GIMME SHELTER: HOW THE ACCOUNTANT'S CONTINGENCY FEE AND THE ATTORNEY'S OPINION LETTER HAVE CONTRIBUTED TO THE PROLIFERATION OF ABUSIVE TAX SHELTERS

I. INTRODUCTION

It has often been said that the only things certain in life are death and taxes.[1] However, the certainty of paying taxes is decreasing as a result of the growing prevalence of tax shelters.[2] Congress, in the Taxpayer Relief Act of 1997,[3] has defined a tax shelter where the "purpose of . . . [an] entity, plan or arrangement is the avoidance or evasion of Federal income tax."[4] Generally, a tax shelter is understood to be an arrangement that generates "losses" on paper in order to offset income and the corresponding "tax liability."[5] This is not to suggest that tax shelters are a new phenomenon.[6] Rather, the popularity and acceptance of tax shelters seems to have increased.[7] While there are legal ways to minimize one's tax liabilities, abusive tax shelters are typically understood to "involve transactions that, if the facts were known, would not be upheld in court."[8] One principal adverse effect of abusive tax shelters is that the federal government is denied vast funds due to the underreporting of taxable income.[9] In addition, tax

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1. *See* CHRISTINE AMMER, THE AMERICAN HERITAGE DICTIONARY OF IDIOMS 158 (indicating that Benjamin Franklin was the first to use this well-known phrase).

2. *See* Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 78 (2006) (attributing the increase in abusive tax shelters to the "financial boom of the 1990s").

3. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 26 U.S.C.).

4. *See* Donald L. Korb, *Shelters, Schemes and Abusive Transactions: Why Today's Thoughtful U.S. Tax Advisors Should Tell Their Clients To "Just Say No,"* 707 PLI/TAX 9, 14 (relying on 26 U.S.C. § 6662 (d)(2)(C) (2006)).

5. *See* Joe M. Chambers, *New Developments in the Fight Against Tax Shelters: Unethical Behavior Under Fire*, 30 J. LEGAL PROF. 117, 117 (2006) ("[T]hese transactions have no economic purpose . . . except to create losses to offset taxable income.").

6. *See* Ben Wang, *Supplying the Tax Shelter Industry: Contingent Fee Compensation for Accountants Spurs Production*, 76 S. CAL. L. REV. 1237, 1251 (2003) (indicating that shelters were also marketed to taxpayers in the 1970s and 1980s).

7. *See id.* at 1250 (noting that tax shelters have experienced "wildfire growth"). This acceptance seems evident in that some accounting agencies even advertise for the design of tax shelters. *Id.* at 1251.

8. Korb, *supra* note 4, at 15.

9. *See* Sen. Carl Levin, *Levin Bill Would Curb Abusive Tax Shelters,* TAX NOTES TODAY, Mar. 26, 2004, LEXIS, 2004 TNT 59-48, at *2 (indicating that abusive tax shelters cost the United

shelters "undermine confidence in the fairness of [the United States] tax system."[10]

While there are a number of ways the public's confidence in the tax system has eroded,[11] or how the United States Department of Treasury is denied revenue, this note will address the roles of an accountant's contingency fee and a lawyer's opinion letter in the abusive tax shelter industry.[12] Part II of this note presents an overview of tax shelters, how they are defined, how they have evolved, and how they are specifically designed. This section also examines various enforcement techniques. Part III offers an example of a tax shelter to demonstrate how a tax shelter actually works. Part IV examines the role of contingency fees and how they fuel the growth of abusive tax shelters, specifically addressing the problems posed to auditor independence. Part V addresses how attorneys, who are commissioned to write opinion letters to validate these shelters, provide a façade of legitimacy to abusive tax shelters. Additionally, Part V demonstrates that an emphasis on professional responsibility can help curb the abusive tax shelter industry. Finally, Part VI provides solutions to curb these practices in the tax shelter industry.

II. TAX SHELTERS

Part of the challenge in understanding how tax shelters operate is determining how a tax shelter is defined.[13] Once defined, it is important to remember that abusive tax shelters are not novel, and that they have evolved over time in conjunction with the very idea of taxation.[14] The evolution of shelters has led to the increasingly complex design of tax shelters to avoid heavy taxation.[15] As a result, judicial doctrines and penalties developed to counteract abusive tax shelters.[16]

States Treasury tens of billions of dollars on a yearly basis); *see also* Wang, *supra* note 6, at 1237 (estimating that annual losses to the Treasury range from $7 million to $30 million).

10. Kenneth A. Gary & Sheryl Stratton, *Stiffer Penalties, More Resources Needed to Combat Tax Shelters, Top Regulators Tell Senate*, TAX NOTES TODAY, Nov. 21, 2003, LEXIS, 2003 TNT 225-1, at *3 (quoting Internal Revenue Service Commissioner, Mark A. Everson).

11. *See* Levin, *supra* note 9, at *2 (stating that tax shelter abuses shift "the tax burden from high income corporations and individuals onto the backs of the middle class," and implying that if the middle class is going to adhere to its responsibility to pay its taxes, so should corporations and high-income individuals).

12. *See* Wang, *supra* note 6, at 1252 (explaining that a tax shelter is often accompanied by an attorney-authored opinion letter that acts as "insurance against tax penalties in case of a successful IRS attack").

13. Korb, *supra* note 4, at 14.

14. *Id.*

15. Wang, *supra* note 6, at 1250-52; Korb, *supra* note 4, at 13-14.

16. Elena Eracleous, *Losing the Audit Lottery: Corporate Tax Shelters and Judicial Doctrine*, 5 FORDHAM J. CORP. & FIN. L. 205, 209-10 (2000).

A. DEFINITION

One of the primary hurdles facing those in the regulatory capacity, such as the Internal Revenue Service (IRS), that attempt to curb the abusive tax shelter industry is defining what, exactly, is a tax shelter.[17] In fact, some scholars and judges have linked the tax shelter definitional problem with that of obscenity—they know it when they see it.[18] A tax shelter might involve "an elaborate series of formal steps [or transactions] . . . contrived to [attain] . . . an unreasonably beneficial tax result."[19] But a tax shelter usually takes advantage of a "loophole" in the law.[20]

B. EVOLUTION OF TAX SHELTERS

Taxpayers have attempted to minimize their tax liability ever since the idea of taxes came to fruition.[21] Taxpayers sought to achieve this goal through the use of tax shelters.[22] For example, one of the earliest attempts to minimize taxes was in ancient Rome, where farmers would transfer their lands to larger landowners, thereby ridding themselves of tax obligations.[23] This trend of tax avoidance continued into the Middle Ages in places like Syria where taxes could be avoided by converting to Islam.[24] Similarly, seventeenth century Russia was forced to change its laws when landlords and serfs conspired to transfer land from the latter to the former to minimize taxes.[25] In the early nineteenth century, homeowners in Charleston,

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17. Korb, *supra* note 4, at 14.

18. *Id. See generally* Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (providing the first use of the phrase "I know it when I see it" in reference to obscenity).

