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Deputizing the Gunslingers: Co-opting the Tax Bar Into Dissuading Corporate Tax Shelters

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DEPUTIZING THE GUNSLINGERS: CO-OPTING THE TAX BAR INTO DISSUADING CORPORATE TAX SHELTERS

Richard Lavoie *

TABLE OF CONTENTS

I.	INTRODUCTION	44
II.	RECENT TRENDS AND ATTORNEY PARTICIPATION IN CORPORATE TAX SHELTER ACTIVITY	47
	A. <i>Disposition of Most Attorneys Against Tax Shelters</i>	50
	B. <i>Cost-Benefit Analysis and Business Judgment</i>	52
	C. <i>The Role of Competitive Pressure</i>	55
	D. <i>Ambiguities in the Law as Shelter to Malpractice Liability</i>	57
III.	RECENT PROPOSALS AIMED AT CURTAILING CORPORATE TAX SHELTERS	59
	A. <i>Altering Existing Substantive Law</i>	60
	B. <i>Increasing Disincentives for Corporate Taxpayers</i>	63
	C. <i>Increasing Service Enforcement Activity</i>	64
	1. <i>Issues Involving the Skills of Service Agents</i>	65
	2. <i>Registration and Disclosure Regimes in Current Law</i>	67

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3. Increased Service Pursuit Based on Common Law Doctrines.....	71
D. <i>Creating Disincentives for Tax-shelter Promoters and Advisors</i>	71
IV. CO-OPTING THE TAX BAR INTO POLICING TAX SHELTER ACTIVITY	73
A. <i>Making Questionable Opinions More Difficult to Justify</i>	74
B. <i>Incentives and Tools to Support Anti-Tax-Shelter Advice</i>	82
1. Providing Rationales for Challenging Advisability.....	82
a. <i>Less Certain Penalty Protection</i>	83
b. <i>Clearer Registration Implications</i>	83
c. <i>Service Pursuit of Promoters</i>	86
2. Incentives to Raise Advisability with Clients	88
C. <i>Disincentives for Drafters of Tax-shelter Opinions</i>	92
1. Malpractice Liability	92
2. Moral Pressure from Other Attorneys	97
V. CONCLUSION	99

I. INTRODUCTION

Corporate tax-shelter activity in the United States has exploded in recent years.¹ In addition to the staggering revenue loss such

¹ See generally, Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775 (June 21, 1999); Office of Tax Policy, U.S. Dep't of Treasury, *Treasury White Paper on Corporate Tax Shelters*, TAX NOTES TODAY (July 2, 1999) (LEXIS FEDTAX lib., TNT file, elec.cit., 1999 TNT 127-12, 127-13) [hereinafter Office of Tax Policy]; *Testimony of Stefan F. Tucker on Behalf of the Section of Taxation, American Bar Association, Before the Subcommittee on Oversight of the U.S. House of Representatives on the Subject of the Revenue Provisions in President's Fiscal Year 2000 Budget* (Mar. 10, 1999), reprinted in 52 TAX LAW. 577 (1999) [hereinafter ABA Testimony]; James P. Holden, 1999 Erwin N. Griswold Lecture Before the American College of Tax Counsel: *Dealing with the Aggressive Corporate Tax Shelter Problem*, 52 TAX LAW. 369 (1999); Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, FORBES, Dec. 14, 1998 at 198, 203. For a number of informative articles regarding the interplay of corporate tax shelters and traditional tax law concepts of business purpose, economic substance and anti-avoidance rules, see Symposium, *Business Purpose, Economic Substance, and Corporate Tax Shelters Essay*, 54

transactions represent,² this blatant³ tax avoidance breeds contempt

SMUL. REV. 1 (2001).

² While determining the actual size of the corporate tax-shelter market is difficult due to the confidential nature of many of the transactions, it has been estimated as certainly in the tens of billions. See Bankman, *supra* note 1, at 1776. Similarly, in early 2000, the Commissioner of the Service stated that by closing down just a handful of identified tax-shelter structures, the projected revenue savings was almost \$80 billion over ten years. See Lawrence H. Summers, *Tackling the Growth of Corporate Tax Shelters, Remarks to the Federal Bar Association*, TAX NOTES TODAY, ¶ 8 (Feb. 29, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 40-34). While most observers believe that corporate tax-shelter activity presents a serious threat to the integrity of our tax system, a notable exception is Kenneth Kies, a former chief of staff of the Joint Committee on Taxation, now with PricewaterhouseCoopers, LLP. According to Kies, there is no evidence to support claims of drastic revenue loss from corporate tax-shelter activity. Kies's primary contention is that since gross corporate tax receipts increased in 2000 over 1999, there has been no erosion of the corporate tax base. See Kenneth J. Kies, *Corporate Tax Shelters: It's Time to Come to Terms with the Data*, 88 TAX NOTES 133 (July 3, 2000); see also Kenneth J. Kies, *Kies Criticizes Proposed Regs on Corporate Tax Shelters*, TAX NOTES TODAY (June 22, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 121-14); Kenneth J. Kies, *Kies Letter to Senate Finance Committee on Corporate Tax Shelters*, TAX NOTES TODAY (June 16, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 117-12); Kenneth J. Kies, *Corporate Tax Receipts Skyrocket; The Silence is Deafening*, 87 TAX NOTES 1545 (June 9, 2000); Christopher Bergin, Maggie Richardson & Sheryl Stratton, *Summers Delivers Sharp Words on Corporate Shelters*, TAX NOTES TODAY (Nov. 17, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 223-1). The relevance of tax receipts to the tax-shelter debate has been questioned since that figure alone gives no indication of what the receipts would have been had there been no tax-shelter activity. See, e.g., Peter Faber, *Letter to Editor: Increased Revenues Prove Nothing*, 87 TAX NOTES 1666 (June 19, 2000). In this vein, it is interesting to note that a recent study by the Institute on Taxation and Economic Policy found that while corporate profits for the 250 largest U.S. companies rose by 23.5% from 1996 through 1998, federal corporate income tax revenues over the same period rose by only 7.7%. See Robert S. McIntyre & T.D. Co Nguyen, *Inst. on Taxation and Econ. Policy, ITEP Report on Corporate Tax Avoidance*, TAX NOTES TODAY (Oct. 20, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 204-25).

³ This is not to imply that the current wave of corporate tax shelters are simplistic in their structure or easily spotted as lacking substance. Quite the contrary is true. See *infra* Part II for a discussion of the hallmarks of recent corporate tax-shelter schemes. These schemes are nonetheless blatant in how they are marketed to a wide cross section of corporate America and in how unlikely achieving the desired tax result seems when the transactions are viewed closely and honestly. It is no wonder that such vigorous activity has made its way into the popular press. See, e.g., Novack & Saunders, *supra* note 1; Anita Raghavan & Jacob M. Schlesinger, *Cat and Mouse: Wall Street Concocts New Tax-Saving Ploy*;

for our self-assessment tax system and leads to the perception that the current tax regime is unfair.⁴ This perception can become a self-fulfilling prophecy as more and more taxpayers decide to undertake tax-shelter transactions in response to the perceived unfairness.⁵ While a number of complex factors have led to the level of tax-shelter activity present today,⁶ the attitudes and participation of the tax bar have certainly contributed to the situation.

Many lawyers involved in corporate tax-shelter activity are deeply troubled by the role they play;⁷ modern tax attorneys have an almost a schizophrenic nature. On the one hand, they search for some rationality to the Internal Revenue Code (Code) and seek to interpret the law in light of coherent tax policy. On the other hand, they are the hired guns of the corporate elite and face tremendous pressure to zealously advance their clients' desires for greater tax savings. Attorneys often find such savings through the exploitation of obscure gaps in the statutory scheme, exploitations which are completely at odds with sound tax policy or the intent of the drafters. In turn, Congress and the Treasury craft more technical rules to close such gaps, thereby increasing the complexity of the Code and, ironically, often creating new opportunities for aggressive tax advi-

Then It's Feds' Turn, WALL ST. J., Nov. 6, 1997, at A1; Tom Herman, *Tax Report*, WALL ST. J., Feb. 10, 1999, at A1; Jacob M. Schlesinger & Anita Raghavan, *U.S. Bars Certain Tax-Free Stock Deals, Cutting Off Billions in Planned Issues*, WALL ST. J., Feb. 28, 1997, at A4; David Cay Johnston, *Sham Shelters for Business Flourish as Scrutiny Fades*, N.Y. TIMES, Dec. 19, 2000, at A1; Janet Novack, *Are You a Chump?*, FORBES, Mar. 5, 2001, at 122.

⁴ See Office of Tax Policy, *supra* note 1, ¶ 95; see also Joel Slemrod & Varsha Venkatesh, *Public Attitudes About Taxation and the 2000 Presidential Campaign*, 83 TAX NOTES 1799, 1799 (June 21, 1999).

⁵ See Office of Tax Policy, *supra* note 1, ¶ 94; see also Lee A. Sheppard, *Should We Have Tax Shelter Legislation?*, 89 TAX NOTES 955, 955 (Nov. 13, 2000) (noting that sophisticated tax-shelter activity is now spreading to wealthy individuals and that ultimately such actions could undermine the social fabric of the country); Novack, *supra* note 3, at 122.

⁶ See Bankman, *supra* note 1, at 1783-86.

⁷ See ABA Testimony, *supra* note 1, at 582; see also Holden, *supra* note 1, at 369 (“[T]he marketing of these products tears at the fabric of the tax law. Many individual tax lawyers with whom I have spoken express a deep sense of personal regret that this level of Code gamesmanship goes on.”). See also, *Not All “Plumbers” Oppose Antiabuse Regs*, TAX NOTES TODAY (June 3, 1994) (LEXIS, FEDTAX lib., TNT file, elec.cit., 94 TNT 107-28) (anonymous practitioner’s allegorical discussion of the tensions within the tax bar relating to the proper role of attorneys in the tax system); *The Commissioner Responds to Rusty Pipes*, TAX NOTES TODAY (June 17, 1994) (LEXIS, FEDTAX lib., TNT file, elec.cit., 94 TNT 117-35) (Service’s response).

sors to find fresh technical glitches or unintended applications of the statutory scheme.⁸ All of this tends to push tax attorneys toward becoming mere technocrats focused only on applying statutes and regulations literally—without consideration of the broader policies underlying the tax laws.

What can be done to prevent tax attorneys from degrading into a mass of pettifogging guns for hire? This article will discuss several avenues for assisting the tax bar in resisting the competitive pressure to promote and participate in abusive tax shelters. Part II of this article examines the recent trends in corporate tax-shelter activity and the important role lawyers play in facilitating such transactions. Part III of this article briefly outlines some of the general proposals that have been suggested for curtailing corporate tax-shelter activity. Part IV discusses proposals more specifically aimed at helping the tax bar dissuade tax-shelter activity and at providing the bar with incentives to do so. Part V concludes that while many of the Part IV proposals will not have an immediate impact they should nonetheless be implemented as positive steps towards (1) reducing the competitive pressures that force tax attorneys into a race to the bottom and (2) cultivating a “culture of compliance in which corporate tax shelters are more seldom created.”⁹

II. RECENT TRENDS AND ATTORNEY PARTICIPATION IN CORPORATE TAX-SHELTER ACTIVITY

Since the adoption of the income tax, taxpayers have sought to lower their tax bills and tax lawyers have advised clients regarding tax planning techniques to achieve such reductions. By its very nature, crafting a tax statute is an exercise in line drawing; the statute subjects some transactions to taxation but not others. Once Congress makes its line drawing decisions, taxpayers clearly may craft their transactions in a manner that minimizes their taxes. As Judge Learned Hand stated, “Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”¹⁰

⁸ See Office of Tax Policy, *supra* note 1, ¶ 101 (“The more complex is the tax law, the more likely it is that aggressive taxpayers will be able to find and exploit discontinuities.”).

⁹ Lawrence H. Summers, *A Better Tax Service and a Better Tax System*, Remarks to the Tax Executives Institute, TAX NOTES TODAY (Mar. 23, 1999) (LEXIS, FEDTAX lib., TNT file, elec.cit., 1999 TNT 55-16).

¹⁰ *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d*, 293 U.S.

In practice, however, knowing exactly when particular transactions fall on the taxable side of the line presents difficulty. This problem becomes particularly pronounced where an attorney casts the transaction in a form that literally falls on the untaxed side of the line drawn by Congress, but where the transaction has the overall economic impact and purpose of a taxable transaction. The proper treatment of such transactions obviously turns on the approach courts take in matters of statutory interpretation. Should courts apply the language of the statute literally, or should courts take a purposive view of the statute and tax such transactions based on the legislative intent embodied in the provision? Historically, the courts have favored a purposive approach to applying tax statutes and the courts have developed a corresponding number of anti-abuse doctrines.¹¹ These doctrines include the sham-transaction doctrine, the step-transaction doctrine, the business purpose doctrine, and the economic substance doctrine. Alternatively, all of these common law doctrines potentially could be viewed as “manifestations of one overarching doctrine—the preference for substance over form.”¹²

The exact parameters of these judicially created anti-abuse doctrines have always been ill defined as a result of their case-by-case development. Traditionally, this ambiguity favored the government since it created a penumbra of uncertainty around the Congressionally drawn line and thereby often dissuaded taxpayers from undertaking transactions likely to fall into the gray zone. In recent years, however, many practitio-

465, 469 (1935) (Where the Supreme Court stated, “The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.”). In a similar vein, Judge Hand also wrote: “Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions.” *Comm’r. v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting).

¹¹ See, e.g., Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C.L. REV. 623 (1986) (reviewing tax cases in which courts have used nonliteral interpretations to further the perceived policies of the Code); Robert Thornton Smith, *Interpreting the Internal Revenue Code: A Tax Jurisprudence*, 72 TAXES 527 (1994). However, recent trends in the thinking on statutory interpretation and decisions by a number of courts applying a plain meaning approach to tax statutes have led some to question the continued validity of a purposive approach. See, e.g., John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501 (1997); Michael Livingston, *Practical Reason, “Purposivism,” and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677 (1996).

¹² John Tiley & Erik Jensen, *The Control of Avoidance: the United States Experience*, 1998 BRIT. TAX REV. 161, 168.

ners have come to view these judicially created anti-abuse doctrines as so vague that they can effectively be ignored.¹³ Downplaying the relevance of the common law anti-abuse doctrines and relying on a literalist approach to statutory and regulatory interpretation has allowed many tax practitioners to give favorable opinions regarding highly questionable transactions.

The goal of the tax law should not be to dissuade taxpayers from validly challenging an interpretation of the tax laws or from taking reasonable positions regarding the coverage of particular statutory provisions. Still, the government has a significant interest in ensuring that taxpayers do not circumvent the tax law by exploiting specific statutory provisions in unanticipated ways to achieve tax results completely at odds with Congressional intent and sound tax policy. The inherent tension between legitimate tax planning and the creation of abusive tax shelters presents us with another line drawing exercise: which transactions should the tax law dissuade and prohibit as abusive, and which transactions should the tax law permit as attempts to work within the statutory framework toward the goal of legitimate tax minimization? With this tension in mind, one can identify certain hallmarks common to recent abusive corporate tax-shelter transactions:¹⁴

(1) The transaction creating the purported tax benefit presents little or no economic risk to the taxpayer. Similarly, such transactions typically involve only slight profit potential apart from the expected tax benefits. Indeed, the large transaction costs involved usually guarantee that such transactions will result in an economic loss to the taxpayer if the tax benefits are not allowed.¹⁵

(2) The transaction exploits (i) a structural flaw in the U.S. tax system; (ii) the interaction of the U.S. tax system with foreign tax systems; or (iii) a specific tax rule by applying it in an unanticipated context. For instance, a tax shelter may take advantage of rules that accelerate taxable income in excess of true economic income by allocating the accelerated income to a party not subject to U.S. taxation and thereby give rise to a symmetrical non-economic loss, deduction, or inflated asset basis in the hands of a domestic taxpayer.

(3) The transaction facilitates inconsistent financial accounting and tax treatments. As a result, a loss or reduction in income can be reported for tax purposes without negatively impacting the publicly

¹³ See Bankman, *supra* note 1, at 1782.

¹⁴ *Id.* at 1777; see also Office of Tax Policy, *supra* note 1, ¶ 11-17.

¹⁵ In this regard one commentator has defined a tax shelter as "a deal done by very smart people that, absent tax considerations, would be very stupid." Herman, *supra* note 3, at A1 (quoting Prof. Michael Graetz).

reported profit and loss statements of the corporate taxpayer.

(4) The transaction is not developed by or for a particular taxpayer; rather, a "promoter" who markets the transaction to a large number of corporations bears the costs of developing the transaction and the corresponding legal opinions. If the taxpayer undertakes the transaction, the promoter receives a significant fee and effectively spreads its development costs among numerous corporate taxpayers. In order to protect its proprietary scheme, the promoter sometimes obtains a confidentiality agreement from the corporations solicited and their advisors.

