

## ARTICLES

### WHERE ETHICS MERGE WITH SUBSTANTIVE LAW— AN ANALYSIS OF TAX MOTIVATED TRANSACTIONS

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#### INTRODUCTION

During the last decade and more acutely during the last several years, there appears to be an extraordinary increase in the number of instances in which the courts, Congress, and the media have questioned the legality and ethics associated with the financial activities of wealthy individuals and businesses.<sup>1</sup> Among the more common are those instances in which corporate and high wealth individual taxpayers have engaged in transactions structured to minimize or avoid imposition of federal income taxes. These transactions generally are referred to as “tax shelters” or “sham transactions” and as the Internal Revenue Code (the “Code”) becomes more complex, the transactions themselves have become extraordinarily complex and hard to identify.<sup>2</sup>

This Article focuses on the recent wave of public accounting, insurance, investment banking, and other consulting firms entering into the business of providing advice in relation to federal tax law. In a number of instances, lawyer and nonlawyer consultants have designed, marketed, and facilitated the execution of tax shelters to taxpayers with the objective of receiving a portion of the reduction in the taxpayers’ federal income tax liability as fees. While the transactions in question are generally designed to meet the specific requirements

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1. See, e.g., Dep’t of the Treasury, *Listed Abusive Tax Shelters and Transactions*, at <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html> (last visited Feb. 16, 2005) (containing a growing list of over thirty transactions identified by the Internal Revenue Service as abusive tax shelters most of which have been identified as such in the last five years); Joseph A. Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1776 (1999) (“It is virtually certain though, that annual investments in corporate tax shelters aggregate to tens of billions of dollars, and that the tax shelter market is growing at a breakneck speed.”).

2. See, e.g., Bankman, *supra* note 1, at 1776. (“The new corporate tax shelter is much more sophisticated and complex than its 1980s predecessor. It may involve tangible assets, such as equipment subject to long-term lease, but is more likely to involve financial instruments. It is also much more aggressive in its interpretation of the tax law.”).

of the letter of the law, many such transactions have been determined by the Internal Revenue Service (the “IRS”) and the courts to be in violation of the spirit of the law. The proliferation of these transactions is detrimental to the U.S. system of taxation and is in conflict with the policy reasons underlying the creation of the progressive tax system in the United States.<sup>3</sup>

There have been a number of attempts to address the problem which have focused on enacting statutes that require disclosure, additional information reporting, or impose penalties upon those who design and market or “promote” such transactions. Most recently, the American Jobs Creation Act of 2004<sup>4</sup> (the “Jobs Act”) contained a number of provisions designed to curtail tax shelter activity. The IRS has also proposed new rules to regulate professionals who practice in front of the IRS. While impact of the Jobs Act is yet to be seen, the rules imposed thus far have fallen short of meaningfully dissuading the aggressive behavior of the taxpayers and professionals involved. Although there are arguably a number of ways to attack the problem, at base the problem arises in part from a failure to impose appropriate penalties and ethical restraints on the providers of advice.

This Article sets out to identify those responsible for the recent increase in tax shelter activity and analyzes the effectiveness of the current judicial, statutory and regulatory regimes in reducing such activities. The Article focuses on the relationship between taxpayers and their professional advisors and questions whether the new provisions targeting tax shelter activity under the Jobs Act will have a measurable impact on those who would promote or engage in tax motivated transactions. The Article argues that the penalty provisions under the new act are insufficient to deter aggressive taxpayers and promoters.

The Article concludes that the judicially developed doctrine aimed at identifying sham transactions is inherently flawed when applied to tax shelter transactions that are developed and marketed by professional firms. Specifically, the low threshold of evidence required to satisfy the economic substance prong of the sham transaction doctrine allows taxpayers, through tax opinions issued by their tax advisors, to avoid imposition of accuracy-related penalties imposed under the Code. Additionally, because the accuracy-related penalties are so

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3. See Prepared Testimony of Mark W. Everson, Commissioner, Internal Revenue [sic], Progress Report on the IRS Restructuring and Reform Act of 1998 (May 20, 2003), available at [http://www.irs.gov/pub/irs-utl/rra98\\_joint\\_review\\_final\\_written.pdf](http://www.irs.gov/pub/irs-utl/rra98_joint_review_final_written.pdf) (The testimony indicated that the IRS is now working to identify and refocus its resources on the biggest areas of risk to the tax system. Toward the end of FY 2002, the IRS began realigning its resources to concentrate on key areas of non-compliance with the tax law, primarily among higher-income taxpayers and businesses. These include, among other things: the promotion of abusive tax schemes, the misuse of devices such as offshore accounts to hide or improperly reduce income, the use of abusive tax avoidance transactions, the underreporting of income by higher-income individuals.).

4. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418. The President signed the Jobs Act on October 22, 2004. White House Press Secretary, Statement on H.R. 4520 (Oct. 22, 2004), the American Jobs Creation Act of 2004, available at <http://www.whitehouse.gov/news/releases/2004/10/20041022-2.html>.

interrelated with the ethical rules that govern tax advisors who practice in front of the IRS, professional advisors and taxpayers who engage in promoting tax shelters should be jointly and severally liable for penalties or ethical sanctions in instances where the transactions are determined to be shams which lack economic substance or a valid business purpose.

## I. THE JUDICIAL, CONGRESSIONAL & AGENCY EFFORTS TO ATTACK MARKETED SHAM TRANSACTIONS

### A. *Judicial Efforts*

Since the inception of the Code, taxpayers have been motivated by a desire to engage in transactions which result in reducing their overall tax liability. Substantial analysis has been done on the evolution of current doctrines developed by the courts in response to the dilemma of how to distinguish between transactions engaged in for legitimate nontax business and economic reasons versus transactions engaged in solely for the purpose of avoidance of tax, the latter being targeted as improper and not respected for federal income tax purposes. The following discussion highlights the history of the sham transaction doctrine in the Supreme Court and the courts of appeal. The goal of this section is to identify the elements of the test for identifying a sham transaction and to identify certain characteristics that are common to many sham transactions.

1. *The Supreme Court on "Sham Transactions."*—In the area of tax motivated transactions, an historical analysis must begin with the case of *Gregory v. Helvering*.<sup>5</sup> In *Gregory*, the taxpayer owned 100% of United Mortgage Corporation ("UMC") which held highly appreciated stock in an unrelated corporation.<sup>6</sup> Under the law at that time, if taxpayer had caused her wholly-owned corporation to distribute the appreciated stock, the distribution would have been treated first as a taxable sale by the corporation followed by a taxable dividend to the taxpayer.<sup>7</sup> Instead of executing a distribution, taxpayer incorporated a Delaware company, Averill Corporation ("Averill"). Taxpayer then caused the UMC to transfer all of the highly appreciated shares to Averill in return for issuance of all Averill shares to herself. Immediately thereafter, taxpayer caused Averill to distribute the highly appreciated shares to herself in

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5. *Gregory v. Helvering*, 293 U.S. 465 (1935); *see, e.g.*, *United States v. Wexler*, 31 F.3d 117,122 (3d Cir. 1994); *Kirchman v. Comm'r*, 862 F.2d 1486, 1490 (11th Cir. 1989); *Yosha v. Comm'r*, 861 F.2d 494, 497 (7th Cir. 1988); *see also* Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440, 441 (1967) ("Hand's decisions on the subject of tax avoidance were more often criticized than praised by the tax bar; yet it was apparent at an early date that those decisions were likely to prove highly influential in the development of the law. His opinion in *Helvering v. Gregory*, which established his preeminence as a tax judge, was a major event in the history of tax administration in this country and is still among the most significant and best remembered judicial statements on the subject.").

6. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

7. *Id.*

liquidation of Averill.<sup>8</sup> It then became possible to sell the distributed shares at a reduced tax liability.

Taxpayer conceded that all of the steps were executed with sole purpose of reducing taxes but argued that avoidance or evasion of taxes is appropriate if it falls within an exception of tax law.<sup>9</sup> On appeal to the Second Circuit, Judge Learned Hand held the transaction was a "sham" not to be respected for federal tax purposes.<sup>10</sup> Judge Hand ruled that while a taxpayer may arrange his affairs to reduce his taxes to as low an amount as possible, the transaction must be within the intent of the statute in order to avoid taxation.<sup>11</sup> Applying the rule, Judge Hand found that by immediately liquidating Averill and selling the appreciated shares, the taxpayer had ignored the intent of the reorganization sections of the Code.<sup>12</sup>

On appeal to the Supreme Court, the issue was framed as whether a reorganization structured to qualify as "tax free" under the Code was supported by the underlying purpose of the reorganization statutes.<sup>13</sup> The Court "denied reorganization treatment with respect to a stock distribution even though the taxpayer had followed each step required by the Code for reorganization."<sup>14</sup> The Court held "the structure of the transaction was a 'mere device' for the 'consummation of a preconceived plan' and not a reorganization" within the meaning of the Code as it then existed.<sup>15</sup> The Court found that the transaction was simply an operation having no business purpose and that the reorganization was a "disguise for concealing its real character," the sole object of which was a preconceived plan, not to reorganize a business, but to transfer corporate shares to the taxpayer in an effort to reduce taxes upon an immediate sale thereafter.<sup>16</sup> The Court reasoned that while a new and valid corporation was created; such corporation was not brought into existence for any valid business purpose.

The Court focused heavily on the taxpayer's motive behind the transaction.<sup>17</sup> The Court determined that the taxpayer's motive in forming Averill was an "elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else."<sup>18</sup> By including a subjective analysis of the taxpayer's motive in determining that the transaction was taxable, the Court respected the substance of the transaction over its form. That is, notwithstanding that the form of the transaction met the strict requirements of the statute granting

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8. *Id.*

9. *Id.*

10. *Id.* at 811.

11. *Id.*

12. *Id.*

13. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); *see, e.g., Winn-Dixie Stores, Inc. v. Comm'r*, 113 T.C. 254, 278 (1999).

14. *Winn-Dixie*, 113 T.C. at 278.

15. *Id.*

16. *Gregory*, 293 U.S. at 469.

17. *Id.*

18. *Id.* at 470.

tax free status to the transaction, the substance of the transaction—the taxpayer’s desire to avoid tax—was the Court’s focus.

The economic substance of the transaction was simple. The taxpayer was first presented with the problem of an increased tax liability associated with the holding of appreciated stock. In order to reduce the overall tax liability, the taxpayer sought to use the reorganization and liquidation sections of the Code to prevent one level of taxation. There was concededly no nontax business profit associated with either form of the transaction. She followed the steps required to execute a proper reorganization and liquidation but, notwithstanding that these steps were properly executed, the Court recharacterized the transaction into a taxable sale followed by a distribution.

The Supreme Court again addressed a tax motivated or “sham” transaction in *Knetsch v. United States*.<sup>19</sup> In *Knetsch*, the taxpayers, husband and wife, and an insurance company engaged in a financial shell game. Their intent was to provide the taxpayers with interest deductions that could be used to offset the taxpayers’ income each year the game continued.<sup>20</sup> Like most tax motivated transaction fact patterns of the recent past, the facts of *Knetsch* contain involved mathematical computations. While the computations first appear rather complex, when the math is simplified, the substance of the transaction becomes unmistakably tax motivated.

In *Knetsch*, the taxpayers purchased “deferred annuity savings bonds” with a face amount of \$400,000 bearing 2.5% interest from an insurance company (“Company”).<sup>21</sup> In order to pay the purchase price of \$4,004,000, taxpayers paid the Company \$4000 and signed a note for \$4,000,000 to the insurance Company which note bore interest at 3.5%.<sup>22</sup> The note required interest to be paid in advance, therefore, on the same day, taxpayers paid \$140,000 of interest to the Company.<sup>23</sup> In theory, the taxpayers were paying for a guaranteed stream of annuity payments in the future. On the first day of the purchase, the stream of future annuity payments was presumably worth approximately \$4,004,000. The closer the bonds came to maturing, the more valuable they would be due to the impending annuity payoff.

It is important to understand the economics of the deal between the taxpayers and the Company. Who would pay \$4,004,000 for bonds at 2.5% interest and then turn around and borrow substantially all of the purchase funds from the same company at 3.5% interest? In short, the taxpayers were thrilled with the transaction because the interest payments at 3.5% were deductible (at very high marginal rates) for tax purposes. The reader should also note that the 1% spread is the cr me for the Company in the transaction.

After two years, taxpayers had paid the Company \$294,570 and received \$203,000 back in the form of purported “loans.” Taxpayers’ out-of-pocket total

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19. *Knetsch v. United States*, 364 U.S. 361 (1960).

20. *Id.* at 361.

21. *Id.* at 362. Note that 2.5% compounded annually on \$400,000 face value is \$10,000.

22. *Id.* at 362-63.

23. Note that \$140,000 is 3.5% of \$4,000,000 compounded annually.

payment of \$91,570<sup>24</sup> was purportedly for the nontax purpose of obtaining either annuity or death benefits, or both. However, the purported objective to obtain annuity or death benefits becomes less believable when one compares the tax benefits to the anticipated death or annuity benefits. Taxpayers' interest deductions in 1953 and 1954 totaled \$290,570. In 1953 and 1954 the top U.S. marginal income tax rate for married couples filing jointly was 92% and 91% prospectively.<sup>25</sup> Assuming that the taxpayers had income sufficient to place them in the highest tax rate, they would have avoided paying \$265,853 of income taxes.<sup>26</sup> Thus, for a payment out-of-pocket of \$91,570 to the insurance company, the taxpayers received a net benefit of \$174,283.<sup>27</sup>

In concluding the transaction that the taxpayer engaged in was a fiction or "sham," the Court acknowledged the rule espoused in *Gregory v. Helvering* that a taxpayer may decrease or avoid taxes by means which the law permits but also required that the taxpayer have a motive apart from avoidance of taxes.<sup>28</sup> Based upon an economic analysis, the Court found that the transaction engaged in by the taxpayer in *Knetsch* did not "appreciably affect [their] beneficial interest except to reduce [their] taxes."<sup>29</sup> The Court reasoned that there was "nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."<sup>30</sup> Similar to the Court's decision in *Gregory*, the *Knetsch* Court appears to focus on the "substance" of the transaction. However, instead of focusing on the subjective intent or nontax business purpose of the taxpayer, the *Knetsch* Court objectively analyzed what economic substance or profit was financially in the transaction for the taxpayers apart from tax savings.

The *Knetsch* Court exposed the fiction behind the transaction by pointing out the \$91,570 that the taxpayers were out-of-pocket was ostensibly paid to the Company in return for an annuity contract with a so-called guaranteed cash value at maturity of \$8,388,000.<sup>31</sup> This contract purportedly would produce monthly

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24. This is the difference between the \$294,570 and the \$203,000 taxpayer received back in the form of "loans."

25. See ROBERT A. WILSON, IRS, DATA RELEASE: PERSONAL EXEMPTIONS AND INDIVIDUAL INCOME TAX RATES, 1913-2002, at 217 (2002) (containing a historical list of individual tax rates from 1913 through 2002), available at <http://www.irs.gov/pub/irs-soi/02inpetr.pdf>. Note that the calculations presented here are for illustration purposes only and do not take into account all of the rules in effect during 1953 and 1954. For instance, for 1953, the highest tax rate was subject to a maximum effective rate limitation equal to 88% of statutory "net income." *Id.* at 223 n.18. Further, for 1954, the highest tax rate was subject to a maximum effective rate limitation equal to 87% of statutory "net income." *Id.* at 223 n.19.

