 (7th Cir. 1999) (excessive price paid to outside fundraiser was not private inurement because fundraiser was not an insider).

171. See generally Jones, *supra* note 156 (providing an in-depth discussion of the theory and categories of private inurement).

172. See *id.* See, e.g., *Birmingham Bus. College, Inc. v. Commissioner*, 276 F.2d 476 (5th Cir. 1960) (Charity paid an unreasonable salary to an insider).

circumstances,¹⁷³ and it is therefore illogical to assume that Charity pays more than a reasonable amount. Even in a transaction not involving an insider, Charity need not pay an above market rate because Charity possesses the rare asset, tax exemption, needed by the taxable participant. As a purely economic matter, Charity can demand a return that results in Charity's enrichment and therefore the private inurement doctrine will not apply to Charity's participation in tax shelters.

An unreasonable payment is not a condition precedent to Charity's violation of the sole affirmative requirement for tax exemption. To qualify for tax exemption, Charity must be "primarily" engaged in activities that "accomplish one or more exempt purposes specified in section 501(c)(3)."¹⁷⁴ Thus, for example, a charity may make reasonable payments in the operation of a manufacturing business but, despite the making of reasonable payments, nevertheless forfeit the right to tax exemption if the conduct of the manufacturing business constitutes its primary activity. As used in this sense, "primary" is a relevant term requiring first a determination as to whether an activity accomplishes an exempt purpose.¹⁷⁵ Assuming the particular activity is not conducive to the accomplishment of the exempt purpose, the primary purpose requirement then requires a quantitative comparison of that activity with other activities that are conducive to an exempt purpose.¹⁷⁶ If the nonexempt activity is "substantial" in relation to the exempt activities, the organization is not primarily engaged as required and therefore is not entitled

173. If, in a transaction with an insider (whether the transaction is a tax shelter or not), Charity makes an unreasonable payment, tax exemption is forfeited. See *id.* The asset of value to the taxable participant to a tax shelter would then be lost.

174. See Regs. § 1.501(c)(3)-1(c)(1); see also *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978).

175. See *World Family Corporation v. Commissioner*, 81 T.C. 958 (1983) (organization's research activity did not accomplish an exempt purpose).

176. See *id.* at 966-67 (organization's noncharitable research activities were insubstantial in comparison to its charitable missionary activities). The court in *World Family Corporation* was careful to note that the relative amount spent on each activity was not determinative. Instead, all the facts and circumstances must be considered in determining whether an activity is "substantial." See *id.* at 967, n.10.

There is no general rule for determining when the level of an activity becomes high enough that it is no longer incidental and instead becomes substantial; however, the courts will examine various factors in determining whether an activity is incidental to the organization's primary activities, including (1) the amount of income derived from the activity in comparison to total income, (2) the amount of expenditures for the activity in comparison to total expenditures; and (3) the amount of time the organization's employees devote to the activity in comparison to total hours worked.

Frances R. Hill & Barbara L. Kirschten, *Federal and State Taxation of Exempt Organizations*, ¶ 2.02[3] (1994 & 1998 Supplement).

to tax exemption.¹⁷⁷ Hence, the primary purpose requirement is not a function of Charity making an unreasonable payment.

To rely, though, on the primary purpose requirement as a response to Charity's participation in tax shelters is essentially to condone such participation. The second part of the primary purpose requirement allows tax shelter participation if, for example, Charity unquestionably engages in exempt purpose activities and only occasionally participates in a tax shelter. Suppose for example that a well-established, centuries-old university engages in tax shelter transactions on average once or twice every three years. It produces hundreds or thousands of graduates each year in many different disciplines and its faculty conduct important research year round. Engaging in the tax shelter transaction is not an exempt purpose activity,¹⁷⁸ but one certainly cannot conclude that the activity constitutes the university's primary activity. The primary purpose test would therefore be ineffective in addressing the problem. And if every charitable organization were permitted to infrequently participate in tax shelters, there would be nothing preventing Charity's participation in tax shelters.

The private benefit doctrine is occasionally referred to in the same breath, or as a "corollary" to the affirmative requirement that Charity operate primarily for the achievement of exempt purposes.¹⁷⁹ Indeed, the formal articulation of the private benefit doctrine occurs within the context of a discussion of the affirmative requirement.¹⁸⁰ But the private benefit doctrine is not always a corollary in the sense that a violation of the affirmative "primary purpose" requirement is the invariable result of a violation of the private benefit doctrine. Private benefit requires a two-step analysis, only the second of which correlates to, and yet differs from, the primary purpose requirement. The first step holds that Charity may confer a private benefit when doing so is a necessary consequence of achieving an overall charitable goal.¹⁸¹ Private benefit

177. See *Better Business Bureau v. United States*, 326 U.S. 279, 283 (1945) ("the presence of a single [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt purposes]."). *Better Business Bureau* did not involve IRC § 501(c)(3) but has been adopted as the appropriate standard in cases that involve IRC § 501(c)(3). See *Copyright Clearance Center v. Commissioner*, 79 T.C. 793, 804, n.11 (1982).

178. See *infra* notes 193-97 and accompanying text.

179. See, e.g., Patrick H. Lucas, *The Service's Latest Attempt to Regulate Hospital-Physician Relationships: A Critical Analysis*, 9 *Akron Tax J.* 13, 27 (1992) (referring to the private benefit doctrine as a "corollary" to the primary purpose requirement.); see Hill & Kirschten *supra* note 176, at ¶ 2.03[2] ("[T]he private benefit prohibition is defined by reference to the requirement that the organization operate 'exclusively' for an exempt purpose in light of the regulatory definition of 'exclusively' as all but an 'insubstantial part' of the organizations activities.").

180. See Regs. § 1.501(c)(3)-1(d)(1)(ii).

181. See *American Campaign Academy v. Commissioner*, 92 T.C. 1053, 1066 (1989) ("Occasional economic benefits flowing to persons as an incidental consequence of an organization pursuing exempt charitable purposes will not generally constitute prohibited private benefits.")

includes any “advantage, profit, fruit, privilege, gain, or interest.”¹⁸² The quoted words seem only roughly synonymous and the search for common meaning is somewhat elusive.¹⁸³ In practice, though, private benefit results when Charity provides a special dispensation to a noncharitable person or select group of persons.¹⁸⁴ If the benefit is not an inherent consequence of achieving a charitable purpose – i.e., if the purpose can be achieved without the special dispensation – the conferral of the benefit results in a violation of the private benefit doctrine, regardless of the overall public benefit provided by the organization.¹⁸⁵ The second part of the private benefit prohibition holds that if

182. See *id.* at 1065-66.

183. Certainly, though, the Charity must somehow “enrich” private interest, rather than simply engage in noncharitable quid pro quo transactions with noncharitable private interests. Otherwise, the private benefit doctrine would prevent Charity from engaging in any unrelated trade or business, and that result would render IRC §§ 511-13 (the provisions which allow Charity to engage in limited unrelated trade or business) meaningless.

184. For a more in-depth discussion of my formulation of the private benefit doctrine see Darryll K. Jones, Private Benefit and the Unanswered Questions From Redlands Surgical Services, 89 Tax Notes 121 (Oct. 2, 2000). In *American Campaign Academy*, the tax court distinguished between inherent benefits to individual students who enrolled in a charitable educational institution, and unnecessary benefits to a particular organization (the Republican party, since it appeared that the organization served as a training program for Republican party campaign workers). 92 T.C. 1053, 1074 (1989). The former benefits are inherently necessary to accomplish the educational goal, the latter are not. See *id.* Cf. Rev. Rul. 70-186, 1970-1 C.B. 129 (1970) (organization formed to preserve and improve a lake could not achieve its purpose without conferring special benefit on lake-front property owners and therefore did not violate the private benefit prohibition).