19. Cecilia Chui, *Regulations Against Corporate Tax Shelters: Should We Keep Them?*, 36 U.S.F. L. REV. 509, 511-12 (2002) (quoting Peter C. Canellos, *A Tax Practitioner's Perspective On Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 48 (2001)).

20. *See* Michael Hamersley, *KPMG 'Whistleblower' Testifies At Finance Hearing on Tax Shelters*, TAX NOTES TODAY, Oct. 22, 2003, LEXIS, 2003 TNT 204-35, at *2 (opining that "most tax shelters involve some contortion of the law," and such contortion of the law is often characterized by tax shelter promoters as a "loophole" even though Congress never intended a result where the law would be twisted beyond its "intended bounds").

21. Korb, *supra* note 4, at 13.

22. *Id.*

23. *See id.* (explaining that small farm-owners would transfer their land to larger landowners without forfeiting much in respect to their everyday needs). The small landowners would not lose any rights to their previously occupied house, land, or animals; they would only lose their obligation to pay the taxes. *Id.* (citing CHARLES ADAMS, FOR GOOD AND EVIL: THE IMPACT OF TAXES ON THE COURSE OF CIVILIZATION 113-14 (1994)).

24. *See id.* at 13 (illustrating that when countries such as Syria and Egypt offered landowners an opportunity to forego the land tax if they became Muslims, the conversions to Islam were so large that it robbed the area of a vast portion of their tax revenue).

25. *See id.* at 13-14 (relying on Adams' examples where a landlord would take on a peasant's debt, financing the peasant himself, and since taxes were based on the poll census, these new serfs would not be taxed because they were not on the census).

South Carolina, were subject to real estate taxes that were computed based on a house's footage that ran along the street.[26] For example, a house that was seventy feet wide would pay higher taxes than a house that was only thirty-five feet wide.[27] This tax scheme led to a number of houses that might only be "10 [feet] wide but 80 or even 100 [feet] deep."[28] Of course, a long, narrow house would incur very low taxes because of its ten-foot width, but it was not very practical if the house was a perfect rectangle, and it was for that reason that many houses may have maintained a small width which would have expanded as the house lengthened.[29]

C. DESIGN OF TAX SHELTERS

Tax shelters were once considered to be tax-planning tools for only the wealthy.[30] However, that notion has long been replaced by the reality that tax shelters are now a "thriving industry . . . being peddled, sometimes in cold-call pitches, to thousands of companies."[31] While the United States' battle with tax shelters dates back to the 1930s, the fight came to a head with the Tax Reform Act of 1986,[32] which was implemented to eliminate tax shelters altogether.[33] The shelters designed after the 1986 Act resulted in transactions that involved the use of complex financial instruments that took advantage of ambiguities or inconstancies in the law.[34] Such transactions were not intended when Congress enacted the act.[35] The complex financial instruments came to be known as tax products, where a promoter would pitch the product to unsolicited individuals who could become

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26. *Id.* at 14.

27. Korb, *supra* note 4, at 14.

28. *Id.* From the text offered by Korb, it appears these houses would simply be abnormally long rectangles. *See id.* Whether correct or not, a tax schemer in this instance might build his house in more of a trapezoid-like shape, where the side fronting the street is quite narrow, but the house's width enlarges the further in you go, much like the infield of a baseball diamond. *See id.*

29. *See id.* Therefore, a trapezoid-shaped house would maximize tax savings as well as living space.

30. Wang, *supra* note 6, at 1249.

31. *See id.* at 1250 (describing the current phenomenon of tax shelters as a collection of tax professionals "distort[ing] the tax system" as a result of their "multimillion dollar tax savings and multimillion dollar fees"). Regardless, this "hustling" now seems to be accepted. *Id.* Tax shelters are both utilized by individual taxpayers and corporations. *Id.* Distinguishing between the two is not important for purposes of this note.

32. Tax Reform Act of 1986, Pub. L. No. 99-514, 110 Stat 2085.

33. *See* Korb, *supra* note 4, at 15-16, 22 (noting that with the Revenue Act of 1937, the Roosevelt Administration tried to shore up the Code by closing a number of loopholes and explaining that the Tax Reform Act of 1986 was intended to eliminate tax shelters directed at individuals). Also, the minimum-mandatory tax originated in 1969 after twenty-one millionaires paid no taxes in 1967. *Id.* at 15-16.

34. Korb, *supra* note 4, at 23.

35. *Id.*

potential clients.[36] Subsequently, these tax products were peddled to both current and prospective clients.[37] While the various tax products were often replicated numerous times, they were usually shrouded in confidentiality agreements in an effort to remain undetected by the IRS.[38] However, the complexity of tax shelter design has not discouraged enforcement personnel from attempting to halt the spread of abusive tax shelters.[39]

D. EFFORTS TO CURB TAX SHELTERS

Courts have developed judicial doctrines in order to combat the abusive tax shelter dilemma.[40] These judicial doctrines were designed to supplement the disclosure requirements and penalties already in place by the IRS.[41] Collectively, judicial doctrines and penalties are part of a larger congressional effort to curb the tax shelter industry.[42]

1. *Judicial Doctrines*

Courts have developed judicial doctrines to hinder the spread of abusive tax shelters.[43] The two most commonly used judicial doctrines include the economic substance and the business purpose doctrines.[44] These judicial doctrines were developed as a result of the problem that many had in defining tax shelters, and they provided the courts and the IRS with some leeway to determine whether tax shelters were being designed solely for tax

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36. *Id.* at 22-23; *see also* Wang, *supra* note 6, at 1251 ("[T]oday's tax shelter promoters parse the numerous weaknesses in the tax code and devise schemes that can be pitched as 'products' to corporate prospects, . . . promoters sell . . . methodically and aggressively."). Wang defines the term "tax product" as "a device that exists solely to avoid taxes." *Id.* at 1252. A promoter is generally understood to be one that develops these tax products for sale to individuals or corporations, the promoter might be an accounting firm, a bank, or even a law firm, though "most . . . observers believe that accounting firms hold the lion's share of the market." *Id.*

37. Korb, *supra* note 4, at 23.

38. *See id.* at 23 (noting that promoters sometimes even forbid clients from showing the product to the client's own lawyers, unless the lawyer also agreed to the confidentiality agreement terms).

39. *See* Eracleous, *supra* note 16, at 209-10 (noting that judicial doctrines and other congressional legislation have been developed to address the tax shelter problem).

40. *Id.*

41. *Id.* at 218-19, 228-29.

42. *Id.* at 209-10.

43. *See id.* (noting that these judicial doctrines are the legal response to tax shelters).

