1985

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Repository Citation
Caplin, Mortimer, "Handling Tax Shelter Disputes and Litigation with the IRS" (1985). William & Mary Annual Tax Conference. 551.
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HANDLING TAX SHELTER DISPUTES AND LITIGATION WITH THE IRS*

By
Mortimer Caplin

For over 15 years Commissioners of the Internal Revenue Service (IRS) and Treasury Secretaries have struggled to solve the tax shelter problem. Despite Congress’ enactment of a series of tax rate reductions—heralded to remove the incentive for “shelter shopping”—tax shelters have proliferated beyond all imagination. The tax shelter industry has become big business. For hundreds of thousands of taxpayers, the beguiling potential for exclusions from income, deferral of tax, leveraging, and the conversion of ordinary income into capital gain, is almost irresistible. Even individuals in the lower tax brackets—earning $25,000 to $30,000—are reported to be heavily involved. The IRS tells of offerings of shelter units for as little as “$35 Down”!

Commissioner after Commissioner has bemoaned IRS’ extraordinary difficulties in trying to combat abusive tax shelters. Shortly before leaving office in 1980, Commissioner Jerome Kurtz castigated schemes which involved essentially artificial transactions, inflated appraisals, unrealistic allocations, and aberrational uses of technical positions. Two years later, before a House subcommittee, Commissioner Roscoe Egger sharpened IRS’ criticisms when he described offerings that were clearly fraudulent in nature—backdated documents, fictitious notes, false affidavits, rigged transactions, forged trading records and other illegal mechanisms. To curb these expanding abuses, the

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1 The Internal Revenue Code does not define an “abusive tax shelter” although reference is made to it in a number of sections. See §§ 6112, 6700 and 7408; cf. § 6661(b) (2) (C). IRS Commissioner Roscoe Egger described it as follows:

- Generally, abusive tax shelters utilize extreme, improper, and even illegal interpretations of the law or involve incomplete or misleading facts to attempt to secure for investors substantial tax benefits which are clearly disproportionate to the economic reality of the transactions. In a very real sense, abusive tax shelters are entered into with little or no expectation of a positive financial outcome, but rather the sole expectation of evading taxes.

He finds useful the working definition contained in the Internal Revenue Manual:

**Abusive Tax Shelters**—Involve transactions with little or no economic reality, inflated appraisals, unrealistic allocations, etc., where the claimed tax benefits are disproportionate to the economic benefits. Such shelters typically seek to evade taxes.


Former Treasury General Counsel Robert H. Mundheim tersely defined it as “a transaction without any economic purpose other than the generation of tax benefits that typically employs exaggerated valuation of assets and otherwise mischaracterizes critical aspects of the transaction.” See No. 15 BNA Daily Tax Report, J-1 (Jan. 22, 1980).


2 See Statement of Roscoe L. Egger, Jr., ibid.
IRS felt compelled to commit a major portion of its resources to both civil and criminal investigations. And yet the end is hardly in sight.

**Clogged IRS and Tax Court Dockets**

Tax shelter disputes and litigation have reached epidemic proportions, and both the IRS and Tax Court dockets are at crisis levels. There are over 30,000 tax shelter cases now docketed in the United States Tax Court, out of a total inventory of 73,000 cases. As some 20 percent of the Tax Court workload is comprised of small tax cases, it is seen that over half of the Tax Court's regular docket is in the tax shelter area. Today an estimated $2 billion in deficiencies are tied up in these cases.

In conjunction with the Tax Court logjam, the IRS finds its own work program intermeshed in this same grid. Over 350,000 tax shelter returns are currently under examination, or before the Appeals office, or held in suspense pending an IRS determination on how to handle groups of similar cases. While a series of major Tax Court decisions has opened up new settlement opportunities, and while innovative procedures and techniques have been adopted by the IRS and the Tax Court, both Tax Court judges and IRS officials continue to be deeply concerned about the adverse impact that the current predicament is having on our entire self-assessment tax system.


Making use of this legislation, the IRS in 1983 embarked upon a comprehensive “front-end” attack on abusive tax shelters by adopting aggressive techniques outlined first in Revenue Procedure 83-78\(^3\) and expanded later in Revenue Procedure 84-84.\(^4\) Immeasurable strength was recently added to the program by the new weapons given to the IRS by the 1984 revenue act.

The remainder of this article is devoted to analyzing the dual assault on abusive tax shelters by Congress and the IRS, and discussing the new procedural rules applicable to partnership audits and litigation.

**Congressional Assistance**

**1969:** Congress began to focus heavily on the tax shelter problem in the 1969 revenue act. Partial correction of well-established tax avoidance patterns was made in a number of common situations: *i.e.*, depreciation for real estate, percentage depletion for oil and gas, development and maintenance costs for citrus groves, farm losses, livestock and hobby losses. But rather than meeting issues head on—by outright repeal or modification of provisions causing the major problems—Congress side-stepped many tough decisions by enacting a

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\(^3\) 1983-2 C.B. 595.

\(^4\) 1984-2 C.B. 782.
new "minimum tax" on certain specified tax preference items, including special rules for deducting "excess investment interest"—percentage depletion, long-term capital gain, qualified stock options, fast depreciation for personal property under net leases, fast depreciation for realty, excess amortization for anti-pollution equipment and for railroad rolling stock, and excess bad debt deductions for financial institutions. The original rate was 10 percent (later 15 percent), imposed as a penalty or add-on tax.

Once called a "love tap" tax, this minimum tax was erratic in discouraging certain activities and, as will be seen later, was ultimately discarded.

1973: Responding to a wave of criticism, Secretary George Shultz early in 1973 acknowledged that tax shelter investments were the underlying cause of little or no tax being paid by many individuals. He recognized that the minimum tax was not sufficient for meeting the problem, and, in its place, he recommended substituting a two-part program: (1) a "limitation on artificial accounting losses" (LAL), which would defer deductions clearly associated with income to be realized in the future, and (2) a tax on "minimum taxable income" (MTI), which would tax at least 50 percent of an individual's real economic income at regular income tax rates. MTI was the equivalent of an expanded tax base, computed by adding to adjusted gross income certain income exclusions allowed by the Code—long-term capital gain, qualified stock options, percentage depletion and income earned abroad. After heated debate and criticism, however—complicated by the Watergate investigations and hearings—the Treasury backed off this impressive, albeit very complicated, attempt to achieve fundamental reform.