185. The first part of this statement is fairly derived from *American Campaign Academy* which assumes that the private benefit occurs as an “incidental consequence” of Charity’s “pursuing exempt charitable purposes.” See *supra* note 181. The second part of the statement – that if Charity is not pursuing an exempt charitable purpose the relative amounts of public and private benefit are irrelevant – seems entirely logical but nevertheless more difficult to place within the language of relevant caselaw. In fact, *American Campaign Academy* stated that prohibited private benefit must be measured against the overall public good (in a manner similar to the “primary purpose” analysis) and that only if the private benefit is substantial will tax exemption be justified. 92 T.C. 1066. The Service holds to the view stated in the text:

Any private benefit arising from a particular activity must be “incidental” in both a qualitative and quantitative sense to the overall public benefit achieved by the activity if the organization is to remain exempt. To be qualitatively incidental, a private benefit must occur as a necessary concomitant of the activity that benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefitting private individuals. Such benefits might also be characterized as indirect or unintentional. To be qualitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit conferred by the activity. It bears emphasis that, even though exemption of the entire organization may be at stake, the private benefit conferred by an activity or arrangement is balanced only against the public benefit conferred by that activity or arrangement, not the overall good accomplished by the organization.

Gen. Couns. Mem. 39,862 (Dec. 2, 1991) (emphasis added). Both major treatises regarding tax exempt organizations take a rather agnostic approach. See Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* § 19.10 (7th ed. 1998) (describing the approach articulated in Gen.

a benefit is a necessary consequence, it must be insubstantial in relationship to the public gain derived from the same activity.¹⁸⁶ At this point, the doctrine seems identical to the primary purpose requirement. The significant difference, though, is that only the single activity resulting in private gain is relevant.¹⁸⁷ The analysis looks to whether the private benefit from the single activity is insubstantial relative to the public gain from that same activity.¹⁸⁸ The analysis does not compare private gain from the single activity with public gain derived from all of Charity's other activities.

Thus, for example, an exempt hospital that treats thousands of patients per year and continuously supports scientific research does not violate the affirmative primary purpose requirement merely because it also enters into a joint venture with, and thereby provides special dispensation to, a taxable physician practice group that serves no charitable purpose.¹⁸⁹ Obviously, a quantitative comparison shows that the hospital is "primarily" operated to achieve exempt purposes. Though the hospital does not violate the primary purpose requirement, it still forfeits the privilege of tax exemption because it confers an unnecessary benefit on the taxable joint venturer in a transaction not inherent to a charitable accomplishment.¹⁹⁰ That is, the benefit conferred on the taxable joint venturer is not an unavoidable consequence of the hospital's pursuit of the purpose for which it was granted tax exemption. Private benefit results but its occurrence does not necessarily prove a violation of the primary purpose requirement.¹⁹¹

Couns. Mem. (GCM) 39,862, but not addressing whether that approach is consistent with *American Campaign Academy*); see Hill and Kirschten, supra note 175 at ¶ 2.03[2] (describing the GCM 39,862 approach as the "Service's position"). One commentator plainly asserts that the GCM 39,862 approach is incorrect. See Lucas, supra note 179, at 29. In my view, the GCM 39,862 approach is correct for two reasons: First, the private benefit doctrine is entirely a creature of the Service's making, though it does have logical connection to the primary purpose requirement. Putting aside whether the Service has properly promulgated its approach and assuming the approach is not an abuse of discretion, it is the Service's meaning that one seeks in applying the private benefit doctrine. *American Campaign Academy* purports to interpret the Service's regulation, not the statute. See 92 T.C. 1053. Second, it is manifestly counter-intuitive to think that Charity may give away part of the store without jeopardizing its tax exemption simply because it doesn't give away all or most of the store. Yet that would be the result under an approach that treated the private benefit prohibition in a manner exactly as the primary purpose requirement.

186. See Gen. Couns. Mem. 39,862 (Dec. 2, 1991).

187. See id. (relevant portion of which is quoted in footnote 185).

188. See id.

189. See also Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

190. See id.

191. Of course, when an organization engages in only one activity, the fact that the activity results in private benefit (the private gain is substantial relative to the public benefit in that one and only activity), necessitates also a finding that the organization is not operated primarily for exempt purposes because the nonexempt activity is the only activity and by definition is substantial. See *Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999) (organization's sole activity was to participate in a health care joint venture that conferred a private benefit, therefore organization violated primary purpose test); *American Campaign Academy*, 92 T.C. 1053, 1078 (1978) (sole activity of operating an educational institute for

The relevance of the foregoing discussion is not quite apparent without two other supported assertions. The first is that the pursuit of capital via a trade or business, though perhaps necessary to accomplish other exempt goals, is not itself an exempt activity.¹⁹² It is instead a nonexempt activity.¹⁹³ To hold otherwise would be to revive the statutorily discredited “destination of income” doctrine. That doctrine allowed an entity to claim tax exemption without regard to the nature of the activities in which the entity actually engaged. If the capital obtained thereby was devoted to charitable activities, the entity achieved tax exempt status. Thus, a macaroni factory that paid all of its profits to New York University¹⁹⁴ and a beach resort that devoted all its profits to a home for women and orphans¹⁹⁵ were both previously entitled to tax exemption. The law has long since rejected the destination of income doctrine and, in doing so, established that the pursuit of capital, *per se*, is not an exempt activity.¹⁹⁶ The second assertion is not as well established, but nevertheless logically correct and defensible. Charity confers a private benefit by lending itself to a taxable person’s pursuit of a tax benefit.¹⁹⁷ Such a holding, though explicitly articulated only once,¹⁹⁸ is entirely logical with the notion that private benefit may be manifested in the form of an “advantage, profit, fruit, privilege, gain, or interest.”¹⁹⁹ Tax benefits are, in a real sense, valuable economic assets and Charity’s conferral of that asset can be a special dispensation for the benefit of a select party. These two assertions, combined with the recognition that the private benefit doctrine is a distinct requirement of tax exemption not mitigated by Charity’s other activities, finally bring us to the first theoretical basis upon which to address Charity’s participation in tax shelters.

When Charity aids a tax shelter it is engaging in a nonexempt activity that confers a benefit on a select, noncharitable beneficiary. The private benefit is composed of the tax benefit conferred by Charity’s participation. It might still be operating primarily for exempt purposes if its many other activities outweigh

Republican campaign workers resulted in private benefit, was therefore a nonexempt activity, and therefore caused a violation of the private benefit and primary purpose requirement); *KJ’s Fund Raisers, Inc. v. Commissioner*, 74 T.C.M. (CCH) 669, 671-72 (1997) (the operation of a charitable bingo was an exempt activity, but the manner of operation conferred private benefit and thus caused a violation of the primary purpose requirement).

192. See IRC § 502; IRC § 513(a). Both provisions are based on the notion that an ordinary trade or business does not become an exempt purpose activity merely because the profits derived therefrom are used to support charitable activities.

193. *University Hill Foundation v. Commissioner*, 446 F.2d 701, 704, 708 (9th Cir. 1971) (the trade or business of engaging in bootstrap sales is a nonexempt activity).

194. See *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120, 123 (3rd Cir. 1950).

195. See *Roche’s Beach, Inc. v. Commissioner*, 96 F.2d 776, 778 (2nd Cir. 1938).

196. IRC §§ 502 and 511-13 were added by the Revenue Act of 1950.

197. See *Housing Pioneers, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2191, 2195 (1993) aff’d 58 F.3d 401 (1995). (Charitable organization’s participation in a joint venture to develop low-income housing allowed “significant federal income tax benefits” to flow to the non-exempt partners in violation of the private benefit doctrine).