(5) The transaction achieves a result so at odds with commonly understood tax principles and policies that it will likely result in a judicial challenge or a Congressional or Treasury clarification of the application of the law.

A. *Disposition of Most Attorneys Against Tax Shelters*

Although some tax lawyers may have a favorable disposition to tax-shelter schemes (based on their views regarding common law doctrines, statutory interpretation, or other factors), the majority of tax lawyers not actively involved in developing such transactions tend to initially view them negatively. A number of possible explanations for such skepticism toward tax-shelter transactions have been posited.¹⁶ The most likely reason for skepticism derives from a review of the more-likely-than-not opinions proffered by the promoters. As discussed above, such opinions often result from opinion shopping by the promoter and usually contradict the reviewing attorney's own evaluation of the transaction. In effect, opinion shopping tends to create more-likely-than-not opinions regarding transactions that a majority of tax lawyers would view as having only a slight chance of surviving challenge if discovered by the Internal Revenue Service (Service).¹⁷

Although many tax lawyers find tax-shelter opinions laughable based on their poor legal analysis and outrageous conclusions, other attorneys take offense even to well reasoned opinions that reach conclusions at odds with sound tax policy.¹⁸ Such practitioners believe that the best interpretation of our highly complex tax law stems from the policies underlying particular provisions, from look-

¹⁶ Bankman, *supra* note 1, at 1783-84.

¹⁷ *Id.* at 1783 ("An irresistible practice of outside counsel in the industry (to the extent permitted by confidentiality concerns) is to share stories and engage in a sort of one-upmanship as to who has seen the most unrealistic legal opinion.").

¹⁸ *Id.* at 1783.

ing to a deeper structure inherent in the Code as a whole. Because of this view regarding how a coherent set of tax laws should operate, such attorneys resent technically supportable positions that reach the wrong answers. While this response can be seen as an aesthetic concern,¹⁹ it also stems from a notion that the tax laws should be interpreted fairly and consistently for all taxpayers. According to this notion, interpretations that reach illogical results when viewed in the context of the entire system should be rejected due to the adverse impact the opinions would have on the coherence of the tax system as a whole and due to the need of taxpayers and advisors to rely on that coherence as a guide in the future.²⁰

Beyond the questionable legal analysis used in many opinions, reviewing counsel will often have serious reservations regarding the factual assumptions upon which the opinions rest.²¹ The primary concern focuses on the portion of the opinion where the writer dismisses common law anti-abuse doctrines based on one or more factual assumptions that: (1) the transaction is motivated by nontax business considerations; (2) the transaction has a realistic possibility of creating an economic profit aside from tax benefits even after accounting for transaction costs; or (3) the transaction could potentially create a significant risk of loss for the participant. Often, promoter-obtained opinions will rely on a bald assumption that such factors exist or will recite underlying facts (which themselves are of questionable veracity or relevance) to demonstrate the existence of the required factors. Even in situations where some real profit or loss potential exists, ancillary hedging or other transactions suggested or arranged by the promoter will often negate such profit or loss potential without being described in the opinion, or perhaps without even being known by the opinion writer.

Finally, the aversion of many tax lawyers to tax-shelter work stems from ethical concerns. To the extent tax shelters are based on questionable technical game playing with the tax law, or worse,

¹⁹ *Id.*

²⁰ As a tax attorney friend once commented, analogizing the Code to a strategic board game: "Some interpretations of the tax code must simply be rejected because to do otherwise would do excessive violence to the game system." See also, Bergin, Richardson, & Stratton, *supra* note 2 (noting that the problems with corporate tax shelters are broader and more serious than mere revenue loss and quoting John Chapoton, an attorney with Vinson & Elkins, as saying "I'm more concerned about business ethics and our duty to the tax system," and saying that the real problem with tax shelters is that they represent a "dumbing down" of the profession, a "race to the bottom," and are demeaning to the tax profession).

²¹ ABA Testimony, *supra* note 1, at 584.

based on taxpayer expectations of not being caught by the government (playing the “audit lottery” as it were), tax-shelter work takes on a decidedly unsavory tone. If the tax-shelter participants ultimately pay significantly less tax through such questionable transactions, how will the government make up the revenue shortfall? Many attorneys cringe at the idea that they are building a tax system that only Leona Helmsley could love.²² Many lawyers also have conscience pains over the social utility of their work.²³ Beyond the economic cost to society from the revenue losses created by tax shelters and the diversion of effort from transactions generating real economic gains, tax-shelter transactions require a troubling subversion of society’s mental capital. Many of the best and brightest attorneys go into tax law, and only the cream of that crop possesses enough creativity and talent to develop tax shelters. Should society really allocate such mental talent in this manner?²⁴

B. Cost-Benefit Analysis and Business Judgment

Given a general inclination against tax-shelter transactions, why don’t attorneys do more to dissuade their clients from engaging in such activity? One possible reason might be a bias among attorneys to provide only the information the client requests, rather than also supplying the attorney’s personal judgment regarding the appropriateness of the transaction.²⁵ Often the client poses the following specific question to a reviewing tax attorney: “Will the transaction result in penalties if undertaken?” In light of the promoter’s proffered more-likely-than-not opinion, the attorney usually responds to this narrow question that no penalties will result. Many

²² That is, one in which “[o]nly little people pay taxes.” See Jeffery L. Yablon, *As Certain as Death - Quotations About Taxes (Expanded 2000 Edition)*, 86 TAX NOTES (TA) 231, 266 (Jan. 10, 2000) (attributing quoted language to Leona Helmsley).

²³ See Bankman, *supra* note 1, at 1783 (“One lawyer states, ‘You feel like asking some of these promoters whether their momma knows what they spend their time doing.’ Outside counsel that would not put the matter in such stark terms may still be upset at the lack of social utility of shelters.”). In this vein, a partner heavily involved in tax-shelter work at a premier accounting firm once commented to me, “I woke up the other morning and wondered when it was that I actually crossed over to the Dark Side.”

²⁴ In this regard, Peter Cobb, former Deputy Chief of Staff of the Joint Committee on Taxation, recently stated, “You can’t underestimate how many of America’s greatest minds are being devoted to what economists would all say is totally useless economic activity.” Office of Tax Policy, *supra* note 1, ¶ 9.

²⁵ See Bankman, *supra* note 1, at 1784.

practitioners will leave their response at that without commenting on the questionable nature of the transaction itself.²⁶ Often the reviewing attorney will hesitate to express ethical concerns to a client, concerns effectively intruding on the client's business judgment. This is especially true in a corporate culture where the bottom line drives executives.

Cost-benefit considerations further exacerbate attorneys' bias to provide only the information requested by clients. Due to the lack of penalty potential, a pure cost-benefit analysis will dictate undertaking a tax-shelter transaction despite an acceptance by all the parties involved (other than the actual opinion writer presumably) that, if uncovered by the Service a successful Service challenge will likely result. More specifically, promoters often indicate, either explicitly or implicitly, that clients should factor the likelihood of discovery into their appraisal of the transaction; promoters advocate playing the audit lottery.

While most attorneys have a strong aversion to this approach to the tax law and would be unlikely to suggest such an analysis affirmatively, they may feel uncomfortable in trying to dissuade clients from making economically justifiable business decisions based on such a calculus.²⁷ Additionally, anecdotal evidence indicates that accounting firms acting as promoters often promise to provide audit support for their tax-shelter transactions at no or reduced cost if a challenge occurs, thereby further decreasing the downside risk for clients even if the client in fact loses the audit lottery.

For instance, assume a particular transaction purports to generate a \$100 million tax loss, thereby yielding a \$35 million tax benefit, at a transaction cost of \$7 million (which represents a 20% fee to the promoter).²⁸ Assume further that despite a more-likely-than-not opinion, which presumably will prevent penalties, the corporate taxpayer believes there is actually only a 10% chance of success on the merits if the transaction is challenged. Conversely, there is an 80% chance that the transaction will not be discovered by the Service. On an expected-value basis, the benefit of this trade to the

²⁶ Indeed, revealing the reviewer's disquiet over the soundness of the opinion may undermine the client's reliance on the opinion and make it less likely to provide the desired penalty shield.

²⁷ See Bankman, *supra* note 1, at 1784.

²⁸ Fees of this size are by no means unusual. For instance, the fee involved in a recent tax-shelter case, *ASA Invest rings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000), was approximately 26.5% of purported tax benefits. See Office of Tax Policy, *supra* note 1, ¶ 17.

taxpayer (after paying the promoter's fee) is still \$21.7 million despite the abysmal chances of success on the merits.²⁹

Even if the Service spots and challenges the transaction, the taxpayer may wind up no worse off for having attempted such an aggressive transaction. After weighing the risk of loss in litigation together with the great expense of litigating a complex tax-shelter transaction,³⁰ the Service may be willing to settle the matter with the taxpayer by allowing a portion of the tax benefit sufficient to defray the taxpayer's original transaction costs.³¹ On the facts assumed here, the Service might settle by allowing the taxpayer to claim a \$5.5 million tax savings from the transaction (i.e., disallowing only \$29.5 million of the claimed \$35 million in tax savings). The settlement would be rational for the Service based on a 10% risk of loss at trial and an expected \$2 million in litigation expenses. For the corporate taxpayer, the settlement would largely defray the original payment of the promoter's fee and leave the taxpayer in essentially the same tax position as if the transaction never had occurred. If the promoter agreed to defend the case for free, this agreement would reduce further the potential downside cost for the corporate taxpayer.

Finally, a promoter's fee usually increases with the likelihood of success on the merits if the Service challenges the proposed transaction. In a deal with only a 10% chance of success, the promoter probably will charge a much smaller fee, thereby making the transaction costs accord even more closely with the expected Service settlement if challenged. Such an adjustment of fees effectively can eliminate almost all of the downside risk of the transaction not succeeding for the client.

A reviewing attorney may have difficulty advising a client not to undertake a transaction that, based upon a cost-benefit analysis, presents such a good business deal. Even if a lawyer protests to the

²⁹ That is, the risk of losing if detected (90%) multiplied by the risk of detection (20%) equals an 18% (90% x 20%) risk, or \$6.3 million. Thus, the \$35 million tax benefit reduced by the expected economic risk (\$6.3 million) and the transaction costs (\$7 million) yields a \$21.7 million expected value to the transaction.

³⁰ For instance, the government's litigation costs in one recent tax-shelter case, *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189, *aff'd in part, rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999), were more than \$2 million. Office of Tax Policy, *supra* note 1, ¶ 9.

³¹ The Service settles roughly 90% of all disputes brought to its Appeals Division. *Tax Report*, WALL ST. J., Aug. 23, 2000, at A1.

client, many clients will undertake the transaction in anyway. Finally, some attorneys may fear that the client will interpret any reticence as evidence that the attorney does not have the client's best interests at heart and therefore might seek new counsel more attuned to the corporation's interests.

C. *The Role of Competitive Pressure*

As noted above, tax-shelter transactions often have the hallmark that the result the transaction achieves is so at odds with tax policy that it will likely result in a challenge if discovered. Focusing on how transactions acquire this last characteristic provides important insight into the role attorneys play in facilitating tax-shelter activity. Fundamentally, if the transaction is likely to be challenged and prospectively shut down by statutory or regulatory clarification if discovered, how can the attorneys involved allow the transaction to go forward? In large part, competitive pressures faced by attorneys explain their actions.

Examining competitive pressures begins with an examination of tax-shelter opinions. While some tax-shelter transactions proceed without any explicit legal opinion regarding the likelihood of obtaining the tax benefits sought, most corporate tax shelters involve a more-likely-than-not level of opinion.³² At its core, a more-likely-than-not opinion indicates the writer's belief that a court would have a greater than 50% chance of allowing the desired tax benefits resulting from the transaction. Should the transaction go awry, such an opinion is usually thought to provide a defense against the imposition of penalties³³ and provide some internal cov-

³² See Bankman, *supra* note 1, at 1782.

³³ I.R.C. § 6662(d). This section generally provides for a 20% penalty on any substantial tax understatement (generally more than 10% of the required tax) unless certain listed requirements are satisfied. While a corporate taxpayer participating in a transaction with a "significant" tax avoidance purpose is ineligible for any of these specified exceptions to the substantial underpayment penalty, the broader reasonable cause exception contained in section 6664(c) and the regulations thereunder is potentially applicable. I.R.C. § 6664(c). While the relevant regulations note that all the facts and circumstances must be considered and that the mere existence of a tax opinion is not sufficient to show reasonable cause, tax-shelter promoters and participants generally believe that the receipt of a more-likely-than-not opinion is itself sufficient to qualify for the reasonable cause exception. For a more detailed discussion of whether such opinions actually provide this expected protection in most tax-shelter situations, see *infra* Part IV.B.1.

erage for corporate executives approving the transaction.³⁴

Since the tax shelter has presumably been designed to exploit a particular aspect of the tax law, some technical basis for claiming the desired tax benefits will exist. As a result, a practitioner's decision whether he can issue an opinion will depend to a large degree on her views regarding (1) the continued validity of the judicially created anti-abuse doctrines and (2) the proper approach to statutory interpretation. If the practitioner believes that the relevant statutes and regulations should be literally enforced and construed against the drafter, then that practitioner may easily justify opining on the validity of a transaction based on a technical interpretation of the relevant rules.³⁵

Therefore, part of the tax-shelter problem evolves from a lack of clarity in the law as to the proper handling of line drawing in tax matters. While such uncertainty may justify differences of opinion in close cases, the extreme nature of many tax-shelter transactions indicates that other factors exert influence in the tax-shelter context. Tax attorneys reviewing a tax-shelter proposal presented to their clients will often find the promoter-obtained opinion unbelievable. Usually such reactions stem from the questionable factual assumptions on which the opinion writer bases the opinion (e.g., that a business purpose exists or that a realistic possibility of economic profit exists) or from the opinion's casual dismissal of common law anti-abuse doctrines.³⁶ To some extent, attorneys use the vagueness of the anti-abuse doctrines and protestations about literal statutory interpretation as mere window dressing to permit them to give opinions they know are highly questionable.

Why would attorneys clutch for justifications to give unsound opinions? First, promoters will pay substantial amounts for opinions

³⁴ See Bankman, *supra* note 1, at 1782.

³⁵ Several commentators have noted distinct rifts within the tax bar regarding such interpretive issues and the appropriate role of general standards as opposed to specific rules in the tax law. See Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47 (2001); Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. REV. 149 (2001). As a broad generalization, those specializing in tax shelter work, younger attorneys and accountants tend to focus on a more literalistic and rule based approach. Conversely, older tax attorneys and those primarily engaged in general tax practice are quite comfortable with the use of interpretive standards as a basis for applying the tax laws.

³⁶ See Bankman, *supra* note 1, at 1783.

blessing their transactions; promoters usually will not closely scrutinize the number of hours spent in developing a favorable opinion. Second, if the attorney participated in the development of the tax-shelter transaction she may have obtained a premium billing arrangement with the promoter whereby the attorney shares in the profit from marketing the transaction beyond her hourly charges. In law firms that judge their attorneys on the attorneys' client billings, keeping a bill-insensitive promoter happy by delivering the aggressive opinions requested might be too great a temptation.³⁷

In sum, the existence of ambiguities in the law, legitimate differences in practitioner views on the application of the law, and personal moral temptations all conspire to allow promoters to "shop" their tax opinion work among a number of law firms. Firms are selected not based on who bids lowest, nor on who is the most competent, but on who best complies. As one article has noted, such a "race is unlikely to go to the more knowledgeable, to the most competent, or even to the swift, but those practitioners most willing to do the tax-shelter promoter's bidding, the more unsavory, desperate, or greedy among us."³⁸

D. Ambiguities in the Law as Shelter to Malpractice Liability

The perception that the ambiguities in the law will shelter the opinion writer from malpractice liability if a court ultimately reaches a contrary conclusion exacerbates this tendency.³⁹ Simi-

³⁷ See *id.*; see also James P. Holden, *Dealing With the Aggressive Corporate Tax Shelter Problem*, 82 TAX NOTES 707, 707 (1999) ("[M]any of these lawyers regard themselves obliged by client loyalty and competitive considerations to comply with requests that they provide services that support these activities."); Lee A. Sheppard, *Corporate Tax Shelters: Red Herrings and Real Solutions*, 91 TAX NOTES 2075, 2075 (2001) ("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."). For an in-depth discussion of the importance of monetary incentives and their adverse impact on the ethics of the legal profession generally, see DEBORAH L. RHODE, *IN THE INTERESTS OF JUSTICE: REFORMING THE LEGAL PROFESSION* (2000). See also Summers, *supra* note 2, ¶ 20 ("The dilemmas of [tax-shelter advisors dealing with ethical questions] have been exemplified by the recent remark of a tax practitioner, that 'writing tax opinions is a choice between eating and sleeping. I like to eat.'").