1976: Extensive and fruitless Congressional hearings continued during 1974 and 1975, and it was not until the sweeping 1976 revenue act that comprehensive action against tax shelters finally took place. Four kinds of shelter activities were specifically covered: (1) holding, producing or distributing motion picture films or tapes, (2) certain kinds of farming, (3) equipment leasing and (4) exploring or exploiting oil and gas resources. Introduced for the first time were the "at risk" rules—limiting loss deductions to the taxpayer's actual investment in the above-specified transactions and partnerships, with real estate excluded as the one major exception. Construction period interest and taxes were required to be capitalized, with a 10-year amortization rule. Certain plant and cultivation costs also had to be capitalized; while farming syndications were curtailed by limiting deduction for prepayments of feed, seed and fertilizer.

In addition, a number of other anti-avoidance provisions were adopted: (a) recapture rules were introduced for intangible drilling costs; (b) capitalization and amortization requirements were imposed for motion pictures, books,

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records and similar property; (c) trading in sports franchises was circumscribed by new rules for allocation of purchase price and recapture; (d) the deductibility of prepaid interest was spread out over the life of the loan; and (e) a series of changes were made in the partnership provisions to curb syndication abuses—such as the deductibility of syndication and organization fees, retroactive allocation of partnership income and losses, and special allocations lacking substantial economic effect.

The anti-shelter drive was now in high gear.

1978: The 1978 act was marked by the extension of the “at risk” rules to almost all activities and to closely-held corporations. The single exception again was real estate.

1981: The 1981 act (“ERTA”), in turn, extended the “at risk” rules to the investment tax credit, tightened the rules governing tax straddles, imposed a new graduated penalty tax (10 percent to 30 percent) for “valuation overstatements,” and increased both the negligence penalty and interest rates on tax deficiencies.

1982: The 1982 act (“TEFRA”) made its contribution primarily by passing new and tougher penalty provisions. It first provided for a true “alternative” minimum tax at 20 percent rates to replace the old 15 percent add-on minimum tax. Then, penalties were imposed for substantial understatements of income tax, with harsher rules for tax shelters (section 6661), and for “knowingly” aiding third parties in understating income tax (section 6701). To counteract some of the fraudulent schemes being marketed throughout the country, heavy penalties were imposed on promoters for organizing or selling “abusive” tax shelters (section 6700) and the IRS was given injunctive authority over them even before income tax filings, to prevent ongoing violations (section 7408).

To aid the IRS in handling large tax shelters—which might have as many as hundreds or thousands of individual limited partners—both audits and litigation of tax shelter partnerships have now been centralized for the first time through a single entity approach. The principle is simple but the implementation is complex. Comparable entity treatment is given to Subchapter S corporations.

1984 Tax Reform Act

Despite these legislative efforts, the IRS continues to be inundated by regional and nationwide tax shelters, some of which have already moved their activities abroad. In response, the Deficit Reduction Act of 1984 (“DEFRA”) —whose tax provisions are sometimes referred to as the Tax Reform Act of 1984—presses forward stridently with a commitment to end trafficking in these

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7 I.R.C. §§ 55.
9 I.R.C. §§ 6241–45.
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abusive schemes. DEFRA does this by establishing a defined code of conduct in many areas, creating a tight set of compliance rules and then imposing specific penalties for a variety of acts which fall under the rubric of tax shelter abuses. As a whole, these 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 may be called "Crime and Punishment."

Described below are the major provisions of DEFRA applicable to tax shelters.10

Registration

From the IRS' standpoint the new registration provision for tax shelters is the most important compliance provision in DEFRA.11 Not later than the first day an interest is offered for sale, certain tax shelters must file for a registration number, and thereafter investors must report the number as a part of their individual tax returns. As a result, the IRS now possesses the tools necessary for advance screening of a broad universe of shelters, is able to track tax shelter developments as well as the individuals making these investments and, most importantly, may readily obtain data to assist it in selecting for audit shelters with profiles that call for examination.

Registration is required if two conditions exist:

(1) The write-off or "tax shelter ratio"—the ratio of deductions and credits to the total investment—is represented as being more than 2-to-1, as of the close of any of the first five years; and

(2) The shelter offering (a) exceeds $250,000 and is made to five or more investors, or (b) is required to be registered under federal or state securities laws, or (c) is sold under a registration exemption that requires the filing of a notice with federal or state securities authorities.

The "tax shelter ratio" is determined by comparing the tax benefits with the "investment base." The tax benefits are comprised of the total amount of the deductions plus 200 percent of the credits "represented to be potentially allowable to any investor." In turn, the "investment base" is the sum of the money plus the adjusted basis of other property contributed (reduced by any liability to which the property is subject). The statute and regulations generally exclude from the "investment base"—and thereby increase the tax shelter ratio—items which they regard as "funny money." This includes (a) cash and marketable securities held by the tax shelter, (b) certain amounts borrowed

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11 I.R.C. §§ 6111, 6707; Act § 141.
from the shelter organizer or a person related to him, (c) loans from third parties
arranged by the organizer, (d) loans from foreign-connected sources and (e)
amounts to be repaid without regard to income earned by the shelter.

In the original proposed Treasury regulations, released in August 1984, the
determination of the 2-to-1 tax shelter ratio did not take into account any
income expected to be earned by the organization. This resulted in many bona
fide business organizations inadvertently being required to register—for ex-
ample, law firms, accounting partnerships and farming operations. The sharp
outcry over this broad application of the statute brought a rapid modification on
October 26, granting a "suspension" from registration for a new category of
"projected income investments." For this type of investment—one not
expected to reduce the tax liability of investors in any of the first five years—no
registration is required unless and until the cumulative income projections are
not subsequently borne out in fact. Only at that later point, when the investment
produces a loss or other tax benefit, must registration take place.

To qualify for this suspension, the tax shelter organizer must provide the
investor with a written statement that the investment is expected to produce net
income and not net tax benefits. Excluded from suspension relief, however, are
certain specified types of ventures—that is, shelters which relate to "collectibles,"
master sound recordings, motion picture or television films, videotapes, lithograph plates, copyrights, or literary, musical or artistic com-
positions.