26. This amount represents the total of the 1953 tax benefit of \$131,988 (92% of \$143,465) plus the 1954 tax benefit of \$133,866 (91% of \$147,105).

27. This amount represents the excess of the tax benefit of \$265,853 over the out-of-pocket expenses of \$91,570.

28. *Knetsch v. United States*, 364 U.S. 361, 365 (1960).

29. *Id.* at 366 (quoting *Gilbert v. Comm'r*, 248 F.2d 399, 411 (2d Cir. 1957)).

30. *Id.*

31. *Id.* at 365.

annuity payments or substantial life insurance proceeds.<sup>32</sup> However, the existence of any available benefits was a “fiction” because each year taxpayers’ borrowings kept the net cash value at “the relative pittance of \$1,000.”<sup>33</sup> The \$91,570 difference was retained by the Company as its fee for providing the “façade of ‘loans’” whereby the taxpayers sought to reduce their taxes via related interest payments.<sup>34</sup> The Court noted that “there may well be single premium annuity arrangements with nontax substance which create an indebtedness”<sup>35</sup> for the purposes of the tax code but the Court labeled this transaction as a “sham.”<sup>36</sup>

Unlike the analysis in *Gregory*, the Court relied primarily on a mathematical analysis of the transaction to show there was effectively no internal build-up in value of the policies due to the fact that the taxpayer consistently borrowed virtually all of the internal build-up each year. From a financial and economic perspective, the transaction can be looked at as a sharing or splitting of the tax savings between the taxpayers and the Company. The taxpayers realized a tax benefit of \$174,283, approximately 2/3 of the total tax savings after payment of the Company’s fees, and the Company received the remaining 1/3, or \$91,507, in the form of fees.<sup>37</sup> By looking objectively at the economic facts, the Court was able to determine that the taxpayers’ sole intention was to avoid paying taxes. As such, the economic-sham analysis focuses on the economic substance to be realized by the taxpayer from a transaction.<sup>38</sup>

2. *The Evolution of Economic Substance in the Courts of Appeal.*—As previously indicated, there appears to be an increasing number of transactions that have been designed to avoid taxes and a corresponding increase in the level of scrutiny by the IRS in detecting and exposing such transactions. This trend has led, among other things, to a number of recent cases that have been adjudicated by the Tax Court and reviewed by the circuit courts of appeal.

Since the early decisions of the Supreme Court, the test for determining whether a transaction has “economic substance” has generally evolved in the circuit courts of appeal. The discussion below seeks to illustrate a general trend in relation to the sequence of activities engaged in by taxpayers and their professional advisors in tax shelter cases. This trend appears to indicate the primary motives of the taxpayer to either avoid taxes or, in the event the transaction is challenged, avoid the payment of any penalties associated with the nonpayment of such taxes. It is that same sequence of engaging in the transaction that reveals the deficiency or defect of the economic substance analysis that ultimately frees taxpayers and their tax advisors to engage in such activities.

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32. *Id.*

33. *Id.*

34. *Id.* at 366.

35. *Id.*

36. *Id.*

37. Is it merely a coincidence that the Company appears to have obtained approximately one-third of the tax savings and the taxpayers took two-thirds?

38. *Knetsch*, 364 U.S. at 366; *see also* *Am. Elec. Power Co. v. United States*, 326 F.3d 737, 743 (6th Cir. 2003), *cert. denied*, 540 U.S. 1104 (2004).

a. *Fourth Circuit*—*Rice's Toyota World, Inc. v. Commissioner*.—In *Rice's Toyota World, Inc. v. Commissioner*,<sup>39</sup> the taxpayer was primarily engaged in the sale of new and used automobiles.<sup>40</sup> Mr. Rice, taxpayer's founder and president, "learned about computer purchase and leaseback transactions through a friend who had entered into similar transactions with Finalco," a computer leasing corporation.<sup>41</sup>

In February 1976, taxpayer entered into an agreement with Finalco to purchase a used computer from Finalco for \$1,455,227 payable over eight years. Finalco then leased the computer back from taxpayer paying rent to taxpayer over the same eight year period.<sup>42</sup> Payments made by Finalco to taxpayer annually exceeded the payments made by taxpayer to Finalco by \$10,000. Contemporaneous with the sale and leaseback, Finalco subleased the computer to a third party.<sup>43</sup>

In May or early June 1976, after entering into the above agreement, taxpayer received projections from Finalco indicating that under the agreement taxpayer was expected to realize total projected losses from accelerated depreciation of \$782,063 during the first five years. Based upon projections and other discussions, Finalco prepared a leasing memorandum which stated that the transaction was "suitable only for persons anticipating substantial taxable income from other sources."<sup>44</sup> Thus, the leasing memorandum focused on the tax benefits related to the depreciation deductions and qualified that these deductions would benefit only individuals that had income substantial enough to be able to take advantage of the depreciation deductions.

The Commissioner disallowed taxpayer's interest and depreciation deductions in relation to a sale and leaseback transaction asserting that the transaction was a tax avoidance scheme which should be disregarded for federal income tax purposes. The Tax Court applied a two-pronged inquiry to determine whether the transaction was, for tax purposes, a sham.<sup>45</sup> The court of appeals agreed with the Tax Court's analysis that to treat a transaction as a sham, the court must find (1) "that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction," and (2) "that the transaction has no economic substance because no reasonable possibility of a [pre-tax] profit exists."<sup>46</sup> Thus, in order to avoid sham treatment, the test requires that a taxpayer meet a minimum threshold of either a business purpose or economic substance.<sup>47</sup>

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39. *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89 (4th Cir. 1985).

40. *Id.* at 91.

41. *Id.*

42. *Id.*

43. *Id.*

44. *Rice's Toyota World, Inc. v. Comm'r*, 81 T.C. 184, 188-89 (1983).

45. *Rice's Toyota World, Inc.*, 752 F.2d at 91.

46. *Id.*

47. *Id.*

In analyzing the second prong of the sham inquiry, the court in *Rice's Toyota World, Inc.* stated that the economic substance prong requires "an objective determination of whether a reasonable possibility of profit from the transaction exists apart from tax benefits."<sup>48</sup> The court found that the transaction carried no hope of earning a profit for the taxpayer unless the computer had residual value sufficient to recoup the \$200,000 in net principal and interest that Rice paid Finalco.<sup>49</sup> Accepting the valuation testimony of IRS valuation experts, the court agreed with the Tax Court's finding that the residual value of the computer was not enough to earn taxpayer a profit.<sup>50</sup> Notwithstanding the court's holding that the transaction had no hope of earning nontax profits, no penalties were imposed upon the taxpayer for engaging in the transaction.

Like the taxpayer in *Knetsch*, the taxpayer in *Rice's Toyota World* heard about the tax benefits associated with a particular transaction. Taxpayer's accountant contacted Finalco, a corporation engaged in leasing equipment, which resulted in Finalco providing information focusing on the transaction's ability to generate large tax losses in early years. Finalco promoted the transaction and assisted the taxpayer in executing the transaction with the sole goal of avoiding taxes. As a computer sale and leaseback, the transaction had no relationship to the taxpayer's business activity of selling new or used automobiles. The taxpayer had no meaningful motivation for entering into the transaction other than to economically reduce its federal tax liability.

With respect to the first prong of the analysis, stating that the business purpose inquiry concerns the subjective motive of the taxpayer in entering the transaction, the court of appeals found that the taxpayer's sole motivation for purchasing and leasing back the computer was to achieve the large tax deductions that the transaction provided in the early years of the lease.<sup>51</sup> The court supported its conclusion by finding, among other things, that the taxpayer paid an inflated purchase price for the computer and did not seriously evaluate whether the computer would have sufficient residual value at the end of the lease.<sup>52</sup>

As applied by the court in *Rice's Toyota World*, the business purpose prong of the sham inquiry does not appear to make a distinction with respect to *when* the taxpayer develops its business purpose. Rather, it appears the taxpayer initially may have only a tax motivated desire to engage in the transaction so long as a meaningful business purpose is developed at some point during the execution of the transaction. The taxpayer in *Rice's Toyota World* did not appear to have a nontax business purpose when Finalco was originally consulted and was later unable to adduce a legitimate nontax business purpose as required by the first prong of the test.

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48. *Id.* at 94.

49. *Id.* Note that the amount of principal and interest actually paid by Rice is reduced by \$80,000 paid in \$10,000 annual increments paid by Finalco to taxpayer.

50. *Id.*

51. *Id.* at 92.

52. *Id.*

*b. Eleventh Circuit.*—In 1989, the Eleventh Circuit addressed the sham transaction doctrine in *Kirchman v. Commissioner*<sup>53</sup> indicating that the sham transaction doctrine emerged from the Supreme Court's decision in *Gregory* and had gained wide acceptance.<sup>54</sup> The Eleventh Circuit accepted the general notion that the substance of the transaction governs the tax consequences as opposed to the form.<sup>55</sup> The *Kirchman* court held that while a taxpayer may structure a transaction to minimize tax liability, the transaction must nevertheless have economic substance.<sup>56</sup> Citing *Rice's Toyota World*, the *Kirchman* court stated that the determination of whether the taxpayer had a legitimate "business purpose" in entering into the transaction also involves a subjective analysis of the taxpayer's intent.<sup>57</sup> The inquiry into whether the transaction has "economic substance" beyond the creation of tax benefits is an objective rather than a subjective inquiry.<sup>58</sup>

However, the court found it unnecessary to determine whether the taxpayer subjectively had a business purpose and held that the transaction was a sham based upon an objective analysis indicating that the transaction lacked a profit motive and therefore lacked economic substance.<sup>59</sup> In relation to the taxpayer's profit motive, the court agreed with the Tax Court's conclusion that the taxpayer engaged in a prearranged transaction in order to achieve tax avoidance rather than nontax profit objectives. The Tax Court held that where the only substance of a transaction is the creation of income tax benefits for a fee, that transaction is a sham for income tax purposes.<sup>60</sup> Once again, notwithstanding the court's determination that the transaction was a sham lacking in economic substance, no penalties were imposed upon the taxpayer under the Code.

In *Kirchman*, the court focused only on the economic substance prong of the sham inquiry. The Eleventh Circuit appears to first apply the objective second prong and if the court determines on an objective basis that the transaction had economic substance, it will go on to the subjective prong to determine if the subjective intent of the taxpayer is appropriate.<sup>61</sup> However, if the court determines the transaction lacked economic substance, the analysis is complete and the transaction is deemed to be a sham not respected for tax purposes.<sup>62</sup>

In *Winn-Dixie Stores, Inc. v. Commissioner*,<sup>63</sup> the Eleventh Circuit again addressed the sham transaction doctrine. In *Winn-Dixie*, the taxpayer, a food retailer, was approached by Weidman & Johnson and The Coventry Group

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53. *Kirchman v. Comm'r*, 862 F.2d 1486 (11th Cir. 1989).

54. *Id.* at 1490-91.

55. *Id.* at 1491.

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.* at 1493.

60. *Id.*

61. *Id.*

62. *Id.*

63. 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, 535 U.S. 986 (2002).

(together hereinafter “WJ/Coventry”) with a proposal for Winn-Dixie to purchase “individual excess interest life insurance policies on the lives of Winn-Dixie’s employees.”<sup>64</sup> Information provided to Winn-Dixie by WJ/Coventry indicated that the policies would consist of “a group of corporate-owned life insurance (COLI) policies covering a wide cross-section of [Winn-Dixie’s] employees.”<sup>65</sup> In short, Winn-Dixie purchased whole life insurance policies on almost all of its full time employees, numbering about 38,000.<sup>66</sup> Winn-Dixie was the sole beneficiary of the policies.

WJ/Coventry, as promoters of the transaction, provided Winn-Dixie with a proposal for the purchase of the policies.<sup>67</sup> The chairman and chief executive officers of WJ/Coventry provided a memorandum to Winn-Dixie describing the benefits and drawbacks of the proposed plan.<sup>68</sup> The memorandum summarized the tax aspects of the COLI program and provided numerous detailed projections of the costs and benefits associated with the COLI plan.<sup>69</sup> In summarizing the tax aspects of the COLI program, the memorandum opined on the tax issues raised by the proposed COLI program, the legislative status from a tax perspective of future COLI programs and exit strategies available to Winn-Dixie in the event that the tax law in effect changed.<sup>70</sup>

The projections contained in the memorandum indicated that during each year that the policies remained in effect, the plan would generate pre-tax losses.<sup>71</sup> However, on an after tax basis the projections indicated that the plan would generate profits.<sup>72</sup> That is, the deductions associated with the plan would sufficiently reduce taxes otherwise payable by Winn-Dixie such that the tax benefits would exceed any actual economic loss experience by Winn-Dixie. In essence, like the situation in *Knetsch*, the high interest rate charged by the insurance company plus administrative fees to execute the transaction exceeded the net cash surrender value and benefits of the policies, with the result that in pre-tax terms, Winn-Dixie lost money on the program. However, the deductions for interest and fees by Winn-Dixie on the policy loans yielded an estimated tax benefit that was projected to reach billions of dollars in excess of any projected pre-tax losses.<sup>73</sup>

On appeal to the Eleventh Circuit Court of Appeals, citing *Kirchman*, the court again first addressed the economic substance of the transaction in question

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64. *Winn-Dixie Stores, Inc. v. Comm’r*, 113 T.C. 254, 256 (1999), *aff’d*, 254 F.3d 1313 (11th Cir. 2001).

65. *Id.*

66. *Id.* at 257.

67. *Id.* at 256.

68. *Id.*

69. *Id.* at 256-61.

70. *Id.* at 259.

71. *Id.* at 260-63.

72. *Id.*

73. *Id.* at 263.

and found that the transaction could never generate a pre-tax profit.<sup>74</sup> However, aside from the manner in which the economic substance test was applied, the actual sequence of the transaction is again of interest. Winn-Dixie, as the taxpayer, was initially approached by WJ/Coventry, a group of insurance professionals.<sup>75</sup> These professionals provided specific and complex advice in relation to tax issues raised by the proposed COLI plan. Like the taxpayers in *Rice's Toyota World*, the advice included an extraordinary number of projections that focused primarily on the pre-tax and post-tax consequences of the transaction.<sup>76</sup> Prior to WJ/Coventry approaching Winn-Dixie, Winn-Dixie itself had no knowledge of COLI plans and no apparent business purpose for engaging in the COLI transaction. Representatives of WJ/Coventry solicited Winn-Dixie to engage in a highly complex transaction, advised Winn-Dixie of the tax consequences of the transaction, opined as to the validity of the transaction under existing tax law and assisted Winn-Dixie in executing the steps necessary to engage in the transaction.<sup>77</sup> From start to finish, WJ/Coventry was instrumental in Winn-Dixie's decision to engage in a transaction that was later determined to be a "sham" transaction for federal income tax purposes. Once again, regardless of the fact that the transaction was designed to be a sham with the sole objective of reducing tax liabilities, there were no penalties imposed on the taxpayer under the penalty provisions of the Code.