198. See *id.*

199. *American Campaign Academy*, 92 T.C. 1066.

its one-time participation in a tax shelter. But in that single activity, there is no public gain since the pursuit of capital, *per se*, is presumptively a nonexempt activity.²⁰⁰ By definition, then, the private benefit resulting from the tax shelter is unnecessary. Charity thereby violates the private benefit doctrine and should forfeit its tax exemption. By this theory, the law has the present ability to impose a real sanction when Charity aids tax shelters.

The second theoretical basis for attacking Charity's participation in tax shelters is the requirement that tax exemption should be denied or withdrawn if Charity acts in a manner contrary to "established public policy."²⁰¹ The notion seems almost entirely intuitive and that is what causes nervousness concerning use of the public policy doctrine.²⁰² Intuition may at first be the evidence of universally accepted belief, but having once been used it may later become the basis for the imposition of policy with insufficient basis or support.²⁰³ It is a fact of human nature, for example, that people often assume that all right minded people think as "I" think. And sometimes it is true that there is only an insignificant deviation of thought amongst the body politic. That significant uniformity thus supports a finding that one person's intuition evinces universally accepted belief. And the more individual intuition is articulated by

200. At least one court has held that a purpose to assist "another party in tax avoidance" is not even a valid business purpose for a taxable corporation. See *ASA Investorings Partnership v. Commissioner*, 201 F. 3d 505, 514 n.6 (1999). In *ASA Investorings*, the court upheld the reallocation of capital gains away from a foreign (essentially tax exempt) partner and to the taxable domestic corporation on the grounds that as an economic matter no partnership was formed. See *id.* at 516. A similar theory was relied upon to hold that allocation of losses to a limited partner should not be respected when the charitable general partner had not, in substance, transferred the loss generating asset to the partnership. See *Smith v. Commissioner*, 50 T.C.M. (CCH) 1444 (1985). In *Smith*, the court found no that "no valid business reasons were served by Georgetown [University's] purported joint venture with [taxable parties]." See *id.* at 1451.

201. See *Bob Jones University v. United States*, 461 U.S. 574 (1983). In articulating the public policy requirement, the Court referred to "clearly defined" public policy, "clearly declared" public policy, "established public policy, and "fundamental public policy." See *id.* at 582, 584, 586. I treat all modifiers as synonymously implying that the public policy must be virtually indisputable.

202. For example, in the absence of its explicit articulation, Congress seems particularly reticent to permit the disallowance of an otherwise deductible IRC § 162 expense based upon sharply defined public policy. See S. Rep. No. 552, 91st Cong., 1st Sess. 274 (1969) ("Public Policy [in circumstances not identified in IRC § 162(c), (e), (f), and (g)] is not sufficiently clearly defined to justify the disallowance of deductions."). The Supreme Court, too, has indicated that the denial of a tax deduction based on public policy not articulated by Congress is an action to be undertaken "in extremely limited circumstances." See *Commissioner v. Tellier*, 383 U.S. 687, 693 (1966).

203. Professor David A. Brennan argues, for example, that although the result in *Bob Jones University* was correct, the Department of Treasury was the wrong entity to make the public policy decision. See David A. Brennan, *The Power of The Treasury: Racial Discrimination, Public Policy and "Charity" In Contemporary Society*, 33 U.C. Davis L. Rev. 389 (2000). It is his fear that now that the "public policy" rubric is out of the bag, it may be used to deny tax exemption to educational institutions that have affirmative action admission policies. See *id.* at 4 ("[C]ould the Treasury revoke an organization's tax-exempt charitable status on the ground that the organization engages in raced-based affirmative action?").

the body politic – preferably but not necessarily through its elected representatives²⁰⁴ – the less discomfort one should feel in its enforcement, even if enforcement is accomplished by indirect or implicit delegation.

In its most famous articulation of the public policy requirement, the Supreme Court held that the Service could deny or withdraw tax exemption when Charity practices racial discrimination.²⁰⁵ The Court articulated a certain unmistakable intuition. Tax exemption is conferred under the assumption that Charity eases the burdens of government.²⁰⁶ Charity must ease, but never increase, societal burdens. Racial discrimination increases societal burdens and the recognition of that fact came after a rather difficult maturation process. Thus, public policy, rather than explicitly stated prohibition, properly denies or revokes tax exemption in certain instances.

Although the Court's application of the public policy requirement was not intended as *sui generis* to cases of racial discrimination,²⁰⁷ applying the doctrine in a more purely tax context is nevertheless discomfiting. In the broadest sense, the Code is itself a massive and detailed articulation of public policy. It might legitimately be asserted that only when the Code explicitly articulates an individual intuition does that intuition gain the imprimatur sufficient for "established public policy."²⁰⁸ Tax law's folly, though, is that it has assumed for so long that words can and always will accurately capture the socio-economic theorem underlying a particular provision. But why should tax legislation assume an ability rarely, if ever, present in any other walk of life? If a speaker complains, for example, that there is so much in life she must see and do before she can finally settle down, although settling down now is tempting, the listener might generally empathize with her need to work a few more years before retiring. But the listener might know better the depth of her life's thirst and her simultaneous weariness in life's travel if she were to state:

204. See *Commissioner v. Tellier*, 383 U.S. 687, 693-94 (1966) ("[W]here Congress has been wholly silent, it is only in extremely limited circumstances that the Court has countenanced [denial of an otherwise available tax deduction]).

205. See *Bob Jones University v. United States*, 461 U.S. 574 (1983).

206. "Charitable exemptions are justified on the basis that the exempt entity confers a public benefit – a benefit which the society or community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues. History buttresses logic to make clear that, to warrant exemption under Regs. § 501(c)(3), an institution must fall within a category specified in that section and must demonstrably serve and be in harmony with the public interest. The institution's purpose must not be so at odds with the common community conscience as to undermine any public benefit that might otherwise be conferred." See *id.* at 591-92.

207. In contemporary times, the public policy rationale has not been used or implicated as a justification for denying tax exempt status. In one recent case, though, the Service came under attack for a letter which implied, according to the applicant organization's legal counsel, that "being gay is wrong" and therefore a potential basis to deny tax exemption to an organization organized to provide support for homosexual youth. See Fred Stokeld, *IRS Letter to Youth Group Raises Concern in Gay Community*, 76 Tax Notes 324 (1997).

208. See Weisbach, *supra* note 91, at 871 (noting that tax rules "apply to their complete domain").

The woods are lovely, dark and deep,
 but I have promises to keep,
 and miles to go before I sleep,
 and miles to go before I sleep.²⁰⁹

Words only rarely capture the whole of thought, and then only by those with rare gifts indeed. This seems especially true with tax legislative pronouncements, which are invariably accompanied by reams of legislative history, implemented by an army of regulation drafters and occasionally interpreted by a host of judges. Acting as though words really can and do capture the whole, particularly when widely held intuition is inconsistent with the literalism of sections and subsections, allows for anti-intuitive results. Ultimately, tax shelters are anti-intuitive results thriving only in a system that embraces literalism and disclaims intuition. Such results ought to cause more discomfort than a system that judiciously applies public policy.