44. *Id.* at 209.

purposes.[45] A transaction must hold both economic substance and a business purpose to avoid being deemed an abusive tax shelter.[46]

Created by the United States Supreme Court in *Gregory v. Helvering*,[47] the economic substance doctrine states, "a transaction, or a series of transactions, will not be respected for tax purposes unless the transaction has 'economic substance separate and distinct from the economic benefit achieved solely by the tax reduction.'"[48] With a specific transaction, the economic substance doctrine analyzes the pre-tax profit potential in relation to the tax benefits expected.[49] In applying the economic substance doctrine, courts often consider whether the transaction's only purpose is to achieve the tax benefits desired, and whether a profit will arise from the transaction.[50]

With a different moniker, the business purpose doctrine attempts to achieve the same goal as the economic substance doctrine.[51] The United States Supreme Court in *Gregory* required that the transaction hold a business purpose.[52] The business purpose must exist separately from the expected tax benefits.[53] More specifically, the tax court in *ACM Partnership v. Commissioner*[54] required that the transaction be rationally related to a "useful non-tax purpose."[55] In summation, the business purpose

45. *See* Rostain, *supra* note 2, at 84 (implying that since shelters are difficult to define, doctrines allow a court to examine a series of transactions in a more global manner, making it easier to determine if the transaction constitutes an abusive tax shelter).

46. Stuart W. Gray, *Controlling Foreign Tax Credit Abuse: The "Economic Substance" Test*, 13 EMORY INT'L L. REV. 729, 751-52 (1999).

47. 293 U.S. 465 (1935).

48. Gray, *supra* note 46, at 745-46 (citing ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 2215 (1997), *aff'd in part, rev'd in part*, 157 F.3d 231, 249 (1998)).

49. *See* Eracleous, *supra* note 16, at 209-10 ("[T]ax benefits may be denied if they 'arise position'" (citing Dep't of the Treas., *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*, 99 TAX NOTES TODAY, July 1, 1999, LEXIS, 99 TNT 127-13)).

50. *See* Gray, *supra* note 46, at 748 (explaining that in determining whether a transaction possesses economic substance, one can look to a two-pronged approach that developed from earlier cases). The two prongs are: (1) that the only purpose was to obtain tax benefits; and (2) "that the transaction has no . . . reasonable possibility of profit." *Id.*

51. Eracleous, *supra* note 16, at 213-14.

52. *Id.* at 213.

53. *See* Gregory v. Helvering, 293 U.S. 465, 469-70 (1935) (holding that a business purpose did not exist); *see also* Eracleous, *supra* note 16, at 213 (explaining that while a taxpayer can attempt to minimize his taxes within the law, the business purpose doctrine attempts to determine if such minimization occurred as the statute intended).

54. 157 F.3d 231 (3d Cir. 1991).

55. *ACM P'ship*, 157 F.3d at 253.

doctrine requires that the transaction have a business purpose aside from the desired or intended tax consequences.[56]

2. *Penalties*

While judicial doctrines aid the IRS in its efforts to curb abusive tax shelters, the imposition of penalties also provides a level of deterrence.[57] When a taxpayer's actions have resulted in underpayment, an accuracy-related penalty equal to twenty percent of the underpayment is assessed.[58] Additionally, if it has been determined that the taxpayer's transaction in question lacked economic substance or a business purpose, the taxpayer will likely be penalized, even if the transaction was based on the advice of a tax advisor.[59] While these penalties are a part of the arsenal of weapons that can be employed against a taxpayer, some commentators believe this particular tool is not strong enough to deter abuse, thereby suggesting that the penalties should be substantially harsher.[60] For example, if the tax shelter is deemed abusive, and the only consequence of this determination is that the individual has to pay what he was supposed to pay in the first place, that is, had he not used an abusive tax shelter, then the prevailing attitude is "[s]o [what], why not give it a try?"[61] However, if the taxpayer were forced to pay a civil penalty in the range of seventy-five percent of his understated taxable income, perhaps the risk is no longer worth the reward.[62] While penalties are useful tools, taxpayers have developed creative ways to minimize their tax liabilities, as the next part illustrates.[63]

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56. *Id.*; *see also* Rostain, *supra* note 2, at 85 (explaining that the business purpose doctrine "reflect[s] a purposive approach to interpreting the tax code").

57. Eracleous, *supra* note 16, at 214-15.

58. 26 U.S.C. § 6662(a) (2006); Eracleous, *supra* note 16, at 214. A penalty can be imposed for the following: negligence of rules or regulations; a "substantial understatement of income tax;" a misstatement; a "substantial overstatement of pension liabilities;" or an estate or gift tax valuation understatement. *Id.* at 214-15. These penalties originated as an attempt to discourage taxpayers from playing the "audit lottery," a concept where the possibility that the specific taxpayer will be audited, in relation to the millions of tax returns filed each year, make one's chances of escaping audit possible. *Id.*

59. *See* Korb, *supra* note 4, at 43 (explaining that while there are ways to avoid a penalty, failure to demonstrate a reasonable cause or improper reliance on an advisor will not save the taxpayer from the penalty).

60. Gary & Stratton, *supra* note 10, at *3.

61. Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1940 (2005).

62. *Id.*

63. *Id.* at 1942-46.

III. AN ILLUSTRATION

The tax court in *ACM Partnership v. Commissioner* illustrates how the factors of definition, evolution, and design of tax shelters merge.[64] The ACM Partnership was a collection of three partners, each a subsidiary of a different entity that was created just prior to the formation of the ACM Partnership.[65] The partnership consisted of Southampton, Kannex, and Merrill Lynch MLCS, owned by the Colgate-Palmolive Company (Colgate), Algemene Bank Nederland N.V. (ABN), and Merrill Lynch Capital Services (Merrill Lynch), respectively.[66] The partnership formed as a result of Colgate reporting a long-term capital gain that totaled $104,743,250 from the sale of a Colgate subsidiary.[67] Merrill Lynch representatives approached Colgate representatives in regard to establishing a partnership that would result in capital losses that Colgate could use to offset its capital gains from the recently sold subsidiary.[68]

The partnership participated in a series of transactions that allowed it to recognize a long-term gain in the first year of partnership operation and then recognize a loss in the following years of operation.[69] Based on the

64. *See generally* ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998) (addressing a series of transactions involving tax consequences). *But see* Compaq Computer Corp. & Subsidiaries v. Comm'r, 277 F.3d 778, 778 (5th Cir. 1999) (giving an example of a tax scheme that withstood an economic substance test challenge). Compaq undertook a transaction that involved the purchase and immediate resale of American Depository Receipts (ADRs), which was a trading unit that signified ownership in a foreign entity. *Id.* at 779. In *Compaq,* an investment firm purchased ten million Royal Dutch ADR's on behalf of Compaq for $887.6 million, and resold the same ADRs for $868.4 million about an hour after the investment firm purchased them. *Id.* at 780. Compaq was entitled to a dividend of roughly $22.5 million for the time it held the ADRs, owing a tax to the Netherlands of $3.4 million. *Id.* This transaction left Compaq with a net gain of about $19.2 million. *Id.* Compaq then declared a capital loss for the difference between the purchase and resale price on its United States income tax return, which was approximately $20.7 million. *Id.* Compaq used the capital loss to offset a gain it had recognized in the previous year. *Id.*

While the tax court reasoned that Compaq only entered into the transaction for the expected tax benefits, the Fifth Circuit determined that the ADR transaction had pre-tax profit, as well as after-tax profit, leading to a determination that the transaction possessed economic substance. *Id.* at 782-86. The court looked at the gain Compaq received from the dividend, $22.5 million, less the loss of $20.7 million from the resale, and determined that a legitimate profit existed. *Id.* at 787. Therefore, Compaq's ADR transaction possessed a "business purpose independent of tax considerations." *Id.*

65. *ACM P'ship*, 157 F.3d at 233.

