

# Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry

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*This Article considers the role of tax lawyers in the corporate tax shelter controversy. In the mid-1990s, a large market emerged in abusive tax shelters, which cost the Treasury tens of billions of dollars in lost tax revenue a year. Although individual tax lawyers were deeply involved in abusive tax shelters, the organized tax bar supported law reforms intended to rein in the tax shelter market. The bar's initiatives included due diligence obligations for opinion letters issued in connection with tax shelters and other proposals intended to strengthen practice standards. The tax bar's positions in the tax shelter debate cannot be adequately explained by conventional accounts of the organized bar, which assume that bar groups act to further lawyers' or clients' economic interests or to improve the reputation of the bar. Nor, however, should the bar's positions be taken as pure expressions of public-mindedness. A more nuanced conception of professionalism is required to account for the bar's initiatives. This Article argues that the bar's positions reflect a specific professional ideology of tax practice in which tax lawyers, by virtue of their expertise, serve as gatekeepers for the tax system. While not conferring immediate economic benefits to tax lawyers, the bar's reforms further tax lawyers' long-term reputational and other interests, even as they serve to bind lawyers to higher practice standards and protect the integrity of the tax system.*

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## Introduction: The Puzzles of Professionalism

During the financial boom of the 1990s, a substantial market emerged in abusive tax shelters. These shelters, which typically involved complex financing devices, esoteric legal instruments, and multiple layers of corporations, partnerships and trusts, took advantage of the complexity of the Internal Revenue Code to create enormous paper losses that corporations could use to offset their taxable income.<sup>1</sup> Elite professionals played a prominent role in the emergence of this market. Large accounting firms, investment banks, and corporate law firms all became involved, designing and marketing hundreds of highly lucrative shelters that are estimated to have cost the federal government tens of billions in lost tax revenue dollars.<sup>2</sup>

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1 See, e.g., Joseph Bankman, *The New Market for Tax Shelters*, 83 TAX NOTES 1775 (1999). The line between abusive tax shelters and legitimate transactions is often murky. See *id.* at 1782. Whether a particular tax shelter is considered abusive is frequently a contested question that depends on the theory of tax law interpretation espoused. Typically, abusive shelters are transactions whose form falls within the language of the Code but that bestow tax benefits not intended by Congress. See *infra* Section I.A.

2 Janet Novak and Laura Saunders first broke the corporate tax shelter story in a 1998 cover article in *Forbes* that described various shelters being marketed by Deloitte & Touche and other accounting firms. See Janet Novak & Laura Saunders, *The Hustling of X Rated Tax Shelters*, FORBES, Dec. 14, 1998, at 198; see also Susan Beck, *Gimme Shelter*, AM. LAW., Nov. 1999, at 105; Paul Braverman, *Helter Shelter*, AM. LAW., Dec. 2003, at 65; David Kay Johnston, *Tax Magicians: Sham Shelters for Business Flourish as Scrutiny Fades*, N.Y. TIMES, Dec. 19, 2000, at A1; Floyd Norris, *The Rise of Phony Corporate Tax Shelters*, N.Y. TIMES, Feb. 8, 1999, at A22; Michael M. Phillips, *Taking Shelter: As Congress Ponders New Tax Breaks, Firms Already Find Plenty*, WALL ST. J., Aug. 4, 1999, at A1. Many tax officials and scholars believe that abusive shelters are the most serious threat facing the tax system today. See, e.g., Bankman, *supra* note 1; Christopher Bergin, *Corporate Shelters are Serious*

Tax lawyers, notably, participated in every aspect of the shelter industry. Sought after for their technical expertise, well-established practitioners left their corporate firms to join large accounting firms in order to earn higher incomes designing and marketing shelters.<sup>3</sup> Tax lawyers who remained at traditional firms, while often avoiding direct involvement in developing shelters, proved eager to provide legal opinions that blessed questionable tax schemes, earning a share of the enormous sums in play.<sup>4</sup>

Lawyers are often implicated in corporate scandals, so it is not all that surprising that they would have played an active role in the tax shelter market.<sup>5</sup> What is surprising is the response of the organized tax bar. Since the late 1990s, in frequent reports and congressional testimony, representatives of the tax bar have condemned tax shelters and offered proposals to strengthen the government's capacity to combat them. The tax bar has advocated legislative and regulatory measures that would expand disclosure requirements and increase penalties for tax shelter purchasers. It has also sought regulation that would strengthen the role of outside legal advisors in preventing clients from participating in abusive shelters. In particular, the organized bar has urged the Treasury to impose due diligence requirements on opinions provided by legal advisors for their clients to obtain protection against tax shelter penalties, a proposal adopted by the Treasury in December 2004.<sup>6</sup> One segment of the tax bar also supported legislation that would impose a strict liability regime for abusive tax shelters,<sup>7</sup> an idea pursued by Congress in recent tax shelter legislation.<sup>8</sup>

How should the initiatives of the organized tax bar be understood? The working premise of most scholarship on lawyers is that bar associations serve the narrow self-interest of their members.<sup>9</sup> One approach posits bar

*Threat to System, Summers Says*, Feb. 29, 2000, Tax Notes Today, 2000 TNT 40-1. Not only do shelters create enormous tax revenue losses, they are a highly inefficient use of corporate resources, create inequities in tax administration, and foster disrespect for the tax system, contributing to more widespread compliance problems.

3 See, e.g., Susan Beck, *The Trojan Accountant*, AM. LAW., Nov. 1999, at 18.

4 See, e.g., Beck, *supra* note 2; Braverman, *supra* note 2.

5 See, e.g., Susan Koniak, *When the Hurly Burly's Done: The Bar's Struggle with the S.E.C.*, 103 COLUM. L. REV. 1236, 1239-43 (2004) (lawyers' role in Enron scandal); William H. Simon, *The Kaye Scholer Affair: The Lawyer's Duty of Candor and the Bar's Temptations of Evasion and Apology*, 23 LAW & SOC. INQUIRY 243, 247-57 (1998) (law firm Kaye Scholer's role in savings and loan debacle).

6 See 31 C.F.R. § 10.35 (2005). For a discussion of the role of opinion letters in the regulatory regime that was applicable until recently, see *infra* notes 71-75 and accompanying text.

7 See *infra* Section II.D.

8 See American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

9 See, e.g., Koniak, *supra* note 5, at 1269-80 (describing securities bar's efforts to water down obligations under section 307 of Sarbanes-Oxley); Simon, *supra* note 5 (criticizing bar's failure to take stance on possible wrongdoing of Kaye Scholer firm, which was charged with misconduct in connection with representing failed thrift Lincoln Savings & Loan); Theodore Schneyer, *Professionalism as Politics: The Making of a Modern Legal Ethics Code*, in LAWYERS' IDEALS/LAWYERS' PRACTICES: TRANSFORMATIONS IN THE AMERICAN LEGAL PROFESSION 95, 121-24, 127-30 (Robert L. Nelson et al. eds., 1992) (describing American Trial Lawyers Association's and American College of Trial Lawyers'

organizations as preoccupied with lawyers' financial gain. In this view, bar groups support proposals that increase the demand for or cost of lawyers' services.<sup>10</sup> An alternative approach views lawyer associations, especially the corporate bar, as advocates for clients' interests. In this view, the organized corporate bar is intent on protecting corporate prerogatives and power.<sup>11</sup> A third approach, often intertwined with the others, treats the bar's law reform efforts as gestures intended to fend off public criticism and oversight. In this view, bar associations advocate regulatory changes that improve the public image of lawyers but do not impinge on their practices.<sup>12</sup> But the organized tax bar's advocacy in the tax shelter context is difficult to square with any of these approaches. Considered on their merits, the bar's proposals do not advance either clients' or lawyers' immediate interests; nor can the bar's proposed reforms be dismissed as diversionary tactics.<sup>13</sup>

In this Article, I offer an account of the organized tax bar's law reform efforts that rejects the conventional views.<sup>14</sup> As I argue, short-term self-interest does not adequately explain the tax bar's initiatives in the tax shelter area. I

successful efforts to weaken ethics rules imposing obligations to third parties); cf. George M. Cohen, *When Law and Economics Met Professional Responsibility*, 67 *FORDHAM L. REV.* 273, 296 (1998) (arguing that by allowing lawyers to get more information from clients, confidentiality rule gives lawyers a "leg up" on future business).

10 Commentators argue that law reform by the organized bar advances lawyers' financial interests in various ways. One view is that bar groups seek legal rules that bring business to their members, see, e.g., Paul H. Rubin & Martin J. Bailey, *The Role of Lawyers in Changing the Law*, 23 *J. LEGAL STUD.* 807 (1994) (ATLA has sought tort law reforms that benefit lawyers), or increase the general demand for lawyers, see Richard L. Abel, *United States: The Contradictions of Professionalism*, in 2 *LAWYERS IN SOCIETY: THE COMMON LAW WORLD* 186, 212-18 (Richard L. Abel & Philip S.C. Lewis eds., 1988); Michelle J. White, *Legal Complexity and Lawyers' Benefit from Litigation*, 12 *INT'L REV. L. & ECON.* 381 (1992). A second view is that bar reform initiatives are a means of maintaining the profession's regulatory monopoly over the market for legal services. Unauthorized practice prohibitions, for example, which the bar justifies as protecting the public, are actually intended to prevent competition from non-lawyers. See, e.g., RICHARD L. ABEL, *AMERICAN LAWYERS* 7 (1989). Other reforms, such as the imposition of education and entry requirements, are explained as reducing competition among lawyers by limiting supply. See *id.* at 40-71.

11 See, e.g., JEROLD S. AUERBACH, *UNEQUAL JUSTICE* 35-36, 62-64 (1976); see also Susan P. Koniak, *The Law Between the Bar and the State*, 70 *N.C. L. REV.* 1389, 1487 (1992) (suggesting that the laws supported by the bar are used to "justify lives dedicated to the powerful and their right to remain powerful").

12 AUERBACH, *supra* note 11, at 64-65; Susan P. Koniak & George Cohen, *In Hell There Will be Lawyers Without Clients or Law*, 30 *HOFSTRA L. REV.* 129, 138 (2001).

13 Several scholars of the legal profession have mounted challenges to the thesis that bar associations are motivated solely by the material interests of their members. See, e.g., TERENCE C. HALLIDAY, *BEYOND MONOPOLY: LAWYERS, STATE CRISES, AND PROFESSIONAL EMPOWERMENT* 3 (1987) (organized bar's historic efforts to reform the judiciary reflect normative commitment to liberal democratic values); RONEN SHAMIR, *MANAGING LEGAL UNCERTAINTY* (1995) (corporate lawyers' response to New Deal reflected in part attempt to shore up expert authority); Robert W. Gordon, "The Ideal and the Actual in the Law": *Fantasies and Practices of New York City Lawyers, 1870-1910*, in *THE NEW HIGH PRIESTS: LAWYERS IN POST-CIVIL WAR AMERICA* 51 (Gerard W. Gawalt ed., 1984) (founders of first bar organization motivated by progressive ideals).

14 The tax bar's reform efforts have not received much attention in either the scholarship on tax shelters or tax ethics. In 1994, Professor Ted Schneyer noted efforts by the organized tax bar to reign in the first wave of tax shelters. See Ted Schneyer, *From Self-Regulation to Bar Corporatism: What the S&L Crisis Means for the Regulation of Lawyers*, 35 *S. TEX. L. REV.* 639, 657-58 (1994).

suggest, instead, that the positions of the bar may be better understood as attempts to reinforce the professional authority of elite tax lawyers, which had been eroded by the tax shelter market. This authority has traditionally been grounded in expertise in case law doctrines that take a purposive approach to interpreting the Code. The spread of tax shelters has privileged textualist approaches to legal interpretation and devalued these doctrines. The reforms supported by the organized bar seek to reassert the primacy of judicially created doctrines and, by extension, lawyers' role in applying them. Borrowing from Bourdieu, I propose that tax practice is a field in which tax practitioners do not just—or principally—compete for economic rewards.<sup>15</sup> More fundamentally, they vie for the authority to dictate the terms in which the field is constituted. The account of the organized tax bar's activities I offer rejects simple self-interested explanations as well as explanations that claim that the bar is motivated by pure public-mindedness. As I suggest, a more nuanced conception of professionalism is at work. The bar's positions are animated by an account of the well-being of the tax system that puts elite tax lawyers at the front and center of safeguarding its integrity. Although the bar's initiatives, if enacted, will not confer short-term economic benefits on lawyers or their clients, they have the effect of enhancing tax lawyers' power and status.

Part I of this Article offers an account of the rise of corporate tax shelters. I first provide an overview of abusive tax shelters and the purposive approaches to statutory interpretation that courts developed to disallow shelter benefits.<sup>16</sup> I then describe the financial incentives, professional culture, and regulatory backdrop in the 1990s that gave rise to the market for tax shelters and the impact of these forces on the practices of tax lawyers. Attracted by financial incentives, many lawyers joined big accounting firms, which took the lead in the tax shelter market, to design and promote shelters.<sup>17</sup> Others who remained in traditional corporate law firms wrote opinion letters that gave questionable

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15 See generally PIERRE BOURDIEU & LOIC J.D. WACQUANT, *AN INVITATION TO REFLEXIVE SOCIOLOGY* 96-98 (1992).

16 Purposive approaches cover a range of interpretive theories. See, e.g., Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000); Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492 (1995); Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677 (1996); Robert Thornton Smith, *Business Purpose: The Assault upon the Citadel*, 53 TAX LAW. 1 (1999); Lawrence Zelenak, *Thinking About Nonliteral Interpretation of the Internal Revenue Code*, 64 N.C. L. REV. 623 (1986). In the wider scholarly literature, the debate between purposive and textualist approaches to statutory interpretation is represented by William Eskridge, Philip Frickey, and Cass Sunstein, on the one hand, see William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321 (1990); Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405 (1989), and Justice Antonin Scalia, on the other, see, e.g., Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175 (1989); see also John F. Manning, *The Eleventh Amendment and the Reading of Precise Constitutional Texts*, 113 YALE L.J. 1663 (2004) (arguing for a textualist approach in constitutional interpretation).

17 At the beginning of the 1990s there were six first-tier accounting firms, Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG, and Price Waterhouse. In 2005, four remain. I generally refer to these firms in this Article as the "big firms."

transactions an imprimatur of legitimacy. In the weak regulatory environment that prevailed, lawyers were not deterred from participating directly or indirectly in the tax shelter market.

In response, tax bar associations advocated reforms to curb the tax shelter market, which I unpack in Part II. The bar's proposals have sought to strengthen the regulatory regime to deter corporate taxpayers from engaging in tax shelter activity. Several of the bar's initiatives, moreover, assign legal advisors a gatekeeping function that is not easily explained by lawyers' economic interest. Tax lawyers are especially suited to this gatekeeping role because of their expertise in the judicially created doctrines that developed to distinguish abusive tax shelters from legitimate tax planning. In conferring this role on tax lawyers, these proposals subscribe to a professional ideology in which legal advisors not only serve as representatives of clients but also act as guardians of the tax system.<sup>18</sup>

Part III considers how the bar's positions restore tax lawyers' professional authority. The first Section explores the centrality of courts in the tax bar's account in developing and elaborating doctrines that are the basis of the expertise enjoyed by elite tax lawyers. As I argue, the thrust of the bar's reforms seek to affirm the value of this traditional expertise. The second Section turns to the normative distinction between legitimate business activity and tax planning for its own sake, which underlies the bar's proposals. In the tax bar's account, this divide, which drives judicial doctrines, cannot be formulated in a simple rule but requires articulation on a case-by-case basis. The third Section addresses the professional stakes advanced by the bar's initiatives. While the positions of the bar in the tax shelter controversy do not further tax lawyers' short-term financial interests, they confer important long-term benefits, including status that flows from tax lawyers' expertise in case law and, particularly, in purposive approaches to statutory interpretation. This status is threatened by the proliferation of tax shelters, which depend on textualist readings of tax law. The tax bar's law reform initiatives can thus be read as an attempt to regain professional authority in the tax law field.

Recent research has noted that lawyers in corporate practice are increasingly willing to divest themselves of their professional personae, refashioning themselves as "consultants" or "information specialists."<sup>19</sup> The organized tax bar's efforts to oppose the tax shelter market offer an important

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18 I am using "professional ideology" to mean "the claims, values and ideas that provide the rationale" for professional institutions. ELIOT FREIDSON, PROFESSIONALISM: THE THIRD LOGIC 105 (2001); see also Robert L. Nelson & David M. Trubek, *New Problems and New Paradigms in Studies of the Legal Profession*, in LAWYERS' IDEALS/LAWYERS' PRACTICES: TRANSFORMATIONS IN THE AMERICAN LEGAL PROFESSION, *supra* note 9 (arguing for interpretive approach to study of legal profession that attends to ideologies of lawyers). This use is to be distinguished from the use of "ideology" to mean false consciousness.

19 Robert Eli Rosen, "We're All Consultants Now": *How Change in Client Organizational Strategies Influences Change in the Organization of Corporate Legal Services*, 44 ARIZ. L. REV. 637 (2002).

counterexample. In tax practice, enduring conceptions of professionalism have shaped the organized bar's positions into the twenty-first century. As the emergence of the tax shelter industry illustrates, in private representation of clients, lawyers' professional norms can quickly succumb to the pull of powerful market forces.<sup>20</sup> But in public activities, lawyers may still adhere to a professional ideology that is in tension with a market ethos. In the tax shelter context, organized bar activities have provided a space in which lawyers can articulate and act on interests that go beyond immediate financial gain. While tax lawyers' short term economic interests have led many of them to engage in activities that undermine the tax system, their long term investment in a special status as gatekeepers of the tax system has helped keep them in alignment with the broader purposes of tax law.