Establishing the legitimacy of public policy as a rule of law is one thing, actually identifying a certain public policy is quite another. This is especially so with regard to taxation, as opposed to more thoroughly social issues. For one thing, identifying public policy with respect to taxation requires one to imagine a populace composed of persons who actually understand, or at least have more than once-a-year exposure to the Code – a nonexistent Nirvana to some tax professors. Public policy is a quantitative notion, requiring evidence that the overwhelming majority of individuals composing the public hold identical beliefs. Most taxpayers probably haven't given the slightest thought to tax shelters, although they might ascribe to the populace notion that rich individuals and large corporations pay little or no tax. There are legitimate surrogates for the actual numbers necessary to achieve public policy. Newspaper editorials²¹⁰ and tax professionals might legitimately speak on behalf of the public.²¹¹ Still, there must be some indication through the legislature that a certain activity contravenes public policy and should be prohibited, otherwise the danger that individual intuition passes for public policy is too great.²¹² The Congress, of course, is the public's quintessential "voice." Congress might simply assert that tax shelters are against public policy.²¹³ It could go further and

209. Robert Frost, *Stopping By Woods On A Snowy Evening*, in *The Poetry of Robert Frost* 224 (Edward Connery Lathem ed., 1969).

210. See, e.g., David Ignatius, *Billion-Dollar Tax Cheats*, *Washington Post*, May 14, 2000 at B7 (decrying the rise in tax shelters and the professionals who plan them).

211. See, e.g., *Report on Corporate Tax Shelters of New York State Bar Association Tax Shelters*, 83 *Tax Notes* 879 (1999).

212. See *Commissioner v. Tellier*, 383 U.S. 687, 693 (1966).

213. Section 2 of the *Abusive Tax Shelter Shutdown Act of 1999* is entitled "Findings and Purpose," and states:

a) Findings.—The Congress hereby finds that:

(1) Many corporate tax shelter transactions are complicated ways of accomplishing nothing aside from claimed tax benefits, and the legal opinions justifying those transactions take an inappropriately narrow and restrictive view of well-developed court doctrines under which—

(A) the taxation of a transaction is determined in accordance with its

attempt to define tax shelters or it might leave that task to the Service and the Courts. The judiciary, too, can decide that a certain public policy is implicit in Congressional actions that do not explicitly articulate that policy. In such circumstances, the judiciary can at least assert that Congress has spoken, albeit indirectly, to the particular issue. The judiciary need not await an explicit articulation from Congress before finding that a properly presented issue effects public policy.²¹⁴ And as a practical matter, the Service has as much a role as the judiciary in identifying public policy. It is the Service that must first discern and enforce a certain Congressional intuition before the judiciary is able to confirm or deny the existence of a public policy.²¹⁵ Identifying public policy may be presumed difficult, but there is nevertheless an orderly process by which public policy can be correctly discerned.

The foregoing analysis supports an approach that would deny tax exemption to charities that participate in tax shelters. The best way, of course,

substance and not merely its form,

(B) transactions which have no significant effect on the taxpayer's economic or beneficial interests except for tax benefits are treated as sham transactions and disregarded,

(C) transactions involving multiple steps are collapsed when those steps have no substantial economic meaning and are merely designed to create tax benefits,

(D) transactions with no business purpose are not given effect, and

(E) in the absence of a specific congressional authorization, it is presumed that Congress did not intend a transaction to result in a negative tax where the taxpayer's economic position or rate of return is better after tax than before tax.

(2) Permitting aggressive and abusive tax shelters not only results in large revenue losses but also undermines the sense of voluntary compliance with the Internal Revenue Code of 1986.

(b) Purpose.—The purpose of this Act is to eliminate abusive tax shelters by denying tax attributes claimed to arise from transactions that do not meet a heightened economic substance requirement and by repealing the provision that permits legal opinions to be used to avoid penalties on tax underpayments resulting from transactions without significant economic substance or business purpose.

H.R. 2255, 106th Cong., 1st Sess. (1999).

214. Sometimes Congress will explicitly state that it does not want the Service or judiciary to deny a tax benefit on public policy grounds unless that public policy is explicitly articulated in the statute. See S. Rep. No. 552, 91st Cong., 1st Sess. 274 (1969) (stating that trade or business deductions should not be denied on public policy grounds except as specified in IRC § 162(c), (f), & (g)). See also Regs. § 1.162-1(a) (“A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy.”)

215. “Guided, of course, by the Code, the IRS has the responsibility, in the first instance, to determine whether a particular entity is ‘charitable’ for purposes of IRC §§ 170 and 501(c)(3). This in turn may necessitate later determinations of whether given activities so violate public policy that the entities involved cannot be deemed to provide a public benefit worthy of ‘charitable’ status. We emphasize, however, that these sensitive determinations should be made only where there is no doubt that the organization’s activities violate fundamental public policy.” *Bob Jones University*, 461 U.S. at 597-98.

would be for Congress to formally and precisely declare that tax shelters are contrary to public policy, and Charity's participation therein provides sufficient reason to deny or withdraw tax exemption. If Congress adopts one of the two proposed tax shelter measures, it should preface its adoption with a declaration that tax shelters contravene public policy. Charities that aid tax shelters would then be placed on sufficient notice that doing so jeopardizes tax exemption. For its part, the judiciary seems ready to support such a public policy, perhaps even in the absence of a specific Congressional declaration.²¹⁶ In fact, there are already a whole host of provisions from which the Service might derive a public policy prohibiting tax shelters.²¹⁷ The nagging problem with this approach, ironically, is that the provisions already on the books unintentionally lend themselves to an argument that Congress meant to better manage, rather than completely prohibit, tax shelters. Imposing what are essentially disclosure and administrative record-keeping requirements with respect to tax shelters, as current provisions do,²¹⁸ implies management rather than prohibition of those transactions. Since public policy is the elevation of intuition as unarticulated law, it might reasonably be argued that public policy should not be used in cases involving ambiguity.²¹⁹ The notion that Congress is exercising grudging tolerance of tax shelters is severely undercut, though, by unmistakable legislative history expressing a desire to prohibit, not just manage, tax shelters.²²⁰ It is therefore more accurate to say that Congress has expressed a

216. For a contemporary discussion of judicial attempts to eliminate tax shelters see, David P. Hariton, *Sorting Out The Tangle of Economic Substance*, 52 *Tax Law.* 235 (1999).

217. See IRC § 6111 (requiring the registration of certain tax shelters); IRC § 6112 (requiring organizers and sellers of "potentially abusive" tax shelters to maintain lists of investors); IRC § 6662 (accuracy related penalty applicable to tax shelters and other transactions); IRC § 6700 (penalty for promoting "abusive" tax shelters). IRC § 6708 (penalty for failure to maintain list of investors in potentially as required by IRC § 6112).

218. See *supra* note 217 and accompanying text.

219. See *Tellier*, 383 U.S. 687, 693 (1966).

220. A former IRS Commissioner states that Congress's "anti-shelter drive" has been in "high gear" since 1978. See Mortimer Caplin, *Tax Shelter Disputes and Litigation With The Internal Revenue Service - 1987 Style*, 6 *Va. Tax Rev.* 709, 714 (1987). The legislative history of the Deficit Reduction Act of 1984 states:

The second objective of the bill is to prevent further erosion of the tax base as a result of tax sheltering activity. The budget deficit has been aggravated by the growth of tax shelter partnerships and creative use of structural tax rules to achieve tax benefits far in excess of those intended by Congress . . . The committee believes that the proliferation of tax shelters has seriously eroded the tax base and has adversely affected the efficiency and equity of the tax system. The increase in tax shelter activity has aggravated the nation's deficit problem, particularly in the case of "abusive" shelters where the tax write-offs are several times larger than the equity investment. The proliferation of tax sheltered investments shifts the tax burden to those taxpayers who do not or cannot participate in such investments, and the organization and promotion of tax shelters diverts thousands of skilled professions from more productive activities.