Under the circumstances in which the transaction was marketed, it seems unlikely that Winn-Dixie, or any taxpayer presented with the COLI transaction, could have had a valid nontax business purpose in relation to the transaction. Where a taxpayer is approached with a proposal that is represented to be profitable on an after-tax basis, it seems illogical that a nontax business purpose later contrived for purposes of satisfying the business purpose prong of the sham transaction inquiry should be respected. Where taxpayers and their advisors contrive a nontax business purpose after deciding to engage in the transaction, it would seem that the taxpayer's subjective intent remains focused on obtaining the tax benefits.

*c. Other circuits.*—The sequence of events that led up to the transaction described in *Knetsch*, *Rice's Toyota World*, and *Winn-Dixie* appears to be a common thread in many transactions that have been determined to be shams for federal income tax purposes. In *ACM Partnership v. Commissioner*,<sup>78</sup> *ASA Investering Partnership v. Commissioner*,<sup>79</sup> *SABA Partnership v. Commissioner*,<sup>80</sup> and *Boca Investering Partnership v. United States*,<sup>81</sup> Merrill

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74. *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313, 1316 (11th Cir. 2001).

75. *See Winn-Dixie Stores, Inc.*, 113 T.C. at 254.

76. *See id.* at 254, app. A.

77. *Id.* at 280-82.

78. 73 T.C.M. (CCH) 2189 (1997), *aff'd in part and rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

79. 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir.), *cert. denied*, 531 U.S. 871 (2000).

80. 78 T.C.M. (CCH) 684 (1999), *vacated*, 273 F.3d 1135 (D.C. Cir. 2001), *remanded to 85*

Lynch (Merrill) promoted an investment plan to large U.S. corporations. The principal purpose of the investment plan was to generate substantial amounts of capital losses which were projected to be used to offset huge capital gains.<sup>82</sup>

In *ACM*, Colgate-Palmolive Co. (Colgate), was approached by representatives of Merrill.<sup>83</sup> Representatives of Merrill were aware that Colgate had reported a sizeable capital gain (approximately \$105 million) for its 1988 taxable year in relation to its sale of a corporation, and that Colgate might be receptive to the proposed transaction.<sup>84</sup> Through an introduction facilitated by representatives of Merrill, a meeting was held on May 15, 1989, at which the transaction was described to Colgate's assistant treasurer.<sup>85</sup> "Merrill's representatives stated that, apart from the few elements that were essential to secure the desired tax consequences, the partnership structure could be adapted to suit a variety of investment objectives."<sup>86</sup>

"Colgate's initial reaction to the proposal was skeptical" and its assistant treasurer "was not persuaded that the partnership would serve a business purpose of Colgate."<sup>87</sup> Colgate's vice president of taxation agreed that "but for the tax benefits, the transaction did not accomplish anything useful for the company."<sup>88</sup> He also "was concerned that the transaction did not have sufficient economic substance to withstand scrutiny. Absent a connection to Colgate's business, [he] believed, the necessary support would not be forthcoming."<sup>89</sup>

However, after a substantial amount of analysis on the part of the representatives of Merrill, Colgate's vice president of taxation became convinced

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T.C.M. (CCH) 817 (2003).

81. 314 F.3d 625 (D.C. Cir.), *cert. denied*, 540 U.S. 826 (2003).

82. *See, e.g., SABA P'ship*, 78 T.C.M. (CCH) 684. Generally, the investment plan proposed was for the U.S. corporations and a foreign (non-U.S.) entity to jointly form a foreign (non-U.S.) entity not subject to U.S. income taxation. The partners would contribute substantial capital to the foreign joint venture with the foreign venturer retaining a substantial majority ownership interest in the foreign joint venture. The various partnerships would invest in short term private placement notes. Thereafter, the partnerships would sell the notes for a large initial cash payment with the balance of the consideration paid in notes. One-sixth of the basis of the notes would be applied to the down payment with the rest allocated to the notes under the installment sale provisions of the Code. Gain under the partnership agreement would largely be allocated to the foreign partner who owned most of the equity units of the partnership. At the end of the partnership tax year, the U.S. partner would acquire a majority interest in the foreign partnership. Thereafter, the partnerships would distribute the cash to the foreign partner and the notes to the U.S. partner in redemption of the U.S. partner's interest. The U.S. partner would then sell the notes to a third party and realize losses against which it could offset capital gains in the same tax year.

83. *ACM P'ship*, 73 T.C.M. (CCH) 2189, at \*5-\*9.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

that the proposed partnership would serve the purpose of debt risk management for Colgate and that this risk management would serve as a business purpose. Thereafter, Merrill provided projections that indicated substantial tax benefits; Colgate's chief financial officer and the president of the company approved the transaction.<sup>90</sup>

The Commissioner argued that the transaction was merely a prearranged set of steps in a contrived, tax motivated transaction and that the risk management aspect of the transaction was spurious.<sup>91</sup> The Tax Court found that Colgate attempted to artificially create losses through manipulation and abuse of the Code.<sup>92</sup> It held that the transactions lacked economic substance.<sup>93</sup> The Tax Court was convinced that tax avoidance was the reason for the partnership's purchase and sale of the notes and accorded little importance to the risk management aspect of the case. The Tax Court indicated that the key to determining whether a transaction has economic substance is that the transaction must be rationally related to a useful nontax business purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions.<sup>94</sup> The court indicated that a rational relationship ordinarily will not be found unless there is a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs.<sup>95</sup>

The Tax Court reasoned that each of the steps in the investment strategy was planned and arranged to commence considerably in advance of execution of the transaction.<sup>96</sup> "Before the negotiations to form ACM, Merrill had already begun negotiations to purchase" the notes used in the transaction.<sup>97</sup> Before the notes were purchased, Merrill was already negotiating disposition of the notes. No supervening market forces disrupted the execution of the steps. Finally, the Court reasoned that but for the tax losses generated for Colgate, the investment strategy would not have been economically rational from a nontax perspective.<sup>98</sup> On appeal, the Third Circuit Court of Appeals agreed with the Tax Court's analysis. The Third Circuit agreed that the record did not support ACM's assertions that the transactions were designed either to serve nontax objectives or to generate a pre-tax profit.<sup>99</sup> Again, no penalties were imposed upon ACM for engaging in the tax motivated transactions.

Like the transactions in *Knetsch*, *Rice's Toyota World*, and *Winn-Dixie*,

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90. *Id.*

91. *Id.* at \*80-\*91.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.* (citing *Yosha v. Comm'r*, 861 F.2d 494, 499 (7th Cir. 1988), *aff'g* *Glass v. Comm'r*, 87 T.C. 1087 (1986)).

96. *Id.* at \*127.

97. *Id.*

98. *Id.*

99. *ACM P'ship v. Comm'r*, 157 F.3d 231, 254 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

Colgate was approached by professional advisors. Prior to meeting with the representatives of Merrill, representatives of Colgate had no knowledge of the existence such a transaction. The transaction and its expected tax benefits were contrived by Merrill and the transaction was originally marketed to Colgate based solely upon the tax benefits. It was acknowledged that success of the proposal was dependent upon developing a business purpose. Upon initially hearing the proposal, Colgate's vice president of taxes believed that aside from the tax benefits, the transaction would not benefit Colgate.

Nevertheless, Merrill, in league with Colgate's vice president of taxation, was able to manufacture a purported business purpose that Colgate officers accepted. The transaction was highly structured to allegedly provide, among other things, debt risk management as a business purpose in addition to economic tax benefits. Neither the Tax Court nor the Court of Appeals for the Third Circuit accepted the various nontax business purposes forwarded by Colgate.<sup>100</sup> While ACM purported to engage in the transaction with a nontax debt acquisition objective, ACM's pursuit of the two separate objectives within the same partnership did not breathe a business purpose into the tax motivated aspect of the transaction.<sup>101</sup>

### B. Congressional & Agency Efforts

#### 1. Taxpayer Related Provisions.—

a. *Economic substance doctrine.*—Recently, Congress has debated several proposals to codify the “economic substance” doctrine and declined to do so.<sup>102</sup> Congress again declined to clarify or codify the doctrine in the Jobs Act.<sup>103</sup> The House version of the Jobs Act contained no proposal to codify the economic substance doctrine. However, the Senate version of the Act did incorporate a proposal to codify the economic substance doctrine, but, at the last moment, it was dropped.<sup>104</sup> Prior to removing the provision, the Senate version of the Jobs Act contained proposed section 401 entitled “Clarification of Economic Substance Doctrine.”<sup>105</sup> In relevant part, proposed section 401 generally provided that if a court determines that the economic substance doctrine is relevant to a transaction, the transaction will have economic substance only if

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100. *Id.* at 256, 263; *see also* *ACM P'ship*, 73 T.C.M. (CCH) 2189, at \*171.

101. *ACM P'ship*, 157 F.3d at 256 n.48; *see Joint Committee on Taxation, Background and Present Law Relating to Tax Shelters*, (JCX-19-02): *Hearing Before the Senate Comm. on Fin.*, 108th Cong. 16 (Mar. 19, 2002) [hereinafter *Law Relating to Shelters*].

102. *See, e.g.*, CARE Act of 2003, S. 476, 108th Cong. § 701; Jobs and Growth Tax Relief Reconciliation Act of 2003, S. 1054, 108th Cong. § 301; Abusive Tax Shelter Shutdown and Taxpayer Accountability Act, H.R. 1555, 108th Cong. § 101 (2003).

103. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

104. *Id.*

105. *See* Jumpstart Our Business Strength Act, S. 1637, 108th Cong. § 401(a); *see also* S. REP. NO. 108-192, § 401(a) (2003).

two requirements are met.<sup>106</sup> First, the transaction must meaningfully change the taxpayer's economic position apart from federal tax effects.<sup>107</sup> Second, the taxpayer must have a substantial nontax purpose for entering into such transaction and the transaction must be a reasonable means for accomplishing such purpose.<sup>108</sup> Without more, this general rule would not provide much additional guidance to taxpayers or courts on characterizing a transaction.

However, among other things, proposed section 401 also contained a special rule where a taxpayer relies on profit potential in order to satisfy the requirement of a meaningful change in economic position.<sup>109</sup> This special rule generally provided that a transaction shall not have economic substance unless two requirements were met. First, the present value of the expected pre-tax profit from the transaction must be substantial in relation to the present value of the expected net tax benefits. Second, the reasonably expected pre-tax profit must exceed the risk free rate of return.<sup>110</sup>

By requiring that the present value of the expected pre-tax profit be substantial in relation to the pre-tax benefits, the proposed provision clearly would have required taxpayers to substantiate a true economic impact and motive for engaging in the transaction. Without the proposed provision, taxpayers are left to base decisions on varying judicial interpretations of the economic substance prong of the sham transaction doctrine.

*b. Accuracy-related penalties.—*

*i. Section 6662.—*Section 6662 generally provides for "accuracy-related" penalties to be imposed on taxpayers who under certain circumstances fail to accurately report and pay sufficient taxes.<sup>111</sup> Section 6662 and its related regulations address the circumstances under which taxpayers will be subject to certain penalties for, among other things, an understatement of tax. Prior to new § 6662A,<sup>112</sup> § 6662 was the primary penalty statute specifically targeting tax shelter transactions. However, historically, while § 6662 specifically targeted tax motivated shelter transactions, rarely has it been imposed on taxpayers who have engaged in such transactions.<sup>113</sup> Lack of clarity in the economic substance and business purpose doctrines has, at times, caused courts to refuse to impose penalties.<sup>114</sup>

The § 6662 accuracy-related penalty applies to, among other things, the

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106. S. 1637 § 401.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. I.R.C. § 6662 (West, WESTLAW through P.L. 109-2, Feb. 18, 2005).

112. *See id.* § 6662A.

113. *Law Relating to Shelters*, *supra* note 101, at 35 n.141. *See, e.g.*, *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001); *Sheldon v. Comm'r*, 94 T.C. 738, 769-70 (1990).

114. *Law Relating to Shelters*, *supra* note 101, at 35 n.141. *See, e.g.*, *Peerless Indus. v. United States*, 94-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

portion of any underpayment that is attributable to (1) negligence or (2) any substantial understatement of income tax.<sup>115</sup> The penalty is equal to twenty percent of the portion of the underpayment of tax.<sup>116</sup> If any portion of an underpayment<sup>117</sup> of tax imposed is attributable to negligence or disregard of the Code or Regulations, a penalty equal to twenty percent of the underpayment is added to the tax due.<sup>118</sup> With respect to substantial understatements of tax prior to the Jobs Act, if the correct income tax liability for a taxable year exceeds the amount reported by the taxpayer by the greater of ten percent of the correct tax or \$5000 (\$10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to twenty percent of the underpayment of tax attributable to the understatement. Under the Jobs Act provisions, new rules apply to certain types of reportable transactions as discussed below.<sup>119</sup>

With respect to tax shelters, penalties related to understatements were avoided in the past under § 6662 by noncorporate taxpayers if the taxpayer established that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item.<sup>120</sup> A tax shelter is defined under § 6662 as (1) a partnership or other entity, (2) any investment plan or arrangement, or (3) any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax.<sup>121</sup>

Historically, under § 6662, the understatement penalty was abated in all cases in which the taxpayer could demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.<sup>122</sup> The regulations provide that reasonable cause exists where the taxpayer

reasonably relies in good faith on the opinion of a professional tax adviser, if the opinion is based on the tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously states that there is a greater than 50-percent likelihood that the tax treatment of the item

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115. I.R.C. § 6662(b).

116. *Id.* §6662(a).

117. Underpayment is defined in I.R.C. § 6664(a). *See also* Treas. Reg. § 1.6664-2 (as amended in 1992). Generally, the underpayment is equal to the amount of tax imposed less the amount of income tax shown on the taxpayer’s return. Additional rules apply where the taxpayer either paid amounts in addition to those shown on his or her return and where any rebates were received by the taxpayer.

118. Treas. Reg. § 1.6662-3(a) (as amended in 2003).

119. *See* discussion *infra* Part I.B.1.b.ii.

120. I.R.C. § 6662(d)(2)(B); *see also Law Relating to Shelters, supra* note 101, at 34. However, pursuant to newly amended Code § 6662(d)(2)(C), subparagraph (B) of § 6662(d)(2) shall not apply to any item attributable to a tax shelter. I.R.C. § 6662(d)(2)(C).

121. I.R.C. § 6662(d)(2)(C)(iii).

122. *Id.* § 6664(c); *see also Law Relating to Shelters, supra* note 101, at 34.

will be upheld if challenged by the Internal Revenue Service.<sup>123</sup>

The “reasonable cause” exception has been critical to promoters’ success in marketing of tax shelter opinions. In the event a taxpayer implemented a tax shelter transaction, which was challenged by the IRS, the taxpayer generally avoided penalties if the taxpayer obtained and relied upon an opinion from a tax advisor who opined that the taxpayer would “more probably than not” (a greater than fifty percent likelihood) prevail in the controversy. Where a taxpayer relied upon an opinion from his or her tax advisor but unsuccessfully defended a challenge by the IRS in relation to the transaction, courts often have not imposed a penalty.<sup>124</sup> Aside from the fees and expenses charged by the shelter promoters, a taxpayer was generally economically indifferent to engaging in the transaction under prior law. To the extent that a taxpayer retained the amounts that represented the tax savings from engaging in the transaction and reasonably invested the assets, the taxpayer could satisfy any later assessment of taxes and interest with the retained earnings and any investment income earned while waiting to see if the IRS successfully challenges the transaction.