## I. The Rise of the Tax Shelter Market

Although aggressive tax planning dates back to at least the 1930s,<sup>21</sup> the tax shelter industry emerged in the late 1970s and early 1980s. Congress effectively eradicated the first wave of tax shelters, which had been promoted primarily by financial advisers to middle income individuals, when it enacted rules that prohibit the use of passive losses to offset regular income in 1986.<sup>22</sup> The corporate tax shelter market survived these reforms and, over the next decade, took off.<sup>23</sup>

20 Tax lawyers themselves divide the world of practice into those who participate in tax shelters and those who do not. *See, e.g.,* 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, 55-57 (2001). Anecdotal evidence suggests, however, that established corporate firms, whose own members have been active in bar reform efforts, are involved in much more aggressive tax planning than they were a decade ago. *E.g.,* Braverman, *supra* note 2.

21 *See, e.g.,* Gregory v. Helvering, 293 U.S. 465 (1935).

22 *See* Bankman, *supra* note 1, at 1776; George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 218-19 (2001).

23 The exact extent of losses to the government that have resulted from corporate tax shelters is impossible to measure. Between 1996 and 2000 more than 60% of corporations avoided paying any taxes. *See* U.S. General Accounting Office, COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN AND U.S. CONTROLLED CORPORATIONS, 1996-2000 (2004). While corporations were able to reduce some taxes by legally permissible means, a large part of the offset was likely the result of abusive tax shelters. *See id.*; Justin Lahart, *Corporate Tax Burden Shows Sharp Decline*, WALL ST. J., Apr. 13, 2004, at C1; *see also* Braverman, *supra* note 2 (showing that even as corporate earnings were rising between 1999-2002, corporate tax revenue collected by the IRS dropped 34%).

At the market's height in the late 1990s, the Clinton Administration estimated that the Treasury was losing \$10 billion a year in tax revenue from corporate tax shelters. Recent revelations suggest that tax revenue losses were even greater. For example, a single tax shelter marketed by KPMG to twenty-nine Fortune 500 companies under the acronym CLAS cost the Treasury \$1.7 billion. *See KPMG Shelter Shaved \$1.7 Billion off Taxes of 29 Large Companies*, WALL ST. J., June 16, 2004, at A1; *see also* Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters: Hearing Before the S. Comm. on Finance, 108th Cong. 13 (2003) (statement of Michael Brostek, Director, Tax Issues, General Accounting Office) [hereinafter Brostek Statement] (IRS contractor estimated that illegal tax shelters cost the government between \$14.5 and \$18.4 billion in 1999).

A. *Abusive Tax Shelters and the Role of Judicial Doctrines*

Abusive tax shelters shield income from taxation by exploiting formal dimensions of tax law in ways that are inconsistent with underlying substantive tax principles. By their nature, shelters are not susceptible to precise definition, but tend to share several identifying markers, typically characterized as follows: First, the transaction creates a tax loss through an investment with little financial risk and no significant potential for profit. The absence of any business purpose or significant potential for profit is often apparent from a close examination of the underlying economics of the transaction. Second, the transaction involves a domestic corporation and a tax indifferent party and permits the allocation of income, in excess of economic income, to the tax indifferent party, leaving a loss, in excess of economic loss, to the domestic taxpayer; alternatively, the transaction exploits other structural flaws in the U.S. tax system or discrepancies in the interaction between the U.S. and other systems. Third, the transaction has not been developed for a single taxpayer but has been designed by a promoter to be marketed to Fortune 500 or large, closely-held corporations. Because a shelter's results are at odds with generally understood tax principles and policies, once detected, it is likely to be challenged by the IRS in court or shut down by legislative or administrative action.<sup>24</sup>

These characteristics are illustrated in a transaction that was successfully challenged by the government in *ACM Partnership v. Commissioner*.<sup>25</sup> This shelter, which Colgate-Palmolive purchased from Merrill Lynch, took advantage of a rule that accelerated taxation of income relative to economic income at the beginning of a transaction, while permitting off-setting deductions later on. By inserting a tax-indifferent party in the transaction, a foreign party not subject to United States tax that functioned to absorb the excess income generated at the outset, the taxpayer sought to take advantage of deductions subsequently available. Although the taxpayer's deductions were technically consistent with the applicable language of the Code, the Court of Appeals for the Third Circuit declined to recognize the transaction, concluding that it lacked a business purpose and had been entered into solely for the tax benefits it would produce.<sup>26</sup>

The business purpose doctrine is one of a cluster of overlapping doctrines, dating back to the 1930s, that courts have developed to disallow the tax benefits

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24 See DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 11-24 (July 1999) [hereinafter WHITE PAPER]; N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON CORPORATE TAX SHELTERS OF NEW YORK STATE BAR ASSOCIATION TAX SECTION (1999), in *NYSBA Tax Section Applauds Some Anti-Corporate Tax Shelter Proposals, Rejects Others*, Apr. 23, 1999, Tax Notes Today, 1999 TNT 82-29 [hereinafter NYSBA 1999A COMMENTS]; Bankman, *supra* note 1, at 1777. Dana Trier, a tax partner at Davis Polk & Wardwell, was the principal drafter of the NYSBA Tax Section report.

25 73 T.C.M. (CCH) 2189 (1997), *aff'd in part, rev'd in part*, 157 F.3d 231 (3d Cir. 1998).

26 See *ACM P'ship v. Comm'r*, 157 F.3d 231 (3d Cir. 1998).



of abusive transactions.<sup>27</sup> These doctrines reflect a purposive approach to interpreting the tax code. Under the substance-over-form and step-transaction doctrines, the IRS has the authority to re-characterize a transaction for tax purposes if the form of a transaction favored by the taxpayer belies its substance.<sup>28</sup> Under the step-transaction doctrine, for instance, the IRS has the power, in certain circumstances, to re-characterize a series of formally independent steps as a single, integrated transaction for tax purposes.<sup>29</sup>

The doctrines that have gotten the most play in the tax shelter controversy focus on a taxpayer's purpose in entering into a transaction, and specifically whether the taxpayer has a business purpose. As *ACM* illustrates, courts will inquire as to whether a taxpayer has a reason—other than the avoidance of federal taxes—to undertake a transaction or series of transactions.<sup>30</sup> Under the economic substance doctrine, a variation of business purpose, a transaction will be recognized for tax purposes if a taxpayer has meaningfully changed its economic position.<sup>31</sup>

The connection between these doctrines, which are typically applied in a manner that contravenes the text of the Code, and Congress's intent in enacting specific tax provisions is not completely clear.<sup>32</sup> One view is that Congress assumes the ongoing relevance of long-standing judicial doctrines when it revises the Code. Under this approach, the doctrines are treated as implicit in

27 See *Gregory v. Helvering*, 293 U.S. 465 (1935).

28 See, e.g., *ASA Investorings P'ship v. Comm'r*, 76 T.C.M. (CCH) 325 (1998) (concluding that foreign partner in transaction was lender to whom gains were wrongly allocated), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000); see also *WHITE PAPER*, *supra* note 24, at 46-51.

29 To "step-together" a series of transactions, the IRS must satisfy one of three tests. Under the "binding commitment" test, the IRS has the power to integrate separate steps if the taxpayer was, at the time of the first step, under a binding commitment to proceed with later steps. See, e.g., *Comm'r v. Gordon*, 391 U.S. 83 (1968). Under the "end result" test, independent steps will be integrated if the taxpayer intended the end result. See, e.g., *King Enters., Inc. v. United States*, 418 F.2d 511, 517 (Ct. Cl. 1969). Under the "interdependence" test, steps will be integrated if the steps were "so interdependent that the legal relations created by one transaction would have been fruitless without completion of the series." See *Am. Bantam Car Co. v. Comm'r*, 11 T.C. 397, 405 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949); see also *WHITE PAPER*, *supra* note 24, at 50-51. Occasionally, taxpayers are able to invoke the step-transaction doctrine successfully against the government. See, e.g., *McDonald's Rests. of Ill., Inc. v. Comm'r*, 688 F.2d 520 (7th Cir. 1982).

30 See, e.g., *ACM P'ship*, 157 F.3d 231; *Goldstein v. Comm'r*, 364 F.2d 734 (2d Cir. 1966). Mrs. Goldstein sought to shield her winnings in the Irish sweepstakes from taxation by borrowing nearly \$1 million at 4% annual interest and purchasing \$1 million in Treasury bonds paying 2% annual interest. After she prepaid the interest on the loan, she attempted to deduct the amount against her sweepstakes winnings. The court disallowed the deduction on the grounds that the loan had "no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction." *Id.* at 741.

31 See, e.g., *ACM P'ship*, 157 F.3d 231; see also David P. Hariton, *Sorting out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999); Martin J. McMahon, Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 TAX NOTES 1017 (2002); Smith, *supra* note 16. Two of these scholarly articles, which defend the doctrine, were written by well-established tax lawyers at elite firms. Mr. Hariton is a law partner at Sullivan & Cromwell. Mr. Smith, is a law partner at Linklaters.

32 See *Bankman*, *supra* note 16, at 11. Whether the Code should be approached like any other statute or subject to special interpretive conventions is a matter of ongoing debate. See *Livingston*, *supra* note 16.

the statute, unless Congress has indicated otherwise.<sup>33</sup> Another view is that specific provisions of the Code should be read against the backdrop of the Code as a whole.<sup>34</sup> Under this approach, the fundamental goal of the Code—reflected in its terms, structure, and design—is to tax income minus the cost of generating it.<sup>35</sup> Many provisions of the Code have other purposes—to encourage investment in low income housing for example—but, so long as these other purposes are not at issue, the deductions permitted by the Code should apply only to activities aimed at income generation.<sup>36</sup> Put another way, “it cannot be plausibly supposed that Congress intended to sanction transactions that would have no justification or consequence other than to defeat the tax laws.”<sup>37</sup>

### B. *The Incentives Governing Tax Shelter Purchasers*

During the 1990s, tax departments at many large companies experienced pressure to de-emphasize traditional legal compliance and become profit centers.<sup>38</sup> The value of tax and legal services, like other internal services, had come under scrutiny from corporate management, and taxes emerged as a natural locus to realize savings. Under a basic cost-benefit analysis, purchasing tax shelters made sense financially.

Although the regulatory environment changed with the enactment of the American Jobs Creation Act in 2004, before its passage, the absence of meaningful regulatory impediments encouraged abusive shelter transactions.<sup>39</sup> Applicable penalties, which were set at 20%, were likely too low to have meaningful deterrence value. More importantly, in most circumstances, they were assumed not to apply because taxpayers routinely obtained opinion letters from lawyers that served to abate penalties. Substantial understatements of tax

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33 See Bankman, *supra* note 16, at 11-13.

34 See Deborah A. Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445, 459-60 (1993); Geier, *supra* note 16, at 495-502 (1995).

35 See Geier, *supra* note 16, at 497.

36 For an attempt to justify this view under a “structural textualist” approach, distinct from the economic substance doctrine, see Alexandra M. Walsh, *Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism*, 53 STAN. L. REV. 1541 (2001).

37 Smith, *supra* note 16, at 5.

38 See Bankman, *supra* note 1, at 1784; Robert Eli Rosen, *As the Big 5 Become Multi-Disciplinary Practices, Opportunities Abound for Tax Executives*, 51 TAX EXECUTIVE 147, 147 (Mar. 1, 1999). See generally Robert L. Nelson & Laura Beth Nielsen, *Cops, Counsels & Entrepreneurs: Constructing the Role of Inside Counsel In Large Corporations*, 34 LAW & SOC’Y REV. 457 (2000) (describing emergence of entrepreneurial view of role of corporate counsel).

In 2000, the Treasury began to strengthen applicable regulations, and the IRS stepped up enforcement. See *infra* notes 84-99 and accompanying text. As a consequence, the cost-benefit analysis started to shift away from purchasing tax shelters. While it is too early to predict, the increased enforcement of existing law and the enactment of new tax shelter provisions in the American Jobs Creation Act of 2004 may significantly alter the calculus around participating in abusive shelters.

39 The American Jobs Creation Act, Pub. L. No. 108-357, 118 Stat. 1418, is the most significant tax reform act since 1986. In addition to targeting abusive tax shelters, it contains tax incentives for small businesses and agriculture and reflects numerous other tax reforms.

liability attributable to investments in tax shelters were not subject to a penalty if the taxpayer could meet the “reasonable cause and good faith” exception contained in § 6664(c) of the Internal Revenue Code.<sup>40</sup> Until recently, under applicable regulations, reasonable cause existed (and the penalty was abated) if the taxpayer reasonably relies in good faith on an opinion based on a professional tax adviser’s analysis of the pertinent facts and authorities that unambiguously concludes that there is a “greater than 50-percent likelihood that the tax treatment of the item will be upheld” if challenged by the Internal Revenue Service.<sup>41</sup> Although other provisions could theoretically limit the value of a more-likely-than-not opinion, as a practical matter, an opinion letter from a law firm was believed to protect a taxpayer from exposure to the substantial understatement and other more severe civil or criminal penalties.<sup>42</sup>

Apart from this ineffectual penalty scheme, the probability that the IRS would detect that a highly complex financial transaction is a tax shelter was slight. The IRS has not had adequate resources for enforcement. While the number of business tax returns increased between 1996 and 2001, the staff of the IRS was cut, and audits of companies with more than \$250 million in assets decreased by 38%.<sup>43</sup> In addition, the typical time frame between the date a corporation filed its tax return and an IRS audit was five years.<sup>44</sup> This lengthy time lag prevented the Service from addressing tax shelter behavior while it was ongoing.

It was also difficult for the Service to discover tax shelters in connection with the returns it did audit. Corporate tax returns typically run into the thousands of pages. Tax shelters, moreover, are complex transactions usually involving types of deductions or credits that can be claimed legitimately. Tax

40 Treas. Reg. § 1.6664-4 (as of April 2003).

41 Treas. Reg. §§ 1.6662-4(g)(B), 1.6664-4(c), 1.6664-4(e)(B)(1) (as of April 2003). Amendments to the regulations are discussed *infra* notes 89-94 and accompanying text.

42 On its face, I.R.C. § 6662(d)(2)(C) (2003) seemed to impose a strict liability penalty for understatements of corporate tax that are a consequence of shelter investments. The legislative history of § 6664, however, established that the “reasonable cause” exception was still available to the taxpayer in such circumstances. See Bankman, *supra* note 1, at 1778 n.2. Prior to their recent amendment, the regulations promulgated pursuant to § 6664 required that, to meet the reasonable cause exception, a taxpayer have substantial authority for its position and a reasonable belief that its position more likely than not would be sustained if challenged. Treas. Reg. § 1.6664-4(e)(3) (as of April 2003). Even if these conditions were met, the IRS was empowered to find that the taxpayer did not have “reasonable cause,” if the taxpayer’s participation in the shelter lacked a business purpose, if the taxpayer claimed benefits that were “unreasonable” in comparison to its investment in the shelter, or if the taxpayer had purchased the shelter under conditions of confidentiality. *Id.* Despite this regulatory authority, it was widely assumed that the IRS considered a more-likely-than-not opinion sufficient to abate the substantial underpayment penalty. See Bankman, *supra* note 1, at 1779. In later years, the IRS became more aggressive in asserting penalties against taxpayers who claimed to have relied on legal opinions. See, e.g., Long-Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004).

43 See David Cay Johnston, *Corporate Risk of Tax Audit is Still Shrinking, I.R.S. Data Show*, N.Y. TIMES, Apr. 12, 2004, at C1. For companies with more than \$250 million in assets, the audit rate fell from 33.7% in 2002 to 29% in 2003. Before 1996, the audit rate for companies this size was over 50%. *Id.*

44 See Bob Wells, *IRS Chief Wants To Speed up Corporate Tax Audits*, WALL ST. J. ONLINE, Mar. 15, 2004, [http://online.wsj.com/article/0,,BT\\_CO\\_20040315\\_005286,00.html](http://online.wsj.com/article/0,,BT_CO_20040315_005286,00.html).

shelter purchasers had strong incentives not to signal their participation on their returns since, before 2004, the failure to disclose did not affect whether the penalty for substantial understatement of tax liabilities applied.<sup>45</sup>

### C. *The Role of Accounting Firms*

Tax professionals had powerful economic incentives to participate in the tax shelter business. Shelter promoters stood to earn very substantial fees. Typically, tax shelters were sold on a “value-added” or contingency fee based on the amount of tax saved. While expensive to develop, a single tax shelter sold to hundreds of clients could earn a promoter tens of millions of dollars.<sup>46</sup> Until recently, no regulations meaningfully inhibited promoters from marketing tax shelters. In addition, promoters assumed that their activities did not expose them to civil or criminal liability.<sup>47</sup>

Although they were not the only promoters of tax shelters, the big accounting firms were at the forefront of developing the shelter market. Their leadership role resulted from a mix of long-standing and more recent trends. Since the income tax was enacted in the early twentieth century, accountants’ primary practice in tax has been to assist clients in the preparation of tax returns.<sup>48</sup> Consistent with an emphasis on return preparation, the dominant interpretive approach of tax accountancy has historically been textualist.<sup>49</sup>

45 Treas. Reg. § 1.6664-4 (as of April 2003).

46 For example, KPMG earned \$53 million from one tax shelter it sold to 186 individuals. See Tanina Rostain, *Travails in Tax: KPMG and the Tax-Shelter Controversy*, in LEGAL ETHICS: LAW STORIES 89, 101 (Deborah L. Rhode & David J. Luban eds., 2005).

47 Since 2002, high-wealth taxpayers have begun to sue accounting firms who sold them tax shelters after the Service disallowed the tax benefits of such transactions. See Cassell Bryan-Low, *Deals and Deal Makers: Clients’ Suits over Tax Shelters Shed Light on Accountants’ Advice*, WALL ST. J., Jan. 16, 2003, at C5. In addition, in 2002 the Service began to initiate enforcement actions against various accounting firms. See *infra* note 68. In 2004 the Justice Department launched grand jury investigations of Ernst & Young and KPMG. See Cassell Bryan-Low, *KPMG Tax-Shelter Probe Grows, as U.S. Classifies 30 as ‘Subjects,’* WALL ST. J., Mar. 5, 2004, at A2; Jonathan Weil, *Ernst & Young Faces Tax-Shelter Inquiry*, WALL ST. J., May 24, 2004, at C1. Many of the litigation and enforcement activities thus far have focused on tax shelters sold to individuals.