H.R. Report No. 98-432, 98th Cong., 2nd Sess. 1094, 1095 (1984). Caplin describes the 1984 act as one which represents a change in emphasis from voluntary compliance with regard to

clear public policy against tax shelters but has been unable, to date, to articulate a way to absolutely prohibit tax shelters due to heretofore impossible task of defining tax shelters.²²¹ That is, an outright prohibition would have required a precise definition of tax shelters and tax law had not yet reached a level of wisdom allowing for such precision. Hence, Congress adopted statutory provisions implying management of tax shelters, imprecisely defined,²²² as a second best solution rather than with the intent to tolerate tax shelters.²²³

The Service may not have to draw such a broad conclusion though. That is, the Service need not discover and articulate a public policy rule that addresses the entire tax shelter problem. It may instead address the improper use of the tax exemption asset Congress grants to Charity. Certainly, Congress has clearly stated that Charity acts improperly, so far as tax law is concerned, when it “sells” or “rents” its tax exemption.²²⁴ Thus, the Service and judiciary can legitimately assert that Charity acts against established public policy when it engages in a transaction that serves no charitable purpose, but merely pursues capital, and the only asset offered in consideration of that capital is a tax benefit made possible only as a result of Charity’s tax exemption. Such an assertion would be much more limited and supported by entirely unambiguous Congressional declarations.

Tax law, then, is not without the theoretical means to attack Charity’s participation in tax shelters. And to the extent such transactions are rendered impossible without Charity’s participation, it makes sense that the law should mount such an attack. If the problem of tax shelters really is serious, the law should not leave such an obvious stone unturned. After all, tax exemption is an expression of societal trust in Charity’s implicit oath to do good always. The

tax shelters to one which focused on “Crime and Punishment” as it relates to tax shelters. See Caplin at 715. To the extent that description is accurate, it only makes the argument that tax shelters contravene a clearly established public policy all the more stronger. The same unmistakable anti-tax shelter concerns were explicitly voiced again when Congress passed the Tax Reform Act of 1986. See S. Rep. No. 313, 99th Cong., 2nd Sess. 4, 713-718 (1986); H.R. Rep. No. 426, 99th Cong., 1st Sess. 54-55 (1985); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 6-7, 209-212 (1987).

221. See *supra* note 19 and accompanying text.

222. Under current law, the term tax shelter is generally defined as “any entity, investment plan or arrangement, or other plan or arrangement which is of a type which the Secretary determines by regulations as having a potential for tax avoidance or evasion.” IRC § 6112(b)(2). IRC § 6111 provides what seems like a particularly unworkable definition which relies upon representations of “potentially allowable” deductions and credits. IRC § 6111(c).

223. Caplin describes the Congressional approach to tax shelters as one designed to “throttle” and “sound the death knell” for the tax shelter industry. See Caplin, *supra* note 220, at 725.

224. See S. Rep. No. 2375, 81st Cong., 2nd Sess. 31 reprinted in 1950 U.S.C.C.A.N. 3053, 3084 (relating to the predecessor of IRC § 514); see also S. Rep. No. 552, 91st Cong., 1st Sess. 62 (1969) reprinted in 1969 U.S.C.C.A.N. 2027, 2091 (relating to IRC § 514); H.R. Report No. 432, 98th Cong., 2nd Sess. 1138 (1984) (relating to IRC § 168(h)); Staff of the Joint Committee on Taxation, General Explanation of The Revenue Provisions of the Deficit Reduction Act of 1984, at 1151 (relating to IRC § 514(c)(9)).

private benefit and public policy doctrines are available to enforce that expression of trust and tax exemption should be revoked when that trust is violated.

VI. IMPLEMENTING AN EFFECTIVE RESPONSE: THEORY MEETS PRACTICE

Incumbent upon the one who articulates and asserts the adoption of theory is the duty to explain how that theory might be implemented in practice. It would be disingenuous, indeed, to neatly articulate theory without acknowledging whatever practical barriers exist to its implementation. The theory set forth in the preceding discussion is that Charity should forfeit its tax exemption when it aids and abets a tax shelter. Support for the theory can be found in the public benefit and public policy doctrines. There are certain surmountable difficulties, however, in implementing the theory and those difficulties are acknowledged and addressed in this section. This section puts forth one example that demonstrate how the theory would apply to particular facts.

The first difficulty involves what seems like an unfair vicarious responsibility imposed on Charity for the bad acts of another taxpayer. Charity may legitimately assert that it is unfair to exact punishment against it for another taxpayer's asserted tax position. Such an argument, of course, is axiomatic. Implicit in the notion that Charity should be subject to an enforcement action when it aids and abets a tax shelter is the requirement that Charity's actions be undertaken with knowledge of and the intent to aid a tax shelter. In the absence of facts proving that requirement, Charity is but an innocent bystander and, at most, the mere recuperative response of imposing UBIT is appropriate. The theory espoused is not that Charity suffer a sort of strict liability whenever its tax exemption is used by another party to obtain unjustified tax benefits. Charity must instead intend to abuse the grant of tax exemption before a sanction is applied.

The knowledge requirement must be carefully balanced to protect against both unjustified sanction and public inertia. In some instances the requirement to prove Charity's knowledge and intent might be easily met. In the bootstrap and leaseback transactions, for example, Charity must be intimately involved in the tax planning if the shelters are to work. Even some contemporary tax shelters, such as the charitable split-dollar transaction, are such that objective facts are available by which to prove Charity's knowledge and active involvement.²²⁵ But most other contemporary shelters are much more sophisticated,²²⁶ often times not requiring Charity's knowing participation, and imposing a sanction under a standard requiring proof of Charity's knowledge

225. The "charitable split-dollar life insurance" transaction is one example. See *supra* note 113.

226. See Bankman, *supra* note 14.

would be nearly impossible. In the step-down preferred transaction,²²⁷ for example, Charity would not necessarily know or have reason to know that a corporate taxpayer will assert an unjustifiable tax position. An actual knowledge requirement, then, would prevent unwarranted imposition of a sanction against Charity, but might also prevent justifiable sanctions. Effective implementation requires something between perfect hindsight, which would impose unjustifiable sanctions against Charity, and perfect foresight, which would effectively immunize Charity from justifiable sanction.

A related imperative is that the theory must be implemented in a manner that distinguishes between Charity's knowing and intentional assistance to tax shelters, and its participation in legitimate transactions which nevertheless unintentionally assist tax shelters, whether knowingly or not. Charity's pursuit of its legitimate goals should not be discouraged by an overly broad remedy that frightens Charity away from normal markets. Even when Charity knows that its participation in a transaction might assist a taxable person in taking an unjustifiable tax position, it should nevertheless escape sanction if the transaction is motivated entirely by Charity's intent to accomplish a charitable purpose.²²⁸ It might be argued in the latter instance that when Charity knows its legitimate participation in a transaction is aiding a tax shelter, it should be required to seek out an alternative transaction. But this would place too much of the societal burden to eliminate tax shelters on Charity's shoulders. Charity's quasi-governmental, public benefit role should not include a duty to participate in an embargo against taxpayers who assert unjustified tax positions with Charity's unintentional help. Charity would be precluded from legitimate transactions simply because other taxpayers might assert unjustified positions in response. That, too, would act as an unnecessary discouragement of the pursuit of charitable goals, since it would introduce a market distortion. In short, the theory should not impose a punishment when Charity's participation is legitimate solely from Charity's viewpoint.