*ii. New I.R.C. § 6662A.*—Section 812 of the Jobs Act created new § 6662A, imposing additional accuracy-related penalties on understatements with respect to “reportable transactions.”<sup>125</sup> New § 6662A(a) imposes a penalty on understatements attributable to a “listed”<sup>126</sup> or reportable transaction if a significant purpose of the transaction is the avoidance or evasion of federal income tax.<sup>127</sup> The penalty is imposed where a taxpayer has a “reportable transaction understatement.” The “understatement” referred to in relation to a reportable transaction is the increase in taxable income resulting from the

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123. Treas. Reg. § 1.6662-4(g)(4)(i)(B) (as amended in 2003); Treas. Reg. § 1.6664-4(c) (as amended in 2003); *see also Law Relating to Shelters, supra* note 101, at 34-35.

124. *See, e.g.,* Kirchman v. Comm’r, 862 F.2d 1486 (11th Cir. 1989); Rice’s Toyota World, Inc. v. Comm’r, 752 F.2d 89 (4th Cir. 1985); Winn Dixie Stores, Inc. v. Comm’r, 113 T.C. 254 (1999), *aff’d*, 254 F.3d 1313 (11th Cir. 2001).

125. A “reportable transaction” is defined under new I.R.C. § 6707A(c)(1) as any transaction with respect to which information is required to be included with a return or statement because such transaction is of a type which is determined by the Secretary of the Treasury to have a potential for tax avoidance or tax evasion. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 811(a), 118 Stat. 1418, 1575-76. On November 16, 2004, the IRS issued Notice 2004-80 providing interim guidance in relation to the Jobs Act indicating that for purposes of I.R.C. § 6111(a), a “reportable transaction” is defined under Treas. Reg. § 1.6011-4(b) (as amended in 2004). Generally, Treas. Reg. § 1.6011-4(b) provides there are six categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference, and transactions involving a brief asset holding period.

126. New I.R.C. § 6707A(c)(2) provides that a “listed transaction” means a “reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction.”

127. *See id.* § 6662A.

difference between the proper tax treatment of an item and the taxpayer's improper treatment of the same item.<sup>128</sup> This understatement amount generally is multiplied by the highest rate of tax imposed under either I.R.C. § 1 for an individual or I.R.C. § 11 for a corporation to arrive at the "reportable transaction understatement."<sup>129</sup>

It is important to note that, under the new rule, a penalty will be imposed notwithstanding that the taxpayer has no actual tax liability in the current year. Consistent with this principal, the understatement of tax is based upon the highest tax rates. Thus, in practice, the same penalty amount should apply to any understatement amount result regardless of the marginal tax rate that applies to a taxpayer or whether any tax is actually owed in the year in which the transaction was executed.

The penalty rate under § 6662A varies depending on whether the transaction is adequately disclosed.<sup>130</sup> If the transaction is adequately disclosed, the penalty rate is twenty percent.<sup>131</sup> However, where the transaction is not adequately disclosed, the penalty rate increases to thirty percent.<sup>132</sup> Unlike the rules that historically applied under § 6662, the new rules link the penalty rate to the disclosure requirement. In general, failure to disclose increases the penalty rate to 30%.

The addition to tax imposed under § 6662 continues to apply but it is calculated in coordination with the new § 6662A amounts. Reportable transaction understatements under the new rule are aggregated with the amount of any understatements that exist under § 6662 in order to determine whether a "substantial understatement" exists under current § 6662.<sup>133</sup> The § 6662 addition to tax only applies to the extent that the addition to tax under § 6662(a) exceeds the aggregate amount of reportable transaction understatements under 6662A(b).<sup>134</sup>

Reliance on the reasonable cause exception to an understatement penalty also varies under § 6662A depending on whether the transaction is adequately

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128. *See id.* §6662A(b)(1)(A).

129. *Id.* In cases where there is also a decrease in the aggregate amount of credits which resulted from the taxpayer's improper treatment of an item, the decrease is added to reportable transaction understatement. *See id.* § 6662A(b)(1)(B).

130. *See* STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., COMPARISON OF CERTAIN PROVISIONS OF H.R. 4520 AS PASSED BY THE HOUSE OF REPRESENTATIVES AND AS RECOMMENDED BY THE SENATE: REVENUE PROVISIONS 11 (Comm. Print 2004) [hereinafter COMPARISON BY STAFF OF THE JOINT COMMITTEE].

131. *See* I.R.C. § 6662A(a).

132. *See id.* § 6662A(c).

133. Under §6662(d), a substantial understatement generally exists if the amount of tax required to be shown on the return exceeded the amount of tax actually shown on the return by ten percent of the tax required to be shown on the return or \$5000 (whichever is greater). *Id.* § 6662(d)(1)-(2).

134. *See id.* § 6662A(e)(1).

disclosed.<sup>135</sup> Importantly, like the rules that have historically applied under § 6662, no penalty is imposed under new § 6662A with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause and that the taxpayer acted in good faith.<sup>136</sup> However, the reasonable cause and good faith exception only applies where the taxpayer adequately discloses the relevant facts affecting the tax treatment of an item, there was substantial authority for such treatment, and the taxpayer “reasonably believed” that such treatment was more likely than not proper.<sup>137</sup>

New § 6664(d) was added under the Jobs Act and provides rules relating to when a taxpayer is treated as having a reasonable belief.<sup>138</sup> In general, a taxpayer is treated as having a reasonable belief if such belief is based upon the facts and law that exist at the time the relevant return was filed.<sup>139</sup> The taxpayer’s belief must be based solely on the taxpayer’s chances of success on the merits without consideration of the possibility that the return will be audited or settled by the IRS. Further, in establishing a reasonable belief, a taxpayer may not rely upon an opinion of a tax advisor under two circumstances. First, an opinion may not be relied upon if the tax advisor is a “material advisor.”<sup>140</sup> Second, an opinion may not be relied upon if it is a “disqualified opinion.”<sup>141</sup>

In general, a material advisor is a “disqualified tax advisor” if the advisor participates in the organization, management, promotion, or sale of the transaction or is improperly compensated in relation to the arrangement.<sup>142</sup> This

135. COMPARISON BY STAFF OF THE JOINT COMMITTEE, *supra* note 130, at 11.

136. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 812(c), 118 Stat. 1418, 1575-76 (amending § 6664 by adding subsection (d) providing for the reasonable cause exception).

137. Adequate disclosure is defined to be disclosure in accordance with regulations prescribed by the Secretary under § 6011. I.R.C. § 6662A(c). However, a taxpayer failing to adequately disclose in accordance with the rules is treated as having met the disclosure requirements if the penalty is rescinded under new § 6707A(d) (granting the Commissioner of the I.R.S. the power to rescind penalties if rescinding the penalty would promote compliance with the Internal Revenue Code and effective tax administration). *Id.* § 6707A(d).

138. *See* American Jobs Creation Act of 2004, § 812(c) (amending § 6664 by adding subsection (d)).

139. I.R.C. § 6664(d).

140. *Id.* § 6664(d)(3).

141. *Id.* § 6664(d)(3)(B)(iii).

142. *See id.* 6664(d)(3)(B)(ii) providing:

(ii) Disqualified Tax Advisors.—A tax advisor is described in this clause if the tax advisor—

(I) is a material advisor (within the meaning of section 6111(b)(1)) and participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates,

(II) is compensated directly or indirectly by a material advisor with respect to the transaction,

(III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or

definition appears to broadly encompass many advisors who would seek to market tax shelter opinions.<sup>143</sup> The ability of a taxpayer to rely upon an opinion of a tax advisor that engages in marketing tax “opinions” to avoid penalties would appear to be severely undermined under the new rule.

Further, even if the tax advisor is not disqualified under the above rules, the opinion itself may be disqualified if it is not supported by accurate and complete facts. In general, an opinion is disqualified if it is based upon unreasonable factual assumptions, unreasonable taxpayer representations or fails to identify and consider all relevant facts.<sup>144</sup>

*c. Disclosure of reportable transactions.*—Prior to the Jobs Act and over the last several years, the Treasury Department and the IRS increased efforts in an attempt to thwart abusive tax avoidance activities. The Treasury Department finalized regulations under § 6011 requiring disclosure by taxpayers of certain abusive transactions called “reportable transactions.”<sup>145</sup> Six categories of reportable transactions exist under the regulations each having independent characteristics.<sup>146</sup> At least one commentator has pointed out that the creation of the six largely unrelated attributes suggests that the IRS lacks a well defined principle for distinguishing between legitimate and illegitimate transactions.<sup>147</sup> Under these recent regulations, while disclosure of reportable transactions was mandatory, there was no specific penalty imposed on a taxpayer who fails to

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(IV) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

Interim guidance has been issued under IRS Notice 2004-80 providing that a “material advisor” is defined in Treas. Reg. § 301.6112-1(c)(2), (c)(3) and (d) (2003). IRS Notice 2004-80, 2004-50 I.R.B. 963 (Dec. 13, 2004). In short, a material advisor is defined as a person who provides aid, assistance, or advice in organizing, promoting, carrying out, insuring, or selling a reportable transaction and who derives gross income in excess of \$250,000. *See* Treas. Reg. § 301.6112-1(c)(3) (as amended in 2003). The gross income amount is reduced to \$50,000 for a transaction if any person to whom or for whose benefit a potential material advisor makes or provides a tax statement with respect to the transaction is a partnership or trust. *Id.*

143. I.R.C. § 6664(d)(3)(B)(ii).

144. *See id.* § 6664(d)(3)(B)(iii) providing:

(iii) Disqualified Opinions.—For purposes of clause (i), an opinion is disqualified if the opinion—

(I) is based on unreasonable factual or legal assumptions (including assumptions as to future events),

(II) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person,

(III) does not identify and consider all relevant facts, or

(IV) fails to meet any other requirement as the Secretary may prescribe.

145. *See* I.R.C. § 6011 (2000); *see also* Treas. Reg. § 1.6011-4 (2003).

146. Treas. Reg. § 1.6011-4(b).

147. *Developments in the Law—Corporation and Society: Governmental Attempts to Stem the Rising Tide of Corporate Tax Shelters*, 117 HARV. L. REV. 2249, 2254-55 (2004) [hereinafter *Governmental Attempts to Stem the Rising Tide*].

disclose.<sup>148</sup>

The Jobs Act, however, does impose penalties on taxpayers for failing to disclose a reportable transaction. Generally, a penalty is imposed on any person who fails to include any information with respect to a reportable transaction.<sup>149</sup> The amount of the penalty varies depending upon the type of taxpayer and whether the transaction is a listed transaction. In the case of a natural person, the penalty is \$10,000 and in all other cases the penalty is \$50,000. If the transaction is a listed transaction, the penalty is increased from \$10,000 to \$100,000 in the case of a natural person and from \$50,000 to \$200,000 in any other case.<sup>150</sup> Failure to make required disclosures results in imposition of the above penalties regardless of other circumstances.

2. *Promoters.*—

a. *Registration and list maintenance.*—The Jobs Act modifies the old rules in relation to tax shelter registration. Under the new rules, each material advisor must file an information return for each reportable transaction.<sup>151</sup> The old penalty for failure to register tax shelters is repealed and a new penalty of \$50,000 is imposed on a material advisor for either failing to file a return or filing a false or incomplete return with respect to a reportable transaction.<sup>152</sup> If the failure to report is in relation to a listed transaction, the \$50,000 penalty is increased to the greater of \$200,000 or fifty percent of the gross income of the person who provides aid, assistance or advice in regard to the listed transaction.<sup>153</sup>

Material advisors are also required to maintain a list of investors.<sup>154</sup> In general, the new rule modifies the penalty for failing to maintain the required list

148. While there was no penalty for failure to disclose, a taxpayer may not have been able to rely on the reasonable cause defense. *See* I.R.C. § 6664(c)(1) (West, WESTLAW through P.L. 109-2, Feb. 18, 2005) (providing: “No penalty shall be imposed under Section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.”).

149. *See id.* § 6707A(a).

150. *See id.* § 6707A(b). Where a public corporation fails to disclose a listed transaction and a penalty is imposed under § 6662A, § 6707A(e) requires the company to disclose the penalty in reports filed with the Securities Exchange Commission.

151. *See id.* § 6111(a). For this purpose, “material advisor” means any person:

- (i) who provides aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and
- (ii) who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such advice or assistance.

*Id.* § 6111(b)(1)(A). The threshold amount is \$50,000 in the case of a reportable transaction in relation to a natural person and \$250,000 in any other case. *Id.* § 6111(b)(1)(B).

152. *See id.* § 6707(a) & (b).

153. *Id.*

154. *See id.* § 6112(a).

by imposing a time limitation and a corresponding penalty. Now, a material advisor who is required to maintain an investor list and who fails to make a list available upon request will be subject to a \$10,000 per day penalty.<sup>155</sup>

*b. Section 6700: Promoting abusive tax shelters.*—Section 6700 provides for imposition of a penalty on any person who, among other things, organizes, assists, or participates in the sale of any investment plan or arrangement if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement.<sup>156</sup> A qualified false or fraudulent statement is any statement with respect to a taxpayer's ability to take any deduction or credit, exclude any income, or secure any other tax benefit by reason of, among other things, participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter.<sup>157</sup> The Jobs Act amended § 6700(a) to provide for an increased penalty in an amount equal to fifty percent of the gross income derived by the person from such activity.<sup>158</sup> In comparison to the old rules which generally provided for a \$1000 penalty, the fifty percent penalty represents a substantial increase in the promoter penalties.

*c. Section 6701: Aiding and abetting understatement of tax liability.*—Section 6701 imposes a penalty on any person who: (1) aids, assists, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document; (2) knows (or has reason to believe) that the document will be used in connection with any material matter arising under the internal revenue laws; and (3) knows that the document would result in an understatement of another person's tax liability.<sup>159</sup> The concept of aiding or abetting requires "direct involvement" in the preparation or presentation of a tax return or other tax-related document.<sup>160</sup>

Several definitions and special rules apply. However, the penalty for aiding and abetting with respect to an individual's tax liability is \$1000.<sup>161</sup> The penalty increases to \$10,000 if the aiding and abetting is with respect to a corporation's tax liability.<sup>162</sup> A person can only be subject to this penalty once with respect to a particular taxpayer per period.<sup>163</sup>

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155. *See id.* § 6708(a)(1).

156. I.R.C. § 6700(a)(1); *see also Law Relating to Shelters, supra* note 101, at 36.

157. I.R.C. § 6700(a)(2); *see also Law Relating to Shelters, supra* note 101, at 36.

158. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 818(a), 118 Stat. 1418, 1584.

159. I.R.C. § 6701(a).

160. *Law Relating to Shelters, supra* note 101, at 36-37 (citing STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG., GENERAL EXPLANATION TO THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 220 (1982)).

161. I.R.C. § 6701(b)(1).

162. *Id.* § 6701(b)(2).

163. *Id.* § 6701(b)(3); *see also Law Relating to Shelters, supra* note 101, at 37.