48 From early on, the statute required businesses to compute their taxes based on their book-keeping methods, so long as such methods clearly reflected income. See, e.g., I.R.C. § 212(b) (1924). Businesses that had not previously bothered to keep books rushed to hire accountants to implement book-keeping practices and compile financial information to comply with the statute. See MICHAEL CHATFIELD, A HISTORY OF ACCOUNTING THOUGHT 207 (1974). As a consequence, the enactment of the corporate and income tax statutes in the early twentieth century vastly increased the demand for accountants’ services. *Id.*

49 The textualist thrust of tax accountancy is best captured in the more than twenty-five editions of the tax accountancy practice guide published between 1917 and 1958 by Robert Montgomery and his associates at the accounting firm of Lybrand, Ross Bros. & Montgomery, the progenitor of Coopers & Lybrand (now absorbed into PricewaterhouseCoopers). See, e.g., ROBERT H. MONTGOMERY, INCOME TAX PROCEDURE (1923); ROBERT H. MONTGOMERY, FEDERAL TAX HANDBOOK; REVENUE ACT OF 1932 (1932); see also MONTGOMERY’S FEDERAL TAXES (1957). Montgomery has long been considered the undisputed leader of the field. See, e.g., Charles J. Gaa, Book Review, 37 ACCT. REV. 598 (1962) (reviewing LYBRAND, ROSS BROS. & MONTGOMERY, MONTGOMERY’S FEDERAL TAXES (38th ed. 1961)); see also Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*,

Insofar as the goal of return preparation is to reach the correct calculation of taxable income, it is a service that favors bright-line rules over broad standards.<sup>50</sup> In addition, tax accountancy has traditionally been marked by an antagonistic orientation toward tax that has accentuated its textualist perspective.<sup>51</sup>

During the last thirty years, big accounting firms underwent important market and organizational changes that contributed to their eagerness to enter and develop the shelter market. For most of their history, the big accounting firms did not emphasize tax services, but offered them to corporate clients as an ancillary to independent audits, the core service around which they built their reputations.<sup>52</sup> But in the 1970s, the big firms began to experience significant competitive pressures in their audit practices, leading to a steady decline in profitability in this area.<sup>53</sup> At first, firms found a panacea in consulting services, which, by the early 1990s, had eclipsed audit as a source of revenue.<sup>54</sup> With the

54 SMU L. REV. 149, 152-54 (2001) (accountants more comfortable with rules; lawyers more comfortable with standards).

Richard Lavoie has attributed the increase of tax shelter activity among professionals to the new textualism espoused by several members of the U.S. Supreme Court. See Richard Lavoie, *Subverting the Rule of Law: The Judiciary's Role in Fostering Unethical Behavior*, 75 U. COLO. L. REV. 115 (2004). In tax decisions, as in other cases, textualism has enjoyed a significant revival. In recent years, it has served as the basis for several circuit court decisions reversing IRS victories in the tax court. See *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001); *United Parcel Serv. v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); see also *TIFD III-E Inc. v. United States (Castle Harbour)*, 342 F. Supp. 2d 94 (D. Conn. 2004); *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621 (D. Md. 2004); *Coltec Indus. Inc. v. United States*, 62 Fed. Cl. 716 (2004). But this approach enjoys a long pedigree in the field of tax accountancy.

50 Several historical factors may have contributed to tax accountancy's textualist approach to the income tax laws. In their day-to-day return preparation work, tax accountants have had to deal with the ongoing difficulty of trying to make sense of a complicated set of laws that changed biennially, or even annually, becoming more convoluted with each revision. This challenge created an impetus toward simplifying terms and concepts, at the expense of addressing the varying goals underlying the Code. See, e.g., ROBERT H. MONTGOMERY, *FEDERAL TAX HANDBOOK*, 1934-35 (1934). From the beginning, moreover, there was a fundamental lack of fit between the core concepts of accountancy and their counterparts in tax law. Over the years, methods of computing taxable and financial income continued to diverge, as tax concepts developed to further social and political goals that were foreign to accountancy's aim of measuring income. See CHATFIELD, *supra* note 48, at 208-10; Ray M. Sommerfeld & John E. Easton, *The CPA's Tax Practice Today and How It Got That Way*, J. ACCT., May 1987, at 166, 172-74.

51 See GARY JOHN PREVITS & BARBARA DUBIS MERINO, *A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING* 255 (1998). Montgomery articulated and undoubtedly magnified the disdain in which tax accountants have held the tax system in the prefaces to his highly popular handbook. Taking stock of the previous year's changes in the tax statute, his assessments were almost invariably negative. See, e.g., MONTGOMERY, *supra* note 50, at 36-37; ROBERT H. MONTGOMERY, *FEDERAL TAX HANDBOOK*, 1940-41, at 54 (1940).

52 See MIKE BREWSTER, *UNACCOUNTABLE: HOW THE ACCOUNTING PROFESSION FORFEITED A PUBLIC TRUST* 42-98 (2003); Rostain, *supra* note 46.

53 See BREWSTER, *supra* note 52, at 162-64; Rostain, *supra* note 46.

54 In 1975, audit fees of the Big Eight comprised between 60% and 75% of their total fees. By 1985, audit fees were between 50% and 65%. See Stephen Zeff, *Does the CPA Belong to a Profession?*, 1 ACCT. HORIZONS 65, 67 (1987). Six years later, non-audit work represented more than 50% of the big firms' total revenues. O'DWYER'S PR SERVICES REPORT, October 1995, at 1, cited in BREWSTER, *supra* note 52, at 180. Over the next ten years fees from audit continued to decline. See *Special Report*, BOWMAN'S ACCT. REP., Mar./Apr. 2002, at 2-3.

rise of consulting, a client-centered sales approach, which focused on the benefits of services to corporate management, took over.<sup>55</sup> Offering “value-added” services to keep management satisfied became the reigning ethos.

By the late 1990s, the big firms had adapted the consulting approach to tax services. With the financial boom, firms discovered new opportunities to exploit in the tax shelter market. Whereas tax advice had earlier been tailored to the needs of specific clients, firms now turned to the development of tax products that could be sold *en masse*. This shift was spurred by the availability of value-added fees, which could be fixed at a percentage of a client’s anticipated tax savings.<sup>56</sup> Such fees acted effectively as sales commissions, permitting accounting firms to make ever larger profits with each tax product sold.

The largest professional organizations in the world, big accounting firms were able to take advantage of their bureaucratic structure, global reach, and enormous client base to take the lead in the industry.<sup>57</sup> Recognizing the profit potential of tax shelters, firms dedicated substantial organizational resources to development and marketing.<sup>58</sup> Specialized groups were created within firms for the sole purpose of designing new tax products.<sup>59</sup> Rather than serving the individualized needs of clients, tax practitioners in these groups focused on identifying obscure provisions of the Code, new financing devices, and esoteric legal forms that could be combined to develop innovative products. The

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55 As Mike Brewster emphasizes, this consulting ethos spread to audit services, which was marketed as a tool to yield information useful to corporate managers. See BREWSTER, *supra* note 52, at 177-79.

56 See Rostain, *supra* note 46, at 95. The importance of contingency fees in driving the tax shelter market has led one commentator to argue for a broad ban of such fees in tax services. See Ben Wang, *Supplying the Tax Shelter Industry: Contingent Fee Compensation for Accountants Spurs Production*, 76 S. CAL. L. REV. 1237 (2003).

57 See Rostain, *supra* note 46, at 95-96. As of 1998, the world revenue of the then Big Five ranged from \$9.5 billion, for KPMG, to \$15.3 billion, for PricewaterhouseCoopers. See *Special Report*, BOWMAN’S ACCT. REP., Mar. 1999. Their clients constituted over 98% of the companies listed on the New York Stock Exchange. See *Annual Survey of Public Accounting Firms*, PUBLIC ACCT. REP., Feb. 28, 1999.

58 See Rostain, *supra* note 46, at 97-104. The resources devoted by KPMG to developing tax products are described in detail in STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS OF S. COMM. ON GOVERNMENTAL AFFAIRS, 108TH CONG., U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS (2003), Tax Notes Today, 2003 TNT 223-20 [hereinafter U.S. TAX SHELTER INDUSTRY]. The subcommittee’s report emphasizes the development and marketing of tax products to individuals and mid-size corporations, which have received the most publicity thus far. Last year, the IRS disclosed that KPMG sold a tax shelter, which the Service subsequently found to be abusive, to twenty-nine Fortune 500 companies. This shelter earned the firm \$20 million in fees. See *KPMG Shelter Shaved 1.7 Billion off Taxes of 29 Companies*, WALL ST. J., June 16, 2004, at A1; see also Novak & Saunders, *supra* note 2 (describing development and marketing efforts at PricewaterhouseCoopers).

59 See Rostain, *supra* note 46, at 97. See U.S. TAX SHELTER INDUSTRY, *supra* note 58, at para. 81-83; accord Timothy Morris & Laura Empson, *Organization and Expertise: An Exploration of Knowledge Bases and the Management of Accounting and Consulting Firms*, 23 ACCT. ORG. & SOC. 609, 617 (1998).

development process was driven by profitability and speed to market.<sup>60</sup> Designed to minimize taxes, standardized tax products did not address the specific business goals of clients. These goals had to be identified (or manufactured) after the fact during the sales process to provide the client with a business purpose for engaging in the transactions in question.<sup>61</sup> Once a product was approved, firms engaged in a marketing blitz to sell it.<sup>62</sup>

During the 1990s, firms intensified their recruitment of tax lawyers. They increased starting salaries to attract recent law school graduates.<sup>63</sup> They also succeeded in hiring many experienced tax partners from corporate firms, offering them substantially higher incomes than they were earning in traditional practice.<sup>64</sup> Between 1997 and 2001, revenue from tax services in the United States grew approximately 20% a year, with increases in the lower double digits in later years.<sup>65</sup> In 1998, the revenue from tax services to the Big Five accounting firms was between 18% and 23% of total revenue, representing between \$800 million and \$1 billion in revenue to each firm.<sup>66</sup> In 2002, after most of the big firms had divested themselves of their consulting services, revenues from tax services were between 21% and 36%, representing between \$1.1 and \$1.6 billion.<sup>67</sup> With so much money to be made, second-tier accounting firms, investment banks, and law firms were soon eagerly designing and marketing new tax shelters.<sup>68</sup>

60 See Rostain, *supra* note 46, at 97-102. See U.S. TAX SHELTER INDUSTRY, *supra* note 58, at para. 81-135.

61 See Rostain, *supra* note 46, at 100. See, e.g., U.S. TAX SHELTER INDUSTRY, *supra* note 58, at para. 189-206.

62 See Rostain, *supra* note 46, at 102-04. See, e.g., U.S. TAX SHELTER INDUSTRY, *supra* note 58, at para. 136-182 (KPMG). Professionals throughout the firm, including audit professionals, were expected to engage in aggressive efforts to sell products. Firms mined their enormous client databases as well as public databases for potential purchasers, engaged in hard-sell tactics, and even used telemarketing methods. *Id.* The tax shelter sales team at Deloitte & Touche was known inside the industry as the "Predator" group. See Jeremy Kahn, *Do Accountants Have a Future?*, FORTUNE, Mar. 3, 2003, at 115.

63 See, e.g., Anna Snider, *Taking a Look Inside the Big Five*, N.Y. L.J., Sept. 7, 1999, at S11; John T. Lanning, *KPMG Recruiting Pitch: Practice Tax*, LEGAL TIMES, Sept. 6, 1999, at S42.

64 See Amy Boardman & Carrie Johnson, *Accounting for Competition: As Tax Lawyers Jump to the Big Six, Rivalry Grows Between Attorneys, Accountants*, LEGAL TIMES, Feb. 3, 1997, at S1; *Big Five Court Tax Attorneys: Many Make Leap as Accounting Firms Work To Expand Their Legal Reach*, CRAIN'S N.Y. BUS., Mar. 22, 1999, at 13; *Ernst & Young Scores Another Top Tax Lawyer*, THE RECORDER, Mar. 25 1999, at 1; *Tax Report*, WALL ST. J., Feb. 2, 2000, at A1; *Big Five Pays Top Dollar for Tax Partners—Especially KPMG*, NAT'L L.J., Nov. 6, 2000, at B8; see also Tanina Rostain, *Pockets of Professionalism*, 54 STAN. L. REV. 1475, 1482 (2000).

65 See *Special Report*, 14 BOWMAN'S ACCT. REP., Mar. 2000, at 2 [hereinafter 2000 *Special Report*]; *Special Report*, *supra* note 54, at 2-3.

66 See 2000 *Special Report*, *supra* note 65, at 8.s

67 See *Special Report*, BOWMAN'S ACCOUNTING REPORT, Mar./Apr. 2003, at 2-3.

68 BDO Seidman is a second-tier accounting firm that has participated in tax shelters. It became the subject of IRS enforcement summonses in 2000. See David L. Lupi-Sher et al., *IRS Moves Aggressively Against Firms Marketing Tax Shelters*, 96 TAX NOTES 338, 338 (2002). In 2000, its tax products group, known internally as the "wolf pack," earned the firm \$100 million from shelter sales. See Cassell Bryan-Low, *Accounting Firms Face Backlash over the Tax Shelters They Sold*, WALL ST. J., Feb. 7, 2003, at A1. The Service has also brought an enforcement action against Grant Thornton. See

The enforcement environment during the late 1990s failed to discourage tax shelter promoters. Promoter listing and registration requirements were in effect, but the Service did little to enforce them.<sup>69</sup> During the market's heyday, shelter promoters apparently did not observe registration and listing obligations, reasoning that penalty exposure would be significantly lower than the profits to be made from selling tax shelters without disclosing them to the IRS.<sup>70</sup>

#### D. *The Role of Outside Legal Advisers*

Lawyers who eschewed direct involvement in development and sales were still able to profit handsomely from the tax shelter boom by writing opinion letters for clients. Opinion letters were a sine qua non of tax shelter purchases,

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Sheryl Stratton, *IRS Gets John Doe Summons for Grant Thornton, Updates Shelter Stats*, TAX ANALYSTS, Oct. 29, 2003, Tax Notes Today, 2003 TNT 209-2. Investment banks involved in tax shelters include Bear, Stearns and Merrill Lynch. See *ACM v. Comm'r*, 157 F.3d 231 (3d Cir. 1998); Anita Raghavan, *Bear Stearns Taking a Hit on Tax Accord*, WALL ST. J., Aug. 7, 1997, at C1. Among law firms, Brown & Wood, now absorbed into Sidley Austin Brown & Wood, and Sutherland, Asbill & Brennan have been targeted by the government and former clients in connection with their tax shelter practices. See U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS, *supra* note 58; David Cay Johnston, *I.R.S. Seeking Buyers' Names in Tax Shelters*, N.Y. TIMES, June 20, 2003, at C1. Jenkins recently settled a civil action brought by former clients arising out of its tax shelter activities for \$75 million. See Cassell Bryan-Low, *Jenkins & Gilchrist Agrees To Pay \$75 Million in Tax-Shelter Case*, WALL ST. J., Mar. 8, 2004, at C3.

69 During the first wave of tax shelters in the 1980s, Congress required promoters to register certain tax shelters with the IRS and to maintain lists of shelter investors. See I.R.C. § 6112 (1984). Section 6111 was drafted principally to target the shelter investments then in vogue. Wider in scope, § 6112 required promoters to keep lists of investors in shelters covered under § 6111, as well as investors in "potentially abusive shelters," defined as any entity, investment plan, or arrangement identified by the Treasury in regulations as having potential for tax avoidance or evasion. I.R.C. § 6112(b). In 1982, Congress also created penalties for promoting abusive tax shelters and aiding and abetting the understatement of tax. See I.R.C. §§ 6700, 670. In 1997, Congress added a provision to § 6111 that required registration with the IRS of corporate tax shelters sold under conditions of confidentiality. See I.R.C. § 6111(d) (1997). The Treasury did not enact regulations to put § 6111(d) into effect until 2000. See Temp. Treas. Reg. § 301.6111-2T (2000); *infra* note 89 and accompanying text. Since 2002, four of the formerly Big Five accounting firms have been defendants in enforcement actions by the IRS. See, e.g., *DOJ Argues Emergency Motion for Stay Pending Appeal Should Be Denied*, Tax Notes Today, Nov. 4, 2002, 2002 TNT 213-58 (describing enforcement action against Ernst & Young); *United States v. KPMG, L.L.P.*, 237 F. Supp. 2d 35 (D.D.C. 2002); *United States v. Arthur Andersen, L.L.P.*, 2003 WL 21956404 (N.D. Ill., Aug. 15, 2003); *PwC Pays IRS for Not Following Shelter Rules*, BOWMAN'S ACCT. REP., Jul. 1, 2002.