66. *Id.* Southampton and MLCS were incorporated under Delaware law while Kannex was incorporated under Netherlands Antilles law. *Id.* ABN is a major bank in the Netherlands. *Id.*

67. *Id.*

68. *Id.*; *see also* 26 U.S.C. § 1231 (2004) (stating that long-term capital losses can be used to offset long-term capital gains).

69. *ACM P'ship*, 157 F.3d. at 237. Testimony from a member of ABN's legal department indicated that he understood the formation of the partnership to be one where it would create, albeit a capital gain initially, a capital loss in the latter portion of the transaction. *Id.* Therefore, the heavily involved partner, in year one, would take part in the capital portion of the transaction

initial contributions of the three partners, the partnership set itself up to allow this capital gain to be largely attributed, about eighty percent, to ABN, a foreign entity that paid no United States income tax.[70] Once this step of the plan was completed, ABN left the partnership, leaving Southampton as a ninety-nine percent partner, and MLCS as the remaining one percent partner.[71] Therefore, ABN would be a partner in year one, assuming much of the gain from the transaction, but would not be a partner in year two, leaving almost all of the loss to be absorbed by Southampton/Colgate.[72]

With the capital originally contributed by each partner, the partnership bought notes issued by Citicorp.[73] Then, the partnership immediately sold Citicorp notes to other investors for $140 million in cash and installment notes, also known as the LIBOR notes.[74] These LIBOR notes were payable over the next five years.[75] The partnership recognized a gain from the $140 million in cash, less $29 million for the rated value of the installment notes.[76] This left a capital gain of approximately $111 million, of which eighty percent was allocated to Dutch Bank and the remaining twenty percent was allocated to Colgate.[77] Thus, Dutch Bank recognized a capital gain of roughly $90 million and Colgate recognized a capital gain of $20 million.[78] In year two, the partnership recovered the remainder of the

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and the heavily involved parties, in year two and beyond, would take part in the capital loss portion of the transaction. *Id.*

70. *See id.* at 239 (explaining that after all three partners had contributed their capital, Kannex would hold an 82.6% share, Southampton would hold a 17.1% share, and MLCS would hold a 0.3% share in the partnership); *see also* Korb, *supra* note 4, at 24 (indicating that through the use of a foreign bank the transaction could escape United States taxation).

71. *See id.* (explaining that ABN had the right to redeem its interest in the partnership one year after its formation). In year one, once the capital gain was recognized, but before the capital losses were recognized, Colgate would increase its partnership share to ninety-nine percent. *Id.*

72. *Id.* at 237-39.

73. *Id.* at 239.

74. *Id.* at 240. Before ACM Partnership had even purchased the Citigroup notes, Merrill Lynch had set up a transaction in which two banks, the Bank of Tokyo (BOT) and Bank Francaise du Commerce Exterieure (BFCE) would purchase the Citigroup notes that ACM Partnership would purchase, and it was agreed that the two banks would purchase the $175 million of Citigroup notes for $140 million cash and $35 million worth of LIBOR notes. *Id.* LIBOR stands for London Interbank Offering Rate, which is primarily used in European financial markets. *Id.* at 234; *see also* Chirelstein & Zelenak, *supra* note 61, at 1944 (explaining that the LIBOR rate is one that changes on a daily basis, reflecting, among a number of market conditions, loan demand).

75. *ACM P'ship*, 157 F.3d at 240; *see also* Chirelstein & Zelenak, *supra* note 61, at 1944 (explaining that the LIBOR notes were payable over a five-year period, on a quarterly basis).

76. *ACM P'ship*, 157 F.3d at 242.

77. *Id.* The partnership could recover about $29 million, and set against the cash gain of $140 million, the gain was roughly $110 million. *Id.* The partnership divvied this gain according to the ownership percentages. *Id.*

78. *Id.*

Citicorp notes, which amounted to about $111 million.[79] This was a loss, and since ABN was no longer a partner, leaving ninety-nine percent of the partnership to Colgate, Colgate recognized a loss of about $110 million.[80] When compared to $20 million in capital gain it recognized in the first year, Colgate had a net capital loss of roughly $90 million.[81] Therefore, it appeared that ABN gained $90 million in year one, and after year two, Colgate had a loss of $90 million.[82] However, in reality, "neither partner gained or lost anything."[83]

The tax court determined that the transaction did not possess any economic substance.[84] Rather, the tax court found that the partnership engaged in a sham transaction, and that its only purpose was to avoid federal taxes.[85] This is just one example of the great lengths that corporations, historically, would go to in order to shield income from the United States Treasury's coffers.[86]

IV. CONTINGENCY FEES

One of the driving forces in the tax shelter industry is the use of the contingency fee.[87] Typically charged by accountants, contingency fees create a problem when they compromise the independence of the auditor/ accountant.[88] Furthermore, while accountants have a code of ethics to adhere to, they have found creative ways to circumvent this code of ethics.[89]

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79. *Id.*; *see also* Chirelstein & Zelenak, *supra* note 61, at 1945 (explaining that the loss was derived from the $175 million basis in the Citicorp notes, less the $29 million basis recovered in the year of the sale, against the sale price of $35 million for the LIBOR notes).

80. Chirelstein & Zelenak, *supra* note 61, at 1945.

81. *Id.* Recall that Colgate recognized a capital gain of $20 million in the first year of the partnership from the $140 million cash payment, of which it was only a nineteen percent partner. *Id.* Now that it is a ninety-nine percent partner, it had a loss of $110 million, for a net loss of $90 million over the two-year period. *Id.*

82. *Id.*

83. *Id.*

84. *See ACM P'ship*, 157 F.3d at 246-48 (determining that the transaction was lacking in economic substance, and that the court must "'look beyond the form of [the] transaction' to determine whether it has the 'economic substance that [its] form represents,'" and furthermore, a transaction that is "'devoid of economic substance' must be disregarded for tax purposes and 'cannot be the basis for a deductible loss'").

85. *See id.* at 248-49 (analyzing the transaction in light of the Economic Sham Analysis).

86. Chirelstein & Zelenak, *supra* note 61, at 1946.

87. Wang, *supra* note 6, at 1257.

88. Sheryl Stratton, *SEC Looks at Selling Aggressive Products to Audit Clients*, TAX NOTES TODAY, Apr. 3, 2000, LEXIS, 2000 TNT 64-3, at *5.