A more troublesome issue, related to the legitimacy of Charity's participation in certain transactions, cannot be resolved by looking to the extent to which those transactions are conducive to a charitable purpose. Congress explicitly condones certain passive investment activities, – collecting interest, dividends, rent from real property, or royalties from the use of its intangible property²²⁹ – which do not necessarily lend themselves to justification as accomplishing charitable purposes. Those activities therefore cannot be distinguished from activities that purposefully aid tax shelters on the ground that holding the investment achieves an exempt purpose. Instead, the activities represent only the pursuit of capital, though not through a trade or business. With regard to those activities, the pursuit of a charitable purpose is not an

227. See *supra* notes 24-33 and accompanying text.

228. Such a rule would be consistent with the private benefit analysis. See *supra* notes 179-91 and accompanying text.

229. See IRC § 512(b)(1)-(3).

objective distinction between legitimate and illegitimate transactions since the passive activity need not be related to the achievement of an exempt purpose. Another method must therefore be identified to distinguish between legitimate passive investments on the one hand, and passive investments which are intended to assist tax shelters on the other.

The two main barriers, then, to the implementation of a theory which punishes Charity for its participation in a tax shelter are: (1) proving the requisite knowledge such that Charity is not made vicariously liable for another party's illegitimate taking of a tax benefit, and (2) formulating an enforcement mechanism that responds precisely to the vice sought to be prevented. Of course, proving Charity's knowing and intentional complicity by objective facts is a perfectly acceptable approach in cases when such facts are readily available (such as when Charity actively participates in the planning and execution of the tax shelter).²³⁰ But practical evidentiary barriers prevail when the facts are exclusively within the taxable participant's control and Charity is but a passive, though perhaps knowing, participant. It would be overly burdensome and unwise to impose upon Charity the duty to know the tax attributes or motives pertaining to its every taxable trading participant. And any penalty that is contingent upon Charity actually knowing such attributes, in the absence of such a duty, would simply encourage Charity to intentionally maintain an ignorance concerning a taxable participant's motivation for transacting with Charity.

Current law suggests a solution to this seemingly insurmountable practical barrier. There are, for example, several provisions that require self-disclosure by taxpayers who organize, manage or participate in tax shelters.²³¹ One statute, in particular, requires sellers of tax shelters to inform investors that they are participating in a tax shelter.²³² It would be a minor extension of the law to require, or at least strongly encourage, Charity to inquire whether a transaction in which Charity is participating will trigger, in whole or in part, a disclosure obligation²³³ under any provision of existing law for one or more taxable participants. Taxable participants are already required to know the answer and would only be required to convey that answer without stating reasons or opening its books to inspection by Charity. The law should be formulated such that Charity should make such an inquiry prior to closing the

230. See, e.g., *supra* note 113 (describing Charity's role in the charitable split-dollar life insurance transaction).

231. See IRC § 6011 (requiring taxpayers participating in tax shelters to file a disclosure statement to that effect with the Service); IRC § 6111 (requiring the registration of tax shelters and the disclosure of the tax shelter identification number to those who invest in such shelters); IRC § 6112 (requiring organizers of tax shelters to maintain lists of those persons who invest in such tax shelters).

232. See IRC § 6111(b)(1) (requiring sellers of tax shelters to furnish each investor therein with the tax shelter identification number assigned by the Secretary).

233. A "disclosure obligation" would include the obligation to maintain investor lists under IRC § 6112.

transaction. By this device, Charity will be relieved of the unfairness resulting from its inability to know whether a taxable participant is perpetrating a tax shelter with Charity's assistance or even whether a transaction constitutes a tax shelter in light of another taxpayer's tax attributes or motives.²³⁴ Likewise, the Service will not be rendered powerless by Charity's practical inability to know, or its self-preserving desire to maintain ignorance with respect to important facts. The knowledge problem can be solved by requiring that Charity make a simple inquiry prior to entering into certain transactions. To eliminate the minimal nuisance cases, an inquiry might only be required in cases involving amounts above a certain threshold level.²³⁵

If Charity so inquires and a taxable participant responds negatively, Charity should be immune from liability even if the transaction is later determined to be a tax shelter. If, on the other hand, a taxable participant responds affirmatively, there ought to be another step acknowledging that Charity may have legitimate reasons for participating in the transaction wholly apart from the potential bad acts of one or more taxable participants. Thus, Charity should be allowed to proceed in the transaction, even after receiving an affirmative response, if it can demonstrate that the transaction is part of Charity's ordinary operations and that Charity would have so participated irrespective of the motives and actions of a taxable party.²³⁶ In this manner, Charity will not be punished for the bad acts of another taxpayer. The potential distortion caused by prohibiting Charity's legitimate transaction merely because of the potential for abuse by another taxpayer would also be eliminated.

Implementation, of course, is dependent upon Charity making an inquiry and its proving that the transaction, though known to support a tax shelter, is consistent with Charity's legitimate purpose for which tax exemption is granted. One way of encouraging Charity to make the inquiry is by granting immunity when the inquiry is answered in the negative. Because Charity can still avoid liability under the proposal by proving a legitimate purpose, it might still forego the inquiry despite the potential for complete immunity. This would unnecessarily eliminate one level of discouragement. A way to counteract this

234. In general, the disclosure provisions define tax shelters consistent with the definitions described by Professors Johnson, see *supra* note 19, and Bankman, *supra* note 4. For example, Regs. § 301.6111-2T uses the economic substance definition preferred by Professor Johnson (i.e., present value of taxpayer's expected pre-tax profit is insignificant relative to taxpayer's tax savings from the transaction). Regs. § 1.6011-4T(a)(3) defines tax shelters by reference to a list of factors similar to those outlined by Professor Bankman, including the participation of a tax exempt entity.

235. Cf. Regs. § 301.6111-4T(b)(4) (excluding from the definition of tax shelters certain transactions if the reasonably expected tax benefits do not exceed \$5 million in a single year or \$10 million in any combination of years). The threshold level should not be selected arbitrarily, of course, but with an eye towards eliminating the nuisance, *de minimis* cases without also providing loopholes for the more serious cases.

236. Cf. Regs. § 1.6011-4T(b)(3)(ii) (transaction is not a tax shelter with respect to a taxpayer if the taxpayer entered into the transaction in the ordinary course of business and would have done so irrespective of federal income tax benefits).

effect would be by use of a burden-shifting tool. If Charity makes the inquiry, and the response is in the affirmative, no sanction should apply unless the government proves by clear and convincing evidence that the transaction is unrelated to the accomplishment of a charitable purpose. The making of the inquiry should create a presumption, however the inquiry is answered, that the transaction is legitimate from Charity's viewpoint and therefore not an appropriate occasion for sanction. If the answer to the inquiry is in the negative, the presumption should be irrebuttable. If the answer is in the affirmative and Charity proceeds nevertheless, the presumption should be rebuttable, but only in compliance with the Service's meeting a high standard. On the other hand, if Charity makes no such inquiry, and the transaction proves to be a tax shelter, Charity should be subject to sanction unless it proves by a preponderance of the evidence that the transaction is entirely legitimate solely from Charity's perspective.²³⁷ The burden in cases when Charity essentially fails in its small civic duty by making no inquiry should be on Charity.