70 An internal memo released by the Senate Permanent Subcommittee on Investigations during its investigation of KPMG in 2003 illustrates the approach taken to shelter registration requirements by tax professionals at the firm. See Memorandum from Gregg W. Ritchie to Jeffrey N. Stein, May 26, 1998, Tax Notes Today, 2003 TNT 240-52. The memo assumed that the tax product at issue was a tax shelter subject to section 6111's registration requirements. It nevertheless concluded that the product should not be registered because of the "immediate negative impact on the Firm's strategic initiative to develop a sustainable tax products practice and the long-term implications of establishing a precedent in registering such a product." *Id.* The memo's author went on to argue that the firm's financial exposure was minimal, other promoters were not registering tax shelters so that registering the product would put the firm at a "severe competitive disadvantage," and the Service had demonstrated a "lack of enthusiasm" for enforcing the registration requirements. *Id.*



since they were assumed to provide protection against penalties under § 6662.<sup>71</sup> A corporate client could satisfy the good faith requirement if it reasonably relied on a legal opinion unambiguously concluding that there was a greater than 50% chance that the tax treatment of the item would be upheld if challenged by the IRS.<sup>72</sup> In recognizing that advice of counsel was a factor in assessing good faith, this provision reflected the traditional concept that a party's reliance on advice of counsel militates against finding that the party willfully violated the law.<sup>73</sup> Under this principle, a lawyer's advice protects a client on the assumption that the lawyer will engage in disinterested and diligent efforts to ascertain her client's legal obligations. With the rise of the tax shelter market, this function was subverted, and opinions served simply as penalty insurance.<sup>74</sup> In shopping for opinions on tax shelters, corporate clients were less interested in the content of an opinion than whether a lawyer was willing to provide one.<sup>75</sup>

Regulatory mechanisms failed to deter the proliferation of opinions approving highly questionable transactions. Circular 230, the regulations that govern tax practice before the IRS, did not specifically address more-likely-than-not opinions before 2004.<sup>76</sup> The general standards for tax advice in the regulations did not inhibit lawyers from providing opinions for abusive transactions; nor had the American Bar Association enunciated stricter standards.<sup>77</sup>

Efforts to enforce ethical standards that focused on whether the more-likely-than-not standard had been met were vulnerable to the substantive

71 See *supra* note 43 and accompanying text.

72 See Treas. Reg. § 1.6664-4(e)(2)(B)(2) (as of April 2003).

73 This doctrine appears in criminal law as the principle that following counsel's advice can negate a finding of mens rea. See, e.g., John T. Parry, *Culpability, Mistake, and Official Interpretations of Law*, 25 AM. J. CRIM. L. 1 (1997). This principle is captured in the tax context by the following scenario: A client is unsure of how to determine its tax liabilities and seeks advice from counsel to make sure that the tax treatment it favors is correct. Having relied on this advice, the client should not be penalized if the lawyer provides the wrong analysis.

74 See, e.g., Bankman, *supra* note 1, at 1782; NYSBA 1999A, *supra* note 24, at 893. As the New York State Bar Tax Section noted, clients contemplating an aggressive transaction avoided consulting with their regular experienced counsel for fear of losing the protection of the reasonable cause exception. See *id.*

75 *Id.*

76 See Circular 230, 31 C.F.R. pt. 10 (2000). Section 10.34 of Circular 230 provided, in relevant part, that a practitioner could not advise a client to take a position on a tax return unless the practitioner determined that the position has a realistic possibility of success. *Id.* § 10.34(a)(1). This standard was defined as having a one in three, or greater, likelihood of being sustained on the merits. *Id.* § 10.34(d)(1). At the time, the only provision of Circular 230 that addressed tax shelter opinions was section 10.33, which addressed opinions to market shelters to third parties. The ABA's successful effort to convince the Treasury to enact due diligence standards for opinion letters is described *infra* notes 115-132 and accompanying text.

77 Like Circular 230, ABA Formal Opinion 85-352 prohibited a lawyer from recommending a position on a tax return that falls below "some realistic possibility of success." ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985). ABA Formal Opinion 346, issued in 1982, deals only with tax shelter opinions used for marketing purposes. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982) [hereinafter Formal Opinion 346].

ambiguities that pervade this area of law. When well-regarded tax practitioners disagreed about whether particular transactions were abusive, it was difficult to claim that a more-likely-than-not opinion clearly fell below an acceptable threshold. Potential malpractice exposure was also not a meaningful deterrent. Given the ambiguities in this area of the law, it was difficult to argue that an opinion failed to meet the professional standard of care.<sup>78</sup> Moreover, a corporate client would encounter difficulty in proving that it had relied on an opinion in entering into a transaction, since corporations typically did not use opinions to evaluate transactions' merits, which had already been vetted by in-house tax lawyers, but to avoid penalties.<sup>79</sup>

At the height of the shelter market, fees for opinion letters ran into the hundreds of thousands of dollars, with some even commanding \$1 million or more.<sup>80</sup> The complexity of the Code, the availability of textualist interpretative approaches, and the powerful economic incentives to reach a positive evaluation led lawyers to issue more-likely-than-not opinions for questionable transactions. Under the circumstances, it was not that difficult for a lawyer to conclude in good faith that a tax device, which at first glance may have seemed to have a less than 50% chance of success, after further consideration, had a greater than 50% chance. This lawyer would know too that if she declined to provide an opinion, her client could easily find a lawyer who would.<sup>81</sup>

With the expansion of the tax shelter market, tax textualism began to gain currency among lawyers as an approach to tax interpretation.<sup>82</sup> Many tax lawyers who went to work at accounting firms designed shelter products that used formal categories in the Code. Lawyers who remained at law firms felt pressure from clients eager to participate in abusive shelters. As a result, many of them provided opinion letters that emphasized how transactions fit within the terms of the statute, eliding the question of whether the transactions had an underlying business purpose or economic substance.

## II. The Organized Tax Bar's Role in Law Reform

While individual tax lawyers were reaping substantial financial benefits from tax shelter work, the organized tax bar was involved in law reform initiatives directed at reining in the market. Some participants in the debate

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

79 See *id.* at 1782-83. As of 1999, no lawyers had been sued in connection with issuing opinion letters. See Beck, *supra* note 2. In 2003, several individual taxpayers sued their lawyers after the IRS disallowed tax benefits from tax shelters they had purchased. See David Cay Johnston, *Wealthy Sue Accountants over Shelters*, N.Y. TIMES, Feb. 7, 2003, at C1. Jenkens & Gilchrist recently settled such a lawsuit for \$75 million. See Cassell Bryan-Low, *supra* note 68. Reliance is easier for individuals to establish than for corporations, which presumably rely on in-house tax lawyers to assess the merits of shelter transactions.

80 See Johnston, *supra* note 2; Novak & Saunders, *supra* note 2, at 198.

81 See NYSBA 1999A COMMENTS, *supra* note 24, at 893; Bankman, *supra* note 1, at 1782-83.

82 See Bankman, *supra* note 49, at 153-54.

insisted that no problem existed or, if it did, that it could be adequately addressed by tougher IRS enforcement of existing laws. In contrast, the tax bar argued that abusive shelters posed a significant threat to the integrity of the tax system and embarked on sustained law reform efforts to address the problem.

### A. *Legislative and Regulatory Initiatives*

Abusive tax shelters began to receive systematic attention in the late 1990s.<sup>83</sup> During preceding years, Congress and the Treasury had shut down various tax shelters, saving the Treasury tens of billions of dollars.<sup>84</sup> The Treasury had also issued anti-abuse rules targeted to specific provisions of the Code.<sup>85</sup> On the judicial front, the IRS had won a handful of cases, successfully invoking business purpose and related doctrines to challenge several abusive transactions.<sup>86</sup>

By the end of the decade, however, it was clear that a piecemeal approach, which targeted specific shelters after they came to the attention of government officials, could not address the scope of the problem. In 1999, the Clinton Administration offered a series of legislative proposals with more far-reaching effects.<sup>87</sup> These proposals focused on increasing disclosure by taxpayers, strengthening the penalty scheme, increasing the power of the Service to

83 After the cover story in *Forbes* appeared, see Novak & Saunders, *supra* note 2, several congressional committees held hearings on the issue. *Revenue Provisions in President's Fiscal Year 2000 Budget: Hearing Before the H. Comm. On Ways and Means*, 106th Cong. (1999); *Corporate Tax Shelters: Hearing Before the H. Comm. On Ways and Means*, 106th Cong. (1999); *Revenue Raising Proposals in the Administration's Fiscal Year 2000 Budget: Hearing Before the S. Comm. On Finance*, 106th Cong. (1999); STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATED TO TAX SHELTERS) (Comm. Print 1999). Witnesses included several representatives of the tax bar, who testified about the aggressive marketing of tax products with no purpose other than tax avoidance. *Corporate Tax Shelters: Hearing Before the H. Comm. On Ways and Means*, 106th Cong. 60-67 (1999) (statement of Paul J. Sax, Chair, Section of Taxation, ABA) [hereinafter Sax Statement A]; *Revenue Raising Proposals in the Administration's Fiscal Year 2000 Budget: Hearing Before the S. Comm. On Finance*, 106th Cong. (1999) (statement of Stefan F. Tucker, Chair, Section of Taxation, ABA) [hereinafter Tucker Statement A], Tax Notes Today, 1999 TNT 47-65; see also STAFF OF JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF PRESENT-LAW TAX RULES AND RECENT PROPOSALS RELATING TO CORPORATE TAX SHELTERS (Comm. Print 1999).

84 See WHITE PAPER, *supra* note 24, at ii-iii, 4-6. For a chart illustrating the increase in individual transactions listed by the Treasury since 1999, see Brostek Statement, *supra* note 23, at 8.

85 See WHITE PAPER, *supra* note 24, at 38-41.

86 See *ACM P'ship v. Comm'r*, 157 F.3d 231 (3d Cir. 1998); *ASA Investorings P'ship v. Comm'r*, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000). In 2001, the Service suffered several judicial setbacks when some of its tax court victories in shelter cases were reversed on appeal. *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *United Parcel Serv. v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001). The pendulum has begun to swing in the other direction. See, e.g., *Long-Term Capital Holdings, LP v. United States*, No. 04-5687, 2005 WL 2365336 (2d Cir. Sept. 27, 2005).

87 See DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS (1999), available at <http://www.ustreas.gov/press/releases/docs/gmbk99.pdf> [hereinafter ADMINISTRATION'S 2000 REVENUE PROPOSALS].

disallow tax shelters, and imposing sanctions on tax shelter promoters and other third party participants.<sup>88</sup> In 2000, the Treasury also issued temporary regulations under previously enacted legislation that required the registration of confidential corporate tax shelters,<sup>89</sup> the maintenance of lists of investors in potentially abusive shelters,<sup>90</sup> and the disclosure of tax avoidance (“reportable”) transactions on taxpayers’ returns.<sup>91</sup> Prodded by the ABA Tax Section, the Treasury also began to consider revisions of Circular 230 that would include due diligence standards for more-likely-than-not opinions provided in conjunction with tax shelters.<sup>92</sup>

In subsequent years, the Bush Administration continued to address the corporate tax shelter problem through similar regulatory and legislative initiatives.<sup>93</sup> In particular, it focused on strengthening the reporting regime so that the IRS would have systematic information about potentially abusive tax shelters. In 2002, the Treasury issued temporary regulations expanding the categories of transactions subject to the promoter list maintenance and taxpayer reporting requirements under §§ 6112 and 6011, which became final in 2003.<sup>94</sup> To provide meaningful incentives to disclose, the Treasury proposed

88 See WHITE PAPER, *supra* note 24, at 77-112.

89 See Temp. Treas. Reg. § 301.6111-2T (2000). Because part of the calculus in favor of entering into a tax shelter was the high likelihood of avoiding detection, shelters had typically been covered by confidentiality agreements. These agreements also protected quasi-proprietary rights, which were important in the profitable marketing of tax shelters, given their significant development costs. See Jeremy Kahn, *The Discreet Charm of CPAs*, FORTUNE, Sept. 28, 1998, at 52. After Treas. Reg. § 1.6011-4T was enacted, the practice of requiring clients to agree to confidentiality apparently disappeared.

90 See Treas. Reg. § 301.6112-1T (2000).

91 See Treas. Reg. § 1.6011-4T (2000).

92 See ABA SECTION OF TAXATION, REPORT TO AMEND 31 C.F.R. PART 10, TREASURY DEPARTMENT CIRCULAR 230, TO DEAL WITH “MORE LIKELY THAN NOT” OPINIONS RELATING TO TAX SHELTER ITEMS OF CORPORATIONS (1999), Tax Notes Today, 1999 TNT 211-11 [hereinafter ABA TAX SECTION 1999 CIRCULAR 230 REPORT]; Regulations Governing Practice Before the Internal Revenue Service, 65 Fed. Reg. 30,375 (May 11, 2000) (requesting comments on whether standards for more-likely-than-not opinions should be added to Circular 230 and standards for opinions used for marketing tax shelters should be revised). In its final days, the Clinton Administration issued proposed regulations incorporating due diligence requirements. See Requirements for Certain Tax Shelter Options, 31 C.F.R. § 10.35 (Jan. 12, 2001) (“more likely than not tax shelter opinion”).

93 See, e.g., U.S. TREASURY, TREASURY’S PLAN TO COMBAT ABUSIVE TAX AVOIDANCE TRANSACTIONS (2002), available at <http://www.ustreas.gov/press/releases/po2018.htm>.

94 See Temp. Treas. Reg. § 301.6112-1T (2002) (list maintenance); Temp. Treas. Reg. § 1.6011-4T (2002) (taxpayer disclosure requirements). The earlier versions of these regulations had defined potentially abusive tax shelters as transactions that met two of five filters. Concluding that taxpayers and shelter promoters were interpreting these five characteristics in “an overly narrow manner” and the exceptions in an “overly broad manner,” the Treasury expanded and clarified the six categories of reportable transactions and eliminated various exceptions. See Temp. Treas. Reg. § 1.6011-4T (2002). For the final regulations, see Treas. Reg. §§ 1.6011-4, 20.6011-4, 25.6011-4, 31.6011-4, 53.6011-4, 54.6011-4, 56.6011-4 (as amended in 2003) (taxpayer disclosure requirements); Treas. Reg. § 301.6111-2 (as amended in 2003) (registration of confidential tax shelter requirements); Treas. Reg. § 301.6112-1 (as amended in 2003) (list maintenance requirements). In 2003, the Administration also sought legislation that would give the Treasury authority to require promoters to register the same categories of transactions with the IRS. See Dep’t of the Treasury, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2004 REVENUE PROPOSALS (2003); U.S. TREASURY, *supra* note 93.

regulations that would prohibit a taxpayer from relying on a legal opinion to satisfy the reasonable cause and good faith requirements under § 6664-4(c) when the taxpayer had failed to disclose a reportable transaction.<sup>95</sup> In 2003, the Bush Treasury also proposed revisions to Circular 230, incorporating due diligence standards for legal opinions that became final in December 2004.<sup>96</sup> Meanwhile, Congress enacted the American Jobs Creation Act, which contained several measures directed at tax shelters, including provisions that strengthened the disclosure requirements, increased penalties, and eliminated the reasonable cause exception for undisclosed transactions.<sup>97</sup> The statute also reaffirmed the Treasury's authority to establish standards for written advice pertaining to shelter transactions.<sup>98</sup>

Throughout this process, the ABA and New York State Bar Association ("NYSBA") Tax Sections regularly offered comments on the regulatory and legislative proposals under consideration. Both organizations, led by tax lawyers from elite corporate firms in Washington, D.C., and New York City respectively, have long histories of involvement in law reform activities and function autonomously from their parent organizations.<sup>99</sup> During the tax shelter debates, the two groups did not always endorse the same specific recommendations, but each supported reforms that would strengthen standards for taxpayer disclosure to the IRS and provide incentives for tax lawyers to play a gatekeeping function in rendering opinions.

#### B. *The Tax Bar's Support of Increased Disclosure and Penalties*

In 1999, the Clinton Treasury sought to expand the disclosures required of corporate taxpayers and increase the penalties for substantial understatement of taxes. The Treasury's proposal required taxpayers to disclose transactions that met certain tax shelter characteristics on their tax returns, via a short form that included attestation by a corporate officer with knowledge of the factual

95 See Prop. Treas. Reg. § 1.6664-4, 67 Fed. Reg. 79,894 (Dec. 31, 2002). In 2003, the Administration issued final revised versions of the temporary regulations of the previous year. Treas. Reg. § 1.6664-4 (as amended in 2003) (accuracy-related penalties).

96 See Regulations Governing Practice Before the Internal Revenue Service, 68 Fed. Reg. 75,186 (Dec. 30, 2003) (to be codified at C.F.R. pt. 10).

97 American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 811-22, 118 Stat. 1418, 1575-87 (2004).

98 31 U.S.C. § 330(d).

99 The executive committees of the ABA and NYSBA Tax Sections are mostly comprised of partners at American Lawyer's "Top 100" law firms. See Roster for Tax Section Executive Committee, <http://www.nysba.org/MSTemplate.cfm?Template=/CustomSource/CommitteeRoster.cfm&CommitteeID=1539&MicrositeID=66> (last visited Dec. 3, 2005) (leadership of NYSBA Tax Section); <http://www.abanet.org/tax/leadership/officers.html> (leadership of ABA Tax Section); The Am. Law 100, [http://www.law.com/special/professionals/amlaw/2003/amlaw100/amlaw\\_100main.html](http://www.law.com/special/professionals/amlaw/2003/amlaw100/amlaw_100main.html) (last visited Dec. 3, 2005) (American Lawyer top one hundred firms, 2001 and 2002). The ABA Tax Section has been involved in law reform aimed at improving the federal tax system since its formation in 1939. See James P. Holden et al., *The Section of Taxation: The First Fifty Years*, 44 TAX LAW. 1 (1990).

underpinnings of the transaction.<sup>100</sup> The Treasury also recommended that the substantial understatement penalty under § 6662 be raised from 20% to 40% for reportable shelters that were not properly disclosed.<sup>101</sup> As the Treasury emphasized, strengthened disclosure rules and penalties would greatly facilitate detection of shelters; they would obviously also create a disincentive for corporate taxpayers to enter into questionable transactions in the first place.<sup>102</sup>

The ABA and NYSBA Tax Sections both favored an enhanced disclosure scheme and concurred that strengthening the penalty scheme was appropriate. In the view of the ABA Tax Section, the most troubling tax shelters depended on questionable facts about the economics of the transaction. In particular, the section was concerned that the purported legality of many abusive shelters depended on dubious representations that they had a business purpose or economic substance, or assertions of other implausible “facts” that brought these schemes within applicable judicially created doctrines.<sup>103</sup> The Section consequently recommended that taxpayers be required to disclose the underlying nature and economic impact of “large” tax shelters and be subject to separate penalties for nondisclosure that applied regardless of whether the shelter was ultimately legitimate.<sup>104</sup> In the same vein, the NYSBA Tax Section endorsed a disclosure scheme that would highlight a taxpayer’s participation in a tax shelter soon after the transaction had closed and again later on the taxpayer’s return.<sup>105</sup> The NYSBA Tax Section also strongly supported increasing the penalty for substantial understatement of tax for undisclosed transactions significantly above the current 20% rate. The Section emphasized that such an increase was necessary for the penalty to act as an effective deterrent.<sup>106</sup>

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100 ADMINISTRATION’S 2000 REVENUE PROPOSALS, *supra* note 87, at 95-96; DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2001 REVENUE PROPOSALS, (2000), at 122-23 [hereinafter ADMINISTRATION’S 2001 REVENUE PROPOSALS]; WHITE PAPER, *supra* note 24, at 79-84.