89. Wang, *supra* note 6, at 1266-67.

A. PROBLEMS WITH CONTINGENCY FEES

Accountants play a major role within the tax shelter industry.[90] Accountants' use of contingency fees to sell tax products has helped fuel the rise of abusive tax shelters, and most observers believe the "Big Four" lead the way in such abuses.[91] Today, the "Big Four" consists of Ernst & Young, PricewaterhouseCoopers (PwC), Deloitte & Touche, and KPMG.[92] In exchange for the development of a shelter, or "tax product," and putting their reputations on the line, accountants charge a fee contingent upon the amount of tax a client saves.[93] The client is typically a corporation.[94] A number of accounting firms charge contingent fees that range anywhere from thirty to forty percent of the tax savings.[95] The contingent fees charged by firms will vary based on the originality of the product, meaning, a more complex or novel product will yield the accounting firm a higher contingent fee.[96] Additionally, once the accounting firm has created the tax product, it requires very few additional resources to sell another shelter of this kind, making the contingency fees gathered on subsequent shelter sales almost pure profit for the accounting firm.[97]

The potential for huge contingency fees has caused some accounting firms to make quasi-guarantees regarding the possible tax savings that are available.[98] For example, the accounting firm Deloitte & Touche had a promotion where it "promised to zero out a company's taxes for a contingency fee of thirty percent of the tax savings."[99] However, when these quasi-guarantees fail to achieve the intended results that parties anticipated, the parties can become frustrated.[100]

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90. *Id.* at 1252-54.

91. *See id.* at 1253 (referring to the largest accounting firms which include the following: Ernst & Young, PricewaterhouseCoopers (PwC), Deloitte & Touche, and KPMG).

92. Paul Danos, *Back to the Big Eight Again*, FORBES, Apr. 13, 2007, *available at* http://www.forbes.com/opinions/2007/04/12/danos-accounting-bigeight-oped-cx_pd_0413danos.html.

93. *See* Korb, *supra* note 4, at 16-24 (explaining the details regarding individual and corporate tax shelters).

94. *Id.* at 23-24.

95. *See* Wang, *supra* note 6, at 1257 ("[T]he largest driving force behind the wildfire growth of the tax shelter industry, is the use of contingency fees . . . .").

96. *See id.* (explaining that PwC will charge anywhere from eight to thirty percent, depending on the originality of the product).

97. *See id.* at 1258 (indicating that once the shelter has been developed, those costs are sunk, and any future sales have very little, if any, cost in implementing them, which leads to an increased incentive in selling additional shelters based on the contingency fee).

98. *Id.* at 1261.

99. *Id.* The firm must not have felt too confident in the legitimacy of its product, because while it promised to stand behind the shelter before an audit, it was not willing to do so before a court. *Id.*

100. *Id.* at 1261-62.

For example, KPMG filed a breach of contract claim against a bank that failed to pay the contingency fee.[101] KPMG alleged that the bank took advantage of the tax plan and then failed to pay the twenty-five percent contingency fee.[102] There is also the danger of the accounting firm collecting the contingency fees up front, having the tax product deemed to be improper by the IRS, and then being forced to return the collected fees to the various clients, as had occurred with PwC.[103] Situations like these are noteworthy since most accounting firms do not want to advertise that they are developing tax shelters, nor does the client want to draw the IRS's attention to the fact that it is engaging in a tax shelter.[104] Therefore, the commencement of a lawsuit seems counterintuitive since even the prevailing party may have further explaining to do before the IRS.[105]

Contingency fees have had a sine-like existence, and its acceptance has experienced some ups and downs over time.[106] At one time, the American Institute of Certified Public Accountants' (AICPA) ethics rules contained a "blanket prohibition" on contingency fees.[107] However, in an effort to encourage greater competition within the market place, the Federal Trade Commission forced the AICPA to amend this provision in 1990.[108] With that "blanket prohibition" gone, the regulation of an accountant's use of contingency fees is left to the AICPA and United States Department of Treasury's Circular 230.[109] Now that the booming tax shelter industry and the corresponding contingency fees have filled the pockets of accounting firms, the AICPA takes the position that amendments curbing the use of contingency fees will "unreasonably undercut consumer choice in violation of the Federal Trade Commission Act."[110] Essentially, the AICPA seems to be suggesting that if the government is going to lobby for greater

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101. *See* Wang, *supra* note 6, at 1261-62 (outlining a plan developed by KPMG that exposed a loophole in state tax law; the firm had evidently "pitched the idea to an undisclosed number of banks").

102. *Id.* at 1262.

103. *See id.* at 1261 (explaining that PwC was forced to reimburse its clients between $9 and $16 million when the tax plan was deemed to be improper).

104. *See id.* (noting that a whistleblower mailed a detailed copy of letter discussing the tax shelter to the United States Treasury Department).

105. *Id.*

106. *See generally id.* at 1260-65 (discussing the major accounting firms and their involvement within the industry).

107. *See* David A. Lifson, *AICPA Outlines Its Professional Ethics Rules*, TAX NOTES TODAY, June 1, 2000, LEXIS, 2000 TNT 106-17, at *4 (discussing the "rhetoric" of contingency fees in the accounting industry, and the role of AICPA ethics Rule 302—Contingency Fees).

108. *Id.*

109. Wang, *supra* note 6, at 1262-63; *see also* Korb, *supra* note 4, at 50 ("Circular 230 provides regulations governing practice before the [IRS].").

110. Wang, *supra* note 6, at 1264.

competition within the market place, then the government must be willing to accept some of the side effects of that competition.[111]

B. AUDITOR INDEPENDENCE

An additional problem that arises when contingency fees are employed is the effect the fees have on auditor independence, specifically when accounting firms sell tax products or tax services to their audit clients.[112] If one of the "Big Four" sells a tax shelter to one of its audit clients, and uses a contingency fee in the process, then that accounting firm now has a stake in the financial health of the entity it is auditing.[113] If the role of the auditor is to be an independent reviewer of the client's financial endeavors, the independence of that review is compromised when the firm collects a fee that is contingent on the tax savings that resulted from a plan or a product that the firm sold to the audit client.[114] This lack of objectivity is a serious problem for the following reasons:

> There is great potential for auditor independence violations if the audit client has implemented one or more corporate tax shelters and (1) any such corporate tax shelters were developed, promoted, or participated in by the audit firm or any of its partners, or (2) the audit firm or any of its partners promoted or otherwise participated in the same or substantially similar tax shelter.[115]

The crux of this problem is that it takes away the level of "skepticism" that is to be employed by auditors, as mandated through the Generally Accepted Audit Standards.[116] When an accounting firm sells a tax product or tax shelter to an audit client, the auditor is essentially checking "his own work."[117]

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111. *Id.*

112. *See* Stratton, *supra* note 88, at *2 (noting the conflict when a firm audits a company's financial statements and then sells the business a tax shelter).

113. *See id.* (opining that a conflict of interest arises when accounting firms "provid[e] aggressive tax planning to audit clients").

114. *See id.* ("[I]f you are . . . an accounting firm and you go to a corporation with a tax shelter and you are going to get a fee based on a percentage of the tax savings, then you are [less of a] professional advisor . . . [and more of] a commission salesman.").

115. *See* Hamersley, *supra* note 20, at *5 (relating these concerns to the fact that "it must be 'probable' that the tax shelter will succeed on its merits"). Mike Hamersley was a Senior Manager in KPMG's Los Angeles Mergers and Acquisitions Tax Practice, and he was a whistleblower on KPMG's abusive tax shelter practices. *Id.*

116. *See id.* at *6 ("SEC rules require that auditors of public companies maintain independence in fact and in appearance.").