The final barrier to practical implementation involves Charity's passive investment activities. As noted earlier, investment activities are condoned even though they do not necessarily achieve an exempt purpose.²³⁸ Practical implementation therefore requires another way to distinguish Charity's legitimate investment activities from activities that knowingly assist a tax shelter. Perhaps one method would be to require, rather than simply encourage, Charity to inquire whether by its investment, it is participating in a tax shelter. Something about another procedural requirement seems objectionable though.²³⁹ Granted, it would be a minor imposition but the Code contains hundreds of minor impositions. For that reason alone, one should hesitate to impose yet another "minor" imposition. But there seems no other practical way to prevent Charity from intentionally sticking its proverbial head in the sand and thereafter disclaiming responsibility because of a lack of knowledge. And after all, Charity is a trustee with fiduciary responsibility to the public. It should not object to a requirement that it take affirmative steps to prevent the abuse of a trust granted upon Charity's own request. One of the disclosure requirements already enacted require the seller or transferor of a tax shelter investment to have the required information available in any event.²⁴⁰ Requiring, rather than encouraging Charity's inquiry in the case of passive investments does not seem

237. Appendix A contains a flowchart showing the analytical steps in the enforcement of Charity's duty to prevent the use of its tax exemption in a nonpassive, tax shelter transaction.

238. See *supra* note 228 and accompanying text.

239. Charitable organizations are subjected to relatively few administrative requirements. See Staff of the Joint Committee on Taxation, Study of Present-Law Taxpayer Confidentiality And Disclosure Provisions as Required by Section 3802 of The Internal Revenue Service Restructuring and Reform Act of 1998, Vol. II: Study of Disclosure Provisions Relating to Tax Exempt Organizations, 24-42 (2000). Other than the application for exemption from tax required under IRC § 508, Charity is only required to file an annual information return. See IRS Form 990 (2000). IRC § 6104 provides for public inspection and copying of the application for exemption and annual returns.

240. See IRC § 6111(b)(1).

unfair. To alleviate some of the burden, the threshold amount below which inquiry is not required might be set at an even higher level than the threshold amount in non-passive investment cases. In any event, the harm to be prevented, Charity's participation in a tax shelter, coupled with the lack of any countervailing factor related to Charity's efficient accomplishment of its mission, justifies requiring that Charity inquire whether a passive investment constitutes a tax shelter for which disclosure is required.

If, upon inquiry, Charity is informed that disclosure is not required, it should have complete immunity if the investment is later determined to be a tax shelter. But what would Charity's obligation be upon being informed of its participation in a tax shelter via a passive investment? I have argued, with respect to Charity's participation in a tax shelter transaction involving non-passive investments, that Charity should be allowed to proceed if doing so is legitimate solely from Charity's perspective. That is, if a transaction furthers a charitable purpose, Charity should not be precluded from that transaction simply because a taxable participant might abuse Charity's involvement. To require Charity to forego all such transactions might eliminate efficient transactions. That argument does not apply, though, with respect to Charity's passive investments. Those activities serve only to obtain capital and therefore serve no charitable purpose that cannot be achieved without assisting in a tax shelter. The logical conclusion then, is that Charity should be precluded from participating in passive investment tax shelters. This seems rather harsh, but it is consistent with the notion that the law should not take one step forward – assisting Charity to obtain capital for quasi-governmental purposes – and two steps backwards – allowing Charity to assist in greater harm to the tax system in its pursuit of capital. Again, the harshness might be alleviated somewhat by imposing the requirement only with respect to transactions involving amounts over an intentionally high dollar value.²⁴¹

The final portion of the implementation discussion involves an application to actual facts. Assume, for example, that an investment manager develops a financial plan where the benefits are exclusively tax related.²⁴² The plan calls for the formation of a limited liability company that elects to be taxed as a partnership.²⁴³ All the investors are individuals. The partnership's activities consist of purchasing medical equipment offered at bankruptcy auctions, holding the property for one year and one day,²⁴⁴ and then donating the property

241. Appendix B contains a flowchart showing the analytical steps in the enforcement of Charity's duty to prevent the use of its tax exemption in a passive tax shelter transaction.

242. The following facts are based on *Weitz v. Commissioner*, 56 T.C.M. (CCH) 1422 (1989) and *Herman v. United States*, 73 F. Supp. 2d 912 (E.D. Tenn. 1999).

243. See Regs. § 301.7701-3. Cf. *Herman*, 99-2 USTC ¶ 50,899 (individuals formed a limited liability company to purchase medical equipment to be later donated to a charitable hospital).

244. IRC § 170(e)(1)(A) limits the charitable contribution to the taxpayer's basis in the property if the donated property is other than long term capital gains property. To be long-term, the property must be held for more than one year. See IRC § 1222(3).

to tax exempt hospitals. The hope is that the equipment will be purchased at distress sale prices significantly below fair market value and then contributed at the fair market value available in non-distress-sale transactions.²⁴⁵ The investors would then claim their share of the flow-through charitable contribution deduction (determined by reference to fair market value, rather than cost) and that share would far exceed their capital contribution (i.e., their share of the distress sale purchase price).²⁴⁶ The result would be a charitable contribution deduction used to shelter other income to an extent that results in a better economic position than if the investor had not participated.

A charitable hospital would be an indispensable participant in the plan, although the hospital may be unaware of the plan when offered the donated items.²⁴⁷ Suppose that the LLC purchases medical equipment valued at \$1,500,000 for only \$40,000²⁴⁸ and, to decrease transaction costs, seeks to donate all the equipment to a single charitable hospital. Assume also that the threshold value at which the inquiry requirement applies is \$1,000,000. That is, no sanction will ever be imposed on Charity for its participation in a tax shelter if the value of the transaction does not exceed \$1,000,000. Here, the transaction value exceeds the threshold amount and the hospital conscientiously inquires whether the transaction of which the donation is a part will result in a disclosure obligation. If the investment manager responds in the negative,²⁴⁹ the hospital can accept the donation without any further thought concerning its civic responsibility vis-a-vis tax shelters. If the investment manager responds in the

245. IRC § 170(e) allows a deduction equal to the fair market value of property as long as the sale of the property would result in long term capital gain, and would not be used for purposes unrelated to the hospital's exempt purposes.

246. This is precisely what the taxpayers in *Herman* successfully accomplished. See 73 F. Supp. 2d at 915.

247. In *Weitz*, the Tax Court relied, in part, upon the Hospital's involvement in the purchasing of equipment from bankruptcy auctions to disallow the claimed deduction. See 56 TCM (CCH) 1422 (1989). The Court reasoned that since the Hospital frequently purchased equipment from bankruptcy auctions, and because a hospital representative assisted the donors in locating a bankruptcy auction and accompanied the donors to the auction from which the equipment was purchased, the "market" for purposes of determining the donated equipment's value was the bankruptcy market and not the resale market. See *id.* But if the long term holding period is met, Congress grants a tax deduction based upon the amount for which the donor could have sold the property. See IRC § 170(e). The deduction is not otherwise based on the amount the donee would have paid for the property.

248. In *Herman*, the LLC purchased medical equipment for \$40,000 and later successfully claimed a charitable contribution deduction of more than \$1,000,000. See 73 F. Supp. 2d at 916.

249. Regs. § 301.6111-2T(b)(5)(i) allows a corporate taxpayer to avoid registration and notification to investors if the seller "determines there is no reasonable basis to deny the expected Federal income tax benefits from the transaction." Here, of course, the LLC is a partnership for tax purposes. A similar rule should apply for any transaction where, as with the charitable contribution deduction, the taxpayer's expected gain is primarily the result of an intended tax benefit. Cf. FY 2001 Budget Proposal, *supra* note 13 at 124 (a tax benefit clearly contemplated by an applicable provision would not support the finding that a transaction is a tax shelter).

affirmative,²⁵⁰ however, the hospital must then determine whether accepting the donation is a legitimate activity, solely from the hospital's viewpoint and without regard to any tax position that might be asserted by any other party. In this respect, the hospital is in a relatively safe position since the Code specifically intends that Charity be supported by donations.²⁵¹ Thus, the hospital can accept the donation and provide documentation showing the receipt of medical equipment to the donor²⁵² without fear that its doing so will result in sanctions based upon the tax positions asserted by the donors.