³⁸ Robert Feinschreiber & Margaret Kent, *Tax Shelter Malpractice*, 83 TAX NOTES 1037, 1051 (Mar. 17, 1999).

³⁹ For instance, who is to say that opining 51% in favor of a transaction is

larly, a tax attorney may decide to issue a questionable opinion without malpractice concern because attorneys at other firms have issued favorable opinions on the particular type of tax-shelter transaction.⁴⁰ In such cases, a reticent tax attorney may face significant internal pressure from her corporate brethren to deliver opinions in line with those issued by comparable firms. Practitioners may also believe their clients would be unlikely to bring or win malpractice claims in light of the realities surrounding the issuance of the opinions.⁴¹ First, to the extent corporations view these opinions as mere shields against penalties and lack any conviction regarding their validity, a corporation may have little incentive to sue for malpractice. Second, even if a corporation brought a malpractice suit, a firm might defend itself by claiming that the corporation understood the probable erroneous nature of the opinion's conclusion and relied on the opinion only as penalty insurance. This defense may prevent the corporation from establishing damages. Since a corporation in this situation would not have relied on the correctness of the opinion's conclusion in undertaking the transaction, the corporation's damages arguably would not have arisen from reliance on the opinion and would not be recoverable in a malpractice action.⁴²

Beyond the monetary aspects of opinions, promoters sometimes astutely manipulate attorneys into issuing questionable opinions. For instance, assume that a promoter assures the attorney that he can rely on certain factual matters in rendering his opinion, but as the particular transaction progresses it becomes apparent that the facts relied on will not exist. At this point, the parties to the tax shelter have expended significant amounts of time and money in pursuing the transaction. This financial reality places tremendous

malpractice when a court has to write a 100-page opinion justifying a contrary finding? How many percentage points off does a lawyer need to be before committing malpractice? How does a client really know how many percentage points off an attorney was anyway? See Bankman, *supra* note 1, at 1783. However, this perception of no malpractice liability may ultimately prove incorrect given the extreme nature of the conclusions in many recent tax shelters. See discussion *infra* Part IV.C.

⁴⁰ While this argument has some facial appeal since malpractice is usually judged based on a reasonable practitioner standard, it has no force in the context of abusive tax-shelter opinions. An attorney cannot disregard her own senses and rely on a communal judgment she knows to be unreasonable as proof of her own reasonableness. This can be referred to as the "Emperor's New Clothes" malpractice defense. See discussion *infra* Part IV.C.1.

⁴¹ See Bankman, *supra* note 1, at 1782-83.

⁴² A practitioner's faith in avoiding malpractice liability under these theories may well be misplaced. See discussion *infra* Part IV.C.

pressure on the attorney to modify the facts of the opinion without altering the conclusion.⁴³ The remainder of this article will examine what can be done to address the proliferation of such abusive tax-shelter transactions.

III. RECENT PROPOSALS AIMED AT CURTAILING CORPORATE TAX SHELTERS

A number of commentators, as well as the Treasury Department and congressional tax writing committees, have proposed measures aimed at reducing the level of corporate tax-shelter activity.⁴⁴ These proposals generally fall into one of the following four categories: 1) altering existing substantive law; 2) increasing the disincentives for corporate taxpayers; 3) increasing the amount and effectiveness of Service enforcement activity; and 4) creating disincentives for tax-shelter promoters and advisors. No single panacea will eliminate the tax-shelter problem. Instead, significantly curbing these corporate abuses certainly will require some combination of these approaches. The discussion below will examine each of these four proposal types and note some of the difficulties with each approach.⁴⁵

⁴³ See Bankman, *supra* note 1, at 1782.

⁴⁴ See, e.g., Office of Tax Policy, *supra* note 1; Bankman, *supra* note 1; ABA Testimony, *supra* note 1; Senate Finance Committee Staff, *Finance Releases Draft of Corporate Tax Shelter Legislation*, TAX NOTES TODAY (May 25, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 102-9); William V. Roth, Jr., *Finance Releases Revised Draft of Tax Shelter Legislation*, TAX NOTES TODAY (Oct. 6, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 195-8); Charles E. Grassley and Max Baucus, *Grassley-Baucus Draft Bill Would Encourage Greater Disclosure of Tax Shelters*, TAX NOTES TODAY (Aug. 6, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 151-58).

⁴⁵ Others have examined the details of specific proposals and discussed implementing statutory language, so this article will not undertake an in-depth discussion of these areas. See, e.g., Office of Tax Policy, *supra* note 1; Bankman, *supra* note 1; ABA Testimony, *supra* note 1; Joint Comm. On Taxation, 106th Cong., *Description and Analysis of Present-Law Tax Rules And Recent Proposals Relating to Corporate Tax Shelters* (Comm. Print Nov. 1999); Betty M. Wilson, *TEI Comments On Finance Committee's Revised Draft on Corporate Tax Shelters*, TAX NOTES TODAY (Oct. 18, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 202-44); LaBrenda Garrett-Nelson, et al., *Washington Council Ernst & Young Comments on Corporate Tax Shelter Draft*, TAX NOTES TODAY (July 28, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 146-21); Charles W. Shewbridge, III, *TEI Weighs in on Finance Staff Corporate Tax Shelter Draft*, TAX NOTES TODAY (July 21, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 141-18).

A. *Altering Existing Substantive Law*

Proposals dealing with altering the substantive laws applicable to tax-shelter activity run the gamut from implementing a systemic reform of the tax system to adopting a general, statutory anti-abuse rule. The difficulties with systemic tax reform include⁴⁶ (1) the potentially significant economic distortions created by switching to a new tax regime; (2) the possibility that while a new system may end the relevance of current tax-shelter transactions, unforeseen manipulation techniques may undermine the new regime itself; and (3) the difficulty in obtaining a political consensus for any particular systemic reform proposal. In the end, even if systemic tax reform remains a laudable long-term goal, it seems an inappropriate and impractical means for addressing the current wave of corporate tax-shelter activity.

An alternative response would consist of a more evenhanded application of various tax rules by the Service. When the Service interprets a tax rule in a manner that maximizes short-term tax collections (generally by accelerating the reporting of income items) without consideration of the economic realities of a transaction, it does a disservice to the tax system. By favoring revenue raising over an accurate reflection of income, such one-sided interpretations create tax-shelter opportunities and encourage aggressive tax planning.⁴⁷ While an interpretation requiring a non-economic accrual of income may be a boon for the government in one situation, taxpayers can often turn the same rule to their advantage in different factual circumstances. In contrast, if the Service originally applies a rule in a fairer manner, one reflecting a taxpayer's true economic income, then the Service never creates the opportunity for turning the one-sided interpretation against the government. Additionally, the perception that the Service seeks to interpret the law in an unwarranted pro-government manner likely encourages taxpayers and their advisors to take aggressively pro-taxpayer positions simply as a means of leveling the playing field.⁴⁸ Clearly, courts and the Service should make an effort to achieve a more evenhanded application of the tax law. Such application would prevent abuse of the system by both the Service and taxpayers. The issue with this solution lies in the complexity of the tax law. So many

⁴⁶ For a discussion of these issues, see Bankman, *supra* note 1, at 1785-86; Office of Tax Policy, *supra* note 1, ¶ 320-331.

⁴⁷ See Bankman, *supra* note 1, at 1786.

⁴⁸ A position that is apparently based on the logic that two wrongs can make a right.

arguably one-sided interpretations are already deeply intertwined in the overall system that attempting to revise historic one-sided interpretations would be difficult if not impossible.⁴⁹ A revision of such interpretations would create significant uncertainty in various areas and may give rise to new unintended avenues for abusive exploitation by taxpayers.

Formal anti-abuse rules could also address the tax-shelter issue. This could take the form of codifying the existing judicially created anti-abuse doctrines, adopting more regulatory anti-abuse rules, or creating a statutory general anti-abuse rule similar to laws adopted in Canada, Australia and other foreign jurisdictions.⁵⁰ A proponent of such action might argue that the vagaries and ambiguities of the judicially created anti-abuse rules prevent these rules from serving as real deterrents to abusive transactions.⁵¹ If, how-

⁴⁹ See Bankman, *supra* note 1, at 1786.

⁵⁰ See Office of Tax Policy, *supra* note 1, ¶¶ 332-61; see also Calvin H. Johnson, H.R. ____, *The Anti-Skunk Works Corporate Tax Shelter Act of 1999*, 84 TAX NOTES (TA) 443 (July 19, 1999); Kenneth J. Kies, *A Critical Look at 'Corporate Tax Shelter' Proposals*, 83 TAX NOTES (TA) 1463 (June 7, 1999). For a discussion of such general anti-abuse rules in foreign jurisdictions, see U.K. Inland Revenue, *A General Anti-Avoidance Rule for Direct Taxes: Consultative Document*, WORLDWIDE TAX DAILY (Oct. 6, 1998) (LEXIS, FEDTAX lib., TNI file, elec.cit., 98 TNI 193-20); see also Brian J. Arnold, *The Canadian General Anti-Avoidance Rule*, 1995 BRIT. TAX REV. 541; Brian J. Arnold & James R. Wilson, *The General Anti-Avoidance Rule - Part I*, 36 CAN. TAX J. 829 (1988); Brian J. Arnold & James R. Wilson, *The General Anti-Avoidance Rule - Part II*, 36 CAN. TAX J. 1123 (1988); Brian J. Arnold & James R. Wilson, *The General Anti-Avoidance Rule - Part III*, 36 CAN. TAX J. 1369 (1988); John R. Owen, *Statutory Interpretation and the General Anti-Avoidance Rule: A Practitioner's Perspective*, 46 CAN. TAX J. 233, 266-73 (1998); Colin Masters, *Is There a Need for General Anti-Avoidance Legislation in the United Kingdom?*, 1996 BRIT. TAX REV. 647; Peter Wyman, *U.K. Proposed GAAR May Be Counterproductive*, 17 TAX NOTES INT'L 1160 (Oct. 19, 1998); Adam Blakemore, *U.K. Tax Institute Highlights GAAR's Hidden Dangers*, 17 TAX NOTES INT'L 1891 (Dec. 14, 1998); David Ward, *Tax Avoidance: Judicial and Legislative Approaches in Other Jurisdictions*, in *Report of the Proceedings of the Thirty-Ninth Tax Conference*, 1987 CONFERENCE REPORT (Toronto: Canadian Tax Foundation, 1988), at 8:1-8:53.

⁵¹ While many tax-shelter opinions give short shrift to the common law doctrines and seek to dismiss their potential application based on factual distinctions, such an approach misses the real function of these doctrines. The very strength of these doctrines is that they can be applied by a court, not as a formal application of law to facts, but as a prophylactic tool to assure that the policy underlying the relevant statutory provisions is given effect. See Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351*, 11 VA. TAX REV. 349, 425 (1991). See also Lee A. Sheppard,

ever, merely codifying the common law anti-abuse doctrines in specific statutory language would seemingly eliminate very little of this ambiguity,⁵² doing so might in fact aggravate the situation if courts feel constrained by the literal words of the new statutory language and accordingly fail to apply the provision in situations where the courts otherwise would have felt free to apply the existing common law doctrines.

Other proponents of substantive law change argue that the Service should promulgate more specific anti-abuse regulations in various substantive areas of the tax law, or that Congress should adopt a more global statutory anti-abuse rule. The difficulty with more regulatory anti-abuse rules or an overarching statutory provision is that these standards themselves will lack clear definition. Consequently, new such anti-abuse rules will suffer the same ambiguity concerns as the current common law doctrines. Indeed, the level of ambiguity resulting from these changes may actually increase since tax practitioners have significant experience in dealing with and interpreting the existing common law doctrines. Additionally, the impetus for adopting statutory anti-abuse rules in foreign jurisdictions often relates to the lack of common law anti-abuse doctrines in such jurisdictions and the extreme reluctance of

News Analysis – Economic Substance Abuse, TAX NOTES TODAY (Nov. 27, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 228-2) (“[Tax Court Judge Laro] defended the right of courts to interpret the economic substance doctrine and apply it in complicated cases. He defined the doctrine as allowing a judge to recharacterize a result when the taxpayer seeks a result unintended by the statute. Judge Laro fretted that the statutory economic substance test proposed by the Clinton administration ... lacked a subjective business purpose requirement. The subjective test, he argued, ensures that the court looks at all of the relevant evidence.”).

⁵² One specific legislative proposal contained in President Clinton’s Fiscal Year 2001 Budget would have created a codification of the economic substance doctrine. This proposal met with significant resistance among the practicing bar, with some going so far as to assert that no such doctrine exists under current law. See, e.g., Robert H. Scarborough, *NYSBA Tax Section Concerned About Codifying Economic Substance Doctrine*, TAX NOTES TODAY (July 28, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 146-25); Lee A. Sheppard, *News Analysis - Corporate Shelters: A Snowball’s Chance of Pre-Tax Profit*, TAX NOTES TODAY (Aug. 7, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 152-3); Charles W. Shewbridge, III, *TEI’s Testimony at Hearing on Code Penalties and Interest Provisions*, TAX NOTES TODAY (Mar. 13, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 49-92). For an analysis of the efficiency aspects of applying the economic substance doctrine to abusive transactions, see Daniel Shaviro, *Corporate Tax Shelters, and the Compaq Case*, 88 TAX NOTES (TA) 221 (July 10, 2000).

some foreign courts to move beyond a literal application of the statutory language in tax cases.⁵³ While in recent times the Service has utilized the U.S. common law doctrines less and the literalist view of statutory interpretation has gained strength, the most appropriate response to this trend consists of reinforcing the vitality of the existing common law anti-abuse framework rather than creating a new overarching anti-abuse rule with little guidance for practitioners as to its scope and application.

B. Increasing Disincentives for Corporate Taxpayers

As discussed above, a compelling cost-benefit analysis motivates many corporate tax shelters. Consequently, shifting the balance of the cost-benefit scale towards the government should make taxpayers less willing to engage in questionable transactions. A number of methods exist to alter the cost-benefit calculus for taxpayers. The most obvious avenue is increased audit activity by the Service. If the Service performs audits more frequently and thoroughly, the likelihood of detecting abusive transactions increases and the potential benefit to taxpayers from such transactions decreases. The government, however, may lack the necessary resources or skill to effectively pursue such a strategy.⁵⁴ Part III.C. addresses the issues involved with increased enforcement activities.

The discussion in Part II identified the importance of obtaining more-likely-than-not opinions as a shield to the assessment of penalties. Consequently, a number of proposals would limit or completely eliminate this protection (in some cases effectively making tax-shelter activity a strict liability offense) in order to make the assessment of penalties in discovered tax shelters more certain.⁵⁵ Nevertheless, even creating a mandatory penalty at the current 20% level may not suffice to ultimately alter the cost-benefit calculus of

⁵³ See Office of Tax Policy, *supra* note 1, ¶ 334. See generally, Tiley & Jensen, *supra* note 12; INSTITUTE FOR FISCAL STUDIES, TAX AVOIDANCE: A REPORT BY THE TAX LAW REVIEW COMMITTEE (1997).

⁵⁴ See Office of Tax Policy, *supra* note 1, ¶ 228; see also Bankman, *supra* note 1, at 1788, 1789; ABA Testimony, *supra* note 1, at 586; New York State Bar Association Section on Taxation, *Comments on the Administration's Corporate Tax Shelter Proposals*, 83 TAX NOTES (TA) 879, 883 (May 10, 1999) [hereinafter NYSBA]; Calvin H. Johnson, *Corporate Tax Shelters, 1997 and 1998*, 80 TAX NOTES (TA) 1603, 1606 (Sept. 28, 1998).