117. *Id.*

This lack of objectivity likely raises a conflict of interest question.[118] For example, the enormous profit potential that results from contingency fees can cause many auditors to forget about their obligation to "[find] problems," and instead "[focus] on looking for opportunities to (sell tax consulting services)."[119] However, accounting firms have been somewhat novel in circumventing any conflict of interest concerns.[120] One such example is that instead of referring to the fees collected from audit clients as contingent, accounting firms refer to the fees as "value-based" fees.[121] A value-based fee, within the accounting industry, refers to the firm's efforts in "recovering . . . [its] investment in coming up with the idea."[122] Irrespective of what name it is given, it appears that the accounting firm has a stake in the outcome regardless if a value-based fee or a contingent fee is charged.[123] Thus, whenever a firm "has a propriety interest in the strategy, it creates a built-in conflict."[124]

C. ETHICAL OBLIGATIONS

Accountants face ethical obligations on a national level from the AICPA.[125] Locally, North Dakota accountants must also adhere to the standards set forth through the North Dakota State Board of Accountancy.[126] Examining each of these provides context as to how accountants make decisions regarding their use of contingency fees.

1. *American Institute of Certified Public Accountants*

The AICPA Code of Professional Conduct contains a few provisions regarding contingency fees.[127] Specifically, Rule 302.01 governs the use of contingency fees, prohibiting such fees where the accounting firm or a member of the accounting firm will conduct an audit or review of that

118. *Id.*
119. *See id.* at *7 ("[T]hese individuals were often wearing their tax consulting uniforms while playing on the audit team.").
120. Stratton, *supra* note 88, at *3.
121. *See id.* (explaining that if the client only pays if the deal is successful, that amounts to a contingent fee while a "warranty or indemnity . . . or deferral of a portion of the fee until the tax year is closed without disallowance" is a value-based fee).
122. *Id.*
123. *Id.*
124. *Id.*
125. Wang, *supra* note 6, at 1271.
126. N.D. CENT. CODE § 43-02.2-03 (1999).
127. Wang, *supra* note 6, at 1267.

client's financial statement.[128] While the rule addresses the use of contingency fees for audit clients in a fairly clear manner, it does not discuss the use of contingency fees for nonaudit clients.[129] The ethics rule clearly prohibits the use of contingency fees with regard to audit clients, but the rule fails to address the general use of contingency fees in the design or promotion of tax shelters, irrespective of whether the client is an audit or nonaudit client.[130] Furthermore, if a member of the accounting profession wishes to charge a contingency fee to an audit client, that member might deem it to be a value-based fee, in the hope of avoiding Rule 302.[131] Although the AICPA's Ethics Rule 302.01 provides a solid basis for limiting the use of contingency fees, it does not have the teeth to effectively curb the effects that contingency fees have on the tax shelter industry.[132] The rule needs two amendments in order to carry any clout: for one, it needs to prohibit contingency fees between audit and nonaudit clients alike; and two, it needs to draw no distinction when a fee is labeled contingent, value-based, or otherwise.[133]

2. *North Dakota State Board of Accountancy*

The state of North Dakota has adopted the AICPA's Ethics Rule 302, codifying it as section 3-04-04-02 of the North Dakota Administrative Code.[134] In its imitation of AICPA 302, the North Dakota statute faces the same challenges because it fails to address the role contingency fees play in

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128. *See* AICPA CODE OF PROF'L CONDUCT R. 302.01 (1991), *available at* http://www.aicpa.org/about/code/et_302.html (giving the direction of when a contingency fee should not be charged). The rule provides:

> Rule 302—Contingent fees. A member in public practice shall not (1) Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member's firm performs, (a) an audit or review of a financial statement . . . or (2) Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.
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> . . . .
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> [A] contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. . . . A member's fees may vary depending, for example, on the complexity of services rendered.

Id.

129. *See* Wang, *supra* note 6, at 1267 ("Clint Stretch, Director of Tax Policy at Deloitte & Touche, admits there is much greater latitude in the types of fees charged with nonaudit clients.").

130. *Id.*

131. *Id.* at 1267.

132. *Id.* at 1271.

133. *See* Stratton, *supra* note 88, at *3 (discussing contingency and value-based fees charged to audit and nonaudit clients).

134. N.D. ADMIN. CODE § 3-04-04-02 (1999).

the tax shelter industry.[135] While section 3-04-04-02 prohibits the use of contingency fees when the accounting entity is auditing a client, the statute does not address the use of contingency fees in regard to nonaudit clients.[136] Furthermore, the North Dakota statute, similar to the AICPA, fails to address the concept of alternative terms of contingency fees, and how the alternative terms are used to skirt the contingency fee-use prohibitions.[137] More specifically, the potential exists for any North Dakota accounting firm to avoid the provision by classifying its efforts as value-based fees.[138] While section 3-04-04-02 is better than the alternative of having no applicable statute, more inclusive language in the statute would be instrumental in curbing the abusive tax shelter industry.[139] While the use of contingency fees play a role in the abusive tax shelter industry, the use of suspect opinion letters plays a role as well.[140]

V. OPINION LETTERS

Taxpayers seek an opinion letter from an attorney that will represent that their tax transaction will survive an IRS inspection; this is particularly problematic when this representation is false.[141] By relying on this representation, taxpayers attempt to shield themselves from liability.[142] By emphasizing the rules of professional responsibility, the dishonest representations in opinion letters can be curtailed.[143]

A. THE PROBLEM WITH SUSPECT OPINION LETTERS

The accountant is not the only player involved in the creation of a tax shelter who needs to be monitored.[144] There are often many players within the tax shelter industry, and the attorney plays a role, just as accountants and other professionals.[145] While the attorney is typically not the player that designs the shelter, he or she is often the individual that gives the shelter its appearance of legitimacy.[146] An opinion letter will give the abusive

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135. *Id.*
136. *Id.*
137. *Id.*
138. Wang, *supra* note 6, at 1267.
139. *See id.* at 1272.
140. *Id.* at 1254.
141. Chambers, *supra* note 5, at 117-18.
142. *Id.* at 126.
143. *Id.* at 118.
144. Wang, *supra* note 6, at 1252.
145. *Id.*
146. *See* Chambers, *supra* note 5, at 117-18 (indicating that while some attorneys might participate in the creation or promotion of tax shelters, much of that aspect of the industry is

tax shelter the appearance of a legitimate transaction.[147] In an opinion letter, an attorney, who is commissioned to write the opinion, states that the taxpayer has a "reasonable chance of withstanding a challenge by the IRS."[148] However, there is a potential problem with the issuing of such opinion letters: if a transaction is likely to fail an IRS challenge, but the opinion letter is issued regardless, stating that the transaction will survive the challenge, the opinion letter is both inherently faulty and misleading.[149] As a result, an opinion letter's conclusion, which states that the shelter can withstand a challenge, is not as determinative as finding someone to author that conclusion.[150] To clarify, shelter opinion letters provide the taxpayer with a level of protection; if a taxpayer relies upon the opinion in making his decision to proceed with the shelter, the opinion makes it difficult to determine whether the taxpayer "willfully violated the law."[151]