101 ADMINISTRATION’S 2000 REVENUE PROPOSALS, *supra* note 87, at 95. A related proposal made at the time, discussed *infra* notes 137-138 and accompanying text, was to eliminate the reasonable cause defense to penalties for substantial understatements of tax due to tax shelters. In 2000, the Treasury proposed an additional penalty for violations of disclosure requirements. See ADMINISTRATION’S 2001 REVENUE PROPOSALS, *supra* note 100, at 123-24.

102 WHITE PAPER, *supra* note 24, at 79. During the same period, the Treasury enacted temporary regulations broadening the tax shelter registration and list keeping requirements, imposing parallel disclosure obligations on shelter promoters. See *supra* notes 90-91 and accompanying text.

103 Tucker Statement A, *supra* note 83, para. 29-39.

104 Sax Statement A, *supra* note 83, para. 13-14. The Section proposed that a “large” tax shelter be defined as a tax shelter under § 6662(d)(2)(c)(iii) that involved more than \$10 million of tax benefits in which the potential business or economic benefit is immaterial or insignificant in relation to the tax benefit that might result to the taxpayer from the transaction.” *Id.* at para. 18. The Section urged that the required disclosure include a description of the due diligence performed to ascertain the accuracy of the facts underlying the transaction. *Id.* at para. 13. The Section opposed raising the penalty for corporate tax shelters above 20%. Letter from Paul J. Sax, Chair, ABA Tax Section, to Hon. Daniel Patrick Moynihan, U.S. Senator (June 22, 2000), Tax Notes Today, 2000 TNT 127-19.

105 See NYSBA 1999A COMMENTS, *supra* note 24, at 894.

106 *Id.* at 897.

Given that many tax lawyers had been earning large amounts of money facilitating their clients' participation in tax shelters, how should the bar's support of an enhanced disclosure and penalty regime for taxpayers be understood? It is difficult to explain by reference to short-term economic self-interest. Additional disclosure requirements are likely to generate new business for tax professionals, but it is tax accountants who assist in disclosure compliance, not tax lawyers. One might argue that tax lawyers will profit from new disclosure rules because they will be called upon to interpret the new requirements for their clients. But lawyers would enjoy this benefit regardless of the form that new tax shelter rules took, and new regulations appeared inevitable under any scenario.

Strengthened disclosure requirements and higher penalties for violations, moreover, are antithetical to the interests of clients. Presumably, they prefer the freedom to engage in aggressive tax planning without the risk of discovery and higher penalties. As it turned out, it was the American Institute of Certified Public Accountants ("AICPA"), the leading representative of accountants in the United States, and not the organized tax bar, that took up the cause of clients on this issue. The organization, which is led by representatives of big accounting firms, accepted the need for additional disclosure, but forcefully objected to any increase in penalty, repeatedly citing a taxpayer's "right" to minimize taxes by legal means.<sup>107</sup> Indeed, the AICPA initially went further, arguing that penalties should be eliminated completely when a taxpayer fully disclosed participation in a tax shelter, even if the tax shelter was subsequently disallowed.<sup>108</sup>

The organized bar's proposals also appear to be more than a gesture intended to shore up its image. In its positions, the bar went beyond anticipating regulation that was arguably inevitable and offered specific proposals that would make the new regime effective. Both Sections made suggestions about the substance, form, and timing of the required disclosure

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107 See *Revenue Provisions in President's Fiscal Year 2000 Budget: Hearing Before the Senate Finance Comm.*, 106th Cong. (1999) (Statement of David A. Lifson for the Tax Division of the American Institute of Certified Public Accountants), *Tax Notes Today*, 1999 TNT 81-27.

108 *Id.* at para. 99. Had it been adopted, the AICPA's approach would have failed to have any deterrent effect. Simply put, a taxpayer would suffer no downside from engaging in an abusive tax shelter, so long as it was disclosed. At most, a taxpayer that disclosed a tax shelter that was subsequently determined to be abusive would be liable for taxes and accrued interest on the taxes due. When the IRS's willingness to settle at less than full value is considered, a taxpayer's calculus would tip in favor of participating in abusive tax shelters while simultaneously disclosing them. The AICPA later retreated from this position and supported the imposition of additional penalties for failure to disclose a reportable transaction. Letter from Barry Melancon & Robert Zarzar, CEO of AICPA and Chair, AICPA Tax Executive Committee, to AICPA Members (Mar. 24, 2003) (on file with author). Despite the fact that disclosure requirements generally produce business for tax accountants, the AICPA's support for increasing such requirements has historically been lukewarm. In 1997, for example, it objected to legislation, subsequently enacted as I.R.C. § 6111(d), requiring the registration of confidential corporate tax shelters. AM. INST. OF CERTIFIED PUB. ACCTS., COMMENTS ON 1997 BUDGET/TAX LEGISLATIVE INITIATIVES para. 109-11 (1997), *Tax Notes Today*, 97 TNT 111-39.

that would facilitate the IRS's detection of questionable transactions.<sup>109</sup> The bar also argued for increasing penalties. The ABA Tax Section advocated separate disclosure penalties,<sup>110</sup> while the NYSBA Tax Section promoted increased understatement penalties for undisclosed transactions.<sup>111</sup>

It is unlikely that the organized bar offered its particular proposals as a hollow public relations ploy that it believed would never be enacted. Some form of regulation and legislation was highly probable, and, in the end, Congress imposed disclosure requirements on taxpayers that were very similar to those proposed by the tax bar. Under the American Jobs Creation Act of 2004, a taxpayer faces penalties for failure to disclose a reportable transaction regardless of whether or not the transaction results in an understatement of tax.<sup>112</sup> In addition, a taxpayer that has failed to disclose a reportable transaction that results in a substantial understatement of tax also faces a 30% strict liability penalty.<sup>113</sup>

### C. *The ABA Tax Section's Successful Efforts To Amend Circular 230*

Although the ABA Tax Section supported changing the incentives of taxpayers tempted to engage in abusive transactions, most of its energy went to persuading the Treasury to adopt due diligence standards for opinions rendered by lawyers to abate possible substantial understatement penalties under §§ 6662

109 Sax Statement A, *supra* note 83 (proposing clear specific reporting); Tucker Statement A, *supra* note 83 (same); See NYSBA 1999A COMMENTS, *supra* note 24, at 894 (suggesting short form filing within thirty days of transaction).

110 Sax Statement A, *supra* note 83; Tucker Statement A, *supra* note 83.

111 See NYSBA 1999A COMMENTS, *supra* note 24, at 897. Under the final rules issued by the Bush Administration, taxpayers are required to disclose transactions that meet one of six criteria on their tax returns. Treas. Reg. §§ 1.6011-4, 20.6011-4, 25.6011-4, 31.6011-4, 53.6011-4, 54.6011-4, 56.6011-4 (collected at 68 Fed. Reg. 10,161 (Mar. 4, 2003)). The six types of reportable transactions defined by the regulations were listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions, transactions with a significant book-tax difference, and transactions involving a brief asset holding period. 68 Fed. Reg. at 10,163-64. Under the new regulations, for example, corporations must now report transactions that produce or are expected to produce a loss in excess of \$10 million in a year or \$20 million in total. See *id.* Under the book-tax difference provision, certain publicly traded corporations were required to report transactions that produce a book tax difference in excess of \$10 million. As of 2003 no separate penalty attached to the failure to disclose a reportable transaction—prior to 2004, such a penalty was beyond the Treasury's statutory authority—but the IRS would consider the omission of a reportable transaction a strong indication that the taxpayer failed to act in good faith, which would bar the penalty relief previously available pursuant to the reasonable cause exception in section 6664(c). See Treas. Reg. § 1.6664-4 (accuracy related penalties); see also *supra* notes 72-76 and accompanying text (on role of opinion letters under reasonable cause exception); *infra* notes 137-138 and accompanying text (on proposal to enact strict liability regime).

112 I.R.C. § 6707A (2005). The penalty varies from \$10,000 for a natural person to \$50,000 for another entity. I.R.C. § 6707A(b)(2) (2005). It also increases if the transaction is a transaction that has been specifically listed as a tax avoidance transaction by the Treasury. I.R.C. § 6707A(b)(2) (2005). The statute leaves it to the Treasury to define reportable transactions. I.R.C. § 6707A(c)(1) (2005). Under I.R.C. § 6707A(d)(1), the IRS has limited authority to rescind the penalty if the transaction was not a listed transaction and rescission "promote[s] compliance with the requirements of this title and effective tax administration."

113 I.R.C. §§ 6662A(c), 6664(d)(2) (2005).



and 6664. As its support for enforceable opinion standards suggests, the organized tax bar sought to affirm tax lawyers' gatekeeping function, and thereby restore lawyers' authority over their clients, which had been severely eroded by the market forces driving the tax shelter industry.<sup>114</sup>

Beginning in 1999, the ABA Tax Section advocated adding provisions to Circular 230 that would require due diligence standards for more-likely-than-not opinions.<sup>115</sup> At the time, Circular 230 contained no provision specifically addressing legal opinions written to protect clients from penalties.<sup>116</sup> Rather than attempt to refine the more-likely-than-not standard, the Section focused on the factual representations and legal analysis that underlay opinions, consistent with its view that the most egregious tax shelter opinions relied on dubious factual assumptions about the economics underlying transactions.<sup>117</sup> Although the NYSBA Tax Section advocated a strict liability approach that would eliminate the role of legal opinions in abating penalties altogether, it agreed on the need to impose opinion standards if Congress did not adopt a strict liability scheme.<sup>118</sup>

The ABA Tax Section began to enjoy some success in January 2001, when the Clinton Administration adopted its approach and proposed due

114 See Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869 (1990); John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293 (2003); Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097 (2003); Fred Zacharias, *Lawyers as Gatekeepers*, 41 SAN DIEGO L. REV. 1387 (2004). The literature on lawyers as gatekeepers tends to focus on how lawyers can prevent clients from engaging in wrongdoing by withholding legal assistance, but does not consider how legal expertise may underlie this function.

115 See ABA TAX SECTION 1999 CIRCULAR 230 REPORT, *supra* note 92. James P. Holden, a partner at the law firm of Steptoe & Johnson and a tax ethics authority, first proposed due diligence standards for legal opinions in a speech to the American College of Tax Counsel in 1999. See James P. Holden, *1999 Erwin Griswold Lecture: Dealing with the Aggressive Corporate Tax Shelter Problem*, 52 TAX LAW. 369 (1999).

116 See Circular 230, 31 C.F.R. pt. 10 (1999); Regulations Governing Practice Before the Internal Revenue Service: Advance Notice of Proposed Rule Making, 65 Fed. Reg. 30,375 (May 11, 2000) (to be codified at 31 C.F.R. pt. 10) (requesting comments as to whether standards for more-likely-than-not opinions should be added to Circular 230 and standards for opinions used for marketing tax shelters should be revised). Circular 230 had been revised most recently in connection with tax shelter issues in 1984, when section 10.33, which sets out standards for opinions used to market tax shelters publicly to third parties, was added. See Circular 230, 31 C.F.R. § 10.33 (1999). Section 10.33 tracked Formal Opinion 346, issued by the ABA in 1982. Formal Opinion 346, *supra* note 77. It prohibited an opinion writer from relying on unreasonable factual assertions, but applied only to opinions designed to be included or described in tax shelter offering materials that were publicly distributed. See *id.* 31 C.F.R. § 10.33(a)(1), (c)(3).

117 See Tucker Statement A, *supra* note 83, para. 29-36. The ABA Tax Section advocated the introduction of standards for opinion writing that would, inter alia, require lawyers to make reasonable inquiries in connection with the factual representations made by taxpayers, address all applicable law, including common law doctrines, and unambiguously conclude more likely than not that the tax treatment of the item would be upheld if challenged. ABA TAX SECTION 1999 CIRCULAR 230 REPORT, *supra* note 92, at 3-4.

118 See NYSBA Tax Section, REPORT ON PROPOSED AMENDMENTS TO CIRCULAR NO. 230 (July 31, 2000) para. 16-17, Tax Notes Today, 2000 TNT 150-31. For discussion of the strict liability proposal, see *infra* notes 137-149 and accompanying text.

diligence standards for opinion letters.<sup>119</sup> The proposed regulation applied broadly to any written advice about the federal tax treatment of a tax shelter transaction, defined as any entity, plan or arrangement which had as a *significant purpose* tax avoidance.<sup>120</sup> Under the rule, an author of a more-likely-than-not opinion was required to engage in due diligence and could not rely on unreasonable or conclusory factual assumptions.<sup>121</sup> In particular, the rule prohibited a practitioner from relying solely on a client's representation that a transaction had a business purpose or was potentially profitable.<sup>122</sup> Opinions were also required to relate the applicable law to the facts, analyze the material tax law issues, and provide unambiguous conclusions about the federal tax treatment of the transaction.<sup>123</sup> In December 2003, the Treasury again issued proposed rules applicable to tax shelter opinions containing due diligence requirements.<sup>124</sup>

A fundamental problem with the Treasury's proposals, noted by the organized tax bar and accounting profession, was that they would cover all tax opinions and accordingly imposed onerous and expensive requirements on routine written tax advice. Lawyer and accounting groups offered different solutions. The ABA Tax Section took the position that the opinions subject to the requirement should be limited to those specifically intended to provide protection from substantial underpayment penalties under § 6662.<sup>125</sup> Taking a similar tack, the NYSBA Tax Section endorsed an "opt-in" rule under which

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119 See 66 Fed. Reg. 3276, (Jan. 12, 2001) (to be codified at 31 C.F.R. § 10.35).

120 *Id.* § 10.35(c)(2) (2001). The proposed rule adopted the broad definition of a tax shelter from I.R.C. § 6662(d)(2)(C)(iii).

121 31 C.F.R. § 10.35(a)(1) (2001).

122 *Id.* § 10.35(a)(1)(c)(iii). The proposed rule also prohibited an opinion writer from relying on unreasonable or uninformed financial appraisals. *Id.* § 10.35(a)(1)(c)(iv)-(v) (2001).

123 *Id.* § 10.35(a)(4) (2001). The Treasury's proposals, in addition, set forth minimal standards of competence to render tax opinions. *Id.* § 10.35(b) (2001).

124 See Regulations Governing Practice Before the Internal Revenue Service, 68 Fed. Reg. 75,186 (Dec. 30, 2003) (to be codified at C.F.R. pt. 10). A month earlier, the Senate Subcommittee on Special Investigations had held hearings on the tax shelter activities of KPMG and issued a lengthy report. See U.S. TAX SHELTER INDUSTRY, *supra* note 58. One of the Permanent Subcommittee's recommendations was that Treasury revise Circular 230 to include tax shelter opinion standards. *Id.* para. 51(5).