Suppose, however, the investment manager divides the medical equipment into two groups and donates \$750,000 in value to each of two separate charitable hospitals. Here, the threshold value amount is not exceeded and Charity is not at jeopardy of sanction under the proposal. There is an obvious tension between the goal of eliminating Charity's participation in a tax shelter transaction, while simultaneously avoiding undue administrative burdens. The investment manager can still obtain the exact tax benefit by simply making two donations rather than one. Charity, on the other hand, might be overburdened by yet another ministerial duty. Thus, the variation in this example raises the issue whether the threshold value at which the sanction potential would exist should be lowered. It may be no more burdensome to encourage or require Charity to make inquiries when a single donation exceeds \$100,000 than it is when a single donation exceeds \$1,000,000. The potential tax benefit to investors, however, might be eroded by transaction costs (i.e., shipping, insurance, storage, etc), if the investment manager had to divide donations amongst several charitable recipients in an effort to avoid the threshold. The foregoing discussion doesn't militate against the theory, but merely points to the need for careful calibration of the threshold amount.

Thus, theory always has its practical difficulties and the theory discussed in this article is no exception. But the theory relates to a subject about which Congress has already determined to be of high importance and, indeed, has implemented a certain workable statutory approach. There are several provisions already mandating the same disclosures that are necessary to the implementation of a theory making Charity responsible for the knowing misuse of its tax exemption. Requiring Charity to inquire of certain trading partners whether the transaction in which Charity participates, by itself or in conjunction with other transactions, will trigger a disclosure obligation is but a minor extension of existing law. Granted, too, that almost every minor duty imposed by the Code aggregates with other such minor duties to create higher transaction costs. The harm caused by Charity's participation in tax shelters, to the tax base

250. Although the tax benefit resulting from the charitable contribution might be intended by Congress, IRC § 6111(c) might still require that the transaction be registered since the definition of tax shelter in that provision does not exclude transactions resulting in intended tax benefits.

251. See IRC § 170.

252. IRC § 170(f)(8) requires the donee provide a written acknowledgement of the donation containing a description of the property donated.

and to the concept of Charity, and the trust embodied in the grant of tax exemption, justifies another imposition as a condition of tax exemption.

The final practical notion not yet discussed is the nature of the sanction when Charity aids and abets a tax shelter. This is not entirely a matter of analysis so much as it is a matter of one's "sentencing" philosophy. Mine is essentially that a miscreant be offered a means of rehabilitation, particularly when the harm is serious but nonrecurring with regard to the individual taxpayer. But, as implied throughout this article, the penalty ought to be severe enough that it actually discourages future participation in tax shelters. The UBIT penalty does not do that. It follows that Charity should forfeit its entire tax exemption but only for the year in which the violation occurs. There might also be provisions for abatement of that harsh penalty in cases involving serious mitigation.²⁵³ Those might include the wholesale revamping of Charity's governance structure or an undoing of the transaction where possible.²⁵⁴ When the sanction is imposed, however, Charity should be required to undergo a stringent reapplication process by which it demonstrates an awareness of the special trust underlying the grant of tax exemption. Any violation thereafter ought to be grounds for permanent revocation of tax exemption.

VII. EPILOGUE

It is difficult to regulate vice because, while the public may be harmed thereby, those who engage in vice often consider themselves benefitted. In many respects, the potential benefit is available to every individual composing the public. Therefore, every individual has at least a dormant interest in doing nothing about the vice.²⁵⁵ Defeating vice first requires a wisdom and maturity that allows every individual to forsake the potential for individual gain for the good of the whole. Tax law appears to be approaching a certain mature recognition that the notion of ordering one's affairs to pay as little tax as possible is no absolute right.

Vice thrives in an indulging consensual environment. That is, vice requires a willing producer, a willing supplier and a system that indulges one or the other. It is therefore logical that enforcement actions be taken against producer as well as consumer. So long as one is available, the other will be too. It makes little sense that the law take no enforcement action against "zero bracket taxpayers" – i.e., those who might be considered "producers" or "suppliers" of the tools necessary for tax shelters. Some zero-bracket taxpayers

253. Cf. IRC § 4958(b) (providing for abatement of certain excise taxes imposed in response to violations of the private inurement/excess benefit prohibitions.) See also IRC § 4961.

254. See IRC § 4958(f)(6) (defining "correction" for purposes of abatement to include "undoing the [transaction] to the extent possible").

255. This assertion might be proven by making reference to Kenneth Kies, who, after resigning as Chief of Staff of the Joint Committee on Taxation, began working as a co-managing partner for PriceWaterhouseCoopers where he promptly began to campaign against proposals designed to curb tax shelters. See Kies, *supra* note 13.

are beyond enforcement for either legal or policy reasons. Charity, though, is well within the Code's regulatory jurisdiction. Moreover, Charity is akin to trustees in the asylum. Charity occupies an exalted position in tax law and should reasonably be expected to act accordingly. When Charity violates the trust embodied in the grant of tax exemption, the harm caused thereby is arguably greater than the harm caused by the inmates themselves

One need not precisely define the concept of charity in order to know it does not include participation in tax shelters. There are, indeed, theoretically sound reasons to know that charity is inconsistent with tax shelter participation. The private benefit doctrine prevents Charity from unnecessarily benefitting private parties. When Charity participates in tax shelters solely in the pursuit of capital, and not as part of the pursuit of a charitable purpose, it conveys an unnecessary benefit and therefore violates the private benefit doctrine. A more theoretical, but equally valid assertion is that Charity should not act in a manner inconsistent with public policy. That is, Charity should never increase the burdens of society. Tax exemption is granted precisely on that assumption. Charity should alleviate societal burdens. When Charity participates in tax shelters, it exacerbates societal burdens and society should not pay Charity for doing so. Tax exemption should therefore be withdrawn.

Theory is most often easier said than done. The theory offered in this article, as with most theories, creates certain difficulties in implementation. First, the theory requires a means by which Charity's knowing participation in another party's unjustified tax position be shown. Second, the theory requires a means by which enforcement may be enacted without interfering with Charity's legitimate activities. Charity might therefore thwart the theory's intent by maintaining an intentional ignorance regarding another party's tax motives. This would not be hard since Charity has no independent need to know the tax position of a party with whom it enters a transaction. Without more, the theory would be useless. Current provisions suggest a solution. Those provisions require tax shelter organizers or sellers to disclose the fact of the tax shelter in one way or another. It would be a minor extension of that duty to require Charity to inquire whether certain transactions in which it is about to participate are subject to any of those disclosure requirements. Having made the inquiry, Charity may therefore know whether it is allowing an asset granted to it in trust – tax exemption – to be used for harmful purposes. Charity's failure to make such an inquiry would be a factor to be considered in deciding whether to impose sanctions on Charity.

All citizens owe a duty to enforce the tax laws, even if enforcement is manifested merely by their annual filing of individual tax returns. Charity is a special tax citizen, and holds a special place in tax law. It undertakes to assist not aggravate public burdens and is, for that reason, granted tax exemption. The implicit trust in the grant of tax exemption is violated, however, when Charity aids and abets tax shelter transactions. When Charity aids and abets tax shelters it belies the lofty justifications for tax exemption and thereby makes a case for denying or withdrawing tax exemption.