There is a substantial factor that makes this practice difficult to curtail.[152] Tax can be an extremely confusing area of the law, and if seasoned tax professionals disagree as to the merits of an opinion letter, or a potential tax transaction, it becomes difficult to determine that a particular transaction would not meet the "more-likely-than-not" standard.[153] In response to the confusion, in February of 2005, the United States Senate's

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completed by accountants); *see, e.g.*, Senate, Comm. on Homeland Sec. and Governmental Affairs, Permanent Subcomm. on Investigations, *Senate PSI Report Targets Firms Involved in Tax Shelter Industry*, 2005 TAX NOTES TODAY, Feb. 11, 2005, LEXIS, 2005 TNT 28-28, at *10 [hereinafter *Senate PSI Report*] (exploring the expansive role accountants play in the design of tax shelters, and though aided by attorneys, it is accountants that chiefly dream up the various tax products).

147. *See* Chambers, *supra* note 5, at 118 (indicating that tax shelters have become a thriving industry for those involved, and the role of the attorney in this bustling market is largely limited to opinion letters); *see also* Rostain, *supra* note 2, at 92 (emphasizing that lawyers whose involvement in the tax shelter industry included authoring opinion letters profited significantly, and that the "[o]pinion letters were a sine qua non of tax shelter purchases," meaning the opinion letter was indispensable to the success of the tax shelter).

148. Chambers, *supra* note 5 at 93; *see* Rostain, *supra* note 2, at 93 (explaining that a reasonable chance of surviving an IRS challenge is interpreted as having a greater than fifty percent chance that the tax treatment would survive the challenge).

149. *See* Chambers, *supra* note 5, at 117-18 (stating that it is unethical for a lawyer to issue an opinion letter expressing the success of a challenge when the transaction is "suspect at best"). *See generally* Beckett G. Cantley, *The New Tax Shelter Opinion Letter Regulations: Cutting Back on a Client's Ability to Rely on the Advice of His Counsel*, 18 AKRON TAX J. 47, 73-74 (2003) (discussing the tactic of deterring a client's use of counsel).

150. *See* Rostain, *supra* note 2, at 93 ("Corporate clients were less interested in the content of an opinion letter than whether a lawyer was willing to provide one.").

151. *See id.* (expanding on the concept that an opinion letter absolves the taxpayer from liability since the very nature of an opinion letter suggests that the lawyer has "engag[ed] in disinterested and diligent efforts" to determine the appropriate course of action regarding the taxpayer's shelter actions).

152. *See id.* (discussing the role of attorneys in the tax shelter industry).

153. *See id.* (discussing the ambiguities in this particular area of the law and how it muddled the more-likely-than-not determination).

Permanent Subcommittee on Investigations released a detailed report regarding the prevalence and regularity of abusive tax shelters.[154] The report indicated that the rise in abusive tax shelters was related to the economy of the 1990s.[155] The booming economy led KPMG, one of the nation's leading accounting firms, to immerse itself into the design and marketing of tax products, with which it would often require the presence of an opinion letter.[156] KPMG worked closely with the prestigious law firm of Sidley Austin Brown & Wood (Sidley), relying on the firm for design assistance, but also for rendering legal opinions, which garnered huge fees for the firm.[157] The United States Senate's report illustrated that the law firm's compensation amounted to $50,000 for each legal opinion it issued.[158] While this number appears excessive, it should be noted that it was not uncommon for these opinion letters to earn hundreds of thousands of dollars, with some even topping $1 million.[159] With opinion letters commanding these types of fees, it was not difficult to find an attorney who would write the letter, even if it was a stretch to conclude the transaction was more likely than not to survive an IRS challenge.[160]

B. THE RELIANCE ISSUE

The basic problem with opinion letters is that taxpayers rely on their contents to avoid an accuracy-related penalty.[161] The American Jobs Creation Act of 2004 (AJCA) now requires a taxpayer to disclose reportable transactions; an accuracy-related penalty will be assessed to the taxpayer if he fails to disclose a reportable transaction.[162] Prior to the AJCA, there was

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154. *See, e.g.*, *Senate PSI Report*, *supra* note 146, at *68 (discussing the role of lawyers in the tax shelter industry).

155. *Id.* at *5-7.

156. *Id.*

157. *See id.* (revealing that Sidley provided about 600 opinions that covered at least thirteen potentially abusive tax shelters, and this teamwork between Sidley was arranged through a tax partner of Sidley with KPMG).

158. *See id.* at 70 (indicating that the more the client saved in tax, the more the law firm would collect in fees).

159. Rostain, *supra* note 2, at 94; *see Senate PSI Report*, *supra* note 146, at *70 (explaining that Sidley grossed more than $23 million in fees from writing the opinion letters for KPMG over a five-year period).

160. *See* Rostain, *supra* note 2, at 94 (reasoning that if the lawyer's conscience caused her to not issue an opinion letter, the lawyer still knew that "her client could easily find a lawyer who would" write the opinion letter). It is hard for many lawyers to turn down these large fees when one knows they will be available to the next lawyer in line. *Id.*

161. *See* Chambers, *supra* note 5, at 126 (arguing the flaw of relying on opinion letters is eradicated by the change in law from the U.S. Treasury Regulations of 2002 to the American Jobs Creation Act of 2004).

162. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 811, 118 Stat. 1418, 1421 (2004); *see* Chambers, *supra* note 5, at 125 (explaining that part of the teeth of this new act is the

no penalty for failure to disclose.[163] Rather, failing to disclose reportable transactions prevented a taxpayer from claiming that any ensuing understatement in tax "was due to reasonable cause, and the taxpayer . . . acted in good faith."[164] The United States Treasury regulations interpret reasonable cause as the taxpayer relying on a tax professional's advice, such as an opinion letter, expressing that the transaction was more likely than not to survive an IRS challenge.[165] However, the AJCA was not the first legislation attempting to curtail a taxpayer's ability to escape penalty via his reliance on professional advice; rather, Treasury Opinion Regulations sought to curb some of the defenses taxpayers relied upon in avoiding accuracy-related penalties as well.[166] The Treasury Regulations focused on transactions that should have been reported, yet were not reported.[167]

Regarding an underpayment of tax, the Treasury Regulations imposed accuracy-related penalties for a number of infractions: "negligence or disregard of rules or regulations, any substantial understatement of income tax, . . . any substantial overstatement of pension liabilities, or any substantial estate or gift tax valuation understatement."[168] In order to avoid paying a penalty, the taxpayer's conduct would have to "fall within the reasonable cause and good faith exception," such as relying on an opinion letter.[169] But, under the new Treasury Regulations, such reliance on a tax professional's advice would sometimes be in vain, since not all professional reliance will equate to a reasonable cause that was made in good faith.[170] Ultimately, the Treasury Regulations prevent a taxpayer from automatically avoiding penalty by claiming that he or she acted in reliance of a

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assessment of penalties in the amount of $100,000 for individuals and $200,000 for other entities for those who fail to disclose a reportable transaction).