## II. RECENT TAX SHELTER ACTIVITY—A CASE STUDY

In 2002, the U.S. Permanent Subcommittee on Investigations of the Committee on Governmental Affairs (the “Committee”) initiated an investigation into “the development, marketing, and implementation of abusive tax shelters by professional organizations such as accounting firms, banks, investment advisors, and law firms.”<sup>164</sup> In November 2003, the Committee issued a report (the “Report”) containing its findings and recommendations in relation to its study of four transactions or “tax products” that were marketed by the public accounting firm of KPMG.<sup>165</sup> It is important to note that while the Committee focused its case study on products sold by KPMG, the Committee indicated that other professional firms including Ernst & Young, PriceWaterhouse Coopers, Deutsche Bank, Wachovia Bank and J.P. Morgan Chase as well as many others have also sold abusive or illegal tax products.<sup>166</sup>

Each of the four products that the Committee focused its study on had several features in common. The products were developed by KPMG in an internal process through which tax professionals, including certified public accountants and attorneys, employed by KPMG analyzed the technical merits of the proposed products.<sup>167</sup> The four products included complex and highly structured transactions requiring in-depth technical legal opinions. KPMG expended substantial amounts of time, effort, and capital to develop and market the products to potential buyers. Also included within these efforts was the creation of a market research department, a Sales Opportunity Center that worked on tax product marketing strategies, and a telemarketing center staffed with people trained to make cold calls to find buyers for the tax products developed.<sup>168</sup>

In marketing the tax products, the Report indicated that KPMG sold the four tax products to more than 350 individuals during the years 1997 through 2001.<sup>169</sup> Together the four products generated fees for KPMG in excess of \$124 million.<sup>170</sup> As of June 2002, an IRS analysis of a portion of the returns related to three of the products sold by KPMG identified 243 individuals who had relied on the transactions to claim a total of \$5.8 billion in tax losses on their individual federal income tax returns.<sup>171</sup> In the case of one of the products, clients were charged a single fee equal to seven percent of the “tax losses” to be generated by the proposed transaction. The client typically paid the fee to the retained

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164. MINORITY STAFF OF THE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOV'T AFFAIRS U.S. SENATE, 108TH CONG., U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS 1 (Comm. Print 2003) [hereinafter *ROLE OF ACCOUNTANTS*].

165. *Id.* at 2.

166. *Id.* at 7-8.

167. *Id.* at 7.

168. *Id.* at 8.

169. *Id.* at 3.

170. *Id.*

171. *Id.*

investment advisory firm, which then apportioned the fee among KPMG, a participating bank, law firm, and others.<sup>172</sup>

Once a taxpayer agreed to engage KPMG for the purpose of purchasing a tax product, KPMG would assist the client in executing the transaction. Execution of the transactions required the assistance of the lawyers, bankers, investment advisors, and others to carry out the steps of each of the transactions. KPMG issued tax opinion letters advising clients of the tax consequences of the prospective transactions.<sup>173</sup> The Report indicates that the Committee investigation found that KPMG drafted its own prototype tax opinion letter supporting the product and used the prototype opinion letter as a template for the opinion letters actually sent to a number of clients. In addition, KPMG generally arranged for an outside law firm to provide a second favorable opinion letter.<sup>174</sup> The Report indicates that KPMG collaborated with a law firm, Sidley Austin Brown & Wood, prior to engaging the law firm in order to assure that the opinion would be favorable.<sup>175</sup> In certain instances, KPMG would exchange opinion letters with the retained law firm eventually issuing similar opinions.<sup>176</sup>

The prototype tax opinion letter prepared by KPMG and the retained law firm relied upon a set of factual representations made by the client. The client representations were critical to analysis and conclusions presented in KPMG's opinion letters.<sup>177</sup> The Report indicates that some of the key representations went to the very core requirements of the two prong sham transaction test applied by the courts. The Report indicates that the prototype opinion letter provided that the client represented to KPMG that the client had independently reviewed the economics underlying the proposed transaction and that the client believed there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions.<sup>178</sup>

Specifically, in relation to the economic substance doctrine, the prototype opinion letters of KPMG and the retained law firm reflected similar analysis in relation to the law. However, with respect to application of the facts to the law, neither opinion contained specific client facts. Rather, both opinion letters relied on representations made by the client who is viewed as the "investor" in the transaction and provided the following representation:

Investor independently reviewed the economics underlying the Investment Fund before entering into the program and believed there was

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172. *Id.* at 9-10.

173. *Id.* at 11; *see also* KPMG Opinion Letter on Investment Transactions Available, 2003 TAX NOTES TODAY 238-53 [hereinafter *KPMG's Tax Opinion Letter*].

174. ROLE OF ACCOUNTANTS, *supra* note 164, at 11; *see, e.g.,* Brown & Wood Opinion Letter on Investment Strategies Available, 2003 TAX NOTES TODAY 238-54 [hereinafter *Sidley Austin Brown & Wood LLP's Tax Opinion Letter*].

175. ROLE OF ACCOUNTANTS, *supra* note 164, at 11.

176. *Id.* at 11-12.

177. *Id.* at 12.

178. *Id.*

a reasonable opportunity to earn a reasonable pre-tax profit from the transactions described herein (not including any tax benefits that may occur), in excess of all associated fees and costs.<sup>179</sup>

#### A. *Application of the Sham Transaction Doctrine*

As indicated, each of the four transactions was highly structured with the intention of, among other things, producing tax benefits for the various clients that implemented the transactions. While the four transactions differed in terms of the various Code sections used to obtain tax benefits, there were a number of characteristics that the transactions shared. Prior to being engaged by a client and prior to any marketing activities, prototype opinions were drafted that concluded that more probably than not the prospective taxpayer-clients would prevail if the proposed transactions were challenged by the IRS. The tax advisors set up a network of other professionals including lawyers, bankers and investment advisors in most instances to assist the prospective clients in implementing the product.

Application of the two pronged sham transaction analysis to the above scenario reveals the weakness of the two pronged analysis when applied to a marketed tax product. Starting with the requirement that the taxpayer must subjectively have a nontax business purpose for engaging in the transaction, it becomes obvious that no taxpayer who purchased one of the marketed tax products should be able satisfy this prong of the test. Prior to marketing the product, the promoters of the product could not have known who they would market the product to or in what business activity each prospective client would be engaged. Without identifying any particular client, it would appear to be impossible to determine what, if any, subjective intent that the prospective taxpayer might have. This necessarily leaves a promoter such as KPMG in the position of satisfying the objective economic substance prong of the sham transaction doctrine in relation to a proposed transaction. Proving that a transaction has economic substance or a pre-tax profit generally will also satisfy the subjective prong in that taxpayers generally desire (subjectively) to engage in transactions projected to have a pre-tax profit.

What level of pre-tax profit will satisfy the economic substance prong of the test? As indicated previously, Congress recently declined to clarify or codify the economic substance prong of the test.<sup>180</sup> The courts, however, have provided some guidance on this issue. In *ACM*, the court followed the rule that in order to have economic substance, the nontax benefits must be at least commensurate with the transaction costs.<sup>181</sup> In *Rice's Toyota*, the court found that the transaction carried no hope of earning a profit for taxpayer unless the computer

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179. *KPMG's Tax Opinion Letter*, *supra* note 173; *Sidley Austin Brown & Wood LLP's Tax Opinion Letter*, *supra* note 174. Both representations are verbatim.

180. See discussion *supra* Part I.B.1.a.

181. *ACMP'ship v. Comm'r*, 157 231, 249 (3d Cir. 1998) (citing *Yosha v. Comm'r*, 861 F.2d 494, 501 (7th Cir. 1988), *aff'g* *Glass v. Comm'r*, 87 T.C. 1087 (1986)).

had residual value sufficient to recoup the original net principal and interest that the taxpayer paid Finalco.<sup>182</sup> Stated otherwise, the courts of appeal for the Third and Fourth Circuits appear to follow the rule that the projected nontax profits must exceed the transaction costs.

In relation to the economic substance requirement, there is little doubt the professional advisors involved here coordinated with a number of other professional investment advisors and banks to analyze whether there was a chance that the transaction could produce a pre-tax profit. Without analyzing the specific attributes of and facts surrounding each of the four transactions marketed by KPMG and others, one can assume that a group of very intelligent tax professionals would (and probably did) produce financial scenarios based on various possible investment parameters such as interest and market return rates. Further, one may assume that these scenarios indicated that each transaction stood some chance of producing a pre-tax profit in excess of the transaction costs.

At a baseline, the author of this Article believes that such projections are all that is needed under current law in order for tax shelter promoters and their clients to obtain comfort in the transaction from an economic substance perspective. That is, promoters of tax shelters need only seek a reasonable argument that the transaction stands a chance of producing a small economic benefit in excess of transaction costs. Once a projection is made that evidences the existence of a possible pre-tax profit, it will be left to the IRS, courts, and experts to determine whether the likelihood of the pre-tax profit satisfies the economic substance prong of the sham transaction doctrine. Herein lays the continuing defect in the economic substance test. To the extent the taxpayer can project that the transaction stands a chance of a pre-tax profit sufficient to cover the transactions costs, the taxpayer may take the position that the transaction is not a sham for tax purposes. A small chance of a sufficient pre-tax profit is highly likely to translate into a more probably than not opinion.

The proposed clarification of economic substance in the Senate version of the Jobs Act would have addressed the deficiency in the judicial doctrine.<sup>183</sup> The proposed clarification specifically addressed the objective economic substance prong of the sham transaction analysis. By requiring a "substantial" pre-tax profit in excess of tax benefits plus a pre-tax profit that exceeds the risk free rate of return, taxpayers and their advisors would no longer be able to conclude that transactions having a mere scintilla of profit in excess of transactions costs are sufficient to engage in a transaction under the law. In the absence of any congressional direction, taxpayers are left to rely on court opinions which differ in relation to the applicable legal standard and do not appear to provide for a test that requires a true nontax economic consequence.<sup>184</sup> Congressional failure to include a provision in the Jobs Act which clarifies and codifies the judicially created economic substance doctrine leaves the door open for tax shelter

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182. Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 94 (4th Cir. 1985).

183. See *supra* notes 105-10 and accompanying text.

184. See discussion *supra* Part I.B.1.a.

promoters and taxpayers to engage in tax motivated transactions.<sup>185</sup>

For future transactions, the existence of a thin but viable argument that a possibility of profit exits coupled with the receipt of an opinion from a qualified tax advisor will continue to support an argument that a transaction is valid even though it has little economic substance. Further, such arguments will not only target the possible success of the transaction with respect to whether it will meet the economic substance requirement, but also will continue to target avoidance of understatement penalties.

### *B. Application of the Code and Regulations Including the New Jobs Act Provisions*

Prior to the Jobs Act, applying the relevant Code penalties to KPMG's activities resulted in very few instances where meaningful penalties applied to either taxpayers or KPMG. Where an underpayment penalty might have applied to taxpayers, the penalty was systematically avoided by obtaining an opinion from a tax advisor. Where promoter penalties applied under prior law, the penalty amounts were so minor in comparison with the fees collected by KPMG that the penalties become almost immaterial. With the advent of the Jobs Act, taxpayer reliance on undisclosed mass marketed tax motivated transactions should no longer result in avoidance of penalties. However, for a number of reasons, it is unlikely that the new penalty structure will deter all future shelter activities.

*1. Analysis of Penalties Applicable to Taxpayers.*—Prior to the Jobs Act, the § 6662 understatement penalty was abated in cases in which the taxpayer demonstrated that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.<sup>186</sup> However, pursuant to the Jobs Act, notwithstanding that a taxpayer may show reasonable cause, a taxpayer generally may not avoid penalties if the taxpayer fails to appropriately disclose the transaction, the taxpayer relies on an opinion from a disqualified tax advisor, or if the opinion is disqualified because it is not supported by complete and accurate facts.

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185. See 150 CONG. REC. S11,191-203 (Oct. 11, 2004) (statement of Senator Levin, as indicated by Senator Levin in relation to failure to include the economic substance provision: “One of the most glaring of these omissions from this legislation is the provision passed by the Senate numerous times that would have required business transactions to have actual ‘Economic Substance’ in order to receive tax benefits. Refusing to include this anti-abuse tool means that tax dodgers will still be able to escape paying their fair share by using phony transactions that have no business purpose other than tax avoidance . . .”).

186. I.R.C. § 6664(c) (2000); see also *Law Relating to Shelters*, *supra* note 101, at 34. Again, “reasonable cause” exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’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.” Treas. Reg. § 1.6662-4(g)(4)(i)(B) (as amended in 2003).

*a. Disclosure.*—Although a taxpayer may successfully argue that reasonable cause existed based upon the economic substance of a transaction, transactions similar to those marketed and sold by KPMG may nevertheless be subject to penalties for failure to disclose. In order to assert the reasonable cause exception to the new penalty provisions, a taxpayer must adequately disclose a “reportable transaction” in accordance with the regulations.<sup>187</sup>

The transactions engaged in by KPMG are likely to be the type of activity which the Secretary would determine to have a potential for tax avoidance and, therefore, reportable transactions. The IRS’s response to the four transactions referred to in the Report has been consistent. The IRS determined that each of the four transactions marketed by KPMG were abusive.<sup>188</sup> Based upon this response, a failure to report similar transactions in the future would appear, under the new rules, to preclude a taxpayer from relying upon the reasonable cause exception to the imposition of accuracy-related penalties under new § 6662A. The heightened focus on disclosure in the new rules increases the risk that a penalty will be imposed upon taxpayers who would engage in undisclosed transactions.

Without regard to ethical considerations, the beginning point for a taxpayer analyzing whether to engage in a transaction will be whether or not it is a reportable transaction. If it is determined by the taxpayer that the IRS would perceive it to be a reportable transaction, the taxpayer must then decide whether the penalties for disclosure are steep enough to induce the taxpayer to disclose. As of June 2002, an IRS analysis of a portion of the returns relating to three of the products sold by KPMG identified 243 individuals who had relied on the transactions to claim a total of \$5.8 billion in tax losses on their individual federal income tax returns.<sup>189</sup> On average, each of the individuals involved appear to have claimed approximately \$8 million in losses on their respective returns in relation to these marketed tax products.<sup>190</sup> Assuming that each individual is taxed at the highest marginal tax rate of thirty-five percent, each taxpayer was positioned to avoid approximately \$2.8 million in taxes. Even under the new rules, it is somewhat disingenuous to think that taxpayers, such as those involved in the KPMG transactions, would be induced to disclose under the threat of a \$10,000 failure to disclose penalty.

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187. See I.R.C. § 6664(d)(2) (West, WESTLAW through P.L. 109-2, Feb. 18, 2005).

188. IRS Notice 2000-44 (Sept. 5, 2000) (determining that BLIPs was a potentially abusive tax shelter). In August 2001, the IRS issued Notice 2001-45 (Aug. 13, 2001) (determining that both the FLIP and the OPIS transactions were potentially abusive tax shelters); IRS Notice 2004-30 (Apr. 26, 2004) (determining that the SC2 transaction and similar transactions were potentially abusive tax shelters).

189. ROLE OF ACCOUNTANTS, *supra* note 164, at 3.

190. This number was arrived at by assuming that the \$5.8 billion in losses was divided equally amongst the three tax products (\$5,800,000,000 divided by three products results in \$1,933,333,333 of losses each). Further, it assumes that the 243 individuals equally reported losses as amongst each of the products (\$1,933,333,333 divided by 243 results in \$7,956,104 in losses on average per taxpayer).