To register, the organizer must complete and file Form 8264 by the first day
an interest is offered for sale. Included in the form must be descriptions of the
program, tax benefits, tax shelter ratio, accounting method used, type and
source of financing, etc. If the person principally responsible for the organiza-
tion fails to register, then any person participating in the organization, sale or
management has the registration responsibility. Generally, professional advice
by unrelated lawyers or accountants will not constitute "participation." On the
other hand, if the attorney or accountant receives a fee in whole or in part based
on the number or value of the unit sold, then he may be treated as being involved
in the "entrepreneurial risk" and obliged to effectuate the registration.

By filing a properly executed Form 8264, the shelter completes its regis-
tration and will promptly be given an identification number. Obviously, the
issuance of a number does not indicate that the investment or its tax benefits
have been reviewed, examined or approved by the IRS. Within seven days after
receipt, the number must be furnished to investors who must then include it on
Form 8271 which is filed as a part of their tax returns.

The penalty for failure to register is the greater of $500 or 1 percent of the
aggregate amount invested, up to a $10,000 maximum. The maximum is
inapplicable in cases of intentional disregard of the statute or regulations; but

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12 See IR-84-88 (Aug. 13, 1984), T.D. 7964 adding temporary regulations § 301.6111-1T, § 301.6111-2T,
and §301.6707-1T.
13 See IR-84-112 (Oct. 26, 1984), amending the temporary regulations.
the penalty is waived, however, if the failure is due to reasonable cause.

The promoter is penalized $100 for each failure to provide an investor with a
tax shelter registration number. The investor who without reasonable cause
fails to include the number on his tax return is penalized $50.

Promoter's List of Investors

Another important tool given to the IRS by DEFRA is the requirement that a
list of investors be maintained by organizers or sellers of "potentially abusive
tax shelters."14 This applies to any shelter required to register or any other
"plan or arrangement which is of a type which the Secretary determines by
regulations as having a potential for tax avoidance or evasion." Also included
for this purpose is a "projected income investment," one where registration is
suspended because it produces net income.

The list must contain the name, address and taxpayer identification number
of each purchaser and also such other information required by Treasury
regulations. It must be made available for IRS inspection upon request and must
be retained for a period of seven years. The penalty here is $50 for each failure
to meet any requirement imposed by section 6112, up to an annual maximum of
$50,000. Relief is provided when the failure is due to reasonable cause and not
willful neglect.

The requirement that, on request, organizers and sellers turn the list over to
the IRS for inspection solves the Tiffany Fine Arts problem which was before
the Supreme Court this past term.15 Under the facts of the Tiffany case, the IRS
was permitted to use its regular summons authority, without going through the
section 7609(f) John Doe procedure, to procure the names and addresses of
investors. This information must now be turned over without the need for the
IRS to use the John Doe procedure or to show it was auditing the shelter's tax
returns.

Miscellaneous Enforcement Tools

Promoters' Section 6700 Penalty: Beyond introducing registration and
investors' lists, DEFRA toughened a number of existing penalty provisions
relating to tax shelters. The section 6700 penalty for promoting abusive tax
shelters, originally adopted in 1982, is increased from 10 percent to 20 percent
of the income to be derived from the activity.16 Here the tainted activity is (a)
organizing or selling an interest in a tax plan or arrangement, and (b) in the
process, (i) using sales material about the tax benefits which the person knows
or has reason to know is false or fraudulent, or (ii) making a "gross valuation
overstatement" about any material matter—i.e., stating a value more than 200

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14 T.R.C. §§ 6112, 6708; Act § 142.
16 Act § 143.
percent of the finally determined correct value. Not only does the penalty apply to the organizer or promoter, but it also reaches anyone else who assisted him in the organization or marketing of interests.

Section 7408 Injunctions: The related injunctive power contained in section 7408, which is aimed primarily at promoters violating section 6700, has been broadened to include individuals violating section 6701—which imposes penalties for knowingly aiding and abetting a third party in understanding tax liability.\(^\text{17}\) As accountants, lawyers, appraisers and others may fall within the reach of section 6701, they must now give thought to the potential of this injunction threat.

Increased Interest: For underpayments tied to “tax motivated transactions,” interest on tax deficiencies is increased.\(^\text{18}\) As of January 1, 1985, the penalty rate is 120 percent of the regular rate for underpayments of over $1,000 attributable to (1) valuation overstatements of 150 percent or more of the correct amount, (2) disallowance of loss deductions or investment tax credit due to violation of the risk rules, (3) tax straddles, (4) use of accounting methods specified in the regulations as resulting in a substantial distortion of income, or (5) other types of transactions which the regulations specify as “tax motivated.” This new provision is a one-way street—applying to tax deficiencies but not to tax refunds.

Finally, under section 6601(e) (2) (B), interest on certain designated penalties will run from the due date of a return (including extensions), not from the billing date.\(^\text{19}\) This new computation of interest applies to failure to file returns (section 6651(a) (1), gross valuation overstatements (section 6659), valuation understatements for gift or estate tax purposes (section 6660), and substantial understatements of tax (section 6661).

Charitable Contributions

One form of tax shelter subject to wide abuse is the use of appreciated property in claiming charitable deductions. The ploy is to purchase assets, sometimes in bulk, holding them for a period sufficient to qualify them for long-term capital gain treatment (now six months and a day), and then contribute them at a greatly enhanced value to a section 501(c) (3) charitable organization. The publicity given to bulk purchases of gemstones as well as bibles brought this problem to Congress’ close attention.

In a series of Conference Committee admonitions and statutory amendments, Congress came down heavily by requiring new valuation safeguards, appraisals, information reporting and penalties.\(^\text{20}\) The appraisal requirements

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\(^{18}\) I.R.C. § 6621(d); Act § 144.

\(^{19}\) Act § 158.

\(^{20}\) I.R.C. §§ 6050L, 6659(c) and (f); Act § 155. See Merritt and Edwards, DRA changes affecting charitable contributions, estate and gift tax valuations and appraisers, 16 Tax Adviser 140 (1985).
are applicable to individuals, closely-held corporations, personal service corporations and, if there is a flow-through of charitable deductions, to partnerships and subchapter S corporations. To implement the new rules, Congress directed the Treasury to use the broad regulatory authority contained in Code section 170.