163. Chambers, *supra* note 5, at 125.

164. *Id.*

165. 26 C.F.R. § 1.6664-4 (2000); *see* Cantley, *supra* note 164, at 64-66 (explaining the frustration over the inconsistencies in the regulation's attempts to define what constitutes reasonable cause and good faith exception). Cantley specifically notes that the U.S. Treas. Reg. § 1.6664-4 states, that "reliance on a professional opinion does not always show reasonable cause or good faith," even though it later says that if the reliance on the professional was reasonable, then the advice will demonstrate that the "taxpayer was . . . acting with reasonable cause and good faith." *Id.* at 65-66.

166. Cantley, *supra* note 164, at 65-66.

167. 26 C.F.R. § 1.6664-4 (2000); *see* Cantley, *supra* note 164, at 65-66 (discussing how the changes will affect U.S. Treas. Reg. 1.6664-4).

168. *See* Cantley, *supra* note 164, at 58-59 (explaining that if one of these factors triggers an accuracy-related penalty, the severity of the infraction will determine the amount of the penalty).

169. *Id.* at 59.

170. *Id.*

professional opinion.[171] The AJCA expands the concept by preventing a taxpayer from relying on "unreasonable legal assumptions."[172] Essentially, taxpayers can no longer escape an accuracy-related penalty by shielding themselves by alleging their reliance on an opinion letter.[173] However, as this part of the note introduced, obtaining a shield from an accuracy-related penalty is why most opinion letters are commissioned in the first place.[174]

The attempt to prevent taxpayers from relying on professional advice raises other concerns.[175] While the AJCA attempts to prevent taxpayers from engaging in abusive tax shelters through removing the reliance shield, it also raises an inherent problem in prohibiting a client to rely on the advice of an attorney.[176] Additionally, the United States Treasury requires tax professionals to reveal the names of clients who have engaged in certain types of transactions.[177] The taxpayer may be hesitant to disclose the nature of the transaction, for fear the attorney will be forced to disclose both the taxpayer and the nature of the transaction.[178] If a client can no longer satisfy the good faith requirement by relying on his attorney's advice, that client's candor might be compromised in communications with his attorney.[179] The attorney-client relationship is one based upon the free-flow of information, and the AJCA and the Treasury Regulations run the risk of compromising the ideals of the attorney-client relationship, even for those not engaged in abusive tax shelters, in their attempt to prevent taxpayers from hiding behind the advice of counsel to avoid potential penalties.[180]

C. STATE REGULATORY BODIES

In order to curb the practice of abusive tax shelters, strictly enforcing the rules of professional conduct would reduce the number of faulty opinion

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171. *See id.* at 71 ("The new [regulations] require a determination of the taxpayer's education and business sophistication in determining whether the reliance on the advice was reasonable.").

172. *See* Chambers, *supra* note 5, at 126 (using the phrase "canned opinion letters" to describe the dubious letters that are written on a taxpayer's behalf to escape an accuracy-related penalty).

173. *Id.*

174. *Id.*

175. Cantley, *supra* note 164, at 73-74.

176. *Id.*

177. 26 U.S.C. § 6112 (2004); *see* Cantley, *supra* note 164, at 74-75 (explaining that the Treasury requires attorneys to register the names of their clients that have engaged in certain types of transactions, and that this requirement of the Secretary of the Treasury "subrogates the attorney-client privilege").

178. Cantley, *supra* note 164, at 75.

179. *Id.*

180. *See id.* at 76 ("If finalized, the Opinion Regs will have a dramatic effect on [the attorney-client privilege].").

letters.[181] Additionally, requiring that taxpayers who rely on such opinion letters to be strictly liable will impair the taxpayers' liability to hide behind the protection of an opinion letter.[182]

1. *Professional Responsibility*

Questionable legal opinions issued by attorneys raise a number of professional conduct concerns.[183] For example, the North Dakota Rules of Professional Conduct require in Rule 8.4(c) that it is professional misconduct for a lawyer to "engage in conduct involving dishonesty, fraud, deceit, or misrepresentation."[184] A clear violation of this rule occurs when an attorney issues an opinion letter that, by its facts, does not have a more-likely-than-not chance of passing an IRS challenge, yet the attorney asserts in the opinion letter that it does.[185] The attorney has misrepresented to the public, the IRS, and other professionals in the field that this particular transaction has a fifty percent chance of validity, when in fact it does not.[186]

Additionally, as previously noted, these opinion letters often garner rather exorbitant fees.[187] The Senate PSI report shows that the law firm received a minimum of $50,000 for each legal opinion it gave, and that the amount collected by the firm coincided with the size of the tax saved.[188] Sidley spent about 2,500 hours developing and issuing the opinion letters, and it collected over $23 million in fees, which equates to $9,000 per billable hour.[189] Applying the North Dakota Rules of Professional Conduct on fees, Rule 1.5, the lawyers at Sidley appear to have overstepped their

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181. *See* Chambers, *supra* note 5, at 118 ("[F]ew attorneys have faced disciplinary action for issuing a fraudulent opinion letter.").

182. Rostain, *supra* note 2, at 106.

183. Chambers, *supra* note 5, at 118.

184. N.D. RULES OF PROF'L CONDUCT R. 8.4(c) (2006), *available at* http://www.court.state.nd.us/rules/conduct/frameset.htm; *see also* Chambers, *supra* note 5, at 118 (explaining the ethical implications of issuing suspect opinion letters by examining rule 8.4(c) of The Model Rules of Professional Conduct).

185. *See* Chambers, *supra* note 5, at 118 (discussing how this practice "negatively impacts an attorney's fitness to practice"). Chambers also discusses how a lawyer who engages in these opinion letter endeavors "acts dishonestly and misrepresents the realities of such a tax position to the client." *Id.* However, while this may be true, it is often the case where tax attorneys are commissioned, or sought after to provide the desired legal opinion. *Id.*

186. *Id.*

187. *Senate PSI Report*, *supra* note 146, at *71. For example, the United States Senate PSI Report illustrates the fees collected by a prominent law firm that had the benefit of working closely with KPMG on a number of tax shelter-related transactions. *Id.* at *69; *see* Chambers, *supra* note 5, at 117 (indicating that for attorneys who engage in the opinion letter trade, there is a great deal of money to be made).

188. *Senate PSI Report*, *supra* note 146, at *70.

189. *Id.* at *71.

bounds.[190] Part (a) of Rule 1.5 states: "A lawyer shall not make an agreement for, charge, or collect an unreasonable fee," taking into consideration the "time and labor required [and] the novelty and difficulty of the questions involved."[191] An argument can be made that the $9,000 per billable hour is in violation of part (a) of the rule because an unreasonable fee appears to have been charged.[192]

While a number of lawyers might wilt in the face of potential disciplinary action by their respective state bars, attorneys who continue to issue these assembly-line opinion letters appear undeterred.[193] Indeed, possible public censure or disbarment should be effective