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TAX PROFESSIONALS BEHAVING BADLY

By Sheldon D. Pollack and Jay A. Soled

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In this article, the authors contemplate why tax professionals behave badly (that is, unethically), forming highly suspect corporate tax shelters that are void of any economic substance. The reason, they conclude, is simple: money and opportunity. When it comes to corporate tax shelters, there is plenty of both. Establishment of these shelters generates enormous fees, and the penalties and ethical oversight surrounding their formation are virtually nonexistent. Pending legislation, however, creates a glimmer of hope that tax professionals may have no choice but to cease their bad behavior — or face more serious consequences.

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I. Introduction

Like baseball and apple pie, taking questionable tax reporting positions has always been a national pastime of sorts. Ever since the enactment of the modern federal income tax in 1913, the Internal Revenue Service (and before it, the Bureau of Internal Revenue) has been forced to grapple with taxpayers who, under the advice of tax lawyers and accountants, claim doubtful deductions or assert suspect interpretations of the Internal Revenue Code (the code). It did not take long for taxpayers to figure out that entering into some transactions void of any business purpose could produce favorable tax results. The textbooks are replete with infamous early cases that are imbued with then-novel theories advanced by both taxpayers and the government that, to this day, perplex law students, inspire tax professionals, and motivate tax academics.[1]

Virtually all of those early cases raised issues of first impression. The income tax was young, the case law was scant, and the lawyers had a field day. Ah, those were the days when tax lawyers could argue with some measure of authority and a straight face that income derived from the sale of a capital asset was not taxable under the statutes and case law of the day.[2] Arguably, the courts contributed to the flourishing of this national pastime. As often as not, the courts, burdened by the limitations on language, left open the possibility of future code abuses, sometimes supporting questionable theories advanced by the government without fully grasping the consequences.[3]

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[1]Professor Paul Caron has recently published a wonderful collection of essays by some leading tax academics on the most (in)famous of these tax cases. Anyone with an interest in the evolution of the fundamental concepts of the income tax will want to read this book. Paul L. Caron, ed., *Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases* (2003).

[2]Section 22, the precursor of current section 61, provided that "gross income includes gains, profits, and income . . . of whatever kind and in whatever form paid." Indeed, the argument about what is and is not taxable income was not fully resolved until 1955, with the Supreme Court's broad holding in *Glenshaw Glass,* 348 U.S. 426 (1955). As Professor Joseph Dodge points out, the Court's holding "seems so obvious today that one may wonder why this case had to be decided by the Supreme Court as late as 1955." Joseph M. Dodge, "The Story of *Glenshaw Glass*: Toward a Modern Conception of Income," in *Tax Stories, supra* note 1. The reason why the Court was hearing this case is simple: The lower courts ruled in the taxpayer's favor, holding that "gross income" did *not* include punitive damages recovered by a plaintiff from commercial litigation.

Section references are to the Internal Revenue Code of 1986 as amended, except as otherwise noted.

[3]As Edward Tenner reminds us in his entertaining account of the unintended consequences (or "revenge effects") of our own ingenuity, things do not always turn out as planned. Edward Tenner, *Why Things Bite Back: Technology and the Revenge of Unintended Consequences* (1996). Consider, for example, the Supreme Court's holding in *Crane v. Commissioner,* 331 U.S. 1 (1947). In *Crane* the Court ruled that a taxpayer has basis in an asset acquired with borrowed funds. This holding, which under the circumstances makes complete analytical sense, inadvertently helped lay the foundation for the tax shelter industry of the 1970s and 1980s. *See generally* George K. Yin, "The Story of

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Fast-forward to the 1970s and early 1980s — the heyday of the individual tax shelter industry.[4] Virtually anyone with significant wealth seemed to buy into tax shelter ''investments'' (invariably in the form of limited partnership interests) that would generate paper tax losses to shelter their individual incomes and thereby reduce their taxes.[5] Even if offsetting income was realized in subsequent years — and often it was not[6] — tax losses upfront alone could generate considerable economic savings. That much was perfectly legal at the time. (Whether the upfront tax losses generated by the promoters were authentic was quite another matter.[7])

Even Lee Sheppard could not have anticipated the depths to which shelter promoters and tax professionals would sink in a matter of only a few short years.

In 1986 Congress finally took action, striking a harsh blow against this national pastime of creating tax schemes designed to shelter the income of individual taxpayers. It enacted the so-called passive activity loss limitation rules.[8] Those rules defer ordinary loss deductions in investments in which individual taxpayers are not material participants. That deduction limitation essentially put the proverbial nail in the coffin of most tax devices and ostensibly led to the interring of tax shelters as they relate to individual taxpayers.

In the aftermath of the 1986 tax act, many commentators took solace in the apparent fact that the tax shelter era seemed a closed chapter in the chronicles of our nation's tax system.[9] No one anticipated that corporations — whose tax reporting practices did not bear much congressional scrutiny during the code overhaul in 1986 — would soon join the tax shelter bandwagon. After all, large corporations, virtually all of us benightedly assumed, had ''sophisticated'' tax counsel that would not be enticed into engaging in dubious tax schemes.

This article explores the reasons why we could not have been more wrong in placing our trust in corporate counsel and their tax advisers. In the first part of our analysis, we focus on the seemingly irresistible allure of high professional fees — amounts so large that maybe even honest Abe Lincoln, were he alive today, might have succumbed to the Siren calls of corporate CEOs looking for tax breaks. In addition to the corrupting influence of the lucrative fees that professionals can earn from corporate tax shelters (of course, bank robbing can be lucrative too), there are inadequate penalties and controls to deter those who would compromise their professional obligations. In the second part of our analysis, we explain why neither third-party civil tax penalties nor professional boards function effectively to curb the participation of tax professionals in the corporate tax shelter industry.

Is there hope on the horizon? Perhaps. In the last part of our analysis, we examine pending congressional bills that, we hope, may do to the corporate tax shelter industry what the Tax Reform Act of 1986 did to the individual tax shelter industry — bury it.

II. The Allure of Lucrative Professional Fees

After 1986 and the passage of the Tax Reform Act, the tax shelter industry changed gears and focused its energies away from individual taxpayers and toward corporate taxpayers. Promoters commanded a fresh assault on the fisc — this time armed with new ''products'' designed for an even more lucrative market. We now know that by 1988 promoters such as Merrill Lynch, outfitted with tax opinions from leading law firms and aided by national accounting firms such as PricewaterhouseCoopers, already were out peddling a new form of tax shelter to some of the largest, wealthiest corporations in the United States — companies like Colgate-Palmolive, Winn-Dixie Stores, and Compaq Computer Corp. to name but a few.

The innocent among us learned about the new shelters only in the early and mid-1990s as they were uncovered in audits by the IRS and challenged in litigation before the Tax Court. Soon we began to read about even more appalling tax shelters featured on the front pages of *The Wall Street Journal* and *The New York Times*, as well as dissected in lengthy articles in *Tax Notes*. At the time, those deals looked pretty sleazy, but even *Tax Notes* columnist Lee Sheppard — a frequent and often vocal critic of the tax shelter industry — could not have anticipated the depths to which shelter promoters and tax professionals would sink in a matter of only a few short years.

Crane: How a Widow's Misfortune Led to Tax Shelters,'' in *Tax Stories*, *supra* note 1. (Yin concludes that while *Crane* alone did not produce tax shelters, *Crane* in conjunction with a number of other faulty tax rules (overly generous tax depreciation schedules, preferential tax rates for capital gains, and the installment sale rules) created the prerequisites and framework for the tax shelter industry.)

[4]*See generally* R. Meyer, *Running for Shelter: Tax Shelters and the American Economy (1985).*

[5]*See, e.g.*, Susan Nelson, ''Taxes Paid by High-Income Taxpayers and the Growth of Partnerships,'' 5 *Stat. Income Bull.* No. 2, Fall 1985, at 55; Joint Comm. on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* 4-5 (1985).

[6]Many taxpayers walked away from these deals in the back years and simply did not declare the income or, alternatively, they held on to these investments until their death, when the generosity of section 1014 (the so-called ''basis equal to fair market value rule'') legitimately eliminated any income tax associated with their investments.

[7]Often those losses were not legitimate. On behalf of investors, promoters often used inflated purchase prices combined with nonrecourse financing to secure bloated depreciation and amortization deductions. *See generally* Bernard Wolfman, ''The Supreme Court in the *Lyon*'s Den: A Failure of Judicial Process,'' 66 *Cornell L. Rev*. 1075 (1981); Daniel N. Shaviro, ''Risk and Accrual: The Tax Treatment of Nonrecourse Debt,'' 44 *Tax L. Rev*. 401 (1988).

[8]Section 469 was enacted as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, section 501(a), 100 Stat. 2085.

[9]*See, e.g.,* Shaviro, *supra* note 7 at 426. (''[T]he Act essentially put an end to much of the public tax shelter activity that had taken place over the previous 15 or 20 years.'')