The Conference Committee report is very precise and detailed in its instructions to the Treasury.\textsuperscript{21} Foremost is the provision that no charitable deduction will be allowed unless it is supported by a qualified appraisal made by a qualified independent appraiser in full compliance with all the specified rules.\textsuperscript{22} The appraisal requirements apply if the deduction claimed exceeds $5,000 for any one item or group of similar items given to different charities. For non-publicly traded stock, the threshold requiring appraisal is raised to $10,000. If the stock is publicly traded, however, no appraisal is necessary.

A detailed written appraisal, signed by the appraiser and listing his tax identification number, must be in the donor's hands not later than the due date of his return including extensions. In addition, the donor must attach to his return a written appraisal summary signed by the appraiser (including his tax identification number), and acknowledged by the donee. The donor is required to submit the summary to the donee for its signature and acknowledgment of receipt, and must advise the donee of any similar items donated during the same year. Also to be included in the donor's return are: the cost basis and acquisition date of the property; if this information is not available for reasonable cause, an explanatory statement; and all other information required by the regulations.

While the penalty here is total disallowance of the deduction, relief is provided for good faith failure to comply with the substantiation requirements if (a) a qualified appraisal was timely obtained and (b) the IRS was furnished with an appraisal summary.

To close the loop, Congress has directed that, if the donee sells or otherwise disposes of the property within two years of receipt, it must report the transfer to the IRS. This is done by filing an information return, with a copy to the donor. Included would be the donor's name, address, tax identification number, description of the property, date of contribution, date of disposition and the amount received.

No reporting is required if the deductions claimed are not over $5,000 for a single item or group of items donated to one or more donees. The same $5,000 safe harbor applies to donations of closely-held stock.

For failure to meet these reporting requirements, the donee must pay a section 6678 penalty—\textit{i.e.}, $50 per failure up to $50,000 for a single year, with the same penalty applicable for failure to send copies to donors. In both instances, relief is provided if it is shown that the failure is due to reasonable cause and not willful neglect.

Regulation of Appraisers

Independent appraisers, it is apparent, play a pivotal role in supporting charitable deductions for appreciated property. In recognition of these and other responsibilities, provision is made for their closer supervision through both DEFRA\(^2\) and amendment of title 31 United States Code, section 330.

The Treasury may not bar appraisers from appearing before the IRS or the Treasury Department to offer opinion evidence on the value of property or other assets. This relates to appraisers who have been penalized under section 6701 for aiding and abetting another in understating his tax liability. An appraiser, consequently, will be subject to disciplinary action if he knows that his appraisal will be used in connection with the tax laws and result in an understatement. In addition, if the appraiser has been disciplined, the Treasury may declare that his appraisals have no probative effect in any administrative proceedings.

Proposed amendments to Treasury Circular 230 have already been promulgated placing appraisers under the supervision of the Director of Practice and setting forth the applicable disciplinary rules and procedure.\(^4\)

Finally, as noted before, with the section 7408 injunction authority broadened to reach parties subject to section 6701 aiding and abetting penalties, appraisers must be cautioned about their exposure to possible injunction proceedings before U.S. District Courts.

Valuation Overstatements and Understatements

Congress, in 1984, finally gave notice that tax abuse can arise from valuation understatements as well as overstatements. Undervaluation problems occur mostly in estate and gift tax settings, and the new act imposes stiff penalties for this type of error. Also, tougher penalties are imposed for overvaluation of charitable deductions.

Overvaluation: In ERTA (1981), graduated penalties were adopted for certain income tax “valuation overstatements,” with an exception for an overvaluation of property held more than five years. This exception is deleted entirely by DEFRA. In addition, charitable deductions are not covered by special rules for overstatements; a flat 30 percent penalty replaces the previous graduated 10 percent-20 percent-30 percent penalties. Under section 6659(f), the 30 percent penalty applies if the claimed value exceeds the correct value by 50 percent or more and the tax underpayment is at least $1,000.\(^2\) The Service may waive all or part of this penalty if the taxpayer makes good faith investigation of the claimed value and if it is based on a qualified appraisal made by a qualified appraiser.

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\(^2\) Act § 155.
\(^2\) Act § 156.
Undervaluation: A new Code provision, section 6660, imposes a graduated penalty tax on undervaluations for estate and gift tax purposes.\(^2\)

1. If the claimed value is between 50 percent and 66-2/3 percent of the correct value, the penalty is 10 percent of the tax underpayment attributable to the undervaluation;
2. If the claimed value is between 40 percent and 50 percent, the penalty tax is 20 percent; and
3. If the claimed value is less than 40 percent, the penalty is 30 percent.

As can be seen, no penalty is imposed if the claimed value is more than 66-2/3 percent of the correct value. In turn, the IRS is authorized to waive the penalty in whole or in part if the taxpayer shows there was a reasonable basis for a claimed valuation made in good faith.

One area where the undervaluation penalties almost certainly will arise is in the valuation of closely-held businesses. When a partnership interest or corporate stock is involved, the valuation task is extremely difficult and burdensome. Differences in judgment here vary greatly, and it can be anticipated that the IRS will be called upon often to exercise its penalty waiver discretion.

IRS “Front-End” Attack on Abusive Tax Shelters

Full use of these new enforcement tools is evident in the IRS’ aggressive front-end attack on abusive tax shelters. With tax shelter investors spread throughout the country, the new IRS program seeks to curtail abuses at the very outset, at the beginning of the marketing stage.

Early in the 1970s, the IRS had instituted a limited tax shelter program designed to identify tax shelters in traditional areas—such as oil and gas, real estate, farming and motion pictures. It was a horse-and-buggy, after-the-fact approach—selecting tax shelter returns after filing and audit, picking a test case, and suspending related cases until the publication of a court decision. Relatively few cases were litigated under this system, and the inventory of suspense cases increased rapidly. It was not long before the IRS was swamped by an unmanageable backlog.

Although the IRS gradually stepped up its attack, not until the passage of TEFRA (1982) was it in a position to initiate any novel efforts. TEFRA, it will be recalled, contained two major tax shelter provisions:

1. Section 6700—imposing a civil penalty of 10 percent (now 20 percent) of the gross income to be derived from the promotion of an abusive shelter. Covered by this section is the marketing of a plan or arrangement which (a) uses false or fraudulent sales material or (b) makes a “gross valuation overstatement”—using a value more than 200 percent of the correct value.