Assuming a taxpayer is not dissuaded by the \$10,000 penalty and chooses not to disclose, the question then becomes whether such taxpayer would be dissuaded by the possible application of the increased thirty percent accuracy-related penalty under new § 6662A(c). It is at this point that the analysis becomes unclear. First, if the taxpayer believes that the transaction is not a sham and that the transaction has economic substance or a business purpose, the taxpayer will likely move forward with the transaction. Upon a challenge by the Service, if the taxpayer prevails on the merits, there will be no tax or penalty imposed. It is here that the failure of Congress to codify the economic substance doctrine will be most acutely felt. As indicated earlier, the low threshold for economic substance within the judicially created sham transaction doctrine may result in continued taxpayer attempts to exploit the doctrine.

On the other hand, if the taxpayer loses on the merits of the transaction, the increased thirty percent penalty will likely apply due to the fact that the taxpayer did not disclose it. The fact that the taxpayer has obtained an opinion from a tax advisor should be of no assistance to the taxpayer in avoiding penalties. This signifies a meaningful change in the law where in the past taxpayers regularly chose not to disclose under the rules, but still avoided penalties by relying on an opinion to meet the reasonable cause exception.

*b. Disqualified tax advisor.*—Under the new rules, a taxpayer that fully discloses a reportable transaction may continue to be precluded from relying on an opinion of a tax advisor to avoid penalties.<sup>191</sup> A taxpayer may not rely on an opinion of a tax advisor to establish a reasonable belief if the tax advisor is a material advisor.<sup>192</sup> By promoting, selling, organizing, and managing the various transactions addressed in the Report, KPMG most assuredly falls within the definition of a material advisor. The new rules appear to effectively thwart the ability of taxpayers from relying on mass marketed opinions similar to those promoted by KPMG. In this respect the rules appear to be clear and are a welcome addition to deter taxpayers from relying on mass marketed opinions to avoid penalties.

In order to avoid application of the disqualified tax advisor rule, the taxpayer will be induced to obtain an opinion from separate counsel. While only time will tell, nothing in the taxpayer penalty sections appear to prevent taxpayers from implementing ideas pitched by shelter promoters if such ideas are opined upon by separate counsel who does not participate in the organization, management, promotion, or sale of the transaction. Based upon the large number of tax dollars that have been sheltered by recently promoted transactions, it is likely that taxpayers who disclose under the rules will obtain the opinion of separate counsel regarding a promoter's idea. However, one unintended effect of the new rule may occur in instances where a taxpayer chooses not to disclose. Because failure to disclose prevents a taxpayer from asserting the reasonable cause exception, taxpayers who choose not to disclose may have less of an incentive to obtain an opinion from a tax advisor.

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191. See I.R.C. § 6664(d)(3)(B)(ii).

192. *Id.*

c. *Disqualified opinion.*—Under the new rules, taxpayers who disclose an idea and retain independent qualified counsel to provide an opinion may nevertheless continue to be precluded from relying on such opinion if the opinion itself is disqualified.<sup>193</sup> The opinions received from KPMG and Sidley Austin Brown & Wood would likely be “disqualified opinions” due to the fact that neither opinion appeared to identify or consider all relevant facts.<sup>194</sup> Instead, KPMG and Sidley Austin Brown & Wood appear to have relied solely on representations made by the taxpayers or agreements with the various taxpayers.<sup>195</sup> However, taxpayers and advisors alike will now be induced to include analysis of relevant facts in opinions that are obtained in relation to proposed future transactions.

2. *Analysis of Penalties Applicable to Tax Advisors.*—

a. *Registration and information reporting.*—Previously, a tax shelter organizer was required to register a tax shelter with the Treasury Department. A failure to register generally resulted in a penalty imposed upon the promoter equal to one percent of the aggregate amount invested in the shelter or \$500 (whichever was greater). These penalty amounts were apparently not enough to deter promoters such as KPMG from engaging in the activities described in the Report. Under the Jobs Act, material advisors are required to furnish information to the IRS in relation to any reportable transaction.<sup>196</sup> Again, the transactions described in the Report would all appear to be reportable transactions subject to information reporting.<sup>197</sup> In relation to the four tax products marketed by KPMG, a choice not to disclose the four transactions under the new rules would result in a \$50,000 penalty for each undisclosed transaction. Again, applying a cost benefit analysis to the recent KPMG activities, KPMG would be subject to \$200,000 of penalties for failing to disclose the four transactions.<sup>198</sup> An apparent substantial penalty but, again, the four products together generated fees for KPMG in excess of \$124 million.<sup>199</sup> The penalty represents approximately 1.6% of the fees collected on the transactions. Historically, promoters as KPMG have not been dissuaded by these immaterial penalties.

It should be noted that promoters would be subject to much higher penalties where a promoter fails to furnish information in relation to a listed transaction.<sup>200</sup> Transactions become listed transactions only after the IRS has discovered, analyzed, and concluded that the transactions are abusive. It would seem that only the most aggressive tax shelter promoters and taxpayers would engage in an

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193. See *id.* § 6664(d)(3)(B)(iii).

194. See *KPMG’s Tax Opinion Letter*, *supra* note 173; *Sidley Austin Brown & Wood LLP’s Tax Opinion Letter*, *supra* note 174.

195. ROLE OF ACCOUNTANTS, *supra* note 164, at 11.

196. See I.R.C. § 6111(a)-(b).

197. ROLE OF ACCOUNTANTS, *supra* note 164, at 1; I.R.C. § 6707A(c); see also discussion *supra* Part I.B.1.b.ii.

198. The \$200,000 was arrived at by multiplying the \$50,000 penalty by the four transactions.

199. ROLE OF ACCOUNTANTS, *supra* note 164, at 3.

200. See I.R.C. § 6707(b)(2).

activity that has been listed by the IRS as an abusive transaction. It seems unlikely that a professional firm of any standing would recommend such a transaction. Nevertheless, assuming that a professional firm chooses to engage in promoting listed transactions and fails to furnish required information, the penalty is fifty percent of the gross income derived by the promoter.<sup>201</sup> It is interesting to note that the new rules allow a tax advisor who promotes transactions listed by the IRS as abusive, and who further fails to disclose as required by the rules, to retain half of the gross income collected by the advisor in relation to the transactions.

*b. Promotion.*—The Jobs Act also addresses § 6700 promotion penalties. Amended § 6700(a) provides for an increased penalty in an amount equal to fifty percent of the gross income derived from such activity by the person upon whom the penalty is imposed.<sup>202</sup> Under this new rule, even assuming that tax advisors involved in promoting future tax products intentionally made qualifying false or fraudulent statements, the penalty for making such a statement in connection with any of the investment plans generally does not exceed one half of the fees derived from promoting the transactions.<sup>203</sup> Again, together the four products generated fees for KPMG in excess of \$124 million.<sup>204</sup> Under the new rule, if KPMG engaged in similar activities, KPMG would be subject to penalties in an amount approximately equal to \$62 million. Although this penalty is substantially higher than the penalties imposed under prior law, the penalty allows future shelter promoters to retain half of the total fees collected in relation to their activities. While the penalty would serve as a deterrence to some promoters, others may view it only as a cost of doing business.<sup>205</sup>

The penalty for aiding and abetting with respect to an individual's tax liability is \$1000.<sup>206</sup> The penalty increases to \$10,000 if the aiding and abetting is with respect to a corporation's tax liability.<sup>207</sup> Again, KPMG's fees were in excess of \$124 million.<sup>208</sup> If, for this purpose, we assume that there were 500 corporate taxpayers that had relied on the transactions to report reduced federal income taxes on their returns, the penalties imposed on KPMG for aiding and abetting would amount to no more than \$5 million. The \$5 million penalty would represent slightly more than four percent of the overall fees collected by

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201. *Id.* § 6707(b)(2)(B). The penalty increases to seventy-five percent where the transaction in question is a listed transaction and the taxpayer intentionally disregards the disclosure rule.

202. *Id.* § 6700(a)

203. *See id.*

204. ROLE OF ACCOUNTANTS, *supra* note 164, at 3.

205. *See* 150 CONG. REC. S11,191-203 (Oct. 11, 2004) (statement of Senator Levin indicating: "The amendment . . . , which became part of the Senate bill, set the penalty on an abusive tax shelter promoter at 100 percent of the fees earned from the abusive shelter. . . . But that provision was cut in half in this conference report, setting the penalty at 50 percent of the fees earned, meaning the promoters of abusive shelters get to keep half of their gain.").

206. I.R.C. § 6701(b)(1).

207. *Id.* § 6701(b)(2).

208. ROLE OF ACCOUNTANTS, *supra* note 164, at 3.

KPMG in the transaction. While four percent of the fees collected is not meaningless, it would also not appear to be the kind of penalty that might persuade would-be tax shelter promoters from engaging in promotion activities.

### III. FOCUSING ON THE ETHICAL PROBLEM

Scholars and commentators have attempted to explain the recent increase in tax shelter activity by focusing on congressional inactivity, inadequacies in the judicially created tests for identifying tax motivated transactions, and an apparent failure on the part of practitioners to respect the relevant ethical rules imposed upon the profession. One commentator notes the recent resurgence of tax sheltering activity arguing that a “confluence of astonishing taxpayer sophistication and a host of tax avoidance opportunities buried in a bewilderingly complex [Code], along with a sentiment that the Code has become fundamentally unfair,” has induced taxpayers to engage in tax motivated transactions.<sup>209</sup> The same commentator suggests the solution may lie not in attacking taxpayers’ abilities to avoid or evade taxes, but in reducing their willingness to do so. Further, this “may require fundamentally rethinking U.S. taxation principals to focus on economic income or to abandon income as a tax base altogether.”<sup>210</sup> In relation to judicial efforts, the United States Supreme Court appears to be reluctant to provide further guidance as to the definition of a sham transaction.<sup>211</sup>

Commentators have also pointed to the shift in the manner in which courts should interpret statutes focusing on textualist versus non-textualist points of view.<sup>212</sup> Generally, under the former theory, a textualist “searches for the meaning of words used in a statute,” examining the text only.<sup>213</sup> In contrast, “non-textualists attempt to give effect to the legislature’s intent by looking beyond the text of the relevant statute for evidence of that intent.”<sup>214</sup> One commentator argues that under “the Supreme Court’s recent trend of resolving tax cases using textualist interpretation methods, it is doubtful that the Court

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209. *Governmental Attempts to Stem the Rising Tide*, *supra* note 147, at 2249, 2254-55.

210. *Id.* at 2250-51.

211. *See, e.g.*, *Winn-Dixie, Inc. v. Comm’r*, 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, 535 U.S. 986 (2002); *Del Commercial Props. v. Comm’r*, 251 F.3d 210 (D.C. Cir. 2001), *cert. denied*, 534 U.S. 1104 (2002); *ASA Investertings P’ship v. Comm’r*, 201 F.3d 505 (D.C. Cir.), *cert. denied*, 531 U.S. 871 (2000); *ACM P’ship v. Comm’r*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999); *Gardner v. Comm’r*, 954 F.2d 836 (2d Cir.), *cert. denied sub nom.* *Falk v. Comm’r*, 504 U.S. 910 (1992); *Cook v. Comm’r*, 941 F.2d 734 (9th Cir.), *cert. denied*, 502 U.S. 857 (1991); *Lerman v. Comm’r*, 939 F.2d 44 (3d Cir.), *cert. denied*, 502 U.S. 984 (1991) *Herrington v. Comm’r*, 854 F.2d 755 (5th Cir. 1988), *cert denied*, 490 U.S. 1065 (1989).

212. *See* Allen D. Madison, *The Tension Between Textualism and Substance-Over-Form, Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699, 702-03 (2003).

213. *Id.* (citing Antonin Scalia, *Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, in *A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW* 23 (Amy Gutmann ed., 1997).

214. Madison, *supra* note 212, at 212.

would allow the standard sham transaction doctrine, the business purpose doctrine [or other judicially developed doctrines addressing tax motivated transactions] to stand.”<sup>215</sup> Further, the commentator argued that the judicially created doctrines inappropriately override the text of the Code.<sup>216</sup> As such, the commentator concludes that if the Supreme Court were to overturn the judicially created sham doctrines, the goals of textualism would be served and more certainty would be imported into the tax law.<sup>217</sup>

Another commentator, Richard Lavoie, notes that strict statutory construction, as advanced by Justice Scalia and other Justices of the Supreme Court, is premised on a flawed perception that “ignores the law’s cultural connection.”<sup>218</sup> He argues that “[g]rowing acceptance of [textualism] within the judiciary has resulted in our society’s laws becoming increasingly detached from our morals.”<sup>219</sup> As such, “[i]ndividuals are freer to pursue actions offending our collective morality than in the recent past.”<sup>220</sup> This, he argues, is because “the legal constraints on such actions are no longer permitted to draw strength from the moral constraints.”<sup>221</sup> He argues that “tax shelter activity is completely ethical and appropriate under [the textualist approach] since the purpose of the law is irrelevant as long as the literal language of the statute is obeyed.”<sup>222</sup>

This commentator first concludes that an attempt to reform tax law on an “ad-hoc basis” against each particular tax shelter is a losing battle due to the complexity of our tax system.<sup>223</sup> He argues that reforming the Tax Bar is also not likely to succeed under the textualist legal landscape because of the lucrative nature of tax shelter activities and the apparent acceptance of form over substance under the textualist approach.<sup>224</sup> Instead, reform must be focused on the judiciary.<sup>225</sup> As one solution, the commentator advocates that the legislature alter judicial behavior by adopting a “statutory general anti-abuse rule . . . effectively requir[ing] that the judiciary interpret the Code in light of its purpose and intent.”<sup>226</sup> “Once the traditional approach to statutory construction is reaffirmed,” so the argument goes, “the numerous constraints on unethical behavior that were weakened under [the textualist approach] should revive” and unethical behavior should correspondingly decrease.<sup>227</sup>

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215. *Id.* at 749.

216. *Id.*

217. *Id.* at 750.

218. Richard Lavoie, *Subverting the Rule of Law: The Judiciary’s Role in Fostering Unethical Behavior*, 75 U. COLO. L. REV. 115, 118 (2004).

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.* at 183-84.

223. *Id.* at 188.

224. *Id.* at 190.

225. *Id.* at 192-94.

226. *Id.* at 193-94.

227. *Id.* at 195.