125 See ABA SECTION OF TAXATION, COMMENTS ON PROPOSED RULEMAKING CIRCULAR 230 para. 1-35 (2004), Tax Notes Today, 2004 TNT 32-38 (suggesting that standards for tax opinions apply only to legal advice of "a type which ordinarily addresses the final and complete form of a transaction"; alternatively, standards should apply only to opinions expressly stating that they are provided for penalty protection). Initially, the ABA's preferred solution was that the Treasury adopt a narrow definition of tax shelter for purposes of the due diligence requirements. See ABA SECTION OF TAXATION, COMMENTS REGARDING PROPOSED AMENDMENTS TO THE REGULATIONS GOVERNING PRACTICE BEFORE THE INTERNAL REVENUE SERVICE para. 41-42, 57-60 (2001), Tax Notes Today, 2001 TNT 86-47 (stating that tax shelter definition should be limited to transactions with the principal purpose of tax avoidance; alternatively, definition of opinion should be limited to those prepared for "stated purpose" of penalty protection as originally suggested in 1999). Its position evolved over time. See ABA SECTION OF TAXATION, PROPOSED REVISIONS TO CIRCULAR 230 para. 3-4 (2002), Tax Notes Today, 2002 TNT 87-21 (arguing that tax shelter opinion standards should not apply to all advice relating to reportable transactions under disclosure and registration rules; proposing six part filter for transactions subject to section 10.35 opinion standards).

the new standards would apply to opinions expressly providing penalty protection.<sup>126</sup> In contrast to the tax bar, the AICPA repeatedly argued that the definition of the underlying transactions subject to the rule should be narrowed to those with *the principal* (as opposed to *a significant*) purpose of tax avoidance.<sup>127</sup>

With the Treasury's enactment of the ABA Tax Section's proposal in 2004, legal opinions that are offered to provide penalty protection now fall under the jurisdiction of the IRS, which has authority to sanction lawyers for violations.<sup>128</sup> Adopting the tax bar's approach, the Treasury's final rules cover a broad range of written advice, including opinions offered in connection with listed transactions or whose principal purpose is tax avoidance; and more-likely-than-not and marketing opinions offered in connection with transactions with a significant purpose of tax avoidance.<sup>129</sup> To narrow its potential scope, the rule includes an "opt-out" provision, under which a more-likely-than-not opinion is covered unless its author prominently discloses that the advice is not intended to be used to avoid penalties.<sup>130</sup> Along the lines originally proposed by

126 See N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON PROPOSED AMENDMENTS TO CIRCULAR NO. 230 para. 3 (2000), Tax Notes Today, 2000 TNT 150-31 (recommending that "a reasonable cause opinion should state that it is being provided for that purpose"). Although it briefly favored an "opt-out" rule under which only written opinions that made clear that they were not intended for penalty relief would be exempt from the shelter opinion standards, N.Y. STATE BAR ASS'N TAX SECTION, REPORT 995 ON PROPOSED AMENDMENTS TO CIRCULAR NO. 230 para. 32-35 (2001), Tax Notes Today, TNT-149-41 [hereinafter NYSBA Tax Section January 2001 Report] (favoring "opt-out" provision), it has most recently reverted to its original position in favor of an "opt-in" provision. See N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON PROPOSED AMENDMENTS TO CIRCULAR 230, at 7-8 (Mar. 24, 2004), Tax Notes Today, 2004 TNT 58-46 (favoring "opt-in" provision). As of 2004, a sizeable minority of the section still believed that an opt-out approach was preferable. *Id.*

127 See AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, COMMENTS ON ADVANCE NOTICE OF PROPOSED RULEMAKING TO AMEND THE REGULATIONS GOVERNING PRACTICE BEFORE THE INTERNAL REVENUE SERVICE CONTAINED IN CIRCULAR NO. 230, at 4 (2000), Tax Notes Today, 2000 TNT 140-16 (supporting standards for opinions on transactions about which the practitioner "knew or should have known" that the principal purpose was tax avoidance or evasion); AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, COMMENTS ON PROPOSED MODIFICATIONS OF THE REGULATIONS GOVERNING PRACTICE BEFORE THE INTERNAL REVENUE SERVICE, WHICH APPEAR IN THE CODE OF FEDERAL REGULATIONS AND IN PAMPHLET FORM AS TREASURY DEPARTMENT CIRCULAR NO. 230 para. 59-63 (2001), Tax Notes Today, 2001 TNT 82-34 (designation of tax shelter for purposes of sections 10.33 and 10.35 should be determined by reference to "the principal purpose" definition); AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, SUPPLEMENTAL COMMENTS ON REG-11835-99, PROPOSED AMENDMENTS TO CIRCULAR 230 para. 5-6 (2002), Tax Notes Today, 2002 TNT 33-72 (tax shelter should be defined by reference to the "principal purpose" standard or by reference to business purpose or economic substance of transaction); AM. INSTITUTE OF CERTIFIED PUB. ACCOUNTANTS, COMMENTS ON PROPOSED REGULATIONS, REG. 122379-02 para. 14 (2004), Tax Notes Today, 2004 TNT 32-39 ("a significant purpose" definition of proposed regulations overly broad).

128 Prior to 2004, the Treasury had authority to suspend or disbar from practice before it a practitioner who violated Circular 230. The American Jobs Creation Act gave the Treasury authority to impose monetary penalties as well. 31 U.S.C. § 330(b).

129 31 C.F.R. § 10.35 (b)(2)(C) (2005). Covered opinions also included opinions offered under conditions of confidentiality or under contractual protection. *Id.*

130 31 C.F.R. § 10.35(c)(3)(v)(3) (2005). The rule also prohibits an opinion writer from relying on a projection, financial forecast, or appraisal, if the practitioners knows or should know that it is incorrect, incomplete or prepared by an unqualified person. *Id.* § 10.35(c)(1).

the ABA Tax Section, the final rule requires opinion writers to make reasonable inquiries into the underlying facts of transactions and prohibits them from relying on unreasonable factual assumptions or representations. Opinion authors must also relate applicable law to the facts, evaluate all significant federal tax issues, and provide an overall conclusion as to the appropriate tax treatment of the transactions.<sup>131</sup>

The tax bar's five year campaign in favor of due diligence requirements is difficult to explain based on the conventional views of bar activities. Due diligence obligations do not further either the bar's interests or those of its clients. For clients, a regime that permits them to obtain opinion letters from lawyers based solely on representations that transactions have economic substance is clearly preferable to one in which lawyers must satisfy themselves that transactions do in fact have economic substance before issuing opinions. One might argue that due diligence requirements will benefit lawyers by increasing the price of legal opinions. Due diligence takes time, which costs money. The tax bar, however, did not seek broad application of due diligence requirements to encompass routine tax advice. To the contrary, it insisted that the requirement cover only opinions provided in connection with tax shelters.<sup>132</sup>

In addition, the increase in fees from due diligence in connection with covered opinions may be offset by the numerous occasions in which clients will be deterred at the outset from engaging in transactions that have no business

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Treasury's choice of an "opt-out" approach provoked a strong reaction from the bar because it entailed placing detailed legends that had to be "prominently displayed" on all written tax advice. See Letter from David P. Hariton, Chairman, N.Y. State Bar Association, to Eric Solomon, Acting Deputy Assistant Secretary, Department of the Treasury, and Mark W. Everson, Commissioner, Internal Revenue Service (Mar. 5, 2005), *Tax Notes Today*, 2005 TNT 43-56 (noting that members had reconsidered and were now unanimous in supporting opt-in approach; urging Treasury to adopt same); Letter from Kenneth W. Gideon to Arnold I. Havens, General Counsel, Department of the Treasury (May 11, 2005) (on file with author) (urging Treasury to adopt opt-in approach). Although the Treasury continued with an opt-out approach in subsequent regulations, it loosened the definition of "prominently displayed" and excluded several categories of advice from the rule's definition of "covered opinion." See 31 C.F.R. §§ 10.35(b)(2)(ii)(A)-(E), 10.35(b)(8) (2005). Although individual tax practitioners continued to raise concerns, see Letter from Mark E. Berg, Chair, NYSBA Tax Section, to Mark W. Everson, Commissioner, Internal Revenue Service, and others (June 28, 2005), *Tax Notes Today*, 2005 TNT 125-12, the outcry appears to have died out as tax lawyers have developed routine legends, similar to the confidentiality banners that accompany correspondence from law firms, that they include in all tax advice. See Sheryl Stratton, *Circular 230 E-Mails, T-Shirts Attain 'Legendary' Status* (July 5, 2005), *Tax Notes Today*, 2005 TNT 127-1.

The final rules adopted by the Treasury did not provide an opt-out option for opinions relating to transactions whose "principal purpose" was tax avoidance. See 31 C.F.R. §§ 10.35(b)(2)(i)(B), (c)(3)(v)(2) (2005). In response to the tax bar's concern that transactions with a principal purpose of tax avoidance were often contemplated by the Code, see Letter from David P. Hariton to Eric Solomon and Mark W. Everson, *supra*, Letter from Kenneth W. Gideon to Arnold I. Havens, *supra*, Treasury clarified the definition of "principal purpose" to exclude transactions that claimed tax benefits consistent with Congressional purpose. See 31 C.F.R. § 10.35(b)(10) (2005).

<sup>131</sup> 31 C.F.R. § 10.35(b)(4)(ii) (2005).

<sup>132</sup> See Letter from David P. Hariton to Eric Solomon and Mark W. Everson, *supra* note 130; Letter from Kenneth W. Gideon to Arnold I. Havens, *supra* note 130.

purpose or economic substance. Tax practices that earned hundreds of millions of dollars issuing boilerplate opinions on abusive transactions are likely to disappear, as it is doubtful that the fees lawyers in these firms can make from additional due diligence would compensate for the lost earnings.<sup>133</sup>

A skeptic might still argue that the bar's support of due diligence requirements is a type of rent-seeking by the "ethical" segment of the bar to recapture the market for opinions it had lost to practitioners willing to provide opinions on abusive transactions. As an explanation, however, the rent-seeking hypothesis is not very helpful. From the perspective of maximizing financial self-interest, it made more sense for ethical lawyers to abandon their qualms and join their less ethical counterparts who were earning substantial incomes from their opinion practices, rather than go through the lengthy exercise of seeking the imposition of more stringent requirements. That leaders of the tax bar failed to take this route suggests that they had a stake in restoring ethics standards in opinion letters. An economic maximization model does not adequately explain this stake.<sup>134</sup>

To understand the stakes involved, it is necessary to explore how due diligence obligations alter tax lawyers' relationships with government and clients. In persuading the Treasury to adopt a due diligence requirement where previously there was none, the tax bar departed from the legal profession's traditional conception of professional independence. Under this conception, lawyers exercise discretionary expert judgments free from client or governmental interference.<sup>135</sup> In supporting due diligence, the tax bar recognized that lawyers' authority over their clients had been significantly eroded by the tax shelter market. To reclaim this authority, lawyers have to relinquish an important dimension of discretionary judgment to the state. With the due diligence requirement, lawyers can no longer decide for themselves how far to probe into their clients' representations. By enlisting the Treasury as an outside regulatory authority, the tax bar acknowledged that whatever norms of professional independence once underlay the application of tax expertise, these norms alone can no longer counteract the distorting effects of market forces.

Even as the rule supported by the tax bar cedes authority to the IRS, it strengthens the independence of tax advisers vis-à-vis their clients. Because opinion writers will be subject to sanctions in connection with a broad class of transactions, these lawyers will have to insist that clients provide a reasonable business rationale before issuing an opinion that offers penalty protection for a transaction. By delegating to tax advisers the function of policing the economic

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133 See *supra* notes 81-82 and accompanying text.

134 Nor can the bar's support of due diligence be dismissed as an empty gesture intended to improve the tax bar's image. It was, after all, an initiative that originated with the organized bar and that will have significant consequences for tax opinion practice.

135 See Robert W. Gordon, *The Independence of Lawyers*, 68 B.U. L. REV. 1, 6 (1988).

basis of their clients' transactions, moreover, due diligence obligations deter clients from engaging in the most aggressive transactions.

#### D. *The NYSBA Tax Section's Endorsement of a Strict Liability Regime*

While supporting the ABA Tax Section's push for due diligence standards, the NYSBA Tax Section favored a more extreme makeover, arguing for a shift to strict liability for taxpayers who engaged in tax shelters that resulted in substantial understatements of tax. Just as the ABA Tax Section's support of due diligence is difficult to square with pure self-interest, so is the NYSBA Tax Section's advocacy of strict liability. Like the due diligence requirement, strict liability attempts to reaffirm the authority of lawyers over their clients, but does so indirectly, through market competition. Whereas due diligence works by altering the incentives for lawyers, which in turn alter the incentives for clients, a strict liability strategy affects incentives in the other direction. Strict liability neutralizes the protective effects of legal opinions, thereby putting the burden of avoiding abusive tax shelters squarely on taxpayers, who will be induced to seek out legal advice that is knowledgeable and conservative.

In its Fiscal Year 2000 Revenue Proposals, the Clinton Administration proposed that Congress abolish the "reasonable cause" exception for accuracy-related penalties for transactions attributable to corporate tax shelters.<sup>136</sup> Under this proposal, a corporate taxpayer would no longer be able to avoid the penalty for a substantial understatement of income tax due to a corporate tax shelter by claiming that it had relied on the advice of counsel. The Administration also proposed to increase the substantial understatement penalty to 40%, calculated based on the amount of the understatement, if the taxpayer failed to disclose the tax shelter, as required under the proposed legislation. If the taxpayer disclosed the shelter, the penalty would remain at 20%.<sup>137</sup>

The NYSBA Tax Section embraced this approach, calling it a "radical" reform that would alter the calculus of corporate taxpayers deciding whether to engage in tax shelters.<sup>138</sup> As the Tax Section noted, the substantial

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136 See ADMINISTRATION'S 2000 REVENUE PROPOSALS, *supra* note 87, at 95.

137 See *id.* at 95. In the following year, the Administration modified this proposal so that strict liability would apply only to undisclosed corporate tax shelters. For shelters that were disclosed, a taxpayer could obtain abatement of the 20% penalty under a strengthened reasonable cause exception. See ADMINISTRATION'S 2001 REVENUE PROPOSALS, *supra* note 100, at 124.

138 See NYSBA 1999A COMMENTS, *supra* note 24, at 891-94. The ABA Tax Section has been concerned broadly about removing the Service's authority to waive penalties in appropriate circumstances, see *Penalty and Interest Provisions in the Internal Revenue Code: Hearing Before the H. Subcomm. on Oversight of the H. Comm. on Ways & Means*, 106th Cong. 14 (1999) (statement of Pamela F. Olson, Chair-Elect, American Bar Association Section on Taxation). The AICPA has strongly opposed a strict liability approach. See, e.g., *Revenue Raising Proposals in the Administration's Fiscal Year 2000 Budget: Hearing Before the S. Comm. on Finance*, 106th Cong. (1999) (statement of David A. Lifson, Tax Division of the American Institute of Certified Public Accountants), Tax Notes Today, 1999 TNT 218-25.

understatement penalties would now have meaningful deterrent effect. A taxpayer who engaged in an abusive transaction would run a real risk of facing a substantial penalty.

While acknowledging the traditional principle that clients are entitled to rely on advice of counsel, the NYSBA Tax Section recognized that the conditions on which it was premised—a client consulting a lawyer in good faith to determine its legal liabilities—did not hold.<sup>139</sup> As the section noted, the tax “dialogue” between lawyer and client had become distorted, focusing on whether a lawyer would render an opinion rather than on the underlying merits of the transaction.<sup>140</sup> In the NYSBA Tax Section’s view, an important benefit of strict liability would be to restore the importance of well-reasoned tax advice in client decision-making.<sup>141</sup> Strict liability would alter the incentives for seeking legal advice, which would, in turn, alter the advice that was given. Since clients would be unable to purchase penalty protection, they would seek the best legal advice, which lawyers would be motivated to provide. By creating a market for well-reasoned legal advice that addressed the legal merits of a transaction, a strict liability regime would strengthen lawyers’ capacity to dissuade clients from entering into abusive tax shelter transactions.<sup>142</sup>

Although not mentioned by the NYSBA Tax Section, a shift to strict liability would also render tax lawyers more vulnerable to malpractice claims, particularly by corporate clients. Under the previous regime, a corporate client would have had difficulty proving that it relied on a lawyer’s advice in entering into the transaction, having obtained the lawyer’s opinion for penalty protection only.<sup>143</sup> Under strict liability, a taxpayer is motivated to consult a tax adviser to obtain substantive legal guidance. If the lawyer’s advice turns out to be wrong

139 NYSBA 1999A COMMENTS, *supra* note 24, at 892. Professor Calvin Johnson argued that “giving a corporation an immunity from penalty if it has a reasonable basis or substantial authority for its reporting position will mean that the corporation will not try hard enough to predict real outcomes of the case. . . . [It] is a bit like scoring football games by the number of good tries or reasonable efforts. Scoring by touchdowns accomplished seems to encourage each side to try harder.” Calvin H. Johnson, *Corporate Tax Shelters, 1997 and 1998*, 80 TAX NOTES 1603, 1606 (Sept. 28, 1998).

140 See NYSBA 1999A COMMENTS, *supra* note 24, at 893.

141 *Id.*

142 *Id.* The NYSBA Tax Section has taken the position that it favors strict liability for purposes of the substantial understatement penalty but not for “mere disclosure” failures. See Letter from Andrew N. Berg, Chair, NYSBA Tax Section, to Hon. Charles E. Grassley & Hon. Max Baucus, Senate Finance Committee (Oct. 22, 2003), available at <http://www.nysba.org>. Disclosure provisions are intentionally over-inclusive, covering a broad swath of transactions with the characteristics of tax shelters, many of which will turn out to be legitimate transactions. In the Tax Section’s view, a taxpayer who inadvertently fails to disclose a non-tax motivated transaction that falls within one of the categories of reportable transactions should be able to invoke the reasonable cause exception. Strict liability should apply, on the other hand, when the taxpayer would lose on the underlying merits of the transaction. See Letter from Andrew N. Berg, Chair, NYSBA Tax Section, to Hon. William M. Thomas, Chair, House Ways & Means Committee (Sept. 24, 2003), available at <http://www.nysba.org>; accord N.Y. STATE BAR ASS’N TAX SECTION, REPORT ON RECENT TAX SHELTER REGULATIONS 1025 (2003) at 20-21, available at <http://www.nysba.org>.

143 See *supra* notes 74-76 and accompanying text.

on the merits, a taxpayer will have a greater likelihood of success in a subsequent malpractice action.

The NYSBA Tax Section's approach is reflected in the American Jobs Creation Act of 2004, which abolishes penalty protection for opinion letters in connection with reportable tax shelters that are not properly disclosed and are later found to be abusive.<sup>144</sup> Taxpayers who fail to disclose such transactions can no longer avail themselves of the reasonable cause exception under § 6664 and are subject to a 30% penalty.<sup>145</sup> Taxpayers who properly disclose reportable transactions that turn out to be abusive continue to be subject to a 20% penalty, which they can avoid under a more stringent reasonable cause exception. Taxpayers can avoid the penalty if they can establish that they had substantial authority for the claimed tax treatment and reasonably believed that the claimed tax treatment was more likely than not the proper tax treatment at the time the return was filed.<sup>146</sup>

As with due diligence, economic self-interest does not satisfactorily explain the NYSBA Tax Section's support of strict liability. Such a regime is certainly not in the interests of clients who can no longer avoid penalties by claiming that they relied on their lawyer's advice. Nor can the bar's support be construed as purely symbolic: The shift to strict liability will have a dramatic effect on opinion practices. Such a regime, moreover, does not maximize individual lawyers' economic interests. As noted above, tax lawyers are able to make more money when letters provide penalty protection.<sup>147</sup>

Strict liability, like due diligence, reinforces tax lawyers' authority over their clients. Placing the risk of error on taxpayers creates a market for knowledgeable and cautious opinions. As the NYSBA Tax Section

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144 The Bush Administration sought to impose strict liability through administrative measures. See TREASURY'S PLAN TO COMBAT ABUSIVE TAX AVOIDANCE TRANSACTIONS, *supra* note 93; Prop. Treas. Reg. § 1.6664-4(c)(2), 67 Fed. Reg. 79,894 (Dec. 2002). After its regulatory authority to abolish the reasonable cause exception came under doubt, *see, e.g.*, Letter from Samuel J. Dimon to Pamela F. Olson and Hon. Charles Rossotti (May 22, 2002) (on file with author), the Treasury adopted a different strategy, suggested by the NYSBA Tax Section, that tied the failure to disclose to the issue of whether the taxpayer acted in good faith for purposes of meeting the reasonable cause exception. Under the Treasury's final rule, enacted in 2003, failure to disclose a reportable transaction was a "strong indication that the taxpayer did not act in good faith" for purposes of the accuracy-related penalty. See Treas. Reg. § 1.6664-4; *cf.* NYSBA TAX SECTION, COMMENTS ON THE NEW TAX SHELTER REGULATIONS (Nov. 16, 2000), Tax Notes Today, 2000 TNT 44-86 (arguing that the failure to disclose reportable tax shelter should give rise to "rebuttable presumption" that taxpayer did not act in good faith for purpose of applying reasonable cause exception).