⁵⁵ See Johnson, *supra* note 54, at 1606; see also Office of Tax Policy, *supra* note 1, ¶¶ 237-59; NYSBA, *supra* note 54, at 892-94; ABA Testimony, *supra* note 1, at 586-87.

a tax-shelter transaction, especially if the risk of detection on audit is not increased. Therefore, it may be necessary to substantially raise the amount of the penalty assessable in tax-shelter situations.⁵⁶

Proposals requiring disclosure of tax-shelter transactions on a taxpayer's return operate as a disincentive to engaging in questionable transactions due to the increased chance of detection.⁵⁷ Again, the benefit realized from increased disclosure is only as great as the Service's ability to act on the disclosure and effectively understand the transaction disclosed, as discussed below. Last, disallowing tax deductions for the expenses of investigating and implementing a tax-shelter transaction has also been raised as a potential method for increasing the costliness of undertaking questionable tax-shelter transactions.⁵⁸

C. Increasing Service Enforcement Activity

Another general avenue for addressing tax-shelter transactions requires an increase in Service enforcement activity. Increased enforcement could take several forms. First, the Service could conduct more audits each year. One issue presented by increasing the number of audits involves obtaining the necessary funding⁵⁹ – con-

⁵⁶ In this vein, a number of legislative proposals have provided for a 40% penalty in tax-shelter situations. *See, e.g.*, Grassley and Baucus, *supra* note 44. However, it should be noted that some have suggested that increased penalties, unless they approach 100%, would not eliminate the benefits of tax-shelter activity. *See* Sheppard, *supra* note 5, at 957. Additionally, as a general matter, providing any special treatment by statute for tax-shelter transactions obviously raises the difficult issue of exactly which transactions should be governed by the provision. As discussed in Part II, tax-shelter transactions are tremendously varied in their operation and while certain hallmarks of abusive transactions can be identified, particular transactions will often only exhibit some of these hallmarks. Thus, one extremely difficult problem raised by any statutory response to tax-shelter activity is appropriately defining the covered "tax shelters" in a manner that is neither overly broad nor under inclusive. *See* Office of Tax Policy, *supra* note 1, ¶ 249; *see also* ABA Testimony, *supra* note 1, at 584; Bankman, *supra* note 1, at 1789-90; Johnson, *supra* note 50, at 450; Kies, *supra* note 50, at 1466-67.

⁵⁷ *See, e.g.*, Johnson, *supra* note 54, at 1606-1607; Office of Tax Policy, *supra* note 1, ¶ 221.

⁵⁸ *See* Office of Tax Policy, *supra* note 1, ¶ 315.

⁵⁹ The number of Service employees, and therefore the number of audits, has decreased in recent years due to tight resources. *See* George Guttman, *News Analysis - Does the IRS Have the Resources To Do Its Job?*, TAX NOTES TODAY (Dec. 12, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 239-6). However, it is also fair to note that due to the increases in computer matching

ducting audits is expensive and time consuming. Presumably, however, the increased activity could pay for itself by uncovering otherwise hidden tax shelters. This section examines issues involving the skills of Service agents, the registration and disclosure requirements under current law, and the increased Service pursuit of taxpayers based on common law anti-abuse doctrines.

1. Issues Involving the Skills of Service Agents

A larger issue is whether Service agents have the requisite skills to either identify or appropriately challenge tax-shelter transactions.⁶⁰ The typical corporate tax shelter is a tremendously complex and convoluted transaction. Identifying whether purportedly separate transactions really constitute part of an overall set of transactions integral to a tax-shelter scheme also presents difficulty. This difficulty raises two problems: identifying the relevant transactions and understanding the implications of the overall transaction and the relevant tax rules applicable to it. Given the highly technical nature of these transactions, it is very probable that only a few hundred tax specialists in the country could effectively deal with the issues involved on a timely basis.⁶¹

On the other hand, practitioners routinely comment on the lack of sophistication of Service auditing agents, even when these agents review normal transactions.⁶² When an agent identifies an area of potential tax exposure on a taxpayer's return, the agent often fails to formulate the correct rationale for challenging the taxpayer's position. This often permits the taxpayer's counsel to easily refute the agent's claims while never having to defend the taxpayer's position with respect to the actual legal uncertainty involved. Similarly, increased audit activity could have a potentially adverse effect if unsophisticated agents, unable to find well camouflaged abusive transactions, simply identify any highly complex transaction as a

systems and the Service's categorization methods for what constitutes an audit, the decreasing audit figures may be misleading. George Guttman, *Current Audit Statistics Make IRS Look Less Effective Than It Is*, 90 TAX NOTES 1593 (Mar. 19, 2001).

⁶⁰ See Bankman, *supra* note 1, at 1786-87.

⁶¹ See Bankman, *supra* note 1, at 1787; see also Summers, *supra* note 2, ¶ 10 ("And there are now clear signs that abuse of the corporate tax code is becoming more sophisticated and harder to detect: companies are demanding 'black box' features in their transactions that are structured to be impenetrable to all but those who designed it.").

⁶² See Bankman, *supra* note 1, at 1786.

tax shelter. This could wastefully consume the government's limited resources by pursuing permissible business-motivated transactions merely due to their complexity.⁶³

Hiring knowledgeable private-sector attorneys could provide a means for dealing with this lack of sophistication. Such a solution leads us back to budgetary concerns given the high hourly rates commanded by such skilled attorneys, unless the Service compensated such private sector consultants on a contingent fee basis.⁶⁴ For taxpayer perception issues this seems an unlikely course of action, at least in broad application.⁶⁵ Hiring such costly experts only for the limited purpose of training Service employees is another alternative. This solution still leaves the underlying issue of agent competence: can agents absorb the training in such a manner that it

⁶³ The Service is aware of this potential pitfall in reviewing possible tax shelters and has indicated that it will undertake a careful review of suspect transactions to determine their true purposes before expending significant resources. See Announcement 2000-12, 2000-1 C.B. 835 ("The Office of Tax Shelter Analysis, acting with the Office of Chief Counsel and Treasury's Office of Tax Policy, will evaluate the tax treatment of new forms of tax-structured transactions at the earliest possible time. This review process is necessary not only to identify improper tax shelters, but also to protect taxpayers that engage in legitimate business transactions. The Service wants to ensure that transactions are not labeled as improper tax shelters merely because they are novel or complex."); see also Summers, *supra* note 2, ¶ 19 ("Treasury and the IRS are looking at whether to allow taxpayers to pre-file future transactions for IRS approval so that the new regulations and proposed legislative reforms do not interrupt legitimate economic transactions. The IRS is also exploring the possibility of establishing a fast-track procedure at the request of taxpayers under investigation.").

⁶⁴ See Bankman, *supra* note 1, at 1787.

⁶⁵ However, from an economics perspective, such a plan might well be a viable option for addressing tax-shelter issues. More specifically, the ability of companies to undertake abusive transactions and play the audit lottery will ensure that some companies will do so, thereby obtaining a lucrative competitive advantage over their more ethical competitors. In a world with perfect competition, all other companies would have to follow suit to avoid being run out of business. In such a situation, mere changes in the underlying legal standards or penalties may well prove ineffective to adequately dissuade the activity if the force driving the competitive behavior is under-enforcement. Instead, the economically efficient solution arises from unleashing countervailing competitive forces in favor of enforcement. From the standpoint of pure economics then, an efficient and rational method for combating tax abuses would be to create correspondingly lucrative financial incentives for enforcers of the tax laws. For the seminal article regarding the use of countervailing competitive forces to determine the economically efficient level of enforcement, see Gary Becker & George Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEGAL STUD. 1 (1974).

truly improves their audit performance? This hiring also raises the issue of whether the required knowledge base and intuitive detective skills can be effectively taught at all. Most of the tax attorneys in the select group capable of becoming tax-shelter detectives have only gained their skills over years of intensive study of the Code. It seems improbable that a sufficient portion of the required knowledge could be passed on and absorbed by even an experienced Service agent in the course of an intensive training session. To combat such issues, the Service created a new Office of Tax Shelter Analysis as part of its recent restructuring efforts to streamline its identification, analysis, and response to tax-shelter transactions.⁶⁶ It is too soon to appraise the impact this new office will have on the sophistication of the Service in tax-shelter matters.

2. Registration and Disclosure Regimes in Current Law

Beyond mere increased audit activity, greater disclosure and registration of tax shelters will aid the Service in locating and reviewing potentially suspect transactions. In this regard, current tax law already incorporates several registration and disclosure regimes.

Section 6111(c) requires registration of tax shelters meeting certain numerical and other criteria with the Service. This provision, which first entered the law in 1984, was aimed at curtailing particular types of tax-shelter transactions being marketed to individual taxpayers. Despite the fact that this provision was specifically tailored to target particular types of individual tax shelters, the implementing regulations were drafted using very broad language that could be interpreted to require registration of at least some of the current breed of corporate tax shelters. The Service, though,

⁶⁶ See Announcement 2000-12, 2000-1 C.B. 835. The Office of Tax Shelter Analysis will also be involved in educating agents regarding identified tax shelter transactions. John E. Hembera, *Service Narrows Focus in Tax Shelter Arena*, TAX NOTES TODAY (Mar. 28, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 60-4). In September 2001 the Service issued Fact Sheet 2001-10 to publicize its action plan for combating abusive tax shelters and deterring their promotion. *IRS Outlines Actions to Combat Abusive Tax Shelters*, TAX NOTES TODAY (Sept. 5, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 172-6) [hereinafter Fact Sheet]. Among the listed initiatives are creating a tax-shelter hotline, fostering better coordination within the Service regarding tax shelters, obtaining investor lists from promoters, increasing tax-shelter education and training within the Service, and pursuing and sanctioning promoters who fail to register tax shelters.

has only rarely attempted to apply these registration requirements to corporate tax shelters.⁶⁷

In 1997, Congress expanded the registration requirements of section 6111 to cover confidential corporate tax shelters to the extent required by Service regulations. The Service finally issued implementing regulations in 2000.⁶⁸ While these regulations are a helpful step in identifying suspect transactions, the statutory requirement that only *confidential* tax shelters be registered necessarily limits the impact of these regulations. Consequently, promoters can avoid registration under these rules merely by clarifying that persons shown the structure have no requirement of confidentiality.⁶⁹

Section 6112 requires promoters of “potentially abusive tax shelters” to maintain lists of investors for Service inspection. The term “potentially abusive tax shelters” covers transactions to which section 6111 applies as well as any other transaction specified by the Service in regulations. In 2000, the Service exercised this authority and now requires that promoters maintain lists for any transaction having a significant tax avoidance purpose.⁷⁰ Whether a sig-

⁶⁷ The Service apparently asserted that Merrill Lynch had improperly failed to register under section 6111(a) when it marketed the tax-shelter disallowed in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189, *aff'd in part, rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999). See Lee A. Sheppard, *Merrill Lynch Settles Penalty Case For ACM Shelter*, TAX NOTES TODAY (Aug. 29, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 168-2); Randall Smith & John McKinnon, *IRS, Merrill Lynch Reach Settlement on Tax Shelters*, WALL ST. J., Aug. 29, 2001, at C1.

⁶⁸ See Temp. Treas. Reg. § 301.6111-2T. This regulation was amended in August 2001 to address over breadth concerns.

⁶⁹ See Temp. Treas. Reg. § 301.6111-2T(c)(3). The registration rules may still have a beneficial impact because by encouraging nonconfidential transactions, any offeree skeptical of the promoter's transaction, or an attorney without client confidentiality constraints, could disclose the proposal to the Service. Indeed, the Service welcomes the receipt of such disclosures and has created a special tax-shelter “hotline” for this purpose. See Announcement 2000-12, 2000-1 C.B. 835; Fact Sheet, *supra* note 66. The hotline contact information is:

Internal Revenue Service
Office of Tax Shelter Analysis
LM:PFT:OTSA
1111 Constitution Avenue, NW
Washington, DC 20224
Telephone: (202) 283-8740
Fax: (202) 283-8354
E-mail: irs.tax.shelter.hotline@irs.gov

⁷⁰ See Temp. Treas. Reg. § 301.6112-1T, Q&A 4. Certain de minimis ex-

nificant tax avoidance purpose exists is determined under the same standard applicable to the registration of confidential corporate tax-shelters,⁷¹ but without the restrictions regarding confidentiality or corporate status. Consequently, the 2000 listing requirement has a significantly broader reach than the confidential corporate tax-shelter registration requirement; promoters must now maintain investor lists for a wide variety of both corporate and noncorporate transactions that are *not* subject to the registration requirements of section 6111.⁷²

Last, the Service exercised its general authority to specify tax return contents by adopting a tax-shelter disclosure standard in 2000 (which was subsequently amended to address certain overbreadth concerns). This standard explicitly requires corporate taxpayers to disclose on their yearly tax returns large transactions having certain tax avoidance characteristics irrespective of whether the transactions were confidential or otherwise subject to registration under section 6111.⁷³ While these disclosure requirements should assist the Service in identifying abusive transactions and in dissuading taxpayers from relying on the audit lottery in their cost-benefit analysis, critics of the Service approach might voice three concerns.

First, taxpayers may be concerned that the regulations will require the disclosure of tax reducing transactions that have legitimate business purposes and which the tax laws entirely support. Nevertheless, since the regulations merely require disclosure and create no presumption that the disclosed transactions are abusive, a mere disclosure requirement should not dissuade taxpayers from engaging in valid transactions. An overbroad disclosure standard would only create a problem if the Service failed to sufficiently appraise the disclosed transactions, which it has indicated it will not do.⁷⁴

ceptions may apply to eliminate the listing requirement for certain persons. See Temp. Treas. Reg. § 301.6112-1T, Q&A 8(b).

⁷¹ See Temp. Treas. Reg. § 301.6111-2T(b).

⁷² The Service might be able to use this list maintenance requirement as a justification for auditing suspected promoters to uncover abusive transactions. See discussion *infra* Part IV.B.1. However, this ability might be undercut to some extent by amendments made to the relevant regulations in August 2001 that narrow the definition of a significant tax avoidance purpose.

⁷³ See Temp. Treas. Reg. § 1.6011-4T. Generally, corporate taxpayers must disclose transactions expected to result in specified amounts of tax savings if the transaction is specially identified by the Service or has two or more of five listed characteristics. Exceptions exist for certain ordinary business transactions and ones where the Service would have “no reasonable basis” to challenge the alleged tax treatment.

⁷⁴ See *supra* note 63.

Of course another downside of an overbroad disclosure requirement is that the Service could be deluged with disclosures for so many legitimate transactions that it would lack the resources to identify the abusive transactions that were also disclosed.⁷⁵ Consequently, depending on the amount of disclosed transactions, the Service may find it necessary to further adjust the factors triggering disclosure if in fact the current factors appear overly broad.⁷⁶

Second, the use of a five-factor test permits taxpayers to structure their transactions around the factors. Anecdotal evidence suggests that promoters and taxpayers now focus their attention primarily on tax-shelter transactions that avoid the new disclosure regulations.⁷⁷ Again, this concern boils down to whether the definition of reportable transaction is appropriately broad and, if not, whether it could be addressed by tweaking the five-factor test. Of course, the Service must consider any expansion of the definition in light concerns that the regulation may be overly broad as discussed in the preceding paragraph.

Finally, current tax law imposes no penalty for nondisclosure. Instead, the preamble to the 2000 regulations merely suggests that a failure to disclose may suffice to find that a company was not acting in good faith and therefore would be ineligible for the reasonable cause exception to the substantial underpayment penalty. Given the apparent inclination for taxpayers to play the audit lottery, several commentators have suggested that the regulations should provide for a monetary penalty, or at least explicitly provide that failure to disclose will vitiate the reasonable cause exception.⁷⁸

⁷⁵ Indeed, it has been suggested that one reason for the narrowing amendments to these regulations in August 2001 was that numerous nonabusive leveraged leasing transactions were being disclosed under the regulation. Lee A. Sheppard, *News Analysis – Drafting Economic Substance*, TAX NOTES TODAY (Sept. 4, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 171-4).

⁷⁶ Indeed, the preamble to the August 2001 amendments explicitly acknowledges that additional modifications to the regulations may be required in the future. T.D. 8961, 66 Treas. Dec. Int. Rev. 8961 (2001).

⁷⁷ See Sheppard, *supra* note 5, at 956 (“It has been suggested that the disclosure rules would cause some diminution in activity, but the practical result appears to have been a new demand by the potential customers that the transactions they are shown not be covered. Customers will not touch deals that would have to be disclosed or that would put their names on a customer list. Registration is not even a question, because corporate deals are now being peddled without confidentiality restrictions.”).

⁷⁸ See Pamela F. Olson, *ABA Tax Section Sends Treasury Corrected Executive Summary of Corporate Tax Shelter Comments*, TAX NOTES TODAY (Oct. 6, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 195-23); Robert H.

3. Increased Service Pursuit Based on Common Law Doctrines

The Service could increase the effectiveness of its enforcement activity by pursuing more cases based on common law anti-abuse doctrines and purposive statutory interpretation. Recently, the Service seems to have pursued this exact course of action. Even after several successful challenges to tax-shelter transactions using these doctrines, however, the attorneys promoting complex tax-shelter transactions still seem inclined to downplay the significance of such decisions.⁷⁹ Presumably this downplay at least in part reflects the desires of clients for more-likely-than-not opinions that dismiss such general anti-abuse rules. In a similar vein, the Service has attempted to decrease its reaction time to newly uncovered transactions. While current law places certain constraints on the Service's ability to create retroactive regulations covering tax-shelter transactions, the Service has issued notices describing certain transactions. The Service has stated that it will challenge these transactions and that regulations it will promulgate will cover transactions undertaken after the date of the relevant notice.