Although both commentators address the rise of textualism in the judiciary as it relates to the judicially created sham transaction doctrine and tax shelter activities in general, they land at opposite ends of the spectrum. The first commentator accepts textualism and concludes that the judiciary should refrain from injecting its own interpretation of Congress's intent into the law in relation to tax shelters.<sup>228</sup> The second commentator, Lavoie, argues that by adhering to textualism, the judiciary has opened the door to manipulation and abuse of the literal meaning of the Code.<sup>229</sup> He argues by minimizing or eliminating the judiciary's ability to interpret the meaning of the law, the Code is open to strained interpretations that result in the allowance of tax motivated transactions.<sup>230</sup> In order to avoid this outcome, he proposes that Congress should codify the anti-abuse doctrines and enact a statute that induces the judiciary to engage in applying the Code based upon the intent of Congress in enacting the Code.<sup>231</sup> Thus, Lavoie would encourage the continued application of the judicially developed economic substance doctrines. He predicts that taxpayers contemplating engaging in sham transactions would be dissuaded by the increased risk that they would be found to be in violation of the substance of the law, rather than the letter of the law which is subject to manipulation.<sup>232</sup>

It is certainly possible that the recent trend toward a textualist approach within the Supreme Court is partially responsible for the increase in tax motivated transactions and the apparent ethical failure amongst tax advisors practicing in front of the Internal Revenue Service. However, this theory seems unlikely in that it contemplates that taxpayers believe the Supreme Court, if presented with a sham transaction, would not rely on its time tested decisions in *Gregory* and *Knetsch*.<sup>233</sup>

Similarly, the textualist theory presupposes that the judiciary's desire or ability to interpret the intent and meaning of the law has devolved to a point where the Court would only apply the rigid meaning of the Code without looking at the intent of the statute as required under the holding in *Gregory*.<sup>234</sup> Under the textualist theory, taxpayers would also have to conclude that the common law sham transaction doctrines no longer apply and that there has been a change at the very foundation of the Supreme Court's espousal of the rule in 1935 in its opinion in *Gregory*. No longer would a question for determination in sham cases be whether what was done, apart from the tax motive, was the thing which the statute intended.<sup>235</sup> For almost seventy years the Supreme Court has left unchanged, and the courts of appeal have diligently applied, some form of this

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228. See Madison, *supra* note 212, at 749.

229. Lavoie, *supra* note 218, at 118.

230. *Id.* at 192-94.

231. *Id.* at 193.

232. *Id.* at 195.

233. See discussion *supra* Part I.A.1.

234. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

235. *Id.*

rule.<sup>236</sup> It is unreasonable to conclude that the Supreme Court would turn so abruptly away from this well reasoned rule. It is equally hard to imagine that taxpayers who contemplate engaging in a tax motivated transaction do not give credence to this rule which has been so consistently applied.

The increased activity is certainly due in part to an ethical lapse primarily caused by a group of professionals who do not adhere to the ethical rules imposed upon the profession. However, it is also likely that the increase in tax motivated transactions is due in part to the weakness in the economic substance prong of the sham transaction analysis allowing promoters to issue opinions that, at a minimum, operate to abate penalties as described earlier. A statement made in the report by the Minority Staff of the Senate Governmental Affairs Permanent Investigations Subcommittee frames the ethical scenario quite well. In summarizing the Committee's findings in relation to KPMG's recent tax shelter activities, the Report included the following statement:

The tax products featured in this Report were developed, marketed, and executed by highly skilled professionals in the fields of accounting, law, and finance. Historically, such professionals have been distinguished by their obligation to meet a higher standard of conduct in business than ordinary occupations. When it came to decisions by these professionals on whether to approve a questionable tax product, employ telemarketers to sell tax services, or omit required information from a tax return, one might have expected a thoughtful discussion or analysis of the firm's fiduciary duties, its ethical and professional obligations, or what should be done to protect the firm's good name. Unfortunately, evidence of those thoughtful discussions was virtually non-existent and considerations of professionalism seem to have had little, if any, effect on KPMG's mass marketing of its tax products.<sup>237</sup>

Again, while the report focuses on the actions of KPMG, the report also confirms the participation of a number of other consultants in the promotion and execution of tax shelters. These activities are so well documented in the report

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236. *But see* *Gitlitz v. Comm'r*, 531 U.S. 206 (2001) (taxpayer received a double benefit under the plain reading of the Code). In *Gitlitz*, Justice Thomas found that the Code's "plain text" required the Court to uphold a tax loophole despite Justice Breyer's assertion that policy favored reading the statute to prevent the use of the loophole. *Id.* at 220, 223. *See also* Madison, *supra* note 212, at 740 (pointing out that the Supreme Court's plain reading in *Gitlitz* reveals a swing to the textualist approach in that it allowed a taxpayer to obtain a double tax benefit which has historically never been allowed even if the Code supported such treatment); Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 863-84 (1982) (criticizing the economic substance doctrine, arguing that the doctrine's articulation and the outcomes of cases such as *Gregory* and *Goldstein*, are incorrect and are the consequence of judicial ambition or impatience); *Coltec Indus. v. United States*, 62 Fed. Cl. 716, 756 (2004) ("Under our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare.").

237. ROLE OF ACCOUNTANTS, *supra* note 164, at 16.

that little doubt is left that there is a systematic involvement of a wide variety of professions in varying industries in tax shelter promotion. The Report reveals a consistent abuse of law and ethics by many participants. The abuses are a result of the unlawful, unethical, and aggressive nature in which such firms are marketing highly structured tax motivated transactions.

#### IV. SPECIFIC ETHICAL ISSUES

Again, using the facts surrounding the Committee's investigation into recent tax shelter activities as a case study, the activities of KPMG, the law firm, and other professionals appear to be in violation of the ABA Model Rules of Professional Conduct (MRPC) that govern the practice of law and also appear to be in violation of Circular 230 governing practice in front of the IRS. It is important to note in relation to the following discussion that while certain provisions of the Jobs Act addressed the disqualification of opinions under various circumstances, such provisions are intended to focus on a taxpayer's ability to avoid understatement penalties under certain circumstances. The following discussion addresses the current ethical rules in relation to practitioners who seek to advise in the area of tax motivated transactions. In relation to tax practitioners, the Jobs Act made one important amendment to Circular 230 which the following discussion addresses.

##### A. *Rules of Professional Conduct*

Some courts may consider Sidley Austin Brown & Wood's tax opinions provided to various taxpayers to be incompetent under the MRPC. MRPC Rule 1.1 provides that a lawyer shall provide competent representation to a client.<sup>238</sup> Competent representation requires the legal knowledge, skill, thoroughness, and preparation necessary for the representation.<sup>239</sup> Generally, "competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem."<sup>240</sup>

The prototype tax opinion contained no application of facts to the law.<sup>241</sup> A determination as to whether the proposed transactions marketed by KPMG met both prongs of the sham transaction analysis requires a lengthy analysis of whether a pre-tax profit or a nontax business purpose exists. While Sidley Austin Brown & Wood's tax opinion addressed the law in relation to economic substance and business purpose, the opinion relied solely on a representation on the part of the client and the investment advisors that there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions. No specific facts supporting the conclusion that the transaction would meet the two pronged sham transaction analysis were indicated in the opinion. In fact, according to the

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238. MODEL RULES OF PROF'L CONDUCT R. 1.1 (2003).

239. *Id.*

240. *Id.*, cmt. 5.

241. See ROLE OF ACCOUNTANTS, *supra* note 164, at 11; see also KPMG's Tax Opinion Letter, *supra* note 173.

Report, the evidence provided to the Committee indicated that KPMG obtained the client's opinion letter from the law firm and delivered it to the client without the client actually speaking to any of the lawyers at the law firm.<sup>242</sup> The lack of any apparent communication with the client or independent analysis of the facts by the law firm would appear to completely disregard the Rule 1.1's requirement that there be an inquiry into the factual elements of the legal problem.

### B. Circular 230

Section 330 of Title 31 of the United States Code authorizes the Secretary of the Treasury to regulate the practice of representatives before the Treasury Department.<sup>243</sup> Thus, under federal law, the Treasury Department has the right to promulgate rules of practice and to censure, including suspension or termination of practice rights, individuals who are authorized to practice before the IRS for incompetent or disreputable conduct.<sup>244</sup> Certified public accountants and attorneys are among those who are authorized to practice in front of the IRS.<sup>245</sup> The Treasury Department regulations governing the practice of certified public accountants, attorneys, and other professionals in front of the IRS are found at Title 31 of the Code of Federal Regulations, Subtitle A, part 10 and these rules are commonly referred to as "Circular 230."<sup>246</sup> Representatives of KPMG<sup>247</sup> and Sidley Austin Brown & Wood are subject to the rules under Circular 230 governing the practice of accountants and lawyers in front of the IRS.

On December 20, 2004, the Department of the Treasury finalized new

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242. ROLE OF ACCOUNTANTS, *supra* note 164, at 93.

243. See 31 U.S.C. § 330 (2000).

244. See 31 C.F.R. § 10.50 (2005); see also Steven C. Salch, *Tax Practice Ethics: Practitioner Discipline and Sanctions*, SH080 ALI-ABA 543, 547 (2003).

245. See 31 C.F.R. § 10.3(b).

246. See *id.* § 10.0.

247. The issue of whether KPMG or representatives of KPMG are subject to the rules of professional conduct imposed by each state relates to whether professionals representing KPMG are "engaged in the practice of law" under the relevant rules of each state. Generally, engaging in the practice of law in any manner, unless licensed or authorized, is statutorily prohibited. See, e.g., *Florida Bar v. Sperry*, 140 So. 2d 587, 588 (Fla. 1962); *N.Y. County Lawyers Ass'n v. Bercu*, 78 N.Y.S.2d 209, 211 (1948). For example, the State of New York follows the "incidental" or "public interest" approach. 78 N.Y.S.2d at 216, 220. The incidental approach as applied in New York allows a certified public accountant to perform legal services or give legal advice to clients that are incidental to the accountant's work. *Id.* For example, an accountant employed to keep a taxpayer's books, audit taxpayer's financials, or file his tax returns would be permitted to answer legal questions arising out of and incidental to the accounting work. *Id.* To the extent that a CPA firm has been retained to provide tax return services to a client, the CPA firm would appear to be authorized to provide advice arising out of filing of the client's return. It is unclear whether a CPA appropriately providing tax advice to a client in relation to preparation of the client's return is subject to the New York rules of professional conduct.

regulations under Circular 230 (the “New Regulations”).<sup>248</sup> Prior to the effective date of the New Regulations, old section 10.33(a) specifically required diligence as to accuracy of the facts surrounding a tax shelter<sup>249</sup> opinion<sup>250</sup> and provided that a practitioner who provides a tax shelter opinion analyzing the federal tax effects of a tax shelter investment shall comply with several requirements.<sup>251</sup> Old section 10.33(a)(1) pertained to factual matters and required among other things that “a practitioner must make inquiry as to all relevant facts, be satisfied that the material facts are accurately and completely described in the offering materials, and assure that any representations as to future activities are clearly identified, reasonable and complete.”<sup>252</sup> The KPMG and Sidley Austin Brown & Wood tax opinions did not identify any specific facts in relation to the client. The opinions do not reflect any effort on the part of KPMG or Sidley Austin Brown & Wood to inquire as to any of the relevant facts surrounding the transaction. Rather, the opinions avoid any actual application of existing law to specific facts, apparently transferring the risk of such analysis to the prospective client, which is required to represent that they have done that analysis.

Old section 10.33(a)(1)(ii) provided that a practitioner could not accept as true “asserted facts pertaining to the tax shelter which he/she should not, based on his/her background and knowledge, reasonably believe to be true.”<sup>253</sup> However, under old section 10.33 a practitioner was not required to “conduct an audit or independent verification of the asserted facts, or assume that a client’s statement of the facts could not be relied upon, unless he/she had reason to believe that any relevant facts asserted to him/her were untrue.”<sup>254</sup> Under the old

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248. T.D. 9165, 69 Fed. Reg. 75839 (Dec. 20, 2004).

249. See 31 C.F.R. § 10.33(c)(2) (defining a “tax shelter” as, among other things, “an investment which has as a significant and intended feature for Federal income or excise tax purposes either of the following attributes: (i) Deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or . . .”) (current section 10.33 will be replaced by new section 10.33 effective 180 days after publication of the new regulations in the federal register).

250. See *id.* § 10.33(c)(3) (generally defining a “tax shelter opinion” as “advice by a practitioner concerning the Federal tax aspects of a tax shelter either appearing or referred to in the offering materials, or used or referred to in connection with sales promotion efforts, and directed to persons other than the client who engaged the practitioner to give the advice. The term includes the tax aspects or tax risks portion of the offering materials prepared by or at the direction of a practitioner, whether or not a separate opinion letter is issued or whether or not the practitioner’s name is referred to in the offering materials or in connection with the sales promotion efforts. In addition, a financial forecast or projection prepared by a practitioner is a tax shelter opinion if it is predicated on assumptions regarding Federal tax aspects of the investment, and it meets the other requirements of the first sentence of this paragraph”) (current section 10.33 will be replaced by new section 10.33 effective 180 days after publication of the new regulations in the federal register).

251. *Id.* § 10.33(a) (former regulation, still currently in effect).

252. *Id.* § 10.33(a)(1)(i) (former regulation, still currently in effect).

253. *Id.* § 10.33(a)(1)(ii) (former regulation, still currently in effect).

254. *Id.*

rule, the IRS could determine that representatives of KPMG who promoted various tax products and provided opinions could not have concluded on the veracity of facts where none were established. On the other hand, the exception in the rule relieving the practitioner of the duty to verify facts left this conclusion in question. It would appear also that where no facts were adduced in arriving at an opinion, but rather the client represented facts, neither KPMG nor Sidley Austin Brown & Wood were required to conduct an audit or independently verify asserted facts. Under the exception provided in the rule, it is ambiguous as to whether the opinion provider could rely on the representation by the client of the ultimate facts needed to arrive at an opinion.

The question then becomes whether representatives of both KPMG and Sidley Austin Brown & Wood had an obligation to verify whether the ultimate facts relating to economic substance asserted in the representations by the taxpayers in the opinions were accurate. Stated otherwise, did the professional firms have an affirmative obligation to verify that there was a reasonable opportunity to earn a reasonable pre-tax profit from the transaction in excess of all associated fees and costs?

Notice 84-4, originally adding old section 10.33 to the regulations, contains specific comments in relation to due diligence as to factual matters.<sup>255</sup> The notice indicates the applicable standards in this area generally were the same as those set forth in ABA Formal Opinion 346.<sup>256</sup> ABA Formal Opinion 346 provided that:

[T]he lawyer should . . . make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry. The extent of this inquiry will depend in each case upon the circumstances; for example, it would be less where the lawyer's past relationship with the client is sufficient to give him a basis for trusting the client's probity than where the client has recently engaged the lawyer, and less where the lawyer's inquiries are answered fully than when there appears a reluctance to disclose information.

Where the lawyer concludes that further inquiry of a reasonable nature would not give him sufficient confidence as to all the relevant facts, or for any other reason he does not make the appropriate further inquiries, he should refuse to give an opinion. However, assuming that the alleged facts are not incomplete in a material respect, or suspect, or in any way inherently inconsistent, or on their face or on the basis of other known facts open to question, the lawyer may properly assume that the facts as related to him by his client, and checked by him by reviewing such

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255. I.R.S. Notice 84-4, 1984-1 C.B. 331 (1984).

256. *Id.*

appropriate documents as are available, are accurate.<sup>257</sup>

The spirit of ABA Formal Opinion 346 is not to simply accept a representation of the ultimate fact from a client which the firm issuing the opinion had no prior contact with. Rather, in those instances where KPMG had no previous contact or relationship with a client that purchased a tax product from KPMG, it would have been incumbent upon KPMG to inquire as to all relevant facts which would allow KPMG to ultimately conclude that the transaction proposed in the tax product had economic substance. Further, the spirit of Formal Opinion 346 appears to indicate that the exception to verifying the facts only exists where the facts are not incomplete or inconsistent. In the case of a tax product such as those promoted by KPMG, it is unlikely that either KPMG or Sidley Austin Brown & Wood could conclude that the facts were so complete and consistent that there was no need to further investigate.