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Based on the initial success of the IRS in litigating against the new generation of corporate tax shelters in cases such as *ACM Partnership v. Commissioner*,[10] *Compaq Computer Corp. v. Commissioner*,[11] *Winn-Dixie Stores Inc. v. Commissioner*,[12] *Saba Partnership v. Commissioner*,[13] and *Boca Investerings Partnership v. Commissioner*,[14] many of us thought there was a good chance of snuffing out the resurrected shelter industry. That turned out to be an overly optimistic assessment as it soon became apparent that those cases were only the tip of the iceberg. For every suspect shelter picked up by the IRS on audit or exposed on the front page of *The Wall Street Journal* or *The New York Times*, dozens (perhaps hundreds) remained unknown — hidden from the prying eyes of the IRS agents by multitiered partnership structures, grantor trusts, and Cayman Island LLCs.[15]

What accounts for the surge in popularity of corporate tax shelters? In a word, *money*. Nothing else so thoroughly captures the moment, in the form of both tax savings that inure to clients and professional fees that bloat the balance sheets of the profit ledgers of professional firms.[16] Once the professional community recognized that the profits to be made from these new shelter deals were astronomical, new firms regularly entered the game. And a vicious cycle soon took off as new firms sought new clients and new clients looking for the kind of tax savings they heard about ''on the Street'' stimulated the growth of new firms.[17] Forever gone were the

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[10]157 F.3d 231, *Doc 98-30659, 98 TNT 198-9* (3d Cir. 1998), *aff'g in part and rev'g in part* T.C. Memo. 1997-115, *Doc 97-6453, 97 TNT 44-17*, *cert. denied* 119 S. Ct. 1251 (1999). In *ACM Partnership*, an abusive tax shelter marketed by Merrill Lynch to Colgate-Palmolive Co. was slammed by the Third Circuit Court of Appeals, thereby providing strong precedent for the IRS in subsequent cases. That shelter was designed to take advantage of a regulation involving the installment sales method of reporting taxable gain. Merrill Lynch managed to generate a $98.5 million capital loss for Colgate, so the victory for the IRS netted $30 million of tax bounty.

[11]113 T.C. 214, *Doc 1999-30659, 1999 TNT 183-7* (1999). In *Compaq Computer*, the IRS successfully challenged in the Tax Court the giant computer manufacturer over a $3.38 million tax savings created by churning investments to use lucrative foreign tax credits. The decision of the Tax Court was subsequently overturned by the U.S. Court of Appeals for the Fifth Circuit. Even though the Tax Court found that the taxpayer had no legitimate expectation of profits from its arrangement designed to capture foreign tax credits, the Fifth Circuit declared even a small prospect to achieve profitability was sufficient to legitimize the arrangement. *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, *Doc 2002-184, 2002 TNT 1-5* (5th Cir. 2001). A comprehensive explanation of the tax advantage sought by the taxpayer through this complicated arrangement is found in Daniel N. Shaviro, ''Economic Substance, Corporate Tax Shelters, and the *Compaq* Case,'' *Tax Notes*, July 10, 2000, p. 221. For a critique of the Fifth Circuit's ruling, see Daniel N. Shaviro and David A. Weisbach, ''The Fifth Circuit Gets It Wrong in *Compaq v. Commissioner*,'' *Tax Notes*, Jan. 28, 2002, p. 511; David P. Hariton, ''The *Compaq* Case, Notice 98-5, and Tax Shelters: The Theory Is All Wrong,'' *Tax Notes*, Jan. 28, 2002, p. 501. *But see* William A. Klein and Kirk J. Stark, ''*Compaq v. Commissioner* — Where Is the Tax Arbitrage?'' *Tax Notes*, Mar. 11, 2002, p. 1335.

[12]113 T.C. 254, *Doc 1999-33731, 1999 TNT 202-6* (1999), 254 F.3d 1313, *Doc 2001-18038, 2001 TNT 127-6* (11th Cir. 2001), *cert. denied* 122 S. Ct. 1537 (2002). In *Winn-Dixie*, the IRS sought $1.6 million by challenging a $3.7 million deduction for interest paid on loans from cash value life insurance policies taken out by Winn-Dixie on the lives of more than 36,000 employees (some of whom no longer even worked for the company). Upholding the Tax Court, the Eleventh Circuit held that the corporate-owned life insurance program was a sham that lacked business purpose. Also, the IRS scored several comparable victories, most notably a case in 2001 against American Electric Power in the U.S. District Court in Ohio. *American Electric Power Inc. v. United States*, 136 F. Supp.2d 762, *Doc 2001-5282, 2001 TNT 36-8* (S.D. Ohio 2001).

[13]T.C. Memo. 1999-359, *Doc 1999-34675, 1999 TNT 208-8*. In *Saba*, Senior Judge Arthur L. Nims III of the U.S. Tax Court held against Brunswick Corp., an investor in yet another Merrill Lynch deal similarly designed to generate capital losses through the manipulation of Treasury regulations governing installment sales. More important than winning on the tax issues, the IRS scored a victory in *Saba* when Judge Nims affirmed that advice provided by tax counsel for a tax shelter deal is not privileged — thereby denying promoters the shroud of secrecy afforded to privileged communications. Without that protection, promoters and their legal counsel could be held accountable for egregious abuses uncovered by the IRS. That has proved an invaluable

(Footnote continued in next column.)

tool of the government in its recent attempts to reach investor lists held by KPMG and BDO Siedman. *See infra* note 57.

[14]*Boca*, 314 F.3d 625, *Doc 2003-1175, 2003 TNT 8-7* (D.C. Cir. 2003). In *Boca*, the court struck down claimed tax benefits because there was no independent business purpose for the partnership.

[15]In testimony before the House Ways and Means Committee on Nov. 10, 1999, Lindy Paull, then-chief of staff of the Joint Committee on Taxation (the congressional agency that provides Congress with professional advice on tax issues), warned that it is beyond the capacity of the government to police all the corporations that are claiming tax benefits from tax shelter investing. ''In many cases, the corporation that claims the tax benefit from a tax shelter escapes audit, or the tax shelter arrangement goes undetected during an audit.'' *Testimony of the Staff of the Joint Committee on Taxation Before the Committee on Ways and Means*, JCX-82-99 (Nov. 10, 1999), *Doc 1999-35935, 1999 TNT 218-20*.

[16]*See* Lee A. Sheppard, ''Corporate Tax Shelters: Red Herrings and Real Solutions,'' *Tax Notes*, June 18, 2001, p. 2075 (''Tax shelters have corrupted the entire tax practice. And it is about money. Tax practitioners are making more money than ever before in what seems to be a price-inelastic market for engineered tax avoidance transactions.'').

[17]To play the game, major national accounting and law firms had to drop their professional standards several notches and devise new transactions lacking even the minimal plausibility of what had been sold to the likes of Colgate-Palmolive, Winn-Dixie, and Compaq Computer in the late 1980s and early 1990s. One cursory look at the more recent device arsenal designed to eliminate corporate taxes (e.g., BOSS, FLIP, BLIPS, SC2, and OPIS) makes plain how low professional standards have sunk since the early 1990s. Hearings into the shelter activities of certain professionals (most notably, a distinctly greedy bunch at KPMG, ably assisted by their cronies at Sidley Austin Brown & Wood and Deutsche Bank) only confirmed the obvious — tax professionals cannot be trusted to police themselves or refrain from grossly unethical behavior. *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals: Hearing Before the Permanent Subcommittee on Investigations of the Senate*

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dreary days of the ''old-fashioned'' and infinitely less lucrative professional practice wherein clients came to their advisers seeking assistance in solving real problems — that is, planning a tax-effective way to do a business transaction, or if the transaction has already been done and botched, cleaning up the mess as best as possible within the limits of the law. Instead, salesmen in the big accounting firms, law firms, investment houses, and banks became the lodestars of too many tax practices. Often, these ''professionals'' approached their firm's own clients — those who had been identified by other partners as having realized significant gains or income during the year. The tax shelter marketing department of some accounting firms, such as giant KPMG, even made ''cold calls'' to nonclients soliciting new investors for their products.[18] Taxpayers were promised untold riches and even given forms to fill out specifying just how large a loss they wanted to ''generate'' and whether it should be capital or ordinary.[19]

Taxpayers were promised untold riches and even given forms to fill out specifying just how large a loss they wanted to 'generate' and whether it should be capital or ordinary.

Tax shelter hucksters then performed tax alchemy, creating tax losses out of thin air and charging their clients previously unheard-of fees — often based on the size of the tax savings they concocted for them.[20] They worked in cahoots with tax lawyers who wrote opinion letters to clients they had never met, sanctioning deals they knew full well were suspect. In the worst cases, the lawyers sanctioned deals that the IRS had already publicly challenged, insisting (presumably, with their tongues firmly in cheek) that there still was a ''realistic possibility'' that the taxpayer would prevail in litigating the position. Yeah, sure. Just to be safe, those same lawyers buried the transaction in mountains of obfuscation. To do so, they used tiered partnerships, grantor trusts, Cayman Island limited liability companies, and circular ''loans'' advanced by their coconspirator investment bankers.[21] Those paper mountains served no purpose other than to hide their handiwork from the prying eyes of the tax collectors, who, they assumed, were overworked and unlikely to audit the client's tax return in any event. That was and is the sorry state of the tax profession as practiced by too many of its members.[22]

Aside from attracting professionals to the field of dreams known as the corporate tax shelter industry, the

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Committee on Governmental Affairs, 108th Cong., 1st sess. (November 18 and 20, 2003). The report of this hearing can be found online at http://govt-aff.senate.gov/_files/sprt10834 tax_shelters.pdf. The fascinating and penetrating interrogation of various tax shelter promoters, accountants, investment bankers, and attorneys by the subcommittee's ranking minority member, Sen. Carl Levin, D-Mich., can be viewed online at http://govt-aff.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=133.

[18]This practice was enforced by KPMG's deputy chairman and chief operating officer, Jeffrey M. Stein. Previously Stein was the vice chairman of the firm's tax practice. In January 2004, he was forced to resign from the partnership along with Richard Rosenthal, KPMG's chief financial officer. Several amazing internal e-mails written by Stein extolling the virtues of KPMG's suspect tax shelters were discovered in litigation and subsequently made public. They can be found online at http://www.pbs.org/wgbh/pages/frontline/shows/tax/schemes/11.html.