\(^{26}\) Ibid.
(2) Section 7408—authorizing injunction actions against persons subject to section 6700 penalties.27

Armed with these statutory weapons, the IRS embarked on an intense drive against targeted, abusive tax shelters. In October 1983, it announced the new techniques it would use. The essence of this program is the redirection of IRS' normal efforts by zeroing in on promoters and investors at the very outset of the promotional stage—far before the time that tax benefits are claimed on tax returns.

The organizational changes and novel approach are fully described in Revenue Procedure 83-78,28 as supplemented by Revenue Procedure 84-84.29

District Coordinator

Each IRS district designates a Coordinator responsible for gathering information on promotions being marketed. Identification of these promotions is made from federal and state securities agencies; other IRS investigations; magazines, newspapers, etc. Professional groups are encouraged, even anonymously, to submit information for IRS consideration.

Section 6700/7408 Committee

Upon obtaining a prospectus or other promotional material, the District Coordinator periodically presents information to the Section 6700/7408 Committee, comprised of representatives from District Counsel, Criminal Investigation Division (CID) and Examination Division. Only managers from CID and Examination serve on the committee.

The committee reviews the information and selects those promotions where the promoter penalty under section 6700, injunctive action under section 7408, or prefiling notification to investors may be applicable. In reaching a decision, the committee considers the promoter's past activity; the type of shelter; the size of the promotion; the tax deductions or credits claimed; the regional or national impact; and the specific issues involved.

Included in the last criteria are asset overvaluation and false or fraudulent statements. Originally, Revenue Procedure 83-78 listed “aberrational use of a technical position” as one of the bases for sending a prefiling notification letter to investors. This was eliminated in Revenue Procedure 84-84, which now limits the prefiling notification only to the two penalty provisions contained in section 6700—gross valuation overstatement or false or fraudulent statements.

27 See Act § 143, expanding the injunction authority to include violators of Code section 6701 aiding and abetting provisions.
Revenue Agent and District Counsel

Once the committee selects the promotion for review, a revenue agent is given responsibility to conduct an examination, with a District Counsel attorney being assigned to him to provide assistance. It is up to the agent to determine whether the section 6700 promotion penalty is applicable, whether injunctive relief under section 7408 should be sought, and whether a basis exists for notifying investors that the purported tax benefits are not in compliance with tax laws.

The revenue agent will send a letter to the promoter notifying him of the examination, advising him that the IRS is considering the issuance of prefiling notification letters to investors, and requesting a list of documents, books and records for examination. The letter explains the purpose of the examination and offers a conference opportunity to the promoter to present any facts or legal arguments. Failure by the promoter to provide the requested information could result in the issuance of IRS summonses. As time is of the essence in these proceedings, extensions are rarely granted.

If the promoter does not provide the requested information, the District Counsel attorney prepares a summons which is referred to the Office of Special Litigation in the Department of Justice if enforcement becomes necessary. If the revenue agent finds indications of fraud, the matter is referred to CID and, if CID accepts the referral, the investigation then proceeds as a joint CID/Examination investigation.

On completion of the examination, the revenue agent and District Counsel attorney make recommendations to the District Director on penalty, injunction and prefiling notification letters. Fundamental to this new procedure is that the District Director himself must approve any action taken.

Prefiling Notifications

One of the most innovative parts of this new procedure is the mailing of prefiling notification letters to investors in the identified promotion. As Revenue Procedure 84-84 underscores, letters are sent to investors only if the standards reflected in section 6700 have been satisfied—i.e., (i) a gross valuation overstatement, or (ii) a false or fraudulent statement with respect to the tax benefits represented in the promotional material. As noted above, these letters are no longer sent to any other grounds.

The prefiling notification letters will advise investors that, based upon review of the promotion, the IRS believes that the purported tax benefits are not allowable. Notification letters may also be issued after tax returns are filed and, if investors have already claimed these tax benefits, they will be advised that they may file amended returns. In all events, any applicable penalties, including the substantial understatement penalty of section 6661, still may be asserted.

Returns in which prefiling notification letters have been issued for the current
or prior year will automatically be selected for review. If investors have claimed the tax benefits or failed to file amended returns, they will be notified that their tax returns are being examined under normal audit and appeal procedure.

The IRS recently received a setback in its front-end program in *Mid-South Music Corporation* when the district court held that the mailing or prefiling notification letters to tax shelter investors violated the confidentiality rules of Code section 6103. In revealing the identity of the tax shelter and the fact that it was under IRS investigation, the IRS was found involved in a willful unauthorized disclosure of "return information" and was therefore subject to compensatory damages of $174,000 and punitive damages of $1,000. Obviously, the IRS is greatly disturbed by this decision as it goes to the heart of its advance-warning procedure. An appeal to the United States Court of Appeals for the Sixth Circuit is now pending.

**Other Remedies**

The IRS may also seek section 7408 injunctive relief or assert section 6700 promoter penalties, whether or not prefiling notification letters are mailed. Before referring the matter to the Department of Justice for enforcement of an injunction or penalty, the IRS requires approval by the District Director. In turn, upon examination of the investor's tax return, the IRS may still assert additional tax liability and, if appropriate, any penalties, regardless of whether prefiling notification letters are mailed.

**Pre-Refund Audits**

The IRS was greatly concerned over applications for refunds related to abusive tax shelters, particularly "quickie refunds" under section 6411 (tentative carryback and refund adjustments). Some shelter schemes attracted investors by representing that carryback refunds growing out of the shelter would actually finance the purchase of units.

To defend against the growth of these practices, the IRS, in Revenue Procedure 84-84, instituted the "Abusive Tax Shelters Detection Program." Based at the IRS Service Center level, the program "[1] will detect and identify those returns that claimed benefits from abusive tax shelter promotions before processing and before refunds are paid (front-end identification), [2] will reduce refunds of investors when appropriate, and [3] will offset deficiencies assessed under the provisions of section 6213(b) (3) of the Internal Revenue

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30 See *Mid-South Music Corp. v. United States*, 56 AFTR 2d 85-6250 (M.D. Tenn. 1985), on remand from 756 F.2d 23 (CA-6, 1984), affiruing and remanding 579 F. Supp. 481 (M. D. Tenn. 1983). Also see *United States v. Mid-South Music Corp.*, 56 AFTR 2d 85-6007 (M.D. Tenn. 1985), upholding a § 7408(a) injunction against the promoters of a master-recordings lease tax shelter ("gross valuation overstatements"). Compare *Western Reserve Oil & Gas Co. v. New*, 765 F. 2d 1428 (9th Cir. 1985) (prefiling notification letters do not violate due process rights).
Code against scheduled refunds resulting from tentative carryback adjustments under section 6411(b).