145 I.R.C. §§ 6664(c), 6662A(c) (2005); *cf.* NYSBA 1999A COMMENTS, *supra* note 24.

146 I.R.C. § 6664(d)(2)(B)-(C) (2005). The new statute also requires that any opinion relied upon by a taxpayer to establish reasonable belief be from an advisor who does not derive significant income from designing or marketing the transaction at issue and not contain unreasonable factual or legal assumptions or representations. I.R.C. § 6664(3)(B) (2005).

147 Like the organized bar's support of due diligence, the NYSBA Tax Section's support of strict liability could be argued to be a form of rent seeking, but this view again leaves unexplained the actions of the reform-minded lawyers who had incentives in the prior regime to issue opinion letters risk free.



emphasized, with strict liability, “a greater premium will be placed on receiving the most thoughtful and accurate legal advice, not the most aggressive.”<sup>148</sup>

### E. *The Tax Bar’s Resistance to Codifying the Economic Substance Doctrine*

In contrast to its support for most of the major governmental initiatives targeted at abusive tax shelters, the organized bar has expressed strong opposition to the proposal, raised intermittently since the late 1990s, to codify the economic substance doctrine. One of the more controversial strategies targeted at corporate tax shelters, the proposal initially appeared in the Clinton Administration’s 1999 proposals.<sup>149</sup> At first receptive to the idea of codification, the Bush Administration eventually decided against pursuing it.<sup>150</sup> Despite this lack of enthusiasm, proposals to codify the economic substance doctrine have surfaced recently in several bills pending before Congress.<sup>151</sup> The organized tax bar has based its resistance on the argument that a statutory formulation would supplant and confuse existing judicially created doctrines.

In its 2000 Fiscal Year Revenue Proposal, the Clinton Administration proposed broadening Internal Revenue Code § 269, a provision that authorizes the IRS to disallow tax benefits from certain acquisitions whose principal purpose is the evasion or avoidance of federal income tax. The proposal would have permitted the IRS to deny benefits in “tax avoidance” transactions.<sup>152</sup> The

148 See NYSBA 1999A COMMENTS, *supra* note 24, at 893.

149 See ADMINISTRATION’S 2000 REVENUE PROPOSALS, *supra* note 87, at 97-98; ADMINISTRATION’S 2001 REVENUE PROPOSALS, *supra* note 100, at 124-26. For the debate, see, e.g., David P. Hariton, *Economic Substance Complaint No. 1: “Too Vague and Too Broad,”* 96 TAX NOTES 1893 (Sept. 30, 2002), Tax Notes Today, 2002 TNT 190-30; David P. Hariton, *How To Fix Economic Substance*, 99 TAX NOTES 539 (Apr. 28, 2003), Tax Notes Today, 2003 TNT 82-33 [hereinafter *Economic Substance*]; James M. Peaslee, *Economic Substance Codification Gets Worse*, 99 TAX NOTES 1101 (May 19, 2003), Tax Notes Today, 2003 TNT 97-28; Samuel C. Thompson Jr. & Robert Allen Clary II, *Coming in from the “Cold”: The Case for ESD Codification*, Tax Notes Today, 2003 TNT 102-33; Monte A. Jackel, *For Better or for Worse: Codification of Economic Substance*, Tax Notes Today, 2004 TNT 96-33; Mark J. Silverman, et. al, *The Case Against Economic Substance Codification*, 104 TAX NOTES 314 (July 19, 2004), Tax Notes Today, 2004 TNT 139-43.

150 Compare Warren Rojas, *Bush’s 2003 Budget Offers Leftover Tax Cuts and Brand New Ideas*, Tax Notes Today, 2002 TNT 24-1 (administration considering economic substance doctrine) with Sheryl Stratton, *Shelter Disclosure, Doctrine Codification Debated*, Tax Notes Today, 2003 TNT 61-3 (Treasury against codifying economic substance doctrine).

151 See, e.g., CARE Act of 2003, S.476, 108th Cong. § 701 (2003); Jobs and Growth Tax Relief Reconciliation Act of 2003, H.R.2, 108th Cong. § 301 (2003); Rebuild America Act of 2003, S. 1409, 108th Cong. § 1101 (2003); Tax Shelter Transparency and Enforcement Act, S.1937, 108th Cong. (2003); Jumpstart our Business Strength Act, 108th Cong. § 401 (2004) (Senate Amendment No. 2647); Tax Shelter and Tax Haven Reform Act, 108th Cong. §§ 301, 303 (2004). Although the American Jobs Creation Act did not codify the economic substance doctrine, in 2005 Congress was still considering the proposal. See Sheryl Stratton, *Government, Practitioners Look at Attacking Tax Shelters from Both Sides*, Tax Notes Today, 2005 TNT 189-3.

152 See ADMINISTRATION’S 2000 REVENUE PROPOSALS, *supra* note 87, at 97-98. “Tax avoidance” transactions were defined as transactions in which the reasonably pre-tax profit of the transaction (determined on a present value basis) is insignificant compared to the tax benefits achieved in the transaction. The proposal also anticipated that it would also cover “certain transactions involving the improper elimination or significant reduction of tax on economic income.” *Id.* at 96.

NYSBA Tax Section objected on the grounds that it greatly expanded the power of the IRS without providing sufficient guidance. According to the section, granting such broad authority to the Service without direction from Congress, in the form of “substantial legislative background and history,” created “significant potential for mischief.”<sup>153</sup> Such a broad provision, furthermore, gave little guidance to taxpayers as to what sorts of transactions would be disallowed, undercutting any deterrence value of the provision.<sup>154</sup>

The Section’s most serious concern, however, was that the proposal put at risk the judicially created doctrines that had developed to curb abusive transactions. In the Section’s view, a “super-section 269” could interfere with the development of law in this area by supplanting current law and requiring the development of new law to make “the required, highly nuanced distinctions between transactions.”<sup>155</sup> The Section emphasized that “[it] could be self-defeating if a super-section 269 provision replaced such law and, in effect, a body of interpretative cases had to develop anew to address corporate tax planning.”<sup>156</sup>

When the Treasury recast the proposal as a “codification” of the economic substance doctrine the following year,<sup>157</sup> the Section reasserted its faith in judicial doctrines over codification. According to the Section, economic substance could not be formulated as a statutory rule.<sup>158</sup> The Section “did not think it possible . . . to devise a sequence of abstract words that distinguishes abusive tax-motivated transactions from other transactions.”<sup>159</sup> As the Section observed, the doctrine is fundamentally a doctrine of statutory interpretation founded on a purposive view of the Code. The first and foremost issue in applying the doctrine, consequently, is whether the taxpayer is seeking tax benefits under circumstances in which Congress did not intend for such benefits to be available. If the tax results were of the sort contemplated by Congress, then the transaction would not be deemed abusive. According to the

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153 See NYSBA 1999A COMMENTS, *supra* note 24, at 898.

154 *Id.*

155 *Id.* at 899.

156 *Id.* The Section suggested other possible approaches, including a strategy that singled out certain classes of transactions, such as the loss generator at issue in the *ACM* case. *Id.* at 899-900.

157 See ADMINISTRATION’S 2001 REVENUE PROPOSALS, *supra* note 100, at 126. Under the Treasury’s proposal the tax benefits from transactions were to be disallowed if the “reasonably expected pre-tax profit” was insignificant relative to “the reasonably expected tax benefits.” *Id.* In financing transactions, tax benefits would be disallowed if the present value of the tax benefits to the taxpayer to whom the financing was provided were significantly in excess of the value of the pre-tax profit or return of the person providing the financing. *Id.*

158 See N.Y. STATE BAR ASS’N, TREASURY’S PROPOSAL TO CODIFY THE ECONOMIC SUBSTANCE DOCTRINE (2000), Tax Notes Today, 2000 TNT 146-25 [hereinafter N.Y. STATE BAR ASS’N TAX SECTION 2000 REPORT]. David P. Hariton was the principal drafter of this report. In its comments, the Section emphasized that it did not have a consensus in favor of codification. Nor, apparently, did it have a consensus against. Some members believed that a more narrow substantive disallowance rule would be helpful, others supported a broader rule, and a third group was opposed to any form of codification. *Id.* at 938.

159 *Id.* at 939.

section, this inquiry is based on considerations that cannot be translated into a broad objective formula, but depend on the facts of the case and the particular statutory provision at issue.<sup>160</sup> The Section insisted that if the Treasury decided to pursue codification, congressional purpose needed to be incorporated into the statute.<sup>161</sup>

The NYSBA Tax Section has sounded a similar refrain in response to subsequent congressional proposals to codify the doctrine, which seek to improve on the Clinton Administration's first attempts.<sup>162</sup> In the most current version, a court will disallow a transaction for lack of economic substance if the court determines that the doctrine is "relevant" to a transaction unless a taxpayer can establish that: first, the transaction changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position; second, the taxpayer has a substantial non-tax reason for entering into the transaction; and, third, the transaction is a reasonable means of accomplishing that purpose.<sup>163</sup> If a transaction is disallowed, the taxpayer faces penalties that vary depending on whether the transaction has been properly disclosed.<sup>164</sup> According to Congressional proponents, the purpose of this legislation is "to clarify for the courts the appropriate standards to use in determining whether a transaction has economic substance."<sup>165</sup> In particular, codification would eliminate the apparent lack of uniformity among courts as to whether a conjunctive test—requiring economic substance and business purpose—or a disjunctive test—under which one or the other might be sufficient—is applied.<sup>166</sup> Codifying the doctrine would also clarify that in transactions that a taxpayer claims are profit driven, the profit must be more than nominal.<sup>167</sup>

160 *Id.* at 938.

161 *Id.* at 946. Mr. Hariton has subsequently proposed such an approach; see *Economic Substance*, *supra* note 149. The NYSBA also objected to the specific formulation offered by the Treasury in 2000. N.Y. STATE BAR ASS'N TAX SECTION 2000 REPORT, *supra* note 159, at 942-45. While strongly disfavoring codification, the Section offered several alternatives, which it argued fit more closely the economic substance doctrine. *Id.* at 946.

162 See, e.g., CARE Act; Jobs and Growth Tax Relief Reconciliation Act; Rebuild America Act; Tax Shelter Transparency and Enforcement Act, Jumpstart our Business Strength Act, Tax Shelter and Tax Haven Reform Act.

163 See, e.g., CARE Act § 701(m)(1)(B)(i)(I); Jobs and Growth Tax Relief Reconciliation Act § 301; Jumpstart Our Business Strength Act §§ 401, 404; Tax Shelter and Tax Haven Reform Act § 301. When a taxpayer relies on profit potential to establish economic substance, it must show that the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected tax benefits and the reasonably expected pre-tax profit exceeds a risk-free rate of return. Fees and foreign taxes, for purposes of determining pre-tax profit, are treated as expenses.

164 See, e.g., CARE Act § 662B; Tax Shelter and Tax Haven Reform Act § 303.

165 S. REP. NO. 108-11, at 78 (2003).

166 *Id.* Under the ABA Tax Section's position, the case law does not contain inconsistent approaches. Courts have required either business purpose or economic substance, unless the Code provision expressly required business purpose in addition to economic substance. See Letter from Herbert N. Beller, ABA Tax Section, to Hon. Charles E. Grassley & Hon. Max Baucus, Senate Finance Committee, (April 23, 2003), Tax Notes Today, 2003 TNT 81-74.

167 *Id.* The bill rejected the approach taken in the *Toyota World*, *Compaq*, and *IES Industries* cases, which required an objective determination of whether a reasonable possibility of pre-tax profit existed apart from tax benefits. See STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION

Despite these attempts to refine the approach, the NYSBA Tax Section remained unconvinced. In response to one proposal in 2002, the Section insisted that the doctrine “embodies a fluid, fact specific inquiry into the purpose and effect of numerous different kinds of transactions and events. Distilling that inquiry into a specific statutory test could rob the doctrine of the flexibility that gives it strength, or could prove a meaningless exercise.”<sup>168</sup> Even if Congress were able to provide objective markers for transactions that lacked economic substance, a “fact-intensive case-by-case” inquiry would still be necessary, with the attendant risk that fact-finders would “articulate their standards and conclusions in varied and perhaps inconsistent ways.”<sup>169</sup> A year later, the Section reaffirmed its conviction that “courts are uniquely well suited to make the [necessary] determinations and apply the correct standard in the particular situation before them.”<sup>170</sup>

The ABA Tax Section was initially more sanguine about the prospects for codification. According to the Section, a “clarification” would reaffirm the importance of the doctrine to counter the unsound interpretations of the code on which tax shelters depended.<sup>171</sup> Under the Section’s approach, Congress would not attempt to define the doctrine or specify when it was relevant—issues that the Section believed were best left to the courts. Instead, the Section’s “relatively modest” proposal was that, contrary to the advice that certain practitioners were giving to clients, “Congress confirm that de minimis non-tax benefits will not sustain a tax motivated transaction.”<sup>172</sup>

When the more sweeping ambitions of codification proposals became apparent, however, the Section changed tacks, arguing that the proposed formulations could not capture the nuances of the doctrine and that, in any case, no short formulation would work.<sup>173</sup> Echoing the NYSBA Tax Section, the

OF THE CARE ACT OF 2003 (2003) (citing *Rice’s Toyota World v. Comm’r*, 752 F.2d 89 (4th Cir. 1985); *Compaq Computer Corp. v. Comm’r*, 277 F.3d 779 (5th Cir. 2001) (economic substance satisfied because taxpayer had “income”); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001)).

168 See N.Y. STATE BAR ASS’N TAX SECTION, REPORT ON TAX SHELTER LEGISLATION, (2002), Tax Notes Today, 2002 TNT 167-25.

169 *Id.*

170 See N.Y. STATE BAR ASS’N TAX SECTION, ECONOMIC SUBSTANCE CODIFICATION, (2003), Tax Notes Today, 2003 TNT 121-26.

171 See *Revenue Raising Proposals in the Administration’s Fiscal Year 2000 Budget: Hearing Before the S. Comm. on Finance*, 106th Cong. para. 36 (1999) (statement of Stefan F. Tucker, Chair, ABA Tax Section).

172 See *Penalty and Interest Provisions in the Internal Revenue Code and Corporate Tax Shelters: Hearing Before the S. Comm. on Finance*, 106th Cong., (2000) (statement of Paul J. Sax, Section of Taxation, American Bar Association), Tax Notes Today, 2000 TNT 48-18 [hereinafter *Sax Statement(B)*].

173 See Letter from Herbert N. Beller to Hon. Charles E. Grassley & Hon. Max Baucus *supra* note 166, at para. 16-19. The Section emphasized that in requiring both economic substance and business purpose, the proposals would greatly expand the economic substance doctrine. *Id.* It also emphasized that the [new] “reasonable means” requirement of the proposed legislation failed to provide adequate guidance to distinguish between abusive transactions and legitimate tax planning. *Id.* at para. 23-30. It argued further that the formulation of profit potential, as “reasonably expected pre-tax profit,”

ABA Tax Section urged that both the decision of whether the doctrine applies in the first place and how it should apply in any particular context should be left to the courts. Codification, it worried, would “encourage the IRS and the courts to focus too much on vague and subjective considerations rather than precise questions of statutory interpretation and legislative purpose essential to the functioning of a statutory system.”<sup>174</sup>

Over the years, the organized tax bar has engaged in a sustained attack on codification, which, like its other positions, is difficult to understand in terms of the short-term interests of lawyers or clients. Tax lawyers will not earn public relations points from opposing codification, nor are lawyers’ financial interests hurt by codification. To the contrary, a new provision of the tax code with such broad import would likely increase the demand for lawyers’ services. It may be that clients prefer the uncertainty flowing from judicial doctrines (which they know) over the uncertainty of a new provision (which they do not know), in which case the tax bar would be advancing client interests in resisting codification. But the vehemence of the bar’s opposition would seem to be out of proportion to an apparently weak preference. In any case, it does not make sense to give weight to client preferences here, when they played no role in the bar’s strong support of other measures to curtail abusive tax shelters.

Given the organized tax bar’s support of other initiatives, why has it been so adamant in resisting codification? In the last Part of this Article, I argue that the bar’s anti-codification stance is a piece of its broader goal to reassert the authority of traditional tax expertise, which has been eroded by the proliferation of tax shelters and the textualist approach to interpretation on which those shelters are based.

### III. Reaffirming the Professional Authority of Elite Tax Lawyers

As I have argued, it is implausible to explain the organized tax bar’s support of reform in terms of its members’ or clients’ financial interests. Had elite tax lawyers been intent on increasing their or their clients’ incomes, they would have done better to jump into the tax shelter market whole-heartedly and oppose initiatives to reign it in. Embracing textualism as an approach to tax interpretation would have provided excellent cover. This approach would have authorized tax lawyers to provide legal opinions on questionable transaction. It would also have produced arguments for opposing reforms.

Instead, the organized bar adopted a different route. As I argue in this Part, the bar’s arguments in the tax shelter debate reflect an agenda grounded in a specific view of professional authority. In its law reform activities, the bar is seeking to restore the importance of tax expertise based in judicial doctrines.