Apparently recognizing a deficiency in the current rules, on December 8, 2004, the IRS approved final regulations containing several changes and amendments to Circular 230.<sup>258</sup> The final regulations replace old section 10.33 with a new section 10.33 containing a set of “best practices” for all tax advisors. The purpose of new section 10.33 is to restore, promote, and maintain the public’s confidence in the honesty and integrity of the professionals providing tax advice.<sup>259</sup>

In order to accomplish this goal, new section 10.33 provides, among other things, a number of statements that are purely aspirational.<sup>260</sup> Section 10.36(a)

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257. ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 346 (1982).

258. T.D. 9165, 69 Fed. Reg. 75839 (Dec. 20, 2004) (approved Dec. 8, 2004).

259. *Id.*

260. Specifically, new section 10.33 will provide:

Best practices for tax advisors.

(a) *Best practices.* Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service . . . best practices include the following:

(1) Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client’s expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

(2) Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations relating to applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.

(3) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.

(4) Acting fairly and with integrity in practice before the Internal Revenue Service.

*Id.* at 3.

generally provides that firms engaged in providing advice concerning tax issues or preparing submissions to the IRS should take reasonable steps to ensure that the firm's procedures are consistent with the best practices.<sup>261</sup> However, section 10.36(a) does not subject practitioners to discipline for failing to comply.

While laudable, the aspirational list of best practices is unlikely to thwart tax shelter activity. In its investigation, the Report issued by the Senate Subcommittee Minority Staff indicates that KPMG took measures to hide its tax product activities from the IRS and the public.<sup>262</sup> As of the date of the Report, despite having an inventory of 500 tax products, KPMG had never registered, and thereby never disclosed to the IRS the existence of, a single one of its tax products.<sup>263</sup> The Report indicates that KPMG professionals concluded that KPMG should ignore the federal tax shelter requirements, even if required by law, because the penalties associated with the failure to comply were substantially less than the fees received from clients engaging KPMG to implement its tax products.<sup>264</sup> Penalties associated with failure to disclose under the Jobs Act continue to be substantially less than the fees received from clients. If tax shelter promoters are primarily concerned with the penalty cost versus fee benefits of promoting shelters, it would appear unlikely that they will alter their activities based upon the breach of aspirational ethical considerations.

While new section 10.33 is aspirational, new section 10.35 contains specific requirements for "covered opinions" that, if not respected, will subject practitioners to discipline under the rules.<sup>265</sup> The new rules replace old section 10.33 with new section 10.35 prescribing diligence requirements for practitioners providing covered opinions.<sup>266</sup> New section 10.35(c)(1)(ii) and (iii) state:

(ii) The practitioner must not base the opinion on any unreasonable factual assumptions (including assumptions as to future events). An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such a projection, financial forecast or appraisal. The opinion must identify in a separate section all factual assumptions relied upon by the practitioner.

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261. 31 C.F.R. § 10.36 (2005).

262. *See* ROLE OF ACCOUNTANTS, *supra* note 164, at 10.

263. *Id.*

264. *See id.* at 13.

265. *See* 31 C.F.R. § 10.52(a).

266. *Id.* § 10.35(a), (c)(1).

(iii) The practitioner must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. For example, a practitioner may not rely on a taxpayer's factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete. The opinion must identify in a separate section all factual representations, statements or findings of the taxpayer relied upon by the practitioner.<sup>267</sup>

Additionally, the new regulations require practitioners to relate the applicable law to the relevant facts and prohibit practitioners from assuming the favorable resolution of any material federal tax issue or otherwise base opinions on unreasonable legal assumptions, representations, or conclusions.<sup>268</sup> For instance, under section 10.35 the IRS attempts to prevent practitioners from relying upon client representations as to the factual existence of a business purpose and economic substance of a transaction.

Further, the new regulations attempt to identify the characteristics of covered tax shelter style opinions and require practitioners to: (1) identify and consider all relevant facts and not rely on any unreasonable factual assumptions or representations; (2) relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts and not rely on any unreasonable legal assumptions, representations, projections, or conclusions; (3) consider all material federal tax issues and reach a conclusion, supported by the facts and the law, with respect to each material federal tax issue; and (4) provide an overall conclusion as to the federal tax treatment of the tax shelter item or items and the reasons for that conclusion.<sup>269</sup> All of these requirements help clarify the existing ethical requirements for issuing tax shelter opinions.

However, the existing and new regulations again fall short of seriously dissuading participants in the tax shelter promotion arena from continuing to issue opinions similar to those recently issued by KPMG and Sidley Austin Brown & Wood. The suggested changes to Circular 230 do not directly target the apparent unethical behavior associated with the issuance of a "covered" tax shelter styled opinion that does not meet the standard of a transaction with economic substance and a legitimate nontax business purpose. Rather, the new rules attempt to outline what content is required in a tax shelter opinion to pass under the ethical rules. Absent is any definition of what constitutes an unacceptable opinion in relation to the relevant legal standard for purposes of the ethical rules.

Also absent from the existing regulations are any sanctions for issuance of

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267. *Id.* § 10.35(c)(1)(ii)-(iii).

268. *Id.* § 10.35(c)(2).

269. *Id.* § 10.35(c).

a tax shelter opinion that improperly concludes that the transaction has either economic substance and/or a legitimate nontax business purpose. Apparently recognizing the absence of any monetary sanctions in the regulations or a lack of any authority to sanction practitioners, Congress did in fact amend § 330(b) of Title 31 via the Jobs Act to authorize the Secretary to impose a monetary penalty on individuals practicing in front of the Treasury Department.<sup>270</sup> Section 330(b) now specifically provides:

The Secretary may impose a monetary penalty on any representative described in the preceding sentence. If the representative was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to such penalty, the Secretary may impose a monetary penalty on such employer, firm, or entity if it knew, or reasonably should have known, of such conduct. Such penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty and may be in addition to, or in lieu of, any suspension, disbarment, or censure of the representative.<sup>271</sup>

Importantly, the sanction is limited to situations where the practitioner is found to be incompetent, disreputable, in violation of regulations prescribed under Circular 230, or who is found to have willfully and knowingly threatened or mislead the person being represented with intent to defraud.<sup>272</sup> While no regulatory guidance has yet been issued in relation to the amendment, it is clear that the Secretary of the Treasury now has authority to impose a monetary sanction on those who practice in front of the IRS. To the extent that would-be tax shelter promoters can be held liable for the sanctions up to an amount equal to one hundred percent of the fees collected, this sanction in and of itself may operate to dissuade promoters much more than the new penalty provisions within the Jobs Act.

Other than the possibility of being sanctioned under amended § 330, there is little in the amendments to Circular 230 that will deter practitioners from issuing tax shelter opinions that meet the requirements of section 10.35 but do not meet the applicable judicial standards. Worse yet, the current standards under Circular 230 are less stringent than requirements under the Jobs Act in relation to opinions issued by tax advisors that will support an argument that the taxpayer meets the reasonable cause exception.

## V. PROPOSED SOLUTION

On January 31, 2004, the Chief of Staff of the Joint Committee on Taxation (the "Chief of Staff") asked members of the American Bar Association Section of Taxation to comment upon how lawmakers should address tax shelter

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270. See 31 U.S.C. § 330(b) (West, WESTLAW through P.L. 109-2, Feb. 18, 2005).

271. *Id.*

272. *Id.*

transactions.<sup>273</sup> In his speech, the Chief of Staff indicated that disclosure is not enough to tackle the kinds of tax shelters that are being marketed.<sup>274</sup> He indicated that a substantive change in the law is required and the change should take the form of a general standard rather than a specific rule. The Chief of Staff indicated that standards are deficient because they lack certainty and involve discretion.<sup>275</sup> Finally, he indicated that the solution should lack such disadvantages.<sup>276</sup> The new provisions within the Jobs Act do not have such qualities. They do not take the form of a general standard. Rather, they appear to be a group of specific rules that increase the focus on, among other things, disclosure and the dollar amounts of the penalties.<sup>277</sup>

The sham transaction doctrine contemplates a determination of whether the transaction itself has economic substance and a legitimate nontax business purpose. The analysis unavoidably requires uncertainty and discretion. Tax shelter opinions invariably arrive at a conclusion that the proposed transaction more probably than not satisfies either or both the business purpose and the economic substance requirement. But in many instances, the courts and the IRS have determined that the very same transactions opined upon are abusive sham transactions. The facts surrounding the development, purchase, implementation and ultimate determination that a tax product is a sham occurs over and over again, and with taxpayers historically avoiding payment of any penalty for engaging in such conduct.

Under the new law, taxpayers who would engage in tax motivated transactions may or may not be more likely to obtain an opinion from a tax advisor depending on whether they are induced to disclose under the new rules. Further, if disclosure is made, opinions sought will likely be more replete with facts to support opinion conclusions. However, even assuming these desirable consequences come to pass, aggressive taxpayers and their advisors are likely to be more focused on the decision of whether they will disclose. Taxpayers may disclose and argue that the transaction is not a sham in court under the judicially created doctrines. Given the low threshold that is needed to meet the economic substance prong of the sham transaction doctrine, taxpayers will perceive a reasonable probability of success. On the other hand, if sufficient tax dollars are at stake, they may choose not to disclose the transaction, increase the odds against the IRS's discovery of the transaction, and position for the same contest in court. In this case, the odds of success will be the same but the stakes will be higher pursuant to the increased understatement penalties which may be unavoidable if the taxpayer loses in court.

The IRS's main Code deterrent with respect to the taxpayer is the imposition

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273. See George K. Yin, Remarks at American Bar Association Tax Law Conference (Jan. 31, 2004); *JCT's Yin Requests Tax Bar Suggestions on How to Address Shelters*, 2004 TAX NOTES TODAY 22-14.

274. *Id.*

275. *Id.*

276. *Id.*

277. *Id.*

of the twenty or new thirty percent accuracy-related penalty under §§ 6662 and 6662A. The imposition of the twenty or thirty percent penalty may still be thwarted in the tax shelter arena by the fact that the taxpayer has disclosed the transaction and obtained an appropriate opinion from a qualified tax advisor. Given the multitude of extremely complex transactions that are created and promoted by highly educated professional advisors, the new laws may induce a large quantity of disclosures. If widespread disclosure is indeed the result, an already understaffed and under-funded IRS may find it hard to procure sufficient resources to analyze and pursue every transaction disclosed. Alternatively, given the aggressive nature of taxpayers as evidenced in the Committee's 2002 Report, the possibility remains if the tax dollars are sufficiently high, that taxpayers will choose not to disclose and rely upon their prospects of success in arguing under the judicial doctrine that the transaction is not a sham. Regardless of the IRS's resources, without clarification via codification of the judicially created economic substance doctrine, it will be an uphill task for the IRS to challenge transactions wherein a taxpayer asserts that it has satisfied the economic substance doctrine—whether or not disclosure took place.

It is for these reasons that the author recommends codification and clarification of the economic substance prong of the sham transaction doctrine. The proposed codification by the Senate in the Jobs Act, requiring that a taxpayer prove that the present value of expected pre-tax profit is substantial in relation to the expected net tax benefits, would have a positive deterrent effect.<sup>278</sup> This is due to the fact that taxpayers would not be able to argue that a transaction has economic substance where there is only a slim possibility that nontax profits will exceed transaction costs.

Further, the § 6662A penalty provisions, applicable to taxpayers, and Circular 230, applicable to practitioners, create a symbiotic relationship between taxpayers who seek to engage in tax shelter transactions and practitioners who seek to advise and opine upon such transactions. Congress has recognized this relationship and taken an initial step toward solving the problem by amending the Code to authorize the Secretary of the Treasury to impose a monetary sanction on practitioners who practice before the IRS.<sup>279</sup> While this step is highly commendable, it continues, in the author's opinion, to fall short of actually penalizing practitioners. This is because promoters who practice in front of the IRS may abide by the rules and regulations under Circular 230 and avoid the possibility of a total 100% sanction. At the same time, such promoters can continue to choose not to disclose in violation of the new disclosure requirements. However, it is not clear whether a failure to disclose a transaction would amount to an action that is found to be, for instance, incompetent, disreputable, or in violation of regulations prescribed under Circular 230. Thus, it is possible for taxpayers and practitioners to avoid detection through nondisclosure and, if caught, be found to be in violation of the Internal Revenue Code but not the Circular 230 rules.

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278. See *supra* Part I.B.1.a.

279. See 31 U.S.C. § 330(b) (West, WESTLAW through P.L. 109-2, Feb. 18, 2005).

One method of remedying this shortfall which leaves less discretion or uncertainty is to treat the relationship between a practitioner that issues a tax shelter opinion and the taxpayer that relies on the opinion as interconnected in relation to the Circular 230 sanction and Code penalty provisions. This can be accomplished, for example, by imposing the new monetary sanctions upon practitioners who issue tax opinions with respect to transactions that are later determined to be in violation of the disclosure provisions applicable to tax advisors under the Internal Revenue Code. In instances where a taxpayer and his or her advisor decide not to disclose the transaction, the taxpayer would be subject to the increased thirty percent penalty for understatements and all the fees earned by a practitioner would be forfeited under the sanction. After all, why should a tax advisor be able to avoid the monetary sanction in instances where they choose not to abide by the Code's disclosure provisions?

Further, if a disclosed transaction which is the subject of a tax shelter opinion is determined to be abusive by a court, the penalty could apply to the taxpayer or its tax advisor jointly and severally. The penalty or sanction upon a practitioner issuing such an opinion could, for example, be equal to the twenty or thirty percent understatement penalty that is otherwise being avoided by a taxpayer by obtaining a tax opinion. The imposition of this penalty may be limited only to those practitioners that engage in providing tax shelter style opinions. Thus, the penalty would not apply to those practitioners that endeavor to provide tax advice outside of the tax shelter arena.

The possibility of an ethical sanction imposed upon the practitioner plus a monetary penalty imposed jointly upon either the client or the practitioner injects a level of risk in the tax shelter arena that most practitioners and clients will not want to take unless they are quite sure of their legal analysis. The result will no longer be a simple financial wash of tax and interest that otherwise would have been paid in the absence of the transaction. Rather, a penalty will be imposed on one of the participants.

#### CONCLUSION

As revealed by the recent activities and practices of numerous professional firms, the marketing of tax motivated transactions to taxpayers has become a big business, resulting in a large cost to the federal government in the form of lost tax revenues. The success of tax shelter promoters and taxpayers who reduce their federal tax liability through the use of highly structured transactions in violation of the spirit of the tax laws undermines the integrity and fairness of the federal tax system.

The success of the promoters and taxpayers who would game the system with such transactions is due in part to the fact that the judicial doctrines developed over time to identify such transactions have not set a clear deterrence standard. Specifically, the economic substance prong of the judicially developed sham transaction requiring a minimal amount of profit allows taxpayers and their advisors to succeed in making creative but unlikely arguments under an uncertain standard. The very existence of such an argument injects sufficient uncertainty under the current Code and Treasury regulations to allow taxpayers to

consistently avoid penalties in relation to such transactions. In order to avoid this unacceptable consequence, Congress should codify and clarify the economic substance doctrine.

Further, the current regulatory regime under the Internal Revenue Code and the ethical sanctions under Circular 230 are not in harmony. Due to the unavoidable relationship between taxpayers and their advisors, the monetary sanction authority granted to the IRS under the Jobs Act should be amended to make it applicable in instances wherein an advisor ignores the requirements under the Code as well as under Circular 230.