Revenue Procedure 84-84 establishes an Executive Committee, or central decision-making group, comprised of the Assistant Regional Commissioners (Examination). Its initial function is to evaluate, rank and coordinate on a national level abusive tax shelter promotions. Based on this evaluation, a recommendation to freeze refunds related to certain promotions is ultimately made to the Assistant Commissioner (Examination), who himself must approve all freeze actions. Refunds are denied and tentative allowances offset in cases where it is highly likely that there is (1) a gross valuation overstatement, or (2) a false or fraudulent statement on the tax benefits contained in the promotional material.

Abusive Tax Shelter Team

Although Revenue Procedure 84-84 is primarily concerned with "quickie" and other refunds, it has another purpose. It seeks to supplement the district tax shelter program by establishing an Abusive Tax Shelter Detection Team at each Service Center.

Each Team is staffed by representatives from Examination Division, CID, and other affected functions, such as return processing. Its sole function is to identify returns of potentially abusive tax shelters. Consequently, referred to it are any returns coming into the Service Center which reflect tax shelter sensitivity—viz., Forms 1040, 1041, 1065 an 1120S; amended returns (Form 1040X) and Applications for Tentative Refund (Form 1045).

Evidence of an abusive tax shelter case is assembled by the Team and then referred to CID or Examination Division in the district with jurisdiction over the promoter. The CID Chief or Examination Chief evaluates the case, secures additional data, and forwards a summary and recommendations to the District Section 6700/7408 Committee. This committee will review the information and select those cases where an injunction, promoter penalty, or prefiling notification seems appropriate.

If a refund freeze is involved, the Section 6700/7408 Committee sends the case for review and handling, as described before, by the Assistant Regional Commissioner (Examination). Other cases are referred to the Team for any action which it regards as appropriate.

The Team concept at the Service Center level has the obvious advantage of being able to cross the IRS district and regional lines and to take an overview of a broader cross-section of shelter promotions. Key target tax shelter cases can be selectively identified and assigned to the particular district where most of the investors are located. If the workload of one district becomes excessive, IRS personnel from another can be easily assigned to handle the overflow.

Out-of-Pocket Settlements ("OOPS")

Renewed emphasis is being placed on the rapid movement of tax shelter
cases through the IRS system. With the 1984 act provisions for registration and investor lists, the entire front-end program is proceeding at enhanced speed.

The IRS has experimented with giving investors the opportunity to dispose of their pre-1981 tax shelter cases on a cash, out-of-pocket basis. This is offered to investors within a specified time frame and, if not taken advantage of promptly, will not be available again in any settlement negotiations.

Investors’ out-of-pocket expenditures in buying tax shelter interests are not always fully deductible. At times they may be personal or subject to capitalization—i.e., syndication fees, prepaid fees, disguised capital acquisitions, etc. Consequently, it is the IRS position that no taxpayer is entitled as a matter of right to an out-of-pocket settlement—an “oops.” Rather, allowing “oops” deductions is treated by the IRS as a settlement technique, not an acknowledgement of the propriety of the transaction.

Policy Statement P-4-64 gives revenue agents authority to settle pre-1981 abusive tax shelter cases on an “oops” basis.31 As revenue agents generally are not authorized to “settle” cases, this procedure is justified as an administrative technique to reduce the tax shelter inventory, and it is not based on the traditional hazards of litigation rationale.

Concern is expressed within the IRS that some lawyers and accountants delay acceptance of this settlement proposal until the eve of the trial in the hope of obtaining more favorable settlement terms. Once the IRS has prepared for trial, however, it believes that little time is saved or efficiency improved by settling on the courthouse steps. With this in mind, the IRS, in conjunction with the Chief Counsel, has instituted a “SWOOPS” approach—selective withdrawal of out-of-pocket settlements. This is a total denial of all “oops;” and once withdrawn these settlement terms will not be offered again. To encourage fruitful settlement negotiations in other cases, the IRS says that it would rather litigate in these instances.

Cooperation Afforded the IRS

Broadscale cooperation has been given the IRS on many fronts.

The U.S. Assistant Attorney General (Tax Division), through his office of Special Litigation, is playing a key role. Injunctions, consent decrees, enforcement penalties, refund suits related to these penalties and criminal prosecutions, all are handled by the Tax Division before the the various U.S. District Courts and U.S. Courts of Appeals. Conferences and settlement negotiations relating to these actions are conducted by representatives from that office, in cooperation with IRS personnel. The Tax Division is the actual enforcement arm of the IRS tax shelter program and, in a relatively brief period, has achieved a commendable record.

The Tax Court itself, with an enormous backlog of shelter cases, is also lending a firm hand. It has experimented with a variety of speed-up procedures,
including consolidation of cases and the continuous trial by a single Tax Court judge of all tax shelter cases arising in a particular locality. Its willingness to try new techniques, particularly in very large shelter cases, is critical to the success of the IRS' efforts.

Mention should also be made of the activities of the organized bar and of the Director of Practice at the IRS. On January 29, 1982, publication was made of American Bar Association Formal Opinion 346, which expresses the ABA's official views on the standards applicable to lawyers who issue tax shelter opinions. Imposing extremely heavy responsibilities on lawyers, it became the model for the 1984 final amendments to Treasury Circular 230, which similarly set forth the duties of tax practitioners who furnish opinions on tax shelter offerings.\textsuperscript{32} Circular 230 regulates the conduct of all persons authorized to practice before the IRS—lawyers, CPA's and enrolled agents. Its new mandate on tax shelter opinions is of obvious importance to anyone engaged in tax practice; for a violation could lead not only to public reprimand or suspension, but also to total disbarment. This could prevent a practitioner from appearing or representing a taxpayer before any official of the IRS for a given period of time or for lifetime.

Another event worthy of note is the recent change in the ethical rules governing lawyers who give advice on tax return preparation. In July, 1985, the American Bar Association's Ethics Committee overturned the previous "reasonable basis" standard and substituted a much stricter "good faith" requirement.\textsuperscript{33} The old rule, in existence for over 20 years, simply stated that lawyers "may freely urge the statement of positions most favorable to the client just as long as there is a reasonable basis for this position."\textsuperscript{34} In contrast, the new standard permits a lawyer to advise a client in this fashion only "so long as the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law and there is some realistic possibility of success if the matter is litigated."