[19]That little tidbit of information about shelter marketing was revealed in the complaint filed in the U.S. District Court in the Southern District of New York by a disgruntled investor who is suing his accountants at Ernst & Young, among others. *Henry Camferdam Jr., et al. v. Ernst & Young International Inc., Jenkens & Gilchrist, Sidley Austin Brown & Wood, L.L.P., Deutsche Bank AG, R.J. Ruble, Paul M. Daugerdas, et al.*, Case No. 02 Civ. 10100 (BSJ) (S.D.N.Y. Feb. 13, 2004).

[20]Don't be fooled by the whining of their ''duped'' clients, whom the IRS has audited and against whom the IRS has assessed taxes, interest, and penalties. *See infra* note 31. Sophisticated business people who realize huge capital gains that somehow magically disappear at the hands of their tax professionals in exchange for a wink, a nod, and a million-dollar fee are committing tax fraud, and they know it too.

(Footnote continued in next column.)

[21]*See* Report of the Minority Staff of the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals* (90-655 PDF) 108th Cong., 1st sess. (Washington, D.C.: Government Printing Office, 2003), at 5, 14. The report can be found online at: http://govt-aff.senate.gov/_files/sprt10834tax_shelters.pdf.

The use of a grantor trust to camouflage a tax shelter (by directly netting the artificial tax loss from the shelter with the very real taxable gain recognized on the sale of, say, a business or greatly appreciated stock) is particularly troubling, as it evidences a willful intent to avoid detection. For this reason, the Service announced that use of a grantor trust in conjunction with the so-called son-of-BOSS shelter (a shady reincarnation of the original Bond and Option Sales Strategy deal, itself a shelter transaction of questionable merit) would be treated as evidence of *criminal* fraud. *See* IRS Notice 2000-44, 2000-36 IRB 255, *Doc 2000-21236, 2000 TNT 157-7* (Sept. 5, 2000). University of Texas law professor Calvin Johnson has stated that the son-of-BOSS deal smacks of ''willful misrepresentation of the law.'' Quoted in John D. McKinnon, ''How New Tax Shelter Promised Big Savings but Finally Fell Apart,'' *The Wall Street Journal*, Aug. 21, 2000, at A1.

[22]To be sure, there are others out there who similarly aid and abet tax fraud, although invariably on a much lesser scale. Consider a selective few: Employers who conveniently fail to report on Form W-2 certain ''in-kind'' benefits enjoyed by their corporate executives — things like using the corporate jet for personal vacation — and charities that agree to inflated valuations for donated assets or act as facilitators in scams such as KPMG's SC2 tax shelter. It must be said that such acts of aiding and abetting are pretty petty, but because they are much more widespread than corporate tax shelters known by acronyms such as BLIPS and FLIP, they also contribute significantly to undermining the tax system. But in the end, corporate tax shelters that reduce a single taxpayer's tax liability by a hundred million dollars in one fell swoop present a more immediate and threatening challenge to the U.S. tax system. Thus, we leave scolding the ill-behaved negligent third parties for another day. *See* Jay A. Soled, ''Third-Party Civil Tax Penalties and Professional Standards,'' *Wisconsin Law Review*, forthcoming.

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fiery allure of money has retarded professional organizations from taking meaningful remedial action against their membership, whose behavior has been morally reprehensible — at least to the outside world. In particular, neither the American Bar Association nor the American Institute of Certified Public Accountants has been proactive in policing their respective memberships, shirking their responsibilities to stem the questionable ''tax-planning'' practices.[23] It would be particularly naive to believe that the members of those organizations would wholeheartedly approve of instituting standards that would change an environment in which law firms such as Sidley Austin Brown & Wood can ''earn'' the same $50,000 fee over and over for giving the same canned opinion letter to a hundred different clients (none of whom its lawyers ever apparently even met) and in which accounting firms such as KPMG, shilling as promoters, can ''earn'' an astounding $124 million in fees by establishing corporate tax shelters such as FLIP, BLIPS, OPIS, and SC2[24] — the acronyms of which, ironically, belie the lack of imagination and originality of their creators.

Were the root of the problem only money, perhaps the behavior of tax professionals could be reigned in.[25] The problem, however, is far more systemic. It arises out of serious defects in the code itself. For this reason, we next discuss the inadequacies of the penalty regime applicable to the parties who devise, organize, and market abusive tax shelters and the meek professional standards that are incapable of curbing this unethical behavior.

III. Inadequate Penalties and Meek Standards

The statutory framework for penalizing professionals and other third parties who assist taxpayers in reducing or eliminating their tax liabilities is weak and ineffective, particularly when compared with the penalty structure in place for taxpayers. That is because over the decades Congress and the IRS have been primarily concerned with *taxpayers* who behave badly and not felonious accountants, bankers, and lawyers. Thus, taxpayers who on audit are caught having their hands in the cookie jar suffer severe penalties; in contrast, the tax professionals who cooked up those schemes receive only a slap on the wrist, if that.[26] The current system is poorly designed and the tax authorities poorly equipped to deal with the more dangerous problem, namely tax professionals behaving badly.

Consider the fact that taxpayers who fail in the fulfillment of their reporting responsibilities are subject to a three-tier system of civil tax penalties under the code. The first tier applies automatically to taxpayers who do not file or pay their taxes in a timely fashion,[27] the second tier applies to taxpayers who are negligent in their reporting practices,[28] and the third tier applies to taxpayers who act fraudulently in their reporting practices.[29] The statutory provisions imposing those penalties are found in three separate code sections, and not unexpectedly the degree of penalty severity corresponds to the degree of taxpayer dereliction.[30] Taxpayers who buy dubious tax shelters must contend with those penalties. For those audited taxpayers whose malfeasance is detected, the results can be financially catastrophic because the original tax liability, interest, and the relevant penalties will be assessed.[31] That penalty system is coherent

[23]In testimony before the Senate Permanent Subcommittee on Investigations, Sen. Levin offered the following observation:

> The tax shelter industry of today is fundamentally different than it was a few years ago. Instead of individuals and corporations going to their accountant or lawyer and asking for tax advice, the engine driving the tax shelter industry today is the effort of a horde of tax advisors cooking up one complex scheme after another — so-called ''tax products'' that are unsolicited by any client — and then using elaborate marketing schemes to peddle these products across the country.

See ''Levin Discusses 'Tawdry Tale' of Tax Shelters at Senate Subcommittee Hearing,'' *Doc 2003-24794, 2003 TNT 223-19*.

[24]*U.S. Tax Shelter Industry*, *supra* note 21 at 26.

[25]*See, e.g.*, Ben Wang, ''Supplying the Tax Shelter Industry: Contingent Fee Compensation for Accountants Spurs Production,'' 76 *S. Cal. L. Rev.* 1237 (2003) (proposing that tax professionals be limited in the fees they may charge for tax shelter participation).

[26]Interestingly, tax shelter promoters like R.J. Ruble of Wood & Brown and Paul Daugerdas of Jenkens & Gilchrist, who helped hatch several large-scale suspect tax shelters, are denounced as ''rogue'' partners by their colleagues *after* they are publicly exposed, but were hailed as ''rainmakers'' *before* they got caught. Ruble alone brought in some $23 million in fees from his 300-plus opinion letters written for just three shelter deals sold to clients of the accounting firm KPMG. That was just a portion of his shelter work from which his partnership benefited financially. *See* Kara Scannell, ''How Lawyers Helped to Drive the Boom in Tax Shelters,'' *The Wall Street Journal*, Aug. 18, 2004, at A1.

[27]Section 6651(a).

[28]Section 6662(a).

[29]Section 6663(a).

[30]A 0.5 percent per-month penalty (up to a 25 percent maximum) applies for delinquent payment (section 6651(a)(2)), a 5 percent per-month penalty (up to a 25 percent maximum) applies for delinquent filing (section 6651(a)(1)), a 20 percent penalty applies to the portion of the underpayment arising due to the taxpayer's negligence (section 6662(a)), and a 75 percent penalty applies to the portion of the underpayment arising because of the taxpayer's fraud (section 6663(a)).

[31]Consider the case of taxpayer Henry Camferdam and his three business partners, who were some of the 600 or so investors who bought into the COBRA shelter. This corporate tax shelter was concocted by Jenkens & Gilchrist attorney Paul Daugerdas and marketed by Ernst & Young LLP and BDO Seidman. Camferdam and his three partners paid over $6 million in fees to promoters and third-party professionals to save $14 million in taxes for tax year 1999. Following an audit, the IRS assessed Camferdam and his partners with a total of $11 million in penalties and interest on top of the $14 million of tax now due. The frustrated clients turned around and sued their professional advisers for $75 million in damages under the treble damages provisions of RICO (treble the $25 million in actual damages), $1 billion in punitive damages, plus attorney fees and costs. Ouch! A detailed discussion of the case is found in Paul Braverman, ''Helter Shelter,'' *Am. Law.*, Dec. 2003, at 65; *see also* Sheryl Stratton, ''Clients Sue E&Y and Three Law Firms Over Tax Shelter,'' *Tax Notes*, Dec. 30, 2002, p. 1649. Jenkens & Gilchrist has since agreed to pay $75 million to settle civil claims

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and fairly effective in dealing with recusant taxpayers — assuming sufficient resources are provided the tax authorities to administer and enforce those penalties.[32]

The same coherence and effectiveness of the penalty regime imposed on taxpayers eludes the structure of the third-party civil tax penalty regime. The civil tax penalties applicable to third parties who aid and assist other taxpayers are ill-conceived, inequitable, and difficult to comprehend.[33] Most third parties and tax professionals know this and generally tend to view third-party civil tax penalties with complete disregard or mere token consideration. Were the penalties better structured, more equitable, easier to understand, and, particularly, regularly enforced, clearly the popularity of corporate tax shelters would be much more muted. In other words, right now the guard dog protecting the chicken coop has no teeth and has lost his glasses — and the foxes out there know this.

> ***Were the root of the problem only money, perhaps the behavior of tax professionals could be reigned in. The problem, however, is far more systemic. It arises out of serious defects in the code itself.***

As a backstop to the third-party civil tax penalty structure, professional organizations such as the ABA and the AICPA are supposed to police their memberships. Each organization, as well as the Treasury Department, has instituted professional standards designed to dissuade lawyers and accountants from engaging in overaggressive tax planning. Yet again, as evidenced by the burgeoning growth of the corporate tax shelter industry, the effectiveness of those standards (and their lack of enforcement) must be called in to question.

The next two sections of this analysis suggests that professionals act unethically precisely because they can. Neither the code's penalty provisions nor attorney and accountant professional standards provide a downside risk of doing so.

A. Third-Party Civil Tax Penalties

Third-party civil tax penalties are of relatively recent vintage. In 1976 Congress first instituted those penalties in response to the onslaught of tax shelter activities and the numerous reports that tax return preparers often played a vital role in the underreporting practices of taxpayers.[34] Before the institution of these civil penalties, the IRS's only recourse was to bring criminal action against tax return preparers and other abettors.[35] That weapon is just too big and powerful to be used against petty violators, and practitioners know it. And although criminal sanctions may actually be brought in the most egregious cases,[36] the threat of criminal prosecution cannot be an effective deterrent in the typical case.

Over the last two and one-half decades, third-party civil tax penalties continued to evolve and expand. For example, in 1982 Congress extended the application of these penalties to provide a civil penalty for aiding and abetting the understatement of tax.[37] Notwithstanding those advancements, there were (and continue to be) pitifully few cases in which the IRS has invoked these third-party civil tax penalties and even fewer in which the IRS has prevailed when the matter has been litigated.[38]

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brought by investors who were challenged by the IRS. *See* Casell Bryan-Low, ''Jenkens & Gilchrist Agrees to Pay $75 Million in Tax-Shelter Case,'' *The Wall Street Journal*, Mar. 8, 2004, at C3.

[32]After all, it is not just the *magnitude* of the penalty that is important in deterring tax scofflaws; the *probability* of detection and enforcement of the penalty is also an important component in the compliance equation. A $1,000 penalty that applies to an act that has a very high likelihood of detection and enforcement may be a more effective deterrent than a $1 million penalty that is almost never imposed. Of course, sometimes a $1 million penalty (coupled with the threat of disbarment) is the only thing that may get the attention of would-be violators, especially if they can rake in hundreds of millions in fees for violating the rules.

[33]The penalty structure classifies third parties first by the role they play in the tax system (for example, information return provider, tax return preparer, tax shelter promoter) and second by the acts perpetrated within that role (for example, inadvertence, negligence, and fraud). That approach results in inconsistent outcomes between and among third parties whose malfeasance is similar but whose punishments are not. The severity of these penalties, too, does not appear correlated to the third party's dereliction of responsibilities. That makes the structure of third-party civil tax penalties fundamentally unfair. Finally, third-party civil tax penalties are haphazardly strewed throughout the code; that lack of organization makes comprehensibility a virtual impossibility.

[34]*See* Tax Reform Act of 1976, H.R. REP. NO. 658 (1976), *reprinted in* 1976 *U.S.C.C.A.N.* 3169-78; Tax Reform Act of 1976, S. REP. NO. 938, pt. 1, at 355 (1976), *reprinted in* 1976 *U.S.C.C.A.N.* 3778-89.

[35]Staff of Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1976*, 345-47 (1976), 1976-3 C.B. (vol. 2) 1, 357-358.

[36]In some of the worst cases, the government has pursued fraud charges — for example, with respect to the tax shelter activities of attorney Paul Daugerdas of Jenkens & Gilchrist. Furthermore, in such cases where there is fraud, the attorney-client privilege will not apply. This position was asserted against Jenkens & Gilchrist by the Justice Department in a February 26, 2004, memorandum. *See* Kenneth A. Gary, ''Gov't Raises Fraud Issue in Jenkens & Gilchrist Shelter Suit,'' *Tax Notes*, March 15, 2004, p. 1328. There are several confirmed criminal investigations into the tax shelter activities of several partners of KPMG and the Presidio Advisory Services firm. *See* Sheryl Stratton, ''KPMG's Criminal Probe Could Affect Civil Proceedings,'' *Tax Notes*, March 1, 2004, p. 1062.

[37]Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, section 320(a), 96 Stat. 324.

[38]Some commentators may assert that the anemic use of these penalties signifies the general honesty that exists among those who participate in the tax return preparation process. The more cynical and realistic view is that these penalties are ill-designed for the task at hand. Of course, the fact that the penalties are so minor may explain why they are so seldom litigated by taxpayers in those rare cases in which they are actually invoked by the IRS. It's cheaper to just pay the fine rather than fight City Hall.

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Under the code, there are several categories of third-party civil tax penalties. Those pertinent to this discussion include tax shelter promoter and abetter penalties,[39] as well as the requirements (and associated penalties) imposed on tax shelter promoters and investors regarding keeping investor lists, registering tax shelter products, and disclosure of tax shelter transactions on tax returns. Those code provisions are described below, followed by an analysis and critique of their effectiveness in curbing overaggressive tax shelter activity.

1. Tax shelter promoter and abetter penalties. The broadest category of third-party civil tax penalties is the one that applies to tax shelter promoters and those persons who aid and abet others in the understatement of their tax liability. The two operative code provisions that relate to promoter and abettor penalties are sections 6700 and 6701, respectively.

The penalty set forth under section 6700 applies to those persons who promote ''abusive'' tax shelters.[40] For that penalty to apply, a person must (a) organize, assist in the organization, or participate in the sale of a tax shelter (that is, some sort of entity, plan, or arrangement), and (b) in connection therewith, make or supply a statement regarding the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the tax shelter that the person knows or has reason to know (i) is false or fraudulent as to any material matter or (ii) is a gross valuation overstatement (that is, exceeds 200 percent of fair market value) as to any material matter.[41] Although the statute is written in a highly technical fashion, a cursory reading manifests its intent: to penalize those persons who arrange schemes or gimmicks that have little or no economic utility aside from the tax benefits they generate — in short, the typical tax shelter.[42]

The penalty set forth under section 6701 applies to those persons who knowingly abet others in the understatement of their taxes. It, too, is written in a highly technical fashion. For that penalty to apply, a person must (a) aid or assist in, procure, or advise regarding the preparation or presentation of any portion of a return, affidavit, claim, or other document, (b) know (or have reason to believe) that that portion will be used in connection with any material matter arising under the Internal Revenue laws, and (c) know that such portion (if so used) would result in an understatement of the liability for tax of another person.[43] Like section 6700, this provision is designed to penalize only those persons who knowingly and intentionally help others in the understatement of their taxes.[44]

> ***The statutory framework for penalizing professionals and other third parties who assist taxpayers in reducing or eliminating their tax liabilities is weak and ineffective.***

Sections 6700 and 6701 arguably are designed to apply only to those individuals who aggressively, repeatedly, and intentionally help other taxpayers bilk the tax system. One look at the penalty structure for each of those provisions confirms this conclusion. In the case of section 6700, the penalty is $1,000 for each tax shelter interest sold.[45] In the case of section 6701, the penalty is $1,000 applicable to each act of abetting.[46] Evident from the penalty structure of each code section are two things: On one hand, a rather insignificant penalty — and one the IRS is not likely to pursue — applies to those who only on occasion cause others to abuse the tax system; on the other hand, a larger but still modest penalty might apply if someone knowingly and intentionally promotes a lot of tax shelters or abets a lot of taxpayers.[47] Only direct and

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[39]For a more complete discussion of tax return and information return preparer penalties, see Jay A. Soled, ''Third-Party Civil Tax Penalties and Professional Standards,'' *Wisconsin Law Review*, forthcoming.

[40]*United States v. Jack Cohen*, __ 93 AFTR 2d 2004-2586 __ ; 2004 U.S. Dist. LEXIS 11627, *Doc 2004-12438, 2004 TNT 118-17* (Case No. CV 04-0332 P) (D.C.W.A. 2004) is a recent and representative section 6700 case. In it the government brought an injunctive action against a taxpayer for marketing (a) a kit for employees who wished to stop the withholding process, (b) custom letters to reverse the presumption that U.S. citizens are ''taxpayers'' under the code, (c) Form W-2 and Form 1099 rebuttals that disclaimed the validity of these forms, and (d) a tax-collecting challenge to employers threatening to sue them unless they provided proof of their authority to withhold and demanding they cease and desist absent this proof.

[41]*See generally* section 6700.

[42]For a definition of a tax shelter, see section 6662(d)(2)(C)(iii) (''The term 'tax shelter' means (I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, in which a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.''). The code offers two other definitions of the meaning of the term tax shelter. *See* sections 461(i)(3), 6111(c).

Prof. Michael Graetz once defined a tax shelter as ''a deal done by very smart people that, absent tax considerations,

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would be very stupid.'' *See* Tom Herman, ''Tax Report,'' *The Wall Street Journal*, Feb. 10, 1999, at A1. David Hariton takes issue with this definition, instead positing that a tax shelter ''is a deal done by very smart people who are pretending to be rather stupid themselves for financial gain.'' David P. Hariton, ''Response to Old Brine in New Bottles (New Brine in Old Bottles),'' 55 *Tax L. Rev*. 397, 398 (2002).

[43]*See generally* section 6701.