D. Creating Disincentives for Tax-shelter Promoters and Advisors

The proposals aimed at dissuading tax-shelter promoters and advisors generally take one of two forms. First, Congress could dissuade promoters and advisors by levying an excise tax on, or imposing a penalty equal to a percentage of, fees received in connection with tax-shelter transactions.⁸⁰ This could be a potentially

Scarborough, *NYSBA Tax Section Supports Tax Shelter Regs with Modifications*, TAX NOTES TODAY (Nov.21, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 225-17).

⁷⁹ See Bankman, *supra* note 1, at 1782; see also Sheppard, *supra* note 5, at 956 ("I still do not believe that taxpayers are paying attention to what the case law says [regarding common law anti-abuse doctrines.] If they were, I wouldn't still be writing about even worse deals than the ones that lost in court. Promoters and clients persist in the belief that they can differentiate their own deals and their own facts."). Indeed, recent decisions in the Eleventh and Eighth Circuits upholding tax-shelter transactions have emboldened tax-shelter promoters in their assertions that the common law anti-abuse doctrines are inapplicable to their transactions. See Lee A. Sheppard, *News Analysis – Why The IRS Should Argue The Statute First*, 92 TAX NOTES 465 (2001); David Lupi-Sher, *Corporate Tax Shelters Regain Vitality?*, 92 TAX NOTES 11 (2001).

⁸⁰ See Office of Tax Policy, *supra* note 1, ¶ 313; see generally Roth, *supra* note 44 (proposing the creation of a 50% penalty on practitioners whose tax opinions are determined to be unreasonable).

significant tool in deterring promoters from creating tax shelters. Obviously, such a rule raises due process issues if the promoter was not a party to the taxpayer/Service controversy that originally determined the transaction was an abusive tax shelter. Alternatively, the Service would have to pursue the promoter in a separate litigation, perhaps leading to divergent results regarding the nature of the underlying transaction for tax purposes.

The second type of promoter disincentive ties in with the registration requirements of section 6111 by imposing a penalty if the promoter fails to register the tax shelter. Beyond just enforcing compliance with the registration requirement, such penalty provisions also give the Service an ability to audit taxpayers for compliance with the registration and investor list requirements. The Service can in turn use this power to get a glimpse of potentially abusive transactions that might nevertheless ultimately fall outside the definition of a tax shelter requiring registration. In particular, its experts have noted that:

Promoters would offer a promising "paper trail" to current tax shelters. Tax-shelter promotion is not, however, a criminal activity. The government could not simply rifle through a half dozen or so offices of investment banks and accounting firms on a search for documents that might increase the tax liability of unrelated taxpayers.⁸¹

While the statement is undoubtedly true, presumably the Service could perform registration and investor list compliance audits of suspected tax-shelter promoters to determine whether the transactions being created and marketed fall within the requisite definition of a "tax shelter" for registration or investor list maintenance purposes.⁸²

One of the key elements in many of the above proposals is the need for new or modified legislation. The remainder of this article will consider means of encouraging the practicing bar to help dissuade tax-shelter activity even if new legislation on these issues is not forthcoming or is slow to materialize. Nevertheless, some of the nonstatutory proposals described above (especially those involving Service action) would aid in co-opting the bar in the fight against abusive tax-shelter activity and, to this extent, the following discussion will deal with them in additional detail.

⁸¹ See Bankman, *supra* note 1, at 1790.

⁸² See *infra* Part IV.B.1. for a further discussion of this type of potential audit activity.

IV. CO-OPTING THE TAX BAR INTO POLICING TAX-SHELTER ACTIVITY

The above discussion has demonstrated that the favorable cost-benefit analysis associated with tax shelters largely drives the current tide of corporate tax-shelter activity. A willingness by taxpayers to play the audit lottery and a belief that dubious more-likely-than-not opinions will provide penalty protection contribute significantly to this cost-benefit calculation. The remainder of this article takes the position that the Service, the courts, and the tax bar should take immediate action aimed at stemming the tax-shelter tide, rather than passively waiting for a Congressional fix.⁸³ The proposals below ultimately aim to co-opt the practicing bar into more effectively curbing such overly aggressive tax-shelter transactions. More specifically, a number of actions can be taken that would (1) make tax-shelter opinions more difficult for a drafting attorney to justify; (2) provide reviewing attorneys with the tools and incentives to dispute the advisability of tax-shelter transactions; and (3) provide greater disincentives to the drafters of questionable opinions. While the proposed actions will not have the immediate effect of shutting down tax-shelter activity, over time they have the potential to noticeably impact the growth of the tax-shelter market. To the extent Congress can muster the political will to enact some or all of the statutory changes described in the previous section, all the better.

The following discussion will break the proposals into three categories, based on their intended impact on attorney behavior: (1) actions aimed at making questionable tax-shelter opinions more difficult to justify; (2) actions aimed at giving reviewing attorneys the incentives and tools to support anti-tax-shelter advice; and (3) actions creating disincentives for the drafters of questionable opinions. Understandably, certain actions potentially serve multiple purposes and the proposals below represent some overlap with the proposals discussed in Part III.

⁸³ The need for nonlegislative action is particularly relevant since Congress seems reluctant to take strong action against corporate tax shelters at the present time. See Bergin, Richardson, & Stratton, *supra* note 2, at __ (“The staffers who represented majority and minority views of both congressional taxwriting committees indicated a desire on the part of Congress to kick the tax-shelter problem back to the tax administrators, rather than to enact legislation.”).

A. *Making Questionable Opinions More Difficult To Justify*

As Part II discussed, many tax-shelter opinions reach their questionable results based on a combination of improper factual assumptions, casual dismissal of common law anti-abuse rules, and literal interpretation of a statute or regulation. As this section examines, three nonlegislative courses of action may address these factors.

First, the Service, the ABA, and state court disciplinary authorities should amend their rules of practice⁸⁴ and ethical standards⁸⁵ to address the deficiencies in opinion writing practices discussed above.⁸⁶ In particular, these authorities should require tax-shelter opinions to be based on explicit representations from the taxpayer and other parties involved setting forth and affirming the relevant facts, the business purpose of the transaction, and the non-existence of ancillary transactions aimed at eliminating or reducing the taxpayer's risk of loss. Additionally, the rules should clearly express that a practitioner must in fact believe the facts are fully and correctly represented and have no reason to suspect that any facts relevant to the opinion are incorrect, incomplete, inconsistent, or implausible. Finally, these authorities should require the opinion to address all material federal tax issues that bear on the proposed tax shelter, including the potential application of common law anti-abuse doctrines by a court to enforce the statutory intent of the tax laws involved, and clearly state an opinion regarding the likelihood of each such issue. Similarly, these authorities should require the express disclosure of any reliance on the opinion of another attorney for one or more of the material issues, with the relied upon opinion attached. Obviously, reliance on the opinion of another attorney must be reasonable in light of all the facts and circumstances. Adopting such requirements will not only make overly aggressive tax-shelter opinions more difficult to justify, but, as dis-

⁸⁴ The rules of practice before the Service are contained in Circular 230, 31 C.F.R. § 10 (2000). Section 10.33 of Circular 230 currently has restrictions on tax-shelter opinions that compose part of a prospectus. While this provision places some limitations on covered opinions, the scope of the provision is too limited to serve as either an effective deterrent or a relevant constraint for most corporate tax-shelter opinion writers.

⁸⁵ See ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982) (discussing the relevant ABA rules regarding tax-shelter opinions). However, as with the current rules of Circular 230, this formal opinion is inapplicable to most of the recent corporate tax-shelter opinions.

⁸⁶ See discussion *supra* Part II.

cussed in Part IV.C., will increase the likelihood of successful malpractice litigation.⁸⁷

Recently both the Service and the ABA have taken positive steps toward implementing stricter tax opinion standards. In the final days of the Clinton Administration, the Treasury issued over 100 pages of proposed changes to Circular 230, substantially increasing the opinion writing standards along the lines discussed above.⁸⁸ Similarly, the Standards of Tax Practice Committee of the ABA has produced several drafts of a proposed statement governing tax opinions generally, addressing some of the primary concerns regarding tax-shelter opinions.⁸⁹ While it is encouraging that

⁸⁷ It should be noted that an obvious consequence of increased ethical and practice standards is greater enforcement against attorneys facilitating tax-shelter transactions. Indeed, the Service has announced that it will triple the number of attorneys focusing on Circular 230 violations with a particular emphasis on tax-shelter activity. Christine J. Harris, *IRS Senior Counsel Warns of Vigorous Enforcement of Tax Shelter Cases*, TAX NOTES TODAY (Mar. 5, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 43-7). It might be argued that merely increasing the requirements set forth in the Service's rules of practice will create only a small disincentive for tax opinion drafters since the maximum penalty for violating such rules is being barred from representing clients directly in dealings with the Service (e.g., representing clients on audit or in obtaining a private letter ruling). It is not clear that this is in fact the case since many practitioners have diverse practices that involve both client advising and representation of clients with the Service. Such practitioners would be harmed by being barred from dealing with the Service. Additionally, the proposed changes to Circular 230 would give the Service authority to pursue other members of a firm if they have not taken precautions to ensure that members of the firm adhere to the opinion rules. In any event, if heightened professional ethics rules are also violated, the potential risk of suspension or disbarment from the practice of law should be an effective deterrent. The risk that a practitioner may lose his livelihood as a result of disbarment or prohibition against practice with the Service might be attacked as too draconian for the malfeasance involved. That is, the attorney may claim that his culpability is miniscule compared to that of the promoting investment banker and taxpayer. While such an argument has facial appeal, it overlooks the key role of the attorney in facilitating the tax shelter through his unrealistic opinion. The mere fact that a Mafia Don ordered a murder should not exculpate the hired guns who carried it out. *See also* Darryll K. Jones, *When Charity Aids Tax Shelters*, 4 FLA. TAX REV. 769 (2001) (arguing that tax shelter activity is a societal vice akin to the war on drugs which the government should address by pursuing all parties involved, including charitable organizations acting as accommodation parties in facilitating tax shelter transactions).

⁸⁸ *See* Regulations Governing Practice Before the Internal Revenue Service, 66 Fed. Reg. 3276 (Jan. 12, 2001) (to be codified at 31 C.F.R. § 10).

⁸⁹ *See* Standards of Tax Practice Committee, American Bar Association, *Draft Statement of Standards of Tax Practice 2000-2*, TAX NOTES TODAY (Oct.

both the Service and the ABA have recently taken steps to implement stricter tax opinion standards, it is unclear when the proposals will become effective or what their impact will be.⁹⁰

More specifically, action by the ABA's Standards of Tax Practice Committee has been slowed by issues regarding the definition of a tax opinion, how to address informal advice and e-mail correspondence, how to determine the intended purpose of advice, and whether the heightened standards would merely drive tax opinion writing into the hands of accounting firms subject to looser opinion standards.⁹¹ Even when the Standards of Tax Practice Committee finalizes a statement on tax opinion drafting, its impact may be severely limited if the ABA does not actually adopt the statement as policy.⁹²

Practitioners have criticized the proposed changes to Circular

23, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 205-51) (reproducing the Sept. 13, 2000 draft).

⁹⁰ A hearing on proposed Circular 230 was held on May 2, 2001. While it is impossible to know when these proposals will be finalized, a Treasury official has stated that they hope to do so by the end of the Service's 2001 business plan year (*i.e.*, June 30, 2002). John E. Hembera, *ABA Tax Practice Panel Reviews Circular 230 Developments*, TAX NOTES TODAY (May 15, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 94-8).

⁹¹ See Sheryl Stratton, *ABA Tax Section: Raising the Bar on Opinion Standards*, TAX NOTES TODAY (Oct. 20, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 204-4) [hereinafter Stratton, *Opinion Standards*]; see also Sheryl Stratton, *Raising Professional Standards for Attorneys, Wherever They May Work*, TAX NOTES TODAY (May 17, 2000) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 96-4) [hereinafter Stratton, *Raising Professional Standards*]. The work of the committee may also have been slowed by the conflicting competitive and moral issues faced by tax attorneys generally. See *supra* Part II. In this regard ethicist Frederic Corneel has described the committee as "a special group of people who try to make believe that making money is not all that we are interested in. Sometimes it is so, sometimes it is hard to convince even ourselves." Stratton, *Raising Professional Standards*, *supra*.

⁹² For instance, the Committee's Statement 1999-1 was required to contain a statement that it represented the views of the individual members and was not policy of the ABA or the Tax Section. See David M. Richardson, *Statement of Standards of Tax Practice: Letter to a Former Student*, 87 TAX NOTES 1143, 1144 (May 22, 2000) ("The conditions imposed on the [Tax] [S]ection by the American Bar Association in connection with the publication of Statement 1999-1, and which apparently will be imposed in connection with the publication of [the proposed statement regarding tax-shelter opinions], inhibit the development of standards of practice for tax lawyers, are demeaning to the section and should be embarrassing to the association.").

230 on a number of similar grounds.⁹³ Primarily, critics fear that the heightened standards will apply to almost all written tax advice and greatly increase the time and cost involved in advising clients on ordinary, nonabusive transactions.⁹⁴ The commentators, therefore, typically call for a significantly narrower definition of the types of transactions to which the proposed opinion rules would apply.⁹⁵ While deriving a simple and easily applied definition of a

⁹³ *Unofficial Transcript of IRS Hearing Where Witnesses Say Circular 230 Regs Are Too Burdensome*, TAX NOTES TODAY (May 11, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 92-41) [hereinafter *Hearing Transcript*]; ABA Section of Taxation, *ABA Tax Section Recommends Changes To Circular 230 Regs*, TAX NOTES TODAY (May 3, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 86-47) [hereinafter *ABA Comments*]; Richard M. Lipton and Frederic L. Ballard Jr., *ABA Tax Section Offers Definition of 'Tax Shelter' For Circular 230 Regs*, TAX NOTES TODAY (Aug. 15, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 158-15); Robert A. Jacobs, *New York State Bar Association Recommends Changes To Circular 230*, TAX NOTES TODAY (Aug. 2, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 149-41); Pamela J. Pecarich, *AICPA Suggests Changes to Proposed Circular 230 Regs*, TAX NOTES TODAY (Apr. 27, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 82-34); Les Shapiro, *NAEA Asks to Speak at Public Hearing on Proposed Circular 230 Regs*, TAX NOTES TODAY (Apr. 24, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 79-18); Lawrence M. Hill, *Attorney Recommends Changes to Proposed Circular 230 Regs*, TAX NOTES TODAY (Apr. 18, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 75-22).

⁹⁴ In particular, the large number of attorneys now communicating electronically with their clients has exacerbated this problem by shifting a significant amount of traditionally oral advice into written form. However, the Service presumably could ameliorate this situation to a large degree by indicating that preliminary or interim communications are treated as superceded by the final opinion regarding the overall transaction or simply ignored if the transaction is never consummated.

⁹⁵ As drafted, sections 10.33 and 10.35 of proposed Circular 230 govern opinions on transactions having "a significant" purpose of tax avoidance. This is the standard contained in section 6662(d)(2)(C) for defining a tax shelter in the context of imposing substantial understatement of tax penalties. Most of the commentators strongly advocate that the provisions should only apply to transactions where "the principal" purpose is tax avoidance. This standard is based on the language of section 6662(d)(2)(C) prior to its amendment in 1997. However, in its post-hearing comments the Tax Section of the American Bar Association has moderated its position somewhat by proposing a rather detailed definition of a "tax shelter" that represents a middle ground between the Service's proposed standard and "the principal" purpose rule. See Lipton and Ballard, *supra* note 93. It should also be noted that the Tax Section of the New York State Bar Association has taken a somewhat different tact on this question by advocating an "opt-out" approach. Under this proposal, a practitioner could avoid the application of the proposed new tax-shelter opinion standards by clearly la-

tax shelter that is neither overbroad nor under inclusive is a problematic task at best, the realities of current tax-shelter practice require a broad definition to dissuade those elements of the bar who would utilize the specificity of a narrow definition to escape from higher opinion standards. Additionally, predictions that higher opinion standards would impair normal tax advice seem questionable. If an issue is significantly clear that the advice serves as mere comfort to the client on the matter, it seems highly unlikely that the government would waste its resources in pursuing a violation of the opinion standards since the lack of conformity in no way promotes an abusive transaction.⁹⁶ On the other hand, if a position is supportable but still faces a significant risk of Service challenge, then good opinion practice should require a tax attorney to address all issues fairly and completely for the client, even if the practitioner truly believes the transaction is not an abusive one.⁹⁷

being any written communication as NOT being usable by the taxpayer to avoid penalties. See Jacobs, *supra* note 93.

⁹⁶ Indeed, since attorney tax opinions are typically covered by the attorney-client privilege, a violation of the opinion rules generally will only come to the attention of the Service in situations egregious enough for penalties to be asserted. That is, a taxpayer would only reveal the privileged opinion to the Service in connection with proving reasonable reliance on the opinion to avoid the imposition of penalties for taking the position. While section 7525 creates a similar privilege for certain nonattorney tax advice communications, this privilege is not available in the context of a corporate tax shelter as defined in section 6662(d)(2)(C).

⁹⁷ The "opt-out" approach recommended by the New York Bar Association's Tax Section raises similar concerns. That proposal permits a broad tax-shelter definition to be retained, but exempts any written advice from heightened tax-shelter opinion standards so long as penalty protection is affirmatively disclaimed. See Jacobs, *supra* note 93, ¶¶ 123-135. While such a rule might help address issues regarding the Service's ability to effectively impose penalties on taxpayers, it does not foster the type of practitioner advice that would bolster the integrity of our tax system. If a significant risk of Service challenge exists, a tax attorney should clearly inform her client regarding the issues and risks involved so that the client can make an informed decision before undertaking the transaction. Adopting an opinion standard that endorses the creation of narrowly focused opinions (perhaps even ones based on unrealistic factual assumptions) as long as a boilerplate disclaimer of penalty protection is included, does not foster the kind of informed judgment taxpayers should be making. Unsophisticated taxpayers could well be convinced by the legal reasoning and assume that the narrow opinion would be applicable to their situations despite the presence of a boilerplate penalty disclaimer. This would be especially likely if nearly every piece of paper the client receives contains identical boilerplate language (as most prudent attorneys would do under the opt-out standard). While the Service ultimately would

A related argument against the proposed Circular 230 opinion standards challenges whether they are too vague to justify imposing sanctions.⁹⁸ This criticism primarily stems from a due process concern that the Service will apply the opinion standards in a subjective manner that is unfair to practitioners who require well defined, objective standards as a benchmark for their behavior. Again, for the reasons discussed above, it is unclear that the proposed standards are so ill defined that the Service could not administer them in a fair, uniform manner. Additionally, this criticism may have its root in a belief that new legislation should address tax shelters and that it is simply unfair and inappropriate to sanction attorneys as a means of dissuading tax-shelter activity.⁹⁹ Such a justification overlooks both the crucial nature of tax attorneys in facilitating tax-shelter activity and tax attorneys' historic role in upholding the integrity of our tax system.¹⁰⁰ Indeed, this paper is premised on exactly the opposite proposition: tax attorneys have a duty to the tax system as well as to their clients and measures should be taken to encourage and assist the tax bar in dissuading abusive transactions even if no further legislative action is taken. Consequently, both the Service and the ABA should redouble their efforts in promulgating effective rules to tighten tax opinion writing standards.¹⁰¹

A second avenue for making tax-shelter opinions more difficult to justify involves increasing the strength of common law anti-

be able to collect penalties in such a situation, the unsophisticated taxpayer would have been harmed by the existence of an opinion standard that sanctioned his attorney not providing him with a full disclosure of how the law was actually likely to apply in his particular situation.

⁹⁸ Hearing Transcript, *supra* note 93, ¶ 284-86.

⁹⁹ *Id.* ¶ 292-93 (“I view the provisions as legislating in the tax shelter area where Congress has not spoken. Essentially I view it as the tail wagging the dog. I don’t believe that standards of practice should serve as a substitute for tax shelter legislation. I think to some extent we’re trying to regulate the conduct of taxpayers, by regulating the conduct of tax professionals. I think this is inappropriate in some instances. I think the opposite should be the case.”).

¹⁰⁰ For the tax attorney’s role in the administration of the tax system, see the discussion at notes 138-141 *infra* and accompanying text.

¹⁰¹ While the above discussion assumes that increased opinion standards will help reduce tax shelter activity, it could be argued that higher standards will merely push clients into the arms of the most aggressive tax attorneys. See Franklin L. Green, *Exercising Judgment in the Wonderland Gymnasium*, 90 TAX NOTES 1691, 1707 (Mar. 19, 2001). However, even if this in fact happens, in the long run such a movement would make it easier to identify and sanction such an overly aggressive minority and more readily expose such attorneys to malpractice liability.

abuse doctrines. As discussed above, a major concern regarding tax-shelter opinions is their failure to give adequate weight to existing common law anti-abuse doctrines. In reaching their results, practitioners frequently rely on the ambiguous application and ill-defined scope of the anti-abuse doctrines and the trend in the Supreme Court to adopt a more literal approach to statutory interpretation.¹⁰² Even after two important tax-shelter cases, *ACM Partnership v. Commissioner*¹⁰³ and *ASA Investering's Partnership v. Commissioner*¹⁰⁴, relied on common law doctrines in ruling against recent tax shelters, many attorneys engaged in tax-shelter work quickly dismissed the cases as merely reflecting the predilection of the judges involved and refused to view the cases as representing a serious threat to their own tax-shelter schemes.¹⁰⁵ Additionally, several recent cases have rejected attempts by the Service to apply common law doctrines to tax shelters¹⁰⁶ and thereby strengthened arguments that such doctrines can be easily distinguished in tax-shelter opinions.¹⁰⁷ In order to convince practitioners of the continued validity of common law anti-abuse doctrines, the Service must more vigorously assert them. Failure to do so could lose cases because often a mere technical application of the relevant statutes and regulations would result in a loss for the government. Similarly, the courts must willingly apply these doctrines when raised by the Service to prevent abuses that could be sustained under a purely literal interpretation of the law.¹⁰⁸ While recent cases like *ACM*,¹⁰⁹

¹⁰² See Mary L. Heen, *Plain Meaning, the Tax Code and Doctrinal Incoherence*, 48 HASTINGS L.J. 771 (1997). See also, WILLIAM N. ESKRIDGE, JR., DYNAMIC STATUTORY INTERPRETATION, 227 (1994); William N. Eskridge, Jr. & Philip P. Frickey, *The Supreme Court 1993 Term: Foreword: Law as Equilibrium*, 108 HARV. L. REV. 26, 58 nn.133-34 (1994).

¹⁰³ 73 T.C.M. (CCH) 2189 (1997), *aff'd in part, rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

¹⁰⁴ 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000).

¹⁰⁵ See Bankman, *supra* note 1, at 1782.

¹⁰⁶ See *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *United Parcel Service of America, Inc. v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001).

¹⁰⁷ See authorities cited *supra* note 79.

¹⁰⁸ A number of commentators have endorsed adopting a more liberal view of statutory interpretation in tax cases. See, e.g., Smith, *supra* note 11, at 528; Deborah L. Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445, 459-60 (1993); Deborah L. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 497-502 (1995); Michael A. Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax*

ASA,¹¹⁰ *Compaq Computer Corp. v. Commissioner*,¹¹¹ *The Limited, Inc. v. Commissioner*,¹¹² and *Winn-Dixie Stores Inc. v. Commissioner*¹¹³ indicate that the Service and the courts are taking steps in the right direction, more cases need to be brought and decided on common law anti-abuse grounds, especially in light of the Service's significant losses in *IES Industries, Inc. v. United States*¹¹⁴ and *United Parcel Service of America, Inc. v. Commissioner*.¹¹⁵

The Service should also formally announce that it intends to vigorously assert such doctrines and a purposive view of statutory language in any situation involving a tax result at odds with sound tax policy or statutory intent. Correspondingly, the Service should take care to ensure that its actions do not inadvertently denigrate the scope of these common law doctrines.¹¹⁶

A final means for making tax-shelter opinions more difficult to justify involves more aggressive judicial application of purposive

Statutes, 69 TEX. L. REV. 819, 822-23 (1991); Zelenak, *supra* note 11, at 637-38; Robert Thornton Smith, *Business Purpose: The Assault Upon the Citadel*, 53 TAX LAW. 1, 16-17 (1999).

¹⁰⁹ 73 T.C.M. (CCH) 2189 (1997), *aff'd in part, rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

¹¹⁰ 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000).

¹¹¹ 113 T.C. 214 (1999).

¹¹² 113 T.C. 169 (1999).

¹¹³ 113 T.C. 254 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001).

¹¹⁴ 253 F.3d 350 (8th Cir. 2001).

¹¹⁵ 254 F.3d 1014 (11th Cir. 2001).

¹¹⁶ Although this might seem an unlikely eventuality, it is not without precedent. For instance, in Rev. Rul. 79-250, 1979-2 C.B. 156, the Service enunciated a rule that some interpreted as circumscribing the step-transaction doctrine generally. To clear up the confusion the Service ultimately modified the rationale for the ruling. Rev. Rul. 96-29, 1996-1 C.B. 50 ("Although the holding of Rev. Rul. 79-250 is correct on the facts presented therein, in order to emphasize that central to the holding in Rev. Rul. 79-250 is the unique status of reorganizations under section 368(a)(1)(F), and that Rev. Rul. 79-250 is not intended to reflect the application of the step-transaction doctrine in other contexts, Rev. Rul. 79-250 is modified."). Similarly, in revising the continuity of interest rules for corporate reorganizations, the Service's initial proposals raised questions regarding the role of the step-transaction doctrine generally. See KPMG Peat Marwick LLP, *Focus: Corporate Taxation*, 16 TAX MGM'T. WKLY REP. 482 (Mar. 31, 1997). The final regulations addressed the uncertainty over the application of the step-transaction doctrine by more clearly stating that the regulations were altering the underlying test for continuity of shareholder interest, rather than representing a change in the application of the step-transaction doctrine generally. See T.D. 8760, 63 Treas. Dec. Int. Rev. 8760 (1998).

statutory interpretation in the tax context. A number of tax court cases have placed undue weight on a plain meaning rule analysis of tax issues.¹¹⁷ While a strict view of statutory interpretation may be currently in vogue, there has traditionally been a looser application of such canons in the area of tax legislation.¹¹⁸ More judges need to recognize and apply this more relaxed approach to statutory interpretation when considering tax-shelter cases.

B. Incentives and Tools to Support Anti-Tax-Shelter Advice

In addition to making tax-shelter opinions more difficult for drafting attorneys to justify, measures should be taken to encourage reviewing attorneys to challenge overly aggressive opinions. This section will discuss actions aimed at providing reviewing attorneys with rationales and support for questioning the advisability of abusive tax-shelter transactions, as well as methods for inducing reviewing attorneys to raise concerns about proposed transactions with their clients.

1. Providing Rationales for Challenging Advisability

In order to persuasively challenge the advisability of a tax-shelter transaction, a reviewing attorney must have sufficient legal precedents, authorities, and rationales to justify her concern. The actions aimed at making tax-shelter opinions more difficult to justify, discussed at Part IV.A., should give rise to such precedents and highlight the continued relevance of purposive statutory interpretation and common law anti-abuse doctrines. Similarly, amending opinion standards to require detailed factual representations should force suspected areas of factual concern to the surface for honest resolution. Beyond these factors, the Service can provide reviewing attorneys with additional reasons to urge caution on their clients.

¹¹⁷ See, e.g., Ilyse Barkan, *New Challenges to Use of the Plain Meaning Rule to Construe the IRC and Regs*, TAX NOTES TODAY (Dec. 13, 1995) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2000 TNT 242-48).

¹¹⁸ See generally, Zelenak, *supra* note 11 (reviewing tax cases in which courts have used nonliteral interpretations to further the perceived policies of the Code). See generally the sources cited *supra* note 108 for discussions of the need for a nonliteral approach to the interpretation of tax statutes in light of the "rich range of contextual and policy considerations that inform" the meaning of the Code. Heen, *supra* note 102, at 771.

a. Less Certain Penalty Protection

Reviewing attorneys would have more justification to counsel against tax-shelter transactions if the promoter-obtained opinion provided less certain penalty protection. The prior discussion has generally assumed that *any* more-likely-than-not opinion would shield the client from penalties. In fact, the relevant provisions require that a corporate taxpayer show it acted in good faith and a reasonable cause motivated the underpayment.¹¹⁹ Although the existence of a more-likely-than-not opinion is a significant factor to consider in determining reasonable cause, the taxpayer's reliance must be "reasonable" based on all the surrounding facts.¹²⁰ Thus, if a taxpayer does not in fact believe the promoter-obtained opinion, or such belief is shown to have been unreasonable, then the promoter-obtained opinion provides no penalty protection. Suspect opinions generally result from opinion shopping by the promoter. Consequently, the Service should attempt to assess penalties in tax-shelter cases on the grounds that the taxpayer's reliance on the promoter's opinion is not reasonable in light of all the facts and circumstances or on the grounds that the taxpayer in fact did not believe the conclusion stated in the opinion.¹²¹ In this regard, the views of the client's regular tax attorney regarding the proffered opinion should be highly relevant.¹²² Even if courts only occasionally uphold such penalty assessments, these assessments will nonetheless give reviewing attorneys another reason to counsel against tax-shelter transactions even in situations where a promoter supplies an opinion.

b. Clearer Registration Implications

Similarly, an advising attorney would have an easier time dissuading a client from undertaking a tax shelter if it were clearer that

¹¹⁹ I.R.C. § 6664(c). *See also supra* note 33 and accompanying text.

¹²⁰ Treas. Reg. § 1.6664-4(b)(1), (c).

¹²¹ Despite this potentially fruitful avenue for assessing penalties, the Service has generally failed to raise this issue. As a consequence, the practicing bar typically assumes that *any* more-likely-than-not opinion will provide a penalty shield. *See Bankman, supra* note 1, at 1779.

¹²² Adopting a rule creating an obligation by a tax attorney to provide a client with his views regarding the success of a tax-motivated transaction, even if not explicitly asked to review the issue by his client, would further strengthen such a line of attack. *See infra* Part IV.B.2 for a discussion of such a requirement.

the transaction would come to the attention of the Service through required registration or disclosure. As discussed at Part III.C., certain registration and disclosure requirements currently exist. Clients and promoters, however, often dismiss such requirements as inapplicable or irrelevant when raised by reviewing attorneys.

For instance, taxpayers engaging in corporate tax shelters almost universally ignore the tax-shelter registration rules. More specifically, the new registration provisions under section 6111(d) apply only to confidential arrangements and therefore are easily evaded. Similarly, clients and promoters often summarily dismiss the registration rules under section 6111(c), adopted in 1984, on the ground that these rules only pertain to the "old-style" individual tax shelters of the early 80's. While it is true that Congress adopted the 1984 registration provisions with such old-style transactions in mind, the regulatory language implementing the registration requirement could be interpreted quite broadly to include a number of corporate tax-shelter transactions.

Nevertheless, tax-shelter promoters tend to respond incredulously when tax attorneys raise the potential for registering under the 1984 regulatory provisions. Beyond their belief that these rules are inapplicable because they were only intended to cover old-style tax shelters, they question whether the Service would ever seriously raise a challenge in this context.¹²³ It is not uncommon for a promoter to dispute an attorney's conclusion that registration is required by asking the attorney to compile the authorities where the Service has challenged taxpayers under the registration provisions. The invariable (and unfortunately true) answer is that only a scattering of authorities exist regarding the 1984 registration provisions.¹²⁴

¹²³ Even if promoters pause long enough to consider the possibility, the existence of a reasonable cause exception to the registration requirement in section 6707(a)(1) usually convinces them that the Service could never successfully assert any penalty against them for failing to register. *See* I.R.C. § 6707(a)(1).

¹²⁴ The relevant authorities are: Rev. Rul. 90-84, 1990-2 C.B. 254 (registration number must be furnished to subscriber when promoter is first unconditionally obligated to transfer partnership interest to subscriber, not when promoter accepts conditional subscriptions); Rev. Rul. 90-85, 1990-2 C.B. 255 (passive activity rules are ignored in computing ratio of tax benefits to investment, even if promoter represents to investors that certain losses may be disallowed under such rules); Rev. Rul. 90-86, 1990-2 C.B. 256 (providing guidance regarding calculation of the tax-shelter ratios in tiered partnership structures); Priv. Ltr. Rul. 88-42-042 (Oct. 21, 1988) (dealing with aggregation of distinct partnerships in applying tax-shelter registration rules); Priv. Ltr. Rul. 88-35-030 (June 6, 1988) (dealing with the related party loan rules and investment base calculation); Priv. Ltr. Rul. 88-03-089 (Oct. 30, 1987) (dealing with representations and investment

The mere existence of the requirements, coupled with the other anti-tax-shelter provisions adopted at the same time, effectively shut down the old-style tax-shelter market, explaining this absence of authority. Consequently, the practitioner who believes that section 6111(c) requires registration is placed in the untenable position of trying to persuade the promoter to register based only on an expansive reading of regulations that the Service seems to have forgotten about. Given that the audit lottery mentality heavily influences current tax-shelter transactions, promoters are unswayed by such registration concerns and almost never register.

The willingness of clients and promoters to ignore the 1984 registration requirements can place practitioners in a difficult position since the obligation to register a tax shelter as governed by the 1984 regulations falls onto others involved in the transaction (potentially including reviewing attorneys) if the primary promoter fails to register.¹²⁵ With the penalty for failure equal to 1% of the investment in the transaction, an advising attorney can face a significant risk of nonregistration. Unfortunately, due to the attorney-client relationship, an attorney probably could not ethically register the tax shelter over a client's objections. The regulations address this issue by providing an exception from the registration requirement for attorneys who merely receive hourly fees for their services.¹²⁶ If the client pays the attorney only for the hours she works on the matter at her standard rates, then the provision will not generally consider her a participant subject to a registration obligation. Such registration concerns have caused more than one attorney to ultimately charge promoters only for their hours worked, rather than on a more lucrative premium-billing basis, in order to shield themselves from potential tax-shelter registration penalties.¹²⁷ Even

base calculations); Priv. Ltr. Rul. 86-34-006 (May 8, 1986) (registration number must be furnished to subscriber when promoter is first unconditionally obligated to transfer partnership interest to subscriber, not when promoter accepts conditional subscriptions); *In Re Mitchell*, 64 A.F.T.R.2d (RIA) 5535 (1989), *aff'd*, 1990 WL 142016 (W.D. Wash. 1990), *rev'd*, 977 F.2d 1318 (9th Cir. 1992) (section 6707 failure to register penalty applied). There are also approximately eighteen different sections of the Service Manual that reference section 6707 failure to register penalties.

¹²⁵ Treas. Reg. § 301.6111-1T Q&A 34-39. Additionally, if the attorney believes that a filing may be required, it seems unlikely that he would qualify for the reasonable cause exception to filing merely because his client refuses to file directly.

¹²⁶ Treas. Reg. § 301.6111-1T, Q&A 30.

¹²⁷ Such a decision usually results in much internal griping by the tax attorney and her partners over their "lost" income and the corresponding increased

so, an attorney must act carefully in the role she performs since the fee-for-service exemption does not apply to persons involved in the actual sale or marketing of a tax shelter.¹²⁸ Thus, the provision could potentially charge an attorney who attends marketing meetings, advises the promoter's salespersons regarding how to market the shelter, or performs other activities with an obligation to register the tax shelter even if the client only compensated her on a straight fee-for-service basis.

The above discussion highlights the fact that the 1984 tax-shelter registration rules could be used to reach some of the current tax-shelter activity. In order to do so, the Service should publicly announce that it intends to closely scrutinize current transactions under these registration requirements, including pursuit of attorneys, accountants, and other non-principal promoters receiving premiums in connection with the transactions. Obviously, the Service should then carry through with this announced intent by actually raising the registration issue in the tax-shelter cases it uncovers. If the Service gives these registration requirements a higher profile, reviewing attorneys will have a more forceful argument when dissuading clients from tax-shelter activity.

Beyond registration, the Service recently promulgated regulations requiring corporations to disclose certain suspect transactions.¹²⁹ While these regulations aid reviewing attorneys in questioning the advisability of a client's tax-shelter activity, their ultimate impact remains unclear. More specifically, it remains to be seen whether promoters will successfully design transactions that evade the disclosure requirements and whether the lack of a prescribed penalty for nondisclosure will encourage taxpayers to ignore this requirement.¹³⁰

c. Service Pursuit of Promoters

Finally, the Service can provide reviewing attorneys with more ammunition to convince their clients that it will discover the proposed tax shelter by aggressively pursuing promoters to uncover tax shelters that the promoters have sold to investors. Recently revised

income to the tax-shelter promoter. The moaning is most apparent when the tax attorney actually developed the tax-shelter technique herself and has to watch the promoters reap the huge benefits. This frustration has caused some attorneys to shift into promoter roles themselves. See Bankman, *supra* note 1, at 1783.

¹²⁸ See Treas. Reg. § 301.6111-1T, Q&A 31.

¹²⁹ See Temp. Treas. Reg. § 1.6011-4T.

¹³⁰ See discussion *supra* Part IV.B.1.

regulations require promoters to maintain lists of investors participating in tax shelters.¹³¹ This listing requirement extends well beyond transactions requiring actual registration under section 6111. While a close audit of the primary investment banks and accounting firms acting as tax-shelter promoters would uncover many abusive transactions and provide a direct trail to the taxpayers involved, critics question the legality of engaging in a bald fishing expedition.¹³² Still, nothing prevents the Service from conducting legitimate audits of suspected tax-shelter promoters to verify compliance with the registration and investor list maintenance regulations.¹³³ The Service could possibly even justify the high cost of hiring outside counsel to aid in this type of specialized audit review of select promoters, thereby obtaining expert advice where the Service needs it most—in the initial identification of potentially abusive transactions.¹³⁴ Even if such audits ultimately demonstrate that most of the tax-shelter transactions undertaken fall outside the scope of the registration requirements under section 6111 or the maintenance of investor lists requirements under section 6112, the audits will have

¹³¹ See Temp. Treas. Reg. § 301.6112-1T.

¹³² See Bankman, *supra* note 1, at 1790.

¹³³ While the Service is not supposed to go on fishing expeditions, a focused compliance review of the major suspected tax-shelter promoters should be justifiable. An ancillary problem is determining which of the thousands of transactions an investment bank engages in each year are tax-shelter transactions. Since most promoters have certain specialists in tax-shelter work, it should be possible to limit the review to transactions created by the “tax products desks” or personnel of a given suspected promoter.

¹³⁴ Some will object to such aggressive Service enforcement activity as inappropriate due to the potential for abuse by the Service. However, as long as it is used only for promoters suspected of noncompliance and the audit is limited to the tax products division of the entity, a compliance audit would be justifiable. Such a position would obviously be bolstered if at least one instance of a failure to register or maintain investor lists by the particular promoter existed to serve as the basis for further inquiry of the promoter’s compliance. The Service has apparently taken some tentative steps in this regard, but appears sensitive to concerns of overreaching. See Sheryl Stratton, *IRS Pursues All Fronts in War on Abusive Tax Shelters*, TAX NOTES TODAY (Jan. 16, 2001) (LEXIS, FEDTAX lib., TNT file, elec.cit., 2001 TNT 10-3) (noting that the Service has sent “soft” investor list and tax-shelter information request letters to nineteen promoters, but stressing that the Service will make sure that it has proper documentation on which to base any request for such information). See also IRS Legal Memoranda (ILM) 200038043 (Aug. 9, 2000) (section 7605(b) prohibition against unnecessary examinations would not prohibit the Service from conducting multiple examinations of a tax-shelter organizer for the same tax year to determine penalties arising from different shelters).

served the purpose of uncovering a number of abusive transactions. The Service can then pursue these abusive transactions in a focused manner, thereby demonstrating to attorneys and their clients the significant risk of detection.

Implementing the above proposals would clearly help prevent cautious tax attorneys from being dismissed as mere nervous Nellies when they suggest that the law requires registration or disclosure. Moreover, the above proposals will increase the likelihood that promoters will register and taxpayers will disclose as a protective matter, thereby increasing the likelihood of Service detection. The greater possibility for detection likely would dissuade overly aggressive transactions from going forward in the first place.

2. Incentives to Raise Advisability with Clients

The above discussion has indicated how the Service and the courts can give tax attorneys tools for use in dissuading clients from engaging in tax shelters, but such tools count for naught if the attorneys refuse to honestly express their views to their clients. A number of reasons may explain why an attorney might hesitate to advise against a tax-shelter transaction. First, the tax advantages of the proposal obviously interest the client or the client would not consider the proposal. Attorneys are sensitive to trying to meet their client's needs. The last thing an attorney wishes is for his client to consider him an obstacle, rather than an aid, in reaching the client's objectives.¹³⁵ An attorney that consistently tells his client "no" probably will not have that client for long.

Second, sometimes attorneys for the taxpayer only have tangential involvement in the transaction. The taxpayer may have decided to rely on the promoter opinion without explicitly instructing their normal attorneys to review the opinion. Even if the client's normal tax attorney sees the opinion and believes it is incorrect based on her background and experience, without the benefit of actually researching the issues thoroughly (which the client probably is not paying for) she may hesitate to raise her concerns regarding an area outside her stated role in the transaction.

Third, the penalty protection conveyed by the promoter's proffered opinion can inject a "don't ask, don't tell" philosophy into the

¹³⁵ As a senior partner once only half jokingly admonished me in the midst of structuring an extremely difficult transaction: "From now on you're not allowed to find any more problems with this deal unless you already have a solution."

normal relationship between a client and the client's regular tax advisors. Clients implicitly understand that the proffered results from shopping the transaction to different attorneys and the opinion may in fact not represent the mainstream of legal thought on the transaction despite its more-likely-than-not conclusion. Thus, a client may hesitate to ask her normal attorney to examine the opinion for fear that the attorney will reject the opinion and jeopardize the client's reliance on the proffered opinion.¹³⁶ Similarly, the client's attorney may hesitate to express her concerns regarding an opinion, even when asked, if doing so would decrease the potential penalty protection afforded by the proffered opinion.

Finally, while most attorneys will not affirmatively advise a client to undertake a questionable transaction based on a low risk of audit detection, the attorneys are less likely to raise the ethics of relying on the audit lottery when the client and promoter already implicitly rely on non-detection in their cost-benefit evaluation of the transaction. Lawyers hesitate to suggest that ethical considerations could outweigh business economics unless their client specifically asks them about such issues.¹³⁷

Several approaches could be used to increase the activism of attorneys in raising ethical issues and expressing disagreement with promoter opinions. Impressing practitioners with a sense of obligation to uphold the tax laws would be a good nonspecific, albeit general, approach. It is commonly accepted that a criminal lawyer has both a duty to her client and a sometimes conflicting duty as an officer of the court. As such, an attorney cannot permit the perpetration of frauds on the court or counsel breaking the law. Attorneys have an obligation to advise clients not to undertake illegal actions; in certain situations, the attorney must withdraw from representation of a client. The Service and the tax bar should clearly express their view that a similar duty applies with respect to upholding the tax law.¹³⁸ When a client wishes to undertake an action that bends

¹³⁶ Taxpayers may also merely wish to avoid the additional cost of having their own attorneys review an opinion that is already considered sufficient for penalty protection purposes.

¹³⁷ See Bankman, *supra* note 1, at 1783-84.

¹³⁸ The leading casebook on tax practice ethics emphasizes the existence of such a duty to the tax system. See BERNARD WOLFMAN, JAMES P. HOLDEN & DEBORAH H. SCHENK, *ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE* 1 (3d ed. 1995); see also BERNARD WOLFMAN, JAMES P. HOLDEN & KENNETH L. HARRIS, *STANDARDS OF TAX PRACTICE* § 101.2 (5th ed. 1999) [hereinafter Wolfman, *Standards of Tax Practice*] ("The practitioner's obligation to the client, however, is not unrestricted. The practitioner also owes a duty, albeit less well-defined, to

the law to the breaking point, a tax attorney should at a minimum express her view of the inappropriateness of the action to the client. Indeed, historically tax attorneys have served as the gatekeepers of the tax system by dissuading abusive transactions in the planning stages, thereby focusing the limited resources of the Service and the courts on issues of genuine legal uncertainty.¹³⁹ The Service could attempt to formalize such an interpretation of the tax adviser's role by inserting a general requirement into Circular 230 imposing a formal duty upon practitioners to uphold the tax laws and the fair operation of the tax system.¹⁴⁰

Another approach involves law professors raising such ethical issues in the classroom. While the recent pace of technical amendments has clouded the picture a bit, it is still possible to understand the Code as part of a mostly coherent tax system joined together by guiding policy considerations. In teaching students to appreciate the underlying tax policies, professors should try to impress on students the duty to act consistently with such policies in interpreting the Code and in advising clients. Professors should highlight the importance of the judicially created anti-abuse rules for students as a way to police the consistent and fair application of the tax laws and underlying policies. Professors should not teach students to approach the Code as mere unthinking technocrats. In the same

the tax system as a whole."'). Unfortunately, not all commentators agree that such a duty exists. *See, e.g.*, Mark H. Johnson, *Does the Tax Practitioner Owe a Dual Responsibility to His Client and to the Government? - The Theory*, 15 U.S. Cal. Inst. 25 (1963).

¹³⁹ *See* Green, *supra* note 101, at 1692-93 ("[I]t has been a fundamental role of tax practitioners to identify for taxpayers those tax return positions that may be attempted and those that are beyond the pale In a real sense, the tax adviser is a gatekeeper who regulates the flow of issues into the system For self-assessment to be workable, tax advisers cannot fail to perform their gatekeeper function and cannot allow a floodtide of illegitimate issues to swamp the system. Accordingly, it is imperative that tax advisers apply professional standards with intellectual honesty in determining what positions have enough credibility to be able to be asserted."').

¹⁴⁰ *See infra* note 141 for language that might be used in this regard. However, the extension of Circular 230 to encompass such a general duty might be challenged as not within the authority of the Service. *See e.g.*, ABA Comments, *supra* note 93 (noting that some attorneys questioned the authority of the Service to regulate tax-shelter opinions using Circular 230 since writing opinions for clients may not constitute practice before the Service subject to regulation under 31 U.S.C. § 330). However, the fact that a proposed transaction would ultimately be reflected on a taxpayer's tax return if consummated should provide a sufficient nexus to support inclusion of such a general duty of attorneys to the tax system to be included in Circular 230.

vein, bar associations should promote tax ethics programs to give practicing attorneys a forum to discuss such issues and sensitize each other to the ethical aspects of their specialty.

Beyond highlighting the tax bar's general duty to the tax system, the Service should prescribe certain mandatory attorney behaviors or disclosures to clients when a practitioner becomes aware of a client's consideration of a questionable transaction. For instance, Circular 230 could contain a provision requiring attorneys to affirmatively advise clients against engaging in the audit lottery. Alternatively, as mentioned in note 122, a provision could obligate an attorney to notify clients if the attorney disagrees with the tax treatment of a transaction described in another attorney's opinion letter.¹⁴¹ In this way, the Service would encourage the practicing bar to find its voice even in situations where their normal self-interest and client-interest concerns would counsel silence. While mere disclosure of an attorney's concerns to a client provides no guarantee of dissuading a tax-shelter transaction, it may cause corporate citizens to reevaluate their positions and actions and may give the Service better grounds for assessing penalties if the client nevertheless undertakes such an abusive transaction.

¹⁴¹ See *supra* note 122. Such a statement might be formulated as follows: "An attorney or enrolled agent admitted to practice before the Service has an obligation to uphold the tax laws and the efficient operation of the tax system. This duty applies whenever a practitioner becomes aware of actions or proposed actions by a client that implicate such concerns even if the practitioner has not been specifically retained to examine such actions. The failure of a practitioner to discuss with a client the legality and appropriateness of tax motivated transactions which the practitioner suspects (1) have a potential for undermining the efficient operation of the tax system, (2) could be viewed as contrary to sound tax policy, or (3) may be reported in a manner not supported by current law, would constitute a violation of the practitioner's duty to the tax system. If a practitioner suspects that a client may be considering the lack of detection by the Service as a factor in taking a tax position or engaging in a tax motivated transaction, then the practitioner has an affirmative duty to inform the client that the likelihood of detection is an inappropriate basis for reporting a tax position. In such situations the practitioner must evaluate and discuss with the client the overall legal merits of the position. Notwithstanding the foregoing, a practitioner ultimately can advise a client to take a position contrary to the accepted view of current law if the practitioner believes that the position is a valid interpretation of the internal revenue laws and the practitioner has fairly discussed the relevant legal analysis and the inappropriateness of considering the likelihood of detection with the client."

C. Disincentives for Drafters of Tax-shelter Opinions

The last general category of attorney related responses to corporate tax-shelter activity involves the creation of disincentives for developing tax shelters and providing tax-shelter opinions. As a possible disincentive, commentators suggest the creation of a new penalty provision applicable to tax-shelter advisors or the assessment of an excise tax on fees received in connection with tax-shelter advice.¹⁴² Such proposals would require Congressional action to effectuate, so in keeping with the purpose of this article to highlight attorney related anti-tax-shelter measures available without legislative intervention, this article will not further discuss such penalty provisions. Nevertheless, other avenues for creating disincentives for attorneys issuing overly aggressive opinions remain open, including the threat of malpractice claims and pressure from other attorneys.

1. Malpractice Liability

The primary avenue for creating disincentives for attorneys issuing overly aggressive opinions lies in the area of malpractice liability. The underlying premise of the definition of tax shelter in this article is that the tax reporting position of the taxpayer and the associated shopped opinion is clearly at odds with an honest and reasonable appraisal of the law. Consequently, taxpayers could pursue malpractice claims against the attorneys issuing such overly aggressive more-likely-than-not opinions. Obviously, the potential for malpractice liability in the tax-shelter area will only serve as a deterrent to attorneys crafting such opinions if they perceive the threat as real. Since the law requires damage to the client as a prerequisite for finding malpractice liability, practitioners might ignore their potential malpractice exposure in light of the small risk that a failed tax shelter will be litigated.¹⁴³ This argument, however, fo-

¹⁴² See, e.g., Senate Finance Committee Staff, *supra* note 44 (expanding aiding and abetting penalties to cover 50% of promoter fee).

¹⁴³ To sustain a malpractice case, a plaintiff must generally prove that the attorney owed him a duty of care (e.g., because privity existed between them), the attorney failed to use reasonable care and skill, and that that failure proximately caused the plaintiff damage. See generally RONALD E. MALLIN & JEFFREY M. SMITH, *LEGAL MALPRACTICE* (4th ed. 1996). Thus, to support a claim in respect of a tax-shelter opinion, the plaintiff must not only show that the opinion was not reasonable, but also that he was damaged (had to actually pay the taxes) and that the damage resulted from reliance on the opinion. Consequently, the taxpayer

cuses only on an attorney's liability for a particular transaction and overlooks the greater deterrent effect even a few adverse cases would have on the ability of promoters to shop for aggressive opinions. Lawyers tend to be a conservative bunch (as indicated by the fact that they self-selected for law school and private practice rather than business school and the "vulture culture" of investment banking). To the extent clients bring and win tax-shelter malpractice cases, the tax bar will certainly take notice. It should only take a few recoveries for attorneys to appreciate the risk in giving questionable opinions on tax-shelter transactions with millions of dollars of tax liability at stake.¹⁴⁴ While as yet clients have only litigated a tiny fraction of cases involving the new wave of corporate tax shelters on which clients could assert malpractice, the number of such cases will increase as the Service devotes more effort to locating and pursuing tax-shelter activity.

A critic might challenge the impact of malpractice liability as an effective deterrent to tax-shelter opinions on five grounds. First, it could be claimed that since corporate taxpayers "know" that the opinions are unreliable, they cannot be said to have relied on the advice and therefore have neither the grounds nor the incentive to sue. In situations where the Service has either not asserted penalties due to the existence of the opinion, or has failed in a challenge that reliance on the opinion was unreasonable, the taxpayer should be found to have actually relied on the opinion as a reasonable interpretation of the law. An admission by the taxpayer that it did not rely on the veracity of the opinion could expose the client to penalties. Thus, if explicitly asked, most tax-shelter participants would presumably assert that they did rely on the shopped opinion. In light of the function of the opinion as providing "reasonable reliance" on the more-likely-than-not nature of the tax-shelter transaction in order to insulate the taxpayer from the assertion of tax penal-

must have given up on defending its position and succumbed to the government's challenge before a malpractice suit could be brought. On an attorney's general ethical obligations in tax-shelter matters, see e.g., Paul J. Sax, *Lawyer Responsibility in Tax Shelter Opinions*, 34 TAX LAW. 5 (1980); Joseph J. Portuondo, *Abusive Tax Shelters, Legal Malpractice, and Revised Formal Ethics Opinion 346: Does Revised 346 Enable Third Party Investors to Recover from Tax Attorneys Who Violate Its Standards?*, 61 NOTRE DAME L. REV. 220 (1986); Jacob L. Todres, *Malpractice And The Tax Practitioner: An Analysis of the Areas in Which Malpractice Occurs*, LEGAL MALPRACTICE: TECHNIQUES TO AVOID LIABILITY 1999, 741 (June 1999), available in Westlaw at 608 PLI/LIT 741.

¹⁴⁴ See Feinschreiber & Kent, *supra* note 38, at 1050 (concluding that malpractice suits can be an effective deterrent to tax-shelter activity).

ties, the opinion writer would face a heavy burden in proving that the taxpayer did not in fact rely on the reasonableness of the advice given in the opinion.

Second, critics may argue that a client has no incentive to sue based on an implicit understanding of the real nature and purpose of the opinion, but this criticism seemingly fails to comport with human nature. Our society is a litigious one where looking for recompense from others despite dereliction in our own duties is by no means uncommon. If a corporate taxpayer suffers a large tax liability as the result of a failed tax shelter, it seems unlikely that the company would forgo suing the opinion writer out of a sense of obligation to an accomplice. The fact that we are dealing with corporations can further dilute this sense of obligation and collusion since the corporate management may have changed in the interim between undertaking the tax shelter and the fallout over its failure. Additionally, even if corporate management hesitates to sue the opinion writer for losses related to the failed tax shelter, the possibility that an enterprising attorney will start a shareholder derivative action to force the company to pursue the malpractice claim always remains. Consequently, it seems likely that malpractice suits will arise in the aftermath of failed corporate tax shelters and that practitioners will be unable to dismiss the risk of being sued on a questionable opinion merely based on an implicit understanding with their corporate clients.

Third, critics may point to the ambiguity of the relevant tax rules and common law anti-abuse rules as practical barriers to a client's ability to prove malpractice. Specifically, an opinion writer can justify any more-likely-than-not tax-shelter opinion as nonnegligent based on different views of how the courts will apply these common law doctrines. This assertion is plainly incorrect given the aggressive nature of these tax-shelter transactions.¹⁴⁵ Opinion writers base many of these opinions on a purely literal reading of the Code and relevant regulations or on an extension of an accepted tax principle to an unanticipated area. Consequently, these writers can only reach their conclusion by completely disregarding the potential

¹⁴⁵ See Green, *supra* note 101, at 1710 (“In my personal experience, talented and seasoned tax lawyers almost never disagree as to the existence or nonexistence of a return position (at least when none of them is representing a shelter promoter.)”); *Shelter Insider Raises Important Issues*, 91 TAX NOTES 346 (Apr. 9, 2001) (“[V]ery reputable law firms continue to be willing to write marketing opinions for major investment banks providing clean ‘would’ opinions that ignore and downplay fundamental problems with the conclusions, and that rely on arguments that everyone knows would be rejected by any court.”).

application of the common law doctrines.¹⁴⁶ Such a position itself is patently unreasonable given the context of these transactions. When faced with a highly abusive tax result, a court will stretch to reverse that result using any means at its disposal. Indeed, the common law doctrines were developed explicitly to deal with such situations.¹⁴⁷ Consequently, the amorphous nature of the common law anti-abuse rules, far from supporting an ability to distinguish the doctrines and rely on a purely technical analysis, indicates the courts will have both the room to reject the technical result and the inclination to do so based on the abusive nature of the transaction. To the extent abusive tax-shelter opinions deal with common law doctrines at all, the opinions do so by attempting to factually distinguish the transaction from those where the courts have applied the doctrines. Thus, the opinions fail to appreciate that the courts have implicitly designed the doctrines with sufficient vagueness that the doctrines may serve as a prophylactic means of dealing with overly aggressive transactions. By failing to factor the court's reaction to the tax-shelter transaction into an analysis of whether the common law doctrines will be applied, these tax-shelter opinions become almost per se unreasonable. Additionally, the implicit negligence of tax-shelter opinions will become more apparent to the extent that courts reviewing the substance of corporate tax-shelter transactions in fact conclude that the shelters are clearly inappropriate (which one would expect based on the tax-shelter definition developed at the beginning of this article).

A variant of the position that tax-shelter opinions generally do not create a sufficient basis for finding malpractice liability is the "Emperor's New Clothes" defense.¹⁴⁸ Under this theory, as long as some practitioner has previously given an opinion regarding a particular type of tax shelter, any other attorney can issue the same opinion with impunity. The argument derives from the fact that

¹⁴⁶ This is frequently done by discussing the cases where the doctrines have applied and noting factual distinctions from the instant case.

¹⁴⁷ See Jensen, *supra* note 51, at 425 (arguing against the application of common law anti-abuse doctrines based on an analysis of the specific facts of a case as related to past precedents applying the doctrine) ("The step transaction doctrine—like any legal doctrine—is a mechanism for determining legal consequences. Once this is grasped, it becomes clear that the true function of the doctrine is to implement policy. And once this is understood, it becomes apparent that one *first* needs to determine the policies of the statute, and *then* to apply the doctrine to the case at hand if, but only if, such application furthers the policies of the statute.") (emphasis in original).

¹⁴⁸ See *supra* note 40.

malpractice is generally judged based on how a reasonable practitioner would act. Consequently, if other attorneys have issued similar opinions, then the actions of subsequent attorneys are in line with the conclusions of their peers and therefore *must* have been reasonable.

While this safety in numbers approach has some cosmetic appeal, it ultimately fails to persuade. The mere fact that nobles and peasants uniformly praise the quality of the emperor's new clothes does not make their protestations reasonable when they know for a fact he is nude. Unfortunately for such lemming practitioners, the relevant malpractice standard is one of objective reasonableness. The mere existence of a number of large and well respected firms having joined the tax-shelter bandwagon will not itself prove the inherent reasonableness of their position.¹⁴⁹ While similar actions by others may provide inferential evidence that an action was a reasonable one, an attorney cannot escape liability for issuing an unreasonable opinion based on the unreasonable acts of even an infinite number of other attorneys. It seems inconceivable that any court looking at a malpractice case in the corporate tax-shelter area (where opinion shopping by promoters has effectively created a race to the bottom competition among attorneys) would subscribe to the self-serving arguments of such attorneys in the absence of clear evidence regarding the objective reasonableness of an opinion.

Fourth, an additional criticism of malpractice liability as a deterrent to aggressive opinions stems from the lack of privity of contract that sometimes exists between the ultimate taxpayer and the opinion writer. For instance, the opinion may be written with the promoter or a partnership entity listed as the client instead of the ultimate corporate taxpayer. If the taxpayer and the opinion writer have no privity of contract, then the ultimate corporate taxpayer may have no direct claim for malpractice, depending on the relevant state law. Generally, this is not the situation in corporate tax shelters since the corporation itself usually requires an opinion addressed to it, or one on which the writer explicitly permits the corporate taxpayer to rely, in order to bolster its claim for penalty protection. Even if direct privity does not exist, a taxpayer harmed by reliance on the opinion may well have standing to bring a malprac-

¹⁴⁹ It is reminiscent of a child who—when caught doing something he knew was wrong—attempts to justify his actions by crying out “Timmy did it first!” To which my mother, at least, would invariably quip: “And if Timmy jumped into the lake, I suppose you’d jump too?” A question that always led directly to sitting in a corner sucking on a bar of soap whether one responded or not.

tice suit depending on the particular state law involved.¹⁵⁰

Finally, statute of limitations provisions provide perhaps the most serious reason for doubting the deterrent effect of malpractice litigation. The applicable statute of limitations period and rules can vary dramatically from state to state.¹⁵¹ Tremendous variation exists between the states in determining the date from which the relevant statute of limitations begins to run. While under the modern trend the statute of limitations period commences once the damage occurs or the malpractice is discovered, many jurisdictions still date legal malpractice claims using the occurrence rule. The occurrence rule commences the statute of limitations on the date the opinion writer *performs* the legal work.¹⁵² In a complex corporate tax shelter where the purported tax treatment of the abusive transaction will not be detected by the Service or ultimately rejected by the courts until many years after the transaction, it is highly likely that the statute of limitations will have expired in jurisdictions using the occurrence rule. As such, practitioners could potentially write aggressive tax opinions with impunity, realizing the almost nonexistent chances of actual suit based on these corporate tax-shelter transactions within the relevant statute of limitations. Even in these situations, in keeping with the modern trend in this area, the courts might interpret the malpractice statute of limitations as equitably tolled until the client could reasonably have discovered the negligence.

2. Moral Pressure from Other Attorneys

Besides dissuading aggressive opinion writing by encouraging companies participating in failed tax shelters to pursue malpractice claims, the exertion of moral pressure from other attorneys could also address aggressive opinions. No one likes to believe that peers regard one's work product with derision. Commonly, an attorney who develops a reputation for readily giving overly aggressive opinions becomes the brunt of other attorneys' jokes.¹⁵³ While such

¹⁵⁰ See Mallen & Smith, *supra* note 143, § 7.13 (discussing expanded privity jurisdiction concepts in California and other states).

¹⁵¹ See Mallen & Smith, *supra* note 143, § 21.8 (limitation periods of between one and ten years exist depending on the jurisdiction).

¹⁵² See Mallen & Smith, *supra* note 143, § 21.10. See also Wolfman, *Standards of Tax Practice*, *supra* note 138, § 601.2.3 (discussing statute of limitations issues in tax malpractice situations).

¹⁵³ It is not uncommon for practitioners to ridicule others whose opinions are particularly outrageous over lunch or at social occasions. See Bankman, *supra*

informal censure currently exists and may seemingly have little visible impact, some practitioners have found the moral strength to refuse to issue questionable opinions based on wanting to preserve their own reputation within their professional community.¹⁵⁴ Since peer censure has some impact on behavior, increasing the level of such censure would presumably have a corresponding impact on behavior. The main method for increasing peer censure would make the tax opinions given more widely known. As discussed above, tax-shelter transactions may be subject to explicit confidentiality agreements which would preclude discussing such transactions or the parties involved.¹⁵⁵ Even in the absence of confidentiality agreements, the general attorney-client privilege may prevent many attorneys from speaking about transactions for fear of inadvertently violating the privilege. In its proposed amendments to Circular 230, the Service would expand its sanction options to include public censure.¹⁵⁶ The risk of such a public censure would suffice as a significant disincentive to practitioners,¹⁵⁷ assuming that the risk of having the sanction imposed was credible.¹⁵⁸

note 1, at 1783-84.

¹⁵⁴ In this regard, game theory suggests that reputation is more important in smaller legal communities (like the specialized tax bar in major metropolitan areas) where lawyers anticipate repeated encounters and where the actions of individuals can be well publicized. See Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509, 565 (1994) (studying and concluding that iterated prisoner's dilemma games demonstrate that the expectation of repeated encounters will produce cooperative behavior and deter abusive behaviors).

¹⁵⁵ Nevertheless, the temporary regulations on the registration of confidential tax shelters may ultimately create some public awareness of these opinions and their authors.

¹⁵⁶ See Regulations Governing Practice Before the Internal Revenue Service, 66 Fed Reg. 3276 (proposed Jan. 12, 2001) (to be codified at 31 C.F.R. § 10). It should be noted that the ABA's Tax Section has questioned whether the Service has the authority to create a censure sanction since the relevant statutory authority (31 U.S.C. § 330(b)) only grants authority to suspend or disbar practitioners. ABA Comments, *supra* note 93. In response to this issue a recent draft of proposed tax shelter legislation by the Senate Finance Committee includes a specific provision expanding 31 U.S.C. § 330(b) to include censure. See Grassley and Baucus, *supra* note 44. This proposed bill would also create authority for the Service to impose monetary penalties for violations of Circular 230.

¹⁵⁷ Indeed, some commentators suggested that the censure provision be made less onerous by permitting a private reprimand and providing censure information only in response to specific inquiries rather than automatically publishing the information on a periodic basis. Pecarich, *supra* note 93.

¹⁵⁸ Historically, enforcement of Circular 230 by the Service's Director of

V. CONCLUSION

The recent growth of the corporate tax-shelter market presents an enormous challenge to both the fairness and efficient operation of our system of taxation. Given the diverse nature of tax-shelter transactions and the complexity of the issues involved, no simple solution to the tax-shelter problem is possible. While a wide variety of responses have been proposed and are being considered by Congress, this article has attempted to highlight some actions that could be taken without further Congressional action in order to expedite addressing the issue. In particular, it should be possible for the Service and the courts to foster an environment that gives attorneys the tools and encouragement to try to dissuade their corporate clients from undertaking abusive transactions and not to perpetuate the tax-shelter industry by issuing questionable opinions. Additionally, even in the absence of further Congressional or Service action, the American Bar Association, the tax bar, and individual attorneys should take steps to improve the state of awareness of ethics rules implicated by tax-shelter activity. Many tax attorneys resent the pettifogging direction in which their profession seems to be moving, but feel at a loss to resist the competitive pressures swirling around them. While the changes and actions proposed herein will not change the realities of corporate tax practice overnight, they would help the tax bar find justifiable alternatives to becoming merely the lackey gunslingers of the corporate elite.¹⁵⁹

Practice has been somewhat lax. However, the position of the director's office within the Service has recently been reorganized and the number of employees significantly expanded. See, Stratton, *Opinion Standards*, *supra* note 91.

¹⁵⁹ After all, attorneys may be hired guns, but in the immortal words of *Star Trek's* Captain Kirk: "[W]e can stop it. We can admit that we're killers, but we're not going to kill today. That's all it takes. Knowing that we're not going to kill—today." *Star Trek: A Taste of Armageddon* (original air date Feb. 23, 1967). Until a definitive application of *Star Trek* wit and wisdom to taxation is written, inquiring tax lawyers may wish to refer to the more generic guides in this area. See generally DAVID MARINACCIO, ALL I REALLY NEED TO KNOW I LEARNED FROM WATCHING STAR TREK (1994); SUSAN SACKETT, FRED GOLDSTEIN & STAN GOLDSTEIN, STAR TREK SPEAKS (1979).