Under the new position, however, it is clear that the lawyer can meet the good faith standard even if he believes the client's position "probably will not prevail." And, if he has such a good faith belief in the validity of the position, he has "no duty to require as a condition of his or her continued representation that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditure." At the same time, the lawyer should advise his client (a) whether his position is likely to be sustained in court and (b) of the potential 10 percent penalty consequences under Code section 6661 if disclosure is not made. Of course, if a "substantial understatement of income tax" is attributable to a tax shelter item, disclosure will not insulate the


\textsuperscript{33} Formal Opinion 85-352, American Bar Ass'n Ethics Comm. (July 29, 1985).

\textsuperscript{34} Formal Opinion 314, American Bar Ass'n Ethics Comm. (April 27, 1965).
client against the section 6661 penalty tax. Rather, he would be obliged to show that there "is or was" substantial authority for his position and that he "reasonably believed" that this position was "more likely than not the proper treatment."35

Audits and Litigation of Tax Shelter Partnerships

In representing investors and promoters of tax shelter syndications, lawyers and accountants are now obliged to master a complex series of new rules introduced by TEFRA.36 Most of these syndications are organized as limited partnerships, and the new Code provisions (sections 6221-33) apply for partnership taxable years beginning after September 3, 1982. These new rules are sweeping and comprehensive, and this article will touch on their highlights by a brief comparison of pre-1983 and post-1982 audit and litigation procedures.

Pre-1983 Practice

In the eyes of the Internal Revenue Code, partnerships are merely conduits, not taxable entities. While there is no income taxation at the partnership level, the partnership must file information returns and make allocations of the various partnership items to each of the partners. The partners, in turn, are obliged to report these allocations on their own individual returns.

Individual partners frequently reside in different IRS districts outside of the locale where the partnership itself conducts business or maintains its principal office, and simply locating partners for audits has been a significant burden for the IRS. In some cases, the IRS has found it impossible to locate all of the taxpayers prior to the expiration of the statute of limitations. The scope of these difficulties is illustrated by the Treasury's report of one promoter who organized 35 partnerships involving over 55,000 partners, averaging over 1,500 partners per partnership, with one comprised of more than 7,500.37

In the pre-1983 period, each partner could take whatever reporting position he felt reasonable with regard to partnership items, and there was no requirement that he conform to the partnership return. Preliminary adjustments to the partnership return ultimately were made to his individual return and he was free to conduct his own negotiations, appeal and selection of judicial forum. The statute of limitations for partnership adjustments ran separately for each partner and extensions necessarily were negotiated on an individual basis.

The IRS normally examined partnership activities on a centralized basis seeking to deal with a control group of partners. This control group typically handled negotiations, appeals and litigation, and any settlement reached with it

35 I.R.C. § 6661(b) (2) (C).
36 See notes 8 and 9 supra.
was offered to the remaining partners. At the same time, settlements and judicial determinations on partnership items were binding only on the partners who were actual parties to the proceedings. To provide consistent treatment for the various partners of a single partnership was extremely difficult.

The pre-1983 procedure was cumbersome, erratic and often unfair. Despite continuous efforts of the IRS and the Tax Court to accommodate to the statutory weaknesses, the backlog of cases mounted year after year and finally led to the solution contained in TEFRA.

**Post-1982 Audits and Litigation**

TEFRA dramatically changes how the IRS examines partnership returns, assesses and collects taxes based on partnership adjustments, and refunds any overpayments. It creates a unified partnership proceeding and requires adjustments, deficiencies, assessments and refunds to be made in a partnership context, rather than through the outmoded device of individual examinations. This single, unified tax proceeding at the partnership level covers all "partnership items." It applies essentially to 1983 partnership tax return, although pre-1983 returns may also be included through the request of all partners and with the consent of the IRS. Exempt, however, are "small partnerships" (10 or fewer individuals with no special allocation of partnership items), unless they elect to be covered.

**Duty of Consistency**

A cornerstone of the new regime is the requirement that each partner treat partnership items on his return consistently with its treatment on the partnership return. Inconsistent treatment, absent a waiver provided by the statute, may prompt an immediate assessment and penalties for intentional disregard of the consistency rule. Also, if a partnership administrative or judicial proceeding results in adjustments to the partnership’s treatment of an item, each partner’s tax liability must conform to that result. Important to be noted, however, is that each partner has the right to participate in all administrative and judicial proceedings, or separate himself from the group and negotiate his own settlement.

**"Tax matters partner" (TMP):** A single "tax matters partner" (TMP) is given a special, statutory role to represent the partnership, keep the individual partners informed of progress, and coordinate proceedings before the IRS and the courts. Selection of the TMP is made in the following order: (a) the general partner designated by the partnership; or (b) if none is selected, the general partner with the largest profits interest or, if there is more than one, the first alphabetically; or (c) if the IRS determines that applying (b) is "impractical,"

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38 The term "partnership item" is defined in Prop. Reg. § 1.6231(a) (3)-1 (Jan. 14, 1983).
39 I.R.C. § 6231(a) (1) (B).
40 I.R.C. § 6222. For impact of "computational adjustments," see §§ 6230(a) and 6231(a) (6).
then the partner selected by the IRS.\textsuperscript{41} Despite his pivotal position, the TMP has authority to bind other partners merely in the following respects only:

1. To extend the statute of limitations for the partnership;\textsuperscript{42}
2. To determine the forum for judicial review;\textsuperscript{43} and
3. To enter into a settlement agreement that binds only "nonnotice" partners who have not joined a 5-percent notice group and who have not filed written statements with the IRS expressly denying the TMP this authority.\textsuperscript{44}

"Notice partners": To provide due process for the individual partner and to protect his right to participate in the proceedings, TEFRA requires that written notice be given to individual partners concerning different stages of the administrative process.\textsuperscript{45} Practically every partner is a "notice partner," with the minor exception of less-than-one-percent partner in a partnership of over 100 partners. Even here the less-than-one-percent partners may join together to form a "5-percent notice group," with a designated representative who is then entitled to the same rights as a notice partner.\textsuperscript{46}

The IRS must advise in writing each notice partner (including the representative of the 5-percent notice group) of both the beginning and end of a partnership audit.\textsuperscript{47}

"Final partnership administrative adjustment" (FPAA): The administrative phase ends when the IRS mails to the TMP, and to each partner who does not individually settle, a notice of "final partnership administrative adjustment" (FPAA). Closely analogous to the normal statutory notice of deficiency ("90-day letter"),\textsuperscript{48} the FPAA is subject to judicial review in the Tax Court, the Claims Court or a district court of the United States. It undoubtedly will be referred to as a "150-day letter"—for within 90 days of its mailing the TMP first has the option of filing a "petition for readjustment"; and, if he fails to do so, within an additional 60 days any notice partner may so file on behalf of the partnership, with the TMP having the right to intervene.\textsuperscript{49} In brief, only one action is allowed to proceed—whether brought by the TMP or another partner—with the final judgment binding all partners having an interest in the partnership items.