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for purposes of showing that a transaction had economic substance, would be changing the current law. *Id.* at para. 31.

<sup>174</sup> *Id.* at para. 13-14.

These doctrines, and the expertise to which they give rise are premised on the distinction between legitimate economic activity, which is assumed to be a social good, and pure tax planning, which is not. In privileging traditional tax expertise, the bar's initiatives reinforce the role of lawyers to police this normative boundary and thereby affirm the status of tax lawyers as guardians of the tax system. Not only do these initiatives empower tax lawyers vis-à-vis their clients, as suggested above, they also confer power on elite tax lawyers, as against other tax practitioners, to dictate the substance of tax law expertise in the shelter context.

A. *Courts, Tax Lawyers, and Tax Expertise*

The growth of the tax shelter market eroded tax lawyers' professional authority, which was grounded in their expertise in judicially created doctrines. In their daily dealings with clients, tax lawyers experienced the downgrading of their expertise, as clients offered significant financial inducements to procure opinion letters that legitimated questionable transactions. Clients were not interested in the substantive advice that tax lawyers had to offer, but sought opinions only in order to deflect possible penalties. Moreover, as increasing numbers of tax practitioners became involved in designing, promoting, and providing letters on abusive transactions, textualist readings of the Code, which focused on its terms and categories, spread and gained currency. To reassert tax lawyers' authority, the organized tax bar supported measures that privileged their expertise in the case law. By the same logic, the bar objected to codifying the economic substance doctrine because codification risked weakening the central function of courts to elaborate purposive approaches of interpretation through cases.

In resisting codification, the tax bar invoked a traditional argument for the superiority of judicial over other forms of elaborating law. The development of detailed factual records through adversarial processes allows courts to scrutinize the specific claims made by taxpayers and the IRS and to assess them in light of congressional intent. Furthermore, because their decision-making is incremental, courts have the flexibility to adapt doctrine to changing business arrangements. Because courts engage in a "fact-sensitive, contextual analysis," they are particularly well equipped to articulate the line between legitimate business arrangements, which further Congress's purpose, and sham transactions.<sup>175</sup> According to the organized bar, these attributes render courts particularly well-suited to furthering the fundamental goals of the income tax. Courts are accordingly the primary locus for the development of tax law.

The bar's support of due diligence requirements, which delegate a gatekeeping role to tax lawyers, is informed by the bar's view that tax expertise emanates from courts. Tax lawyers are appropriate gatekeepers because they

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175 See N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 170.

enjoy in-depth knowledge of cases. This knowledge allows lawyers to distinguish transactions that have economic substance or business purpose from those that do not.<sup>176</sup> Due diligence obligations thus affirm a particular understanding of tax law expertise rooted in judicial doctrines, specifically in the purposive doctrines that have arisen to disallow abusive tax shelters. By according value to case law expertise, due diligence obligations strengthen elite tax lawyers' professional authority, not only over clients, who must satisfy their lawyers that their transactions have a business purpose, but also in relation to other tax practitioners, who have less facility with purposive modes of interpretation.<sup>177</sup>

The shift to a strict liability regime operates in a similar manner. Like due diligence, strict liability reinforces the role of tax lawyers as gatekeepers of the tax system and the importance of case law in fulfilling this role. Under strict liability, clients considering whether to enter into shelter transactions will seek out those lawyers who can distinguish tax-favored arrangements that will be upheld by courts from those that will not; that is to say, those with facility with business purpose, economic substance, and other relevant doctrines. In creating a market for a "well reasoned" advice, strict liability affirms the authority of knowledgeable tax lawyers to dissuade clients from entering into overly aggressive transactions. It also confers a competitive advantage over practitioners less expert in the application of judicial doctrines.

At the same time that the organized bar's positions affirm the authority of judicially-based tax expertise, they also reinforce a normative valuation of meaningful business activities over pure tax planning. Put differently, the professional ideology of the tax bar—the account it offers of the role of lawyers in the tax system—is itself premised on a specific conception of tax law. This conception accepts as fundamental the goal of taxing income minus the cost of generating it and the related goal of permitting deductions only for activities aimed at generating income.<sup>178</sup>

176 A hallmark tax of law expertise is "to know economic substance when you see it." This capacity is reinforced by the corporate firm context in which traditional practitioners typically work. According to one lawyer, general corporate practice confers significant epistemic advantages:

"I enjoy being part of a sort of multi-subject legal practice . . . I like going to lunch with the real derivative lawyers at [my firm]. We all meet together and [talk] about their concerns, which are not tax. It gives me a sense of more integration with real business transactions and a real understanding of what I'm working on better."

Rostain, *supra* note 64, at 1484 (omission and second alteration in original) (quoting anonymous practitioner).

177 In upgrading the role of expertise, due diligence reveals an important dimension of lawyers' role in gatekeeping often overlooked in the scholarly literature. In the corporate context, lawyers are often identified as appropriate gatekeepers because they can withhold assistance that clients need to carry out questionable transactions. *Cf.* Gilson, *supra* note 114; Zacharias, *supra* note 114. Due diligence requirements in the tax context valorize the exercise of professional expertise.

178 See *supra* notes 36-37 and accompanying text.

## B. *The Distinction Between Business Activities and Pure Tax Planning*

Underlying the bar's objection to codification is adherence to a particular normative account of the tax code. In this account, the tax code privileges meaningful economic activity, and disfavors tax planning for its own sake. This distinction drives the bar's preference for courts as decision makers. Courts are especially well suited to make this distinction, because they can examine specific transactions in great detail to determine whether they are genuine business deals or planning devices.

This normative distinction also informs the ABA Tax Section's support of law reform initiatives that emphasized the economics of transactions. With regard to taxpayer disclosure obligations, the Section argued that taxpayers should be required to reveal the underlying nature and economic impact of shelter transactions.<sup>179</sup> In the same vein, the Section advocated due diligence requirements because they would require lawyers to ascertain whether transactions had actual business purpose or economic substance.<sup>180</sup> In each instance, the challenge was to develop mechanisms that would permit business enterprise to go forward while deterring tax planning for its own sake.

The same normative orientation is apparent in the NYSBA Tax Section's approach. In advocating for increased obligations for taxpayers and their lawyers, the Section was indifferent to the risk that these reforms would deter legitimate tax planning. As the Section recognized, the measures it favored would discourage transactions that might well be upheld by courts under current law.<sup>181</sup> The Section was not particularly troubled by this result. It noted that tax policy has to take into account the "inherent imperfections" of the tax system. From this perspective, transactions that are motivated solely or primarily by tax avoidance represent an inefficient use of resources and are therefore appropriately deterred.<sup>182</sup>

Contrast the position of the AICPA. Consistent with its textualist approach to interpreting tax law, that organization deployed a rhetoric that treats tax planning as a legal entitlement. Throughout the tax shelter debate, it underscored the "right" of taxpayers to engage in tax minimization for its own sake. For example, in opposing strengthened disclosure requirements, the association emphasized that "it supports and defends the right of taxpayers to arrange their affairs to minimize the taxes they must fairly pay."<sup>183</sup> According

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179 See *supra* notes 104-105 and accompanying text.

180 See *supra* notes 116-118 and accompanying text.

181 See NYSBA 1999A COMMENTS, *supra* note 24, at 885, 896.

182 *Id.* at 885; Rostain, *supra* note 64 at 1488. As one tax lawyer stated in explaining his law reform activities: "'The fact that as a lawyer you can come to the conclusion that . . . [an aggressive tax planning transaction] works doesn't mean that it's a good thing that as a pattern that people are entering into [these] transactions.'" *Id.* (quoting practitioner anonymously interviewed by author).

183 See *Revenue Provisions in President's Fiscal Year 2000 Budget: Hearing Before the Senate Finance Comm*, *supra* note 107, at para. 76.



to the AICPA, a corollary of this right is that taxpayers are entitled to have a clear demarcation between abusive tax shelters and legitimate transactions written into law. This was the basis for its opposition to increased penalties: “Extraordinary sanctions [sanctions above 20%] should not apply in areas that are difficult to distinguish from the normal exercise of a taxpayer’s right to keep taxes at a legitimate minimum level.”<sup>184</sup> In the same vein, although the accounting organization has recognized a place for the business purpose doctrine, it has argued for a narrow, clearly delineated reading of its requirements.<sup>185</sup>

Whereas the organized accounting profession treats tax law as a series of rules that sharply delineate the realms of illegal tax evasion and permitted tax avoidance, the organized tax bar’s proposals suggest a different conception. In the tax bar’s view, no set of specific rules is sufficient given the varying and sometimes conflicting goals of the Code. A wily taxpayer will always find a way of avoiding taxes via tax-favored transactions. According to the bar, if Congress’s basic aim to tax income and provide deductions solely for income generating activities is to be realized, tax rules need to be supplemented with a set of flexible, fact-specific doctrines

In arguing for flexible doctrines over bright-line rules, tax lawyers are not only insisting on a normative line between meaningful business activity and pure tax planning, they are also affirming their claim to be gatekeepers of the tax system. They assert this claim in two different arenas. In the public debate on law reform, the tax bar’s arguments reinforce the view that the positions of the bar should be accorded deference because tax lawyers have an in-depth understanding of the goals and imperfections of the tax code. In their representation of private clients, tax lawyers can invoke their expertise in the application of judicial doctrines to advise clients as to which transactions are legitimate and which are not.

In contrast, the accounting profession’s preference for bright line rules fits with accountants’ emphasis on tax minimization. Such rules permit the delineation of limited spheres of proscribed activity outside of which all activities are permitted. This view is of a piece with the claim that taxpayers have a “right” to minimize their taxes and that accountants should help

184 *Id.* at para. 3; *see also* Letter from Am. Inst. of Certified Pub. Accts to Hon. Charles O. Rossotti para. 61 (Apr. 27, 2001), *Tax Notes Today*, 2001 TNT 82-34 (asserting “fundamental principle that sanctions should be imposed only on failures to meet clearly ascertainable minimum standards”).

185 According to the AICPA, abusive transactions are those that have “no business purpose other than tax avoidance.” Letter from Barry C. Melancon, President & C.E.O., Am. Inst. of Certified Pub. Accts., & Robert A. Zarzar, Chair, Tax Executive Comm., Am. Inst. of Certified Pub. Accts., to members of the Am. Inst. of Certified Pub. Accts. para. 10 (Mar. 24, 2003), *Tax Notes Today*, 2003 TNT 59-62. To establish business purpose, it would be sufficient for a taxpayer to show that it had a “reasonable expectation of making a reasonable pre-tax profit”—a condition easily satisfied by incorporating into a transaction assets with a predictable rate of return—or that the transaction “was clearly relevant to the conduct of a taxpayer’s business.” *Id.* at Q1-A1; *see also* Q2-A2 (broad definition under current law “highly troubling” and “of great concern”).

taxpayers to realize that right. Nowhere does the organized accounting profession evidence a concern that if every taxpayer were successful in asserting the “right to minimize taxes,” no taxes would be paid.

### C. *Ideological Stakes*

If the organized tax bar is not directly seeking to further tax lawyers’ or clients’ financial interests, what are the interests advanced by their positions? To address this question, it is useful to invoke Pierre Bourdieu’s account of a “field.” The concept of a field highlights the relational dimensions of social life.<sup>186</sup> In a legal field, actors and institutions compete “for monopoly of the right to determine the law.”<sup>187</sup>

Following a Bourdieuan approach, tax law is a field in which tax practitioners vie over the authority to dictate the substance of tax law expertise. The proliferation of tax shelters threatened the authority of tax expertise framed around purposive modes of interpretation.<sup>188</sup> Economic incentives created by the regulatory regime in force undermined the value of traditional expertise. Textualism, which legitimized abusive transactions, gained credence as the importance of judicially based doctrines declined.

Through their organized bar activities, elite lawyers argued for initiatives that would reaffirm the primacy of judicially created doctrines. In so doing, they upgraded the value of their own expertise. On one level, the tax bar’s initiatives can be viewed as maneuvers to suppress competition from other tax practitioners—the “tax shelter” bar—which had gained market power by designing, promoting and providing opinions that legitimated abusive tax shelters. In the competition over the field of tax, elite tax lawyers have reasserted their authority, in the face of competition from proponents of textualism, to define the terms in which the field is constituted. In so doing, they have also reclaimed the economic advantages of possessing traditional expertise and diluted the benefits of textualist approaches.

On a deeper level, the organized bar’s initiatives can also be read as an attempt by its own members to rein themselves in. As the market for tax shelters expanded, the path of least resistance was to participate. In the confines

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186 See PIERRE BOURDIEU & LOIC J.D. WACQUANT, *supra* note 15, at 96-98. “In highly differentiated societies, the social cosmos is made up of a number of such relatively autonomous social microcosms, i.e., spaces of objective relations that are the site of a logic and a necessity that are *specific and irreducible* to those that regulate other fields.” *Id.* at 97.

187 See Pierre Bourdieu & Richard Terdiman, *The Force of Law: Toward a Sociology of the Juridical Field*, 38 HASTINGS L.J. 805, 817 (1987). In proposing to understand law as a field, Bourdieu seeks to avoid succumbing, on the one hand, to a formalist conception of law, in which it develops independently through an internal dynamic, and on the other, an instrumental conception of law, which treats law as the reflection of the interests of dominant groups. *Id.* at 814-16; see also ANDREW ABBOTT, *THE SYSTEM OF PROFESSIONS* (1988) (professions compete over the boundaries of “knowledge jurisdictions” in which they control the terms in which problems are framed and solved).

188 See, e.g., Bankman, *supra* note 50, at 153-54.

of their private offices, tax lawyers felt intense pressure to provide clients with opinions on questionable transactions. The activities of the organized bar offered a space for the same lawyers collectively to resist these pressures. In the law reform arena, tax lawyers could support initiatives that strengthened their capacity to resist. On this view, the tax bar's initiatives were a Ulyssean strategy: Tax lawyers tied their own hands, so they could resist the siren song of the tax shelter business.

The organized tax bar's reforms bestow power on elite tax lawyers in their relationships with their clients and in the market for tax advice. To legitimate the power of tax lawyers—to couch it in terms of professional authority—the bar has had to anchor its claims in the normative distinction between genuine business activities and tax planning for its own sake. Thus, to assert the value of its own expertise, the tax bar has affirmed the normative framework that underlies the income tax. Put differently, the long-term economic and reputational benefits that flow from the bar's reforms help keep tax lawyers in alignment with the underlying purposes served by the tax system. By pursuing initiatives that affirm their status as gatekeepers, tax lawyers end up doing well and doing good at the same time.<sup>189</sup>

#### IV. Conclusion: Sheltering Lawyers

The end of the twentieth century saw the rise of a substantial market in abusive corporate tax shelters. Big accounting firms, historically predisposed to tax textualism through their return preparation services, took advantage of their size, organization, and tax expertise to launch a highly lucrative industry in standardized tax minimization strategies. Investment banks, law firms, and second-tier accounting firms followed their lead. Individual tax lawyers, drawn by financial incentives, were soon deeply implicated in all aspects of the tax shelter industry.

While individual lawyers were under strong market incentives to participate in tax shelters, the organized tax bar itself responded by supporting law reform initiatives directed at curbing the market. The organized tax bar's positions illustrate the ambivalent relationship that professional projects can have to the market. Professional ideologies are typically antagonistic to a purely business orientation and at odds with immediate economic interests. But by strengthening the authority of expertise, professional ideologies may also increase the demand for professional services. In the case of tax practice, the bar's reforms reinforce tax lawyers' professional power by aligning the lawyers' interests with the goals of the tax system.

Many factors undoubtedly influence the extent to which lawyers ascribe to professional ideologies that, while affirming the lawyers' authority, require

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<sup>189</sup> See generally FREIDSON, *supra* note 18, at 197–222 (discussing the “soul” of professionalism”).

them to forego short-term economic benefits. At the most fundamental level, though, lawyers participate in law reform insofar as they construct a professional identity around being lawyers, as opposed to consultants or legal information specialists. This consideration suggests the necessity of attending more broadly to the institutions that shape professional ideology, including professional associations, law schools, and perhaps most important, the organizations in which lawyers work. The evidence provided by the activities of accounting firms in the tax shelter industry and of lawyers at these firms suggests that lawyers working in such an environment may be less inclined to view themselves as lawyers with obligations to the legal system.<sup>190</sup> On the other side, the depth of investment by lawyers from corporate firms in the tax bar's reform efforts suggests that practice in traditional firms, organized around serving individual clients' legal needs, may reflect and reinforce professional commitments, including participation in law reform activities.<sup>191</sup>

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190 It is not clear how strongly lawyers who work in accounting firms identify with the legal profession. For example, in an apparent effort to avoid the charge that they are engaged in an impermissible multidisciplinary practice, tax lawyers who joined accounting firms during the shelter heyday insisted that they did not practice law but, like their accounting counterparts, practiced "tax." See John Gibeaut, *Squeeze Play*, A.B.A. J. 42, 44 (Feb. 1998); Lanning, *supra* note 63.

191 See Deborah L Rhode, *Ethical Perspectives in Law Practice*, 37 STAN. L. REV. 589 (1985); Tanina Rostain, *Waking up from Uneasy Dreams: Professional Context, Discretionary Judgment, and The Practice of Justice*, 51 STAN. L. REV. 955 (1999). As David Luban has noted, this point was overlooked in the bar's debate about multidisciplinary practices. See David Luban, *Asking the Right Questions*, 72 TEMP. L. REV. 839 (1999). Another important site is law school. I have previously expressed skepticism about how significant a role legal education can play in shaping lawyers' normative commitments, given the powerful socializing effects of practice. See Rostain, *supra*, at 969-70. Nonetheless, the legal academy has an important function in articulating and defending the normative aspirations of the legal profession in the classroom and in scholarship. See DEBORAH L. RHODE, IN THE INTERESTS OF JUSTICE 185-206 (2000).