[44]As articulated by one district court, for this penalty to apply, advisers must be aware not only of the facts, but also of the ultimate result of their conduct. *Sansom v. United States*, 703 F. Supp. 1505 (N.D. Fla. 1988).

[45]The penalty may be less if the promoter can show that the amount of the gross income the promoter derived by the promotion of the activity is less than the dollar penalty expressed under the statute. Section 6700(a). In the case of abusive tax shelter promotion, the IRS can take steps to enjoin the promoter from further activity. Section 7408(a).

[46]Section 6701(b)(1). The penalty is increased to $10,000 when the assisted taxpayer is a corporate entity. Section 6701(b)(2).

[47]*See In Re Tax Refund Litigation*, 989 F.2d 1290, *Doc 93-4511, 93 TNT 81-21* (2d Cir. 1993) (plaintiffs were liable for section

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repeated attempts to help others avoid taxes are subject to the full panoply of congressional "wrath" — an obvious exaggeration considering the inadequacy of the penalty system.

2. Tax shelter registration, investor lists, and reportable transactions. To deter aggressive tax shelter promoters, as well as investors who would buy into their schemes, over the years Congress and the Treasury Department have instituted a number of rules and requirements that apply to the sale of some tax shelter products. Those allow the IRS to better track the activity of tax shelter promoters and trace the tax shelters to the taxpayers who invest in them. Also, new regulations require taxpayers to openly disclose certain of their tax shelter investments on their tax returns.

a. Tax shelter registration. In 1984 Congress took the first significant step to monitor tax shelter activity. It passed legislation, embodied in section 6111, that requires tax shelter organizers to register their tax shelter products with the Secretary of the Treasury Department. This registration requirement extends to any "potentially abusive tax shelter," as well as any "entity, plan, arrangement or transaction" if:

1. a significant purpose of such is the avoidance or evasion of the federal income tax of a corporation;
2. the transaction is offered under "conditions of confidentiality"; and
3. the promoters receive fees in excess of $100,000.[48]

The scope of this broad definition for purposes of registration is capable of encompassing most tax shelter deals. Accordingly, promoters are required to register most of their tax shelter products. In theory, this gives the IRS important data on the nature and structure of those tax shelters being sold to investors, as well as the names of the promoters who are selling them. Registration is an important tool for monitoring tax shelter activity, although there always is the danger that some promoters will fail to register their products or that the IRS will accumulate too much data to be able to effectively monitor the activities of promoters.

b. Investor lists. In 1984 Congress also enacted a new statutory requirement, found in section 6112, that those who promote or sell any "potentially abusive tax shelter"[49] must maintain "a list identifying each person who was sold an interest in such shelter and containing such other information as the Secretary may by regulations require."[50] That requirement imposed on promoters to keep such "investor lists" also applies in cases of transactions which are identified as "potentially abusive" by the Service in public notices and thereafter enumerated in Treasury regulations.[51] Each year this list gets longer and longer as a wide range of abusive transactions are added. In tax parlance, these suspect transactions are now referred to as *listed transactions*. These now include BLIPS, OPIS, COBRA, BOSS, and various other suspect tax shelters that have been marketed by tax shelter promoters over the years.[52] All of those listed transactions are also required to be registered by their promoters, but as is discussed further below, that has not always been the case. Likewise, promoters have not always kept the required investor lists.

c. Reportable transactions. In 2003 the Treasury Department further expanded the scope of government monitoring of the tax shelter industry and taxpayer investment in tax shelters. While the registration and investor list requirements apply to *promoters*, new regulations were issued in February 2003 requiring that *taxpayers* disclose their tax shelter activities directly on their tax returns. Treasury issued those new disclosure regulations under the authority of section 6011, which generally authorizes the Secretary of the Treasury to prescribe what information must be disclosed to the government on tax returns.[53] Strictly speaking, those regulations apply only to those taxpayers who invest in shelter transactions, requiring disclosure of the taxpayer's participation in any "reportable transaction."[54] Reportable transactions include, most prominently, the aforementioned "listed transactions," as well as several other transactions that possess characteristics common to tax shelter investments.[55] Collectively, those are known in

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6700(a) penalties because properties leased by limited partnerships that plaintiffs promoted were grossly overvalued: the structure of transaction and IRS appraisals showed a lack of arm's-length negotiations, and the fair market value was less than half the declared value); TAM 200243057, *Doc 2002-24037, 2002 TNT 210-28* (the president of a tax-exempt organization could be held liable for a section 6701(a) penalty when he repeatedly gave taxpayers false appraisals regarding the values of their donated cars).

[48]Section 6111(d), as amended in 1997.

[49]"Potentially abusive tax shelter" disclosure is defined in section 6112 by cross-reference to the definition found in section 6111 (the registration requirement).

[50]Section 6112(a)(2).

[51]Treas. reg. section 1.6011-4(b)(2) and Treas. reg. sections 301.6111-2(b)(2), 301.6112-1(b)(2).

[52]The list includes the most abusive shelters and, as such, those most costly to the U.S. Treasury. As of September 30, 2003, the IRS's Office of Tax Shelter Analysis (OTSA) database estimated potential tax losses of $33 billion from investments in listed transactions over the past decade. General Accounting Office, *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters*, GAO-04-104T (Oct. 21, 2003), *Doc 2003-22843, 2003 TNT 204-31* at 10.

[53]Section 6011(a): "When required by regulations prescribed by the Secretary any person made liable for any tax imposed by this title, or with respect to the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary. Every person required to make a return or statement shall include therein the information required by such forms or regulations."

[54]The new rules require taxpayers to disclose their participation in any "reportable transaction" on new Form 8886 (Reportable Transaction Disclosure Statement). The form must be filed with the taxpayer's federal income tax return each year that the taxpayer participates in a reportable transaction. Also, a copy of Form 8886 must be sent to the Office of Tax Shelter Analysis.

[55]The six categories of reportable transactions are (i) listed transactions; (ii) certain confidential transactions; (iii) transactions with contractual protection in the event that intended tax

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tax parlance as *reportable transactions*. Most important, taxpayers must disclose not only their own participation in a reportable transaction, but they also must provide the tax shelter registration number (if there is one) and the names and involvement of *all* other ''participants in the transactions'' — which includes other investors, as well as the promoter and any financial institution that played a role in the transaction. Therefore, while technically the disclosure requirement is imposed on the taxpayer/investor, it also provides the IRS with a mechanism for tracking (and hence, restraining) promoter activity.

The combined requirements of registration, investor lists, and disclosure of tax shelter investments were intended to provide the Service with an effective tool for deterring shelter activity. That is accomplished by requiring promoters and taxpayers to publicly reveal their deals and their investments in them. Of course, the system works only if tax shelter promoters actually register their products and keep their investor lists, which depends on them conceding that the particular deal that they are promoting is a reportable transaction or ''substantially similar'' to one of those listed as a potentially abusive tax shelter. To justify their failure to register or to keep an investor list, promoters have simply argued that their transactions do not meet the conditions of being reportable because their particular tax shelter is somehow different than those listed by the Service.[56] Furthermore, in those rare cases when they are caught red-handed, promoters have refused to turn over the lists or any information about their clients on the grounds that they are protected by the attorney-client privilege.[57]

3. Penalties for failure to register or maintain investor lists. Having provided this brief summary of the statutory and regulatory framework for the government's monitoring of tax shelter activity, the next question is: What happens if tax shelter promoters are derelict in their duties, failing to register their tax shelters or maintain investor lists? (The requirement for taxpayer disclosure is too new to adequately assess its effectiveness; only time will tell if taxpayers comply with this reporting requirement.) Given the obvious importance Congress attaches to these provisions, you would think that a failure to adhere to these code requirements would be fairly Draconian. Think again. Those who make frontal assaults on the code's integrity are subject to two other abettor tax penalties, neither of which is very significant.

The first penalty is imposed on tax shelter promoters who create and market ''tax shelters''[58] and either do not register them with the IRS or file a false or incomplete registration statement.[59] The penalty is equal to the greater of $500 or 1 percent of the aggregate amount invested in the tax shelter.[60] The second penalty targets

consequences are not met, or contingent fees; (iv) certain loss transactions; (v) transactions with a significant ($10 million or more) book-tax difference; and (vi) transactions with a brief asset holding period that generate significant tax credits. *See generally* Treas. reg. section 1.6011-4T.

[56]*U.S. Tax Shelter Industry*, *supra* note 21 at 91-93.

[57]The latter claim of privilege has been asserted and litigated by several accounting firms (KPMG, BDO Seidman, and at least initially by Ernst & Young and PricewaterhouseCoopers) and a few major law firms (such as Jenkens & Gilchrist and Sidley Austin Brown & Wood). *See* Ameet Sachdev, ''Abusive Shelters Targeted by IRS: Accounting, Law Firms Fight Release of Clients' Names,'' *Chicago Tribune*, Oct. 26, 2003, at 1. On the whole, the courts have flatly rejected such claims. The U.S. District Court for the Northern District of Illinois ordered Jenkens & Gilchrist to disclose client identities and produce client files in response to John Doe summonses issued by the IRS in its tax shelter investigation. *United States v. Jenkens & Gilchrist P.C.*, No. 03C5693, *Doc 2004-10679, 2004 TNT 97-24* (N.D. Ill. Apr. 20, 2004). The court's order followed a similar order issued by Judge Matthew F. Kennelly of the same court in a John Doe summons enforcement proceeding against Sidley Austin Brown & Wood. In May 2004, the federal district court for the District of Columbia rejected accountant-client privilege claims asserted by KPMG in a summons issued against that firm. In that action, the district court relied on *United States v. BDO Seidman*, 337 F.3d 802, *Doc 2003-17278, 2003 TNT 142-14* (7th Cir. 2003) (Seventh Circuit denied assertion of privilege by BDO Seidman's clients against the IRS).

So eventually the Service can get what it wants — a list of those taxpayers who have bought the suspect products and

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undoubtedly claimed dubious tax deductions on their returns. Once the Service has this information, it finally has a road map for enforcement, giving it the upper hand against the taxpayer who has been promised confidentiality by his local neighborhood tax shelter salesman. In the case of the abusive (and arguably fraudulent) ''son of BOSS'' transaction, the Service offered a rather lenient settlement offer to those taxpayers who entered into the transaction (back taxes, interest, and a 10 percent to 20 percent penalty). By the June 21, 2004, deadline for accepting the offer, some 1,500 taxpayers came forward. More than 300 of these were previously unknown to the IRS. Of course, there are an estimated 3,000 to 5,000 other taxpayers who bought into the shelter and did not come forward. They must be assuming that their names do not appear on any other promoter's investor list. *See* John D. McKinnon and Rob Wells, ''In Son of 'Boss' Tax-Shelter Case, 1,500 Set Deals,'' *The Wall Street Journal*, July 2, 2004, at A4.

Even when investor lists are missing, the Service has been getting the names of customers who bought into shelter deals by using its administrative summons. So far, 313 administrative summonses have been issued in thirty-seven promoter cases. Of these, 98 have been referred to the U.S. Department of Justice for enforcement. Amy Hamilton, ''IRS to Serve More Summonses, Updates Shelter Stats,'' *Tax Notes*, November 3, 2003, p. 567.

[58]*See generally* section 6111(c)(1). Under Treas. reg. section 301.6111-1T Q&A 4, an investment is a tax shelter if: ''(I) the investment must be one with respect to which a person could reasonably infer, from representations made or to be made in connection with any offer for sale of any interest in the investment, that the tax shelter ratio for any investor may be greater than 2 to 1 as of the close of any of the first 5 years ending after the date on which the investment is offered for sale [and] (II) the investment must be (i) required to be registered under a federal or state law regulating securities, (ii) sold pursuant to an exemption from [such] registration . . . or (iii) a substantial investment.''

[59]These registration requirements are detailed in section 6111 and the regulations promulgated thereunder.

[60]Section 6707(a)(1), (2). In instances in which the failure to provide information pertains to a confidential arrangement that is treated as a tax shelter under section 6111(d), the penalty is equal to the greater of $10,000 or 50 percent of the fees paid to all promoters of the tax shelter regarding the offerings made

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promoters who do not maintain investor lists.[61] The penalty amount is $50 for each such failure.[62] For most tax shelter promoters racking up millions of dollars in fees, these penalties are little more than pocket change.

4. Critique of third-party civil tax penalties. It is apparent that the third-party penalty regime as now constituted and enforced is inadequate to deter the marketing of abusive tax shelters. Indeed, there is considerable evidence that promoters have intentionally ignored the penalties, treating them as a minor cost of doing business.

> ***Right now the guard dog protecting the chicken coop has no teeth and has lost his glasses — and the foxes out there know this.***

The evident disrespect practitioners harbor towards third-party penalties is epitomized in a May 1998 internal e-mail memorandum written and circulated by KPMG partner Gregg Richie and thereafter made public during the hearings conducted by the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs in November 2003. In the e-mail memorandum, Richie compared the cost of failing to comply with the registration requirements of section 6111 (and the penalties imposed under section 6707) with the vast revenue to be made peddling one of the firm's bogus tax ''products'' — the OPIS shelter.

> Based on our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than $14,000 per $100,000 in KPMG fees. . . . For example, our average [OPIS] deal would result in KPMG fees of $360,000 with a maximum penalty exposure of only $31,000.[63]

Based on that analysis, Richie recommended that ''KPMG should make the business/strategic decision not to register the OPIS product as a tax shelter.'' In reaching that ''business/strategic'' decision, Richie noted the ''immediate negative impact on the firm's strategic initiative to develop a sustainable tax products practice and the long-term implications of establishing a precedent in registering such a product.''[64] In other words, it would set bad precedent for KPMG to comply with the code's legal requirements.

OPIS was not the only tax product that KPMG intentionally failed to register. The firm did not register any of its more than 500 tax products, the despite repeated warnings by its own tax professionals that registration was required. That kind of willful disregard of express legal requirements appears to be the industry norm regarding tax shelter registration. Indeed, Richie's 1998 e-mail memorandum suggested that KPMG would be at a competitive disadvantage were it to register its shelters because no one else was registering theirs. In a sense, KPMG's deliberate failure to register its shelters was a rational decision given the vast sums collected by the firm from marketing OPIS, FLIP, BLIPS, and SC2 — a reported $124 million over five years.[65] Of course, Richie's cost-benefit analysis not only erroneously assumed that the failure to register would remain unknown to the IRS, but it failed to take into account that the firm's actions would be the subject of a congressional investigation televised live by CSPAN — foresight that certainly would have changed the cost-benefit analysis.

As far as penalties go, Congress has only recently recognized that special attention is required to control the promoters who sell the abusive tax shelters. Until now, professionals who have assisted others in evading their taxes have been virtually given a free pass, with the bulk of attention and enforcement efforts directed at those taxpayers who are caught red-handed. Despite the new attention given by Congress to tax shelter promoters, abuse remains rampant, and the IRS still has only insignificant punitive arrows in its quiver to wage battle against those professionals who behave unethically.

B. Professional Standards

Aside from the code's statutory sanctions against third-party abettors, the ABA, the AICPA, and the Treasury Department have each issued standards of practice applicable to attorneys, certified public accountants, and tax practitioners (for example, enrolled agents). Those standards of practice apply to, and often are violated by, those involved in tax shelter activities.

For attorneys, those standards of practice are found in the *Model Code of Professional Responsibility* and the *Model Rules of Professional Conduct*.[66] To be operative, those standards first must be adopted by the licensing authority of a particular state.[67] Once adopted, attorneys who practice in that state and who fail to adhere to those rules can face disciplinary action, including the loss or suspension of their license to practice law.[68] At least that is true in theory. In practice, there have been no reported cases of a lawyer facing disciplinary action, suspension, or disbarment under a state code of professional conduct for writing an overaggressive opinion letter in a tax shelter deal.[69]

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before the date that shelter is registered under section 6111. Section 6707(a)(3)(A). In the case of intentional failures or acts, the penalty percentage increases to 75 percent of the promoter's fees. *Id*.

[61]Section 6708(a).

[62]*Id*.

[63]*U.S. Tax Shelter Industry*, *supra* note 21 at 26.

[64]*Id*.

[65]*See U.S. Tax Shelter Industry, supra* note 21 at 3.

[66]Bernard Wolfman, James L. Holden, and Kenneth L. Harris, *Standards of Tax Practice,* section 103 (6th ed. 2004).

[67]*Id*. section 103.2.1.

[68]*Model Code of Prof'l Responsibility* DR 1-102 (1969); *Model Rules of Prof'l Conduct* R. 8.4 (1983).

[69]Paul Daugerdas (the partner expelled by Jenkens & Gilchrist for his involvement in the COBRA deal) and R.J. Ruble (formerly of Sidley Austin Brown & Wood) may be the first lawyers to be disbarred for their involvement in over-aggressive tax shelter deals — as opposed to those more mundane cases wherein attorneys and accountants are sanctioned for committing outright tax fraud and/or failing to file their own tax returns, or encouraging clients not to file theirs, etc. Given the

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For CPAs, standards of practice are found in the *AICPA Code of Professional Conduct* and the *AICPA Statements on Responsibilities in Tax Practice*.[70] Although those rules set a national standard, they are generally enforced by the state's licensing boards of the individual states.[71] Thus, CPAs who fail to adhere to those rules may lose their AICPA membership and their state license.[72] Again, that is in theory. The authors have not uncovered a single case of an accountant facing the loss of his AICPA membership or state license for work performed in connection with tax shelter activities.[73]

Because of the tremendous stake the Treasury Department has in the proper resolution and administration of tax matters, it also has issued standards for those who wish to practice before the IRS. Those rules, promulgated in the form of regulations, are found in what is commonly referred to as *Circular 230*.[74] Among other things, those rules address "(1) eligibility to practice before the IRS; (2) duties and restrictions relating to such practice; and (3) rules applicable to disciplinary proceedings for violation of the regulations."[75] Violations of *Circular 230* can result in suspension or disbarment before the IRS.[76] Once again, that is in theory. As far as the authors have been able to ascertain, no practitioner has ever been suspended or disbarred by the IRS's new Office of Professional Responsibility or its precursor (the Office of the Director of Practice) for a breach of the duties imposed by *Circular 230* regarding tax shelter activities.[77]

Regarding tax practice, the American Bar Assocation, the AICPA, and the Treasury Department have each issued their own standards of professional conduct, found respectively in *Opinion 85-352*, *AICPA Statement on Responsibilities in Tax Practice No. 1*, and *Circular 230*. Despite essentially semantic differences, each standard is virtually identical — namely that a professional should only be a proponent of those taxpayers' positions in which there is *some realistic possibility of success if the matter is litigated*.[78]

While there is no clear articulation of exactly what that standard means, the ABA, the AICPA, and the Treasury Department have each offered guidance. A special ABA task force, for example, attempted to quantify the degree of success necessary to meet that standard. It issued a report stating that a "position with a 5-to-10 percent likelihood of success fails to meet the standard, while a position with a likelihood of success approaching one-third should satisfy the standard."[79] In contrast to the ABA, the AICPA did not believe that standard could be numerically expressed; instead, in an interpretative statement, the AICPA provided a series of fifteen illustrations describing the application of the realistic possibility standard in a variety of situations.[80] Finally, the Treasury Department, essentially following the lead of the ABA, stated that the standard would be met only if a taxpayer's position had a 1 in 3 or greater likelihood of being sustained on the merits.[81]

Far from clear is how much guidance those numerical expressions and illustrations offer third-party practitioners in the operation of their tax practices. Combine this with the vast quilt-work of legal holdings and dicta issued by the Tax Court, the Court of Federal Claims, district courts, appeals courts, federal circuit courts, and the Supreme Court, as well as the administrative guidance issued by the IRS and Treasury, and the result is fertile ground for dubious tax positions. Tax practitioners can find some support for virtually whatever position they advance on behalf of their clients. Will this "support" be enough to meet the realistic-possibility-of-success standard? In many cases it will suffice. That is true even though the taxpayer's position is without merit (for example, having a mere 33.3 percent chance of success if the position were litigated), unless the proffered position is entirely frivolous in nature (for example, having only a 10 percent chance of success if the position were litigated).

There are tougher standards available in lieu of the realistic-possibility-of-success standard. Regarding the issuance of tax shelter opinions, the Treasury Department has voiced a strong preference that practitioners reach a

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long-standing laissez-faire attitude of the professional associations, we are not overly optimistic; however, we can always hope for miracles.

[70]Wolfman, *et al., supra* note 66, section 104.

[71]*Id*.

[72]*Id*.

[73]While it is difficult to verify with certainty, there appears to be no case on record of an accountant having a license revoked by a state board of accountancy or membership in the AICPA terminated following a disciplinary action due to the accountant's involvement in either the creation or promotion of an over-aggressive tax shelter transaction.

[74]31 U.S.C. sections 10.0-10.97.

[75]Wolfman, *et al., supra* note 66, section 105.1.

[76]*Id*. section 105.1.5.

[77]The Office of Professional Responsibility investigates allegations of misconduct or negligence against tax practitioners and enforces the standards of practice for those who represent taxpayers before the IRS, as detailed in *Circular 230*. The office also licenses "enrolled agents," who are tax professionals meeting certain testing or experience requirements. While there are no reported cases of a practitioner having his or her license to practice before the IRS suspended or revoked on account of giving over-aggressive tax shelter opinions, there is no shortage of cases involving disciplinary action taken against practitioners for committing tax fraud or evasion. *See, e.g.*, IR-2004-93, *Doc 2004-14362*, *2004 TNT 135-12* (July 13, 2004). (Treasury denies appeal of CPA who was disbarred from practice before IRS by administrative judge in a case brought by IRS Office of Professional Responsibility alleging that CPA failed to file own tax returns from 1999-2003 and counseled clients that they had no legal obligation themselves to file tax returns.)

[78]*See* Loren D. Prescott Jr., "Challenging the Adversarial Approach to Taxpayer Representation," 30 *Loy. L. Rev*. 693, 720-722 (1997) (describing the "realistic probability standard").

[79]*See* Paul J. Sax, James P. Holden, Theodore Tannenwald Jr., David E. Watts, and Bernard Wolfman, "ABA Special Task Force Report on Formal Opinion 85-352," reprinted in 39 *Tax Law*. 631, 638-639 (1986).

[80]Wolfman, *et al., supra* note 66, section 204.3.2.

[81]Treasury Department *Circular No. 230* (rev. 7-2002), section 10.34(a)(4)(i).

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degree of certainty that is *more likely than not*.[82] That tougher standard requires that the practitioner make a determination regarding each material tax issue that there is a greater-than-50 percent likelihood that it would be upheld if challenged by the IRS.[83] (This more-likely-than-not standard already applies to the accuracy-related penalty under section 6662 where taxpayers take an aggressive reporting position regarding a tax shelter, resulting in a ''substantial underpayment'' of taxes.[84]) Despite the strength and clarity that standard offers, members of the ABA rejected its adoption, asserting that adherence to that standard would undermine the client advocacy role its members were supposed to play.[85] For now, the more-likely-than-not standard remains merely aspirational in nature.

It is apparent that the third-party penalty regime is inadequate. There is considerable evidence that promoters have intentionally ignored the penalties, treating them as a minor cost of doing business.

As far as moral compasses are concerned, those minimal professional standards do not point clearly in the direction of a sacred ethical high ground. Indeed, they allow practitioners tremendous leeway to advance questionable and aggressive positions on behalf of taxpayers. Because the IRS audits fewer than 1 percent of all tax returns,[86] success reigns by default for virtually all taxpayers who, at the prodding of their tax advisers, champion those dubious positions.

IV. Prospects for Hope?

During the spring of 2004, Congress moved to repeal the extraterritorial income provisions of the code that the World Trade Organization previously held to be a prohibited export subsidy. Both the House and the Senate finally passed bills to do just that, but both bills also include numerous other tax provisions. Among the latter are several welcome provisions that would amend existing requirements and penalties that apply to taxpayers, their professional advisers, and third parties who organize and promote tax shelters.

The Senate first passed its version of the bill, S. 1635 (Jumpstart Our Business Strength (JOBS) Act), on May 11; the House passed its own, H.R. 4520 (American Jobs Creation Act of 2004), on June 17.[87] Although S. 1635 includes important and critical proposals and harbors a more aggressive stance against tax shelters than H.R. 4520, it is our expectation that the proposals included in the House bill will serve as the basis of future discussions among the conferees.[88] Furthermore, only the anti-tax-shelter proposals included in H.R. 4520 were initially scored and summarized by the Joint Committee on Taxation.[89] Accordingly, we take them as the starting point for our discussion and analysis.

H.R. 4520 includes a number of provisions that would impose new obligations and penalties on taxpayers and their advisers regarding tax shelter investments. Currently, for example, there is no specific penalty applicable to taxpayers for the failure to disclose a reportable transaction under current law.[90] H.R. 4520 provides for a

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[82]ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (''Tax Law Opinions in Tax Shelter Investment Offerings'') (1982); *Circular* 230, section 10.35; *see generally* William A. Falik, ''Standards for Providing Tax Opinions in Tax Shelter Offerings,'' 37 *Tax Law*. 701 (1984); note, ''Redefining the Attorney's Role in Abusive Tax Shelters,'' 37 *Stan. L. Rev*. 889 (1985); Dean Marsan, ''Tax Shelter Opinions: Ethical Responsibilities of the Tax Attorney,'' 9 *Ohio N.U. L. Rev.* 237 (1982).

[83]*See Circular* 230, section 10.35(c)(5); Treas. reg. section 1.6662-4(g).

[84]Section 6662(d)(2)(C).

[85]Wolfman, *et al., supra* note 66, section 204.2.

[86]Statement by IRS Commissioner Charles O. Rossotti on Audit and Collection Activity for Fiscal 2000 (Feb. 15, 2001), *Doc 2001-4884, 2001 TNT 33-11* (for fiscal 2000, the overall audit rate was .49 percent.) *See also* William Gale, ''Declining Audit Rates,'' *Tax Notes*, July 5, 2004, p. 87. (From 1996 to 2002, the number of tax returns filed rose by 9.4 percent, but the number of examination audits fell by 61 percent; thus, the overall audit rate fell by 65 percent, from 1.37 percent to 0.48 percent). According to Commissioner Mark Everson, however, audits of taxpayers earning more than $100,000 increased 24 percent in 2003. *See* Mary Dalrymple, ''IRS Audited More High-Income Taxpayers Last Year,'' *Philadelphia Inquirer*, March 12, 2004, at C2.

[87]Because revenue bills must originate in the House under Article I, section 7, of the Constitution, the House enacted the bill that previously passed the Senate and then amended it by substituting its own version.

The House bill also included $145 billion in corporate tax cuts, thus setting up an obstacle to reaching a compromise acceptable to Democrats in the Senate. Initially, Democrats in the Senate delayed even appointing conferees. After some partisan wrangling, Senate conferees were finally named on July 15 — too late for a meeting of the conference committee before Congress left town on July 23 for its summer recess.

[88]In a letter to leaders of the House and Senate tax committees, the AICPA expressed ''general support'' for the anti-tax-shelter provisions of H.R. 4520. Reprinted in *Tax Notes*, July 19, 2004, p. 267.

[89]For a detailed description of the bill and the anti-tax-shelter provisions included in Title IV, Subtitle A (Provisions Designed to Curtail Tax Shelters), see Joint Committee on Taxation, *Description of H.R. 4520, the American Jobs Creation Act of 2004*, JCX-41-04, *Doc 2004-12293, 2004 TNT 113-6* (June 10, 2004). The Joint Committee on Taxation has recently compared the differing revenue effects of the Senate and House penalty provisions. *See* Joint Committee on Taxation, *Comparison of the Estimated Budget Effects of H.R. 4520, The American Jobs Creation Act of 2004, as Passed by the House of Representatives, and H.R. 4520, The Jumpstart Our Business Strength (JOBS) Act, as Amended by the Senate*, JCX-53-04, *Doc 2004-15280, 2004 TNT 143-8* (July 23, 2004).

[90]Regulations require taxpayers to disclose their participation in any ''reportable transaction'' on new Form 8886 (Reportable Transaction Disclosure Statement). *See generally* Treas. reg. section 1.6011-4T. Reportable transactions include, most prominently, listed transactions, as well as several other transactions that possess characteristics common to tax shelter investments. There is, however, no specific penalty for the failure by a taxpayer to disclose a reportable transaction. Arguably, the

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new penalty of $10,000 for a natural person (and in other cases, $50,000) for failing to disclose a *reportable* transaction.[91] That penalty could be waived only by special consent of the commissioner, not by revenue agents or an appeals officer. The penalties for failing to disclose a *listed* transaction would be increased to $100,000 and $200,000, respectively, and those penalties could not be waived. This new penalty is estimated to bring in $1.4 billion in revenue over 10 years.[92] Along similar lines, H.R. 4520 would increase the accuracy-related penalty from 20 percent to 30 percent applicable to an understatement in the case of a failure to disclose a reportable transaction or listed transaction.[93]

The good news is that H.R. 4520 would also impose a new penalty on promoters of abusive tax shelters equal to 50 percent of the gross income derived from the tax shelter activity.[94] Also, H.R. 4520 includes a new provision requiring any ''material advisor'' regarding a reportable transaction (including listed transactions) to file an information return disclosing information identifying the transaction and the expected tax benefits.[95] Material adviser is defined to include anyone who aids, assists, or provides advice, or anyone who derives gross income in excess of $250,000 regarding the organization, promotion, marketing, etc., of a reportable transaction. The scope of that definition would include promoters and accounting firms such as KPMG, as well as tax lawyers such as Paul Daugerdas of Jenkens & Gilchrist, who earned more than just a fee for providing his legal opinion.[96]

Tax practitioners can find some support for virtually whatever position they advance on behalf of their clients.

That new disclosure requirement imposed on material advisers would replace the current tax shelter registration requirements imposed on promoters. Failure to file the new information return (or filing a false or misleading return) would expose a material adviser (for example, the shelter designer, promoter, or marketer) to a more serious penalty of $50,000, or, in the case of a listed transaction, a penalty in an amount equal to the greater of (1) $200,000 or (2) 50 percent of the taxpayer's gross income.[97] Intentional disregard of the reporting requirement by a material adviser regarding a listed transaction would result in a penalty equal to 75 percent of the taxpayer's gross income. The penalty could not be waived for a listed transaction. Also, the statute of limitations would be extended under H.R. 4520 for cases involving taxpayers who fail to disclose listed transactions.[98]

Under the House bill, a material adviser is also required to maintain investor lists. A penalty of $10,000 per day is imposed when a material adviser fails to provide the IRS with an investor list.[99] The bill authorizes the secretary of the Treasury Department to issue injunctions against those who fail to file information reports or keep investor lists[100] and to censure and impose sanctions and monetary penalties against ''incompetent or disreputable'' tax representatives under *Circular 230*.[101]

H.R. 4520 includes a provision that expands the denial of privilege for communications between a tax practitioner and a corporate client to include any individual engaged in tax shelter activity.[102] However, the House bill is notable for one omission: The original version of H.R. 4520 included an important provision that was mysteriously dropped by Ways and Means Committee Chair

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failure to disclose a reportable transaction could be construed under section 6664(c) as an indication of bad faith, thus barring the taxpayer from relief of the accuracy-related penalty provisions of section 6662 (hence, exposing the taxpayer to greater penalties).

[91]H.R. 4520, 108th Cong. section 611 (2004).

[92]Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4520, as Passed by the House of Representatives*, JCX-45-04, *Doc 2004-12931, 2004 TNT 121-10* (June 22, 2004).

[93]H.R. 4520 section 612, proposing new section 6662A. Significantly, regarding the safe harbor from the penalty provision available to a taxpayer who has a more-likely-than-not supporting legal opinion regarding his tax shelter investment, a taxpayer may not rely on a legal opinion from a tax advisor who participates in organizing or promoting a tax shelter or who receives financial benefits from the tax shelter. Oddly, this provision would impose additional penalties on those taxpayers duped by attorneys such as Paul Daugerdas of Jenkens & Gilchrist, who never disclosed to outsiders (or even his own law partners) his financial relationship with Ernst & Young and the other accounting firms that promoted his COBRA shelter. The tax professionals themselves would not be subject to the new penalty. Once again, it is the taxpayer who is penalized, but not the tax professional.

[94]H.R. 4520 section 618.

[95]H.R. 4520 section 615. Hoping to stem the tide of corporate tax shelters, the California Legislature recently passed legislation that greatly stiffens the penalties of those third parties that promote them. *See* Joseph Bankman and Daniel Simmons, ''Terminating Tax Shelters: Has California Broken the Legislative Log Jam?'' *Tax Notes*, Nov. 26, 2003, p. 1111 (reporting that California passed legislation that provides a penalty on tax shelter promoters equal to 50 percent of the gross income derived from the sale of each shelter).

[96]Paul Daugerdas of Jenkens & Gilchrist allegedly also shared the promoter's fee with the accounting firms that marketed his COBRA shelter. *See supra* note 31. Only law firms that earn a fee of more than $250,000 for their legal opinion would be deemed material advisors. That kind of fee would likely be collected by a law firm only in the case of a major tax shelter transaction for a large corporate taxpayer.

[97]H.R. 4520 section 616. The comparable provision in the Senate bill (S. 1637) would impose the penalty in an amount equal to 100 percent of the taxpayer's gross income.

[98]H.R. 4520 section 614.

[99]H.R. 4520 section 617.

[100]H.R. 4520 section 620.

[101]H.R. 4520 section 622.

[102]H.R. 4520 section 613.

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William Thomas and the House Rules Committee on June 17 immediately before the floor vote.[103] That provision would have made clear in law that the privilege of confidentiality does not apply regarding the names of tax shelter clients. That would have affirmed and codified those recent court decisions holding in favor of the government on the issue of confidentiality of client names.[104] Because the Senate bill includes a comparable provision and because Treasury and the IRS were strongly in favor of the original provision, conferees will need to address the issue again.

The Senate bill also includes a provision that would codify the so-called economic substance doctrine applied by the courts in most tax shelter cases. Thus, the conferees also will need to decide whether that powerful judicial doctrine is best left to the discretion of the courts or whether it should be enacted into law.[105] For reasons too complicated to delve into here, the authors believe that the doctrine is most flexible and effective as judicial doctrine applied by the courts rather than as codification in a statute — which in any event ultimately would require judicial interpretation.[106]

Overall, provisions such as those included in H.R. 4520 (as well as many of those included in S. 1637) would greatly strengthen the penalty regime as it applies to third parties who promote abusive tax shelters or aid and assist taxpayers in entering into such investments. Because those provisions raise direct revenue for the government in the form of tax receipts and stop taxpayers from draining revenue in the form of hollow tax shelters, it is highly advantageous for tax writers to pass them, particularly in light of recent deficit projections. Because of this, all or some of the anti-shelter provisions undoubtedly will be enacted — whether as part of H.R. 4520 or some other pending tax bill, such as H.R. 1308 (the package of expiring tax credits). Those improvements to the tax shelter penalty regime are long overdue. Although some of the horses may already be out of the barn, it's never too late to close the door — especially when billions in tax dollars are at stake.

V. Conclusion

In this analysis, we revealed that we have the climatic conditions for the perfect storm at hand: Lucrative transactions with virtually no downside risk of engagement. And what a storm it has been — billions of dollars of government revenue have been swept down the drain and then gathered up by waiting tax professionals and their clients. Have professional organizations acted to stop the revenue hemorrhage stemming from the bad behavior of their members? To a large extent, they have abdicated their responsibilities and have simply borne witness to the misdeeds of their members, feigning that any toughening of professional standards would be far worse than the evil itself.

When tax professionals behave badly, the IRS needs effective tools to protect the Treasury. While it always is true that some taxpayers will claim dubious reporting positions, it becomes even more imperative that the Service has effective policing tools when tax professionals, for example, mastermind bogus transactions that generate $100 million tax losses. In its proper role as a law enforcement agency (rather than some kind of customer relations agency), the IRS needs not only powerful sanctions to impose on those caught abusing the tax system, but also resources to enforce them.

Some of the legislative proposals now before Congress would provide additional weapons to the IRS in its continuing efforts to police the tax shelter industry. No one should think that if those proposals are enacted by Congress the problem of tax shelters will be solved. The tax shelter industry was not shut down in 1986, nor is it likely to just give up and disband if a few additional penalties are added to the code. Still, stronger penalties and a stronger IRS, along with the threat of suits brought by disgruntled clients that result in multimillion dollar judgments not covered by professional liability insurance, may just curb the activities of the most aggressive tax professionals. For now, that would be a significant improvement.

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[103] Allen Kenney, "Loss of Shelter Measure in House ETI Bill Causes Concern," *Tax Notes*, June 28, 2004, p. 1581.

[104] For a discussion of those cases, see *supra* note 57.

[105] For expositions of the economic substance doctrine, see Joseph Bankman, "The Economic Substance Doctrine," 74 *S. Cal. L. Rev*. 5 (2000); David P. Hariton, "Sorting Out the Tangle of Economic Substance," 52 *Tax Law*. 235 (1999). The case for codification of the economic substance doctrine is made in Ellen P. Aprill, "Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines," 54 *SMU L. Rev.* 9 (2001); Lawrence Zelenak, "Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters," 54 *SMU L. Rev.* 177 (2001).

[106] The case against codification of the economic substance doctrine is aptly presented in a recent report of the New York State Bar Association Tax Section, "Economic Substance Codification," reprinted in *Tax Notes*, June 23, 2003, p. 1829:

> Currently, the economic substance and business purpose doctrines are rules of statutory interpretation — efforts to establish whether Congress intended that a provision of the Internal Revenue Code reach a particular result. As such, the doctrine is designed to separate abusive from nonabusive transactions. Whether abuse exists, however, cannot be determined apart from the facts of the particular case, the nature of the tax benefit sought, the legislative purpose in enacting the relevant provision of the code, the way the provision relates as a structural matter to other relevant code sections and the nature and extent of other relevant antiabuse rules. Application of the rule needs to be sensitive to the nature of the provision of the Internal Revenue Code being construed. . . . We continue to believe courts are uniquely well suited to make these determinations and apply the correct standard in the particular situation before them.

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