"Request for administrative adjustment" (RAA): A partner may initiate a

\textsuperscript{41} I.R.C. § 6231(a) (7).
\textsuperscript{42} I.R.C. § 6229(b) (1) (B).
\textsuperscript{43} I.R.C. §§ 6226(a) and 6228(a).
\textsuperscript{44} I.R.C. § 6224(c) (3).
\textsuperscript{45} I.R.C. §§ 6223, 6231(a) (8) ("notice partner" definition).
\textsuperscript{46} I.R.C. § 6223(b) (2).
\textsuperscript{47} I.R.C. § 6223(a).
\textsuperscript{48} I.R.C. § 6213(a).
\textsuperscript{49} I.R.C. § 6226(a), (b). See Barbados #6 Ltd., A Partnership, 85 T.C. No. 53 (Dec. 10, 1985), holding that Tax Court has jurisdiction where TMP, who is also qualified as a "notice partner," fails to file petition within 90 days but does file within following 60-day period ("petitioner wore two hats—one as the tax matters partner and another as a notice partner"). Chief Judge Sterrett and Judges Hamblen and Clapp dissented. This is the first case before the Court under its new rules governing partnership proceedings. See Title XXIV, Rules of Practice and Procedure (Rules 240–47), 82 T.C. 1076, effective Jan. 1, 1984.
change in his own tax liability attributable to partnership items by filing a request for administrative adjustment. The RAA functions as an amended return or a claim for refund, and only the TMP may file it on behalf of the partnership itself. In turn, the IRS has the option of responding to the TMP in one of three different ways: it may take no action, allow adjustment, or conduct a full partnership examination. In contrast, if the RAA is filed by an individual partner, the IRS' options are broader: (1) it may process the RAA similar to a request for refund of items which are not partnership items; (2) assess any additional tax that would result from the RAA; (3) notify the partner that all his partnership items covered by the RAA will be treated as nonpartnership items; or (4) conduct a full partnership proceeding.

Judicial review of RAA: If the IRS response to a TMP filing is not satisfactory, the TMP may seek judicial review in any of the three courts which could review an FPAA. All partners are treated as parties to the proceeding and may participate in it. As with judicial review of an FPAA, appeal of the trial court's decision may be taken only by the TMP, a notice partner or a 5-percent group. An individual partner's suit following his filing of an RAA is treated as an ordinary civil refund suit under Code section 7422, but the limitations on the partner's right to bring suit are generally parallel to the limitations on the TMP's right to sue on behalf of the partnership.

Coordination with nonpartnership procedures: The new procedural regime affects only that portion of a partner's tax liability attributable to "partnership items." The balance of his liability ("nonpartnership items") is determined under the normal audit, deficiency and refund procedures. Consequently, because of this bifurcation of his tax obligations, an individual partner may be involved in multiple administrative and judicial proceedings for any single tax year, with each proceeding resulting in only a partial determination of his overall tax liability.

Summary on partnership procedure: TEFRA has drastically changed the rules governing partnership audits and litigation. It seems to achieve its basic goal of a single, unified tax proceeding at the partnership level for all partnership items. In this sense it has greatly eased the IRS' burdens in coping with the extraordinary administrative problems flowing from regional and nationwide tax shelter syndications. The price paid, however, is a high level of procedural complexity. This results primarily from Congress' effort to provide due process for each partner by permitting him to participate individually in the ultimate determination of his own tax liability.

The Tax Court has helped matters by amending its Rules of Practice to provide special procedures for these new partnership actions. Still needed,
however, are clear Treasury regulations to amplify and implement the innovative statutory scheme. Even then it will take years of experience, rule-making, judicial decisions and perhaps further statutory amendments before we are able to fully understand the new system and evaluate how well it works.\textsuperscript{56}

**Conclusion**

The IRS is determined to move the huge stream of pending shelter cases through the pipeline. In light of the recent flow of Tax Court decisions favorable to the government, the IRS plans soon to unleash thousands of shelter cases now being held in suspense. Unless rapid settlement is attained, 90-day letters will be mailed in bulk and cases will be pushed into the Tax Court for final disposition. A large number of these cases, many said to have little merit, are expected to be disposed of quickly through the newly-vitalized summary judgment procedure.

The IRS has expressed confidence in placing a final stranglehold on the monstrous tax shelter problem. Nowhere is that more evident than in the Chief Counsel's statement in the *1984 Annual Report of the Commissioner and Chief Counsel Internal Revenue Service*:

"From our standpoint, the most significant event of 1984 was the Service-wide commitment to process substantially all existing shelter inventory on an expedited basis. The need to deal efficiently and effectively with these cases is one of the greatest challenges ever faced by our office. It arises against the backdrop of numerous favorable court decisions, a commitment of state-of-the-art automation of our shelter case management system, formation of the National Office tax shelter branch, implementation of the 'project' concept for moving promotions, the selective withdrawal of out-of-pocket settlement offers for pre-1981 shelters and a determination to make—and stand behind—realistic assessments of litigating hazards on a promotion-by-promotion basis...[W]e can be confident of our ultimate success in this most important endeavor."

Not only has the IRS been aggressive in combatting abusive tax shelters, but it also has been extremely creative and bold in its use of administrative powers. Whether its efforts will ultimately succeed is highly speculative; for needed still may be additional legislation—along the lines of the Treasury's November 1984 tax reform proposal—to place a statutory lid on tax shelter growth. Unless laws of this sort are forthcoming, one can only be quizzical in evaluating the IRS' ability to achieve its ambitious goal.

\textsuperscript{56} See articles cited in note 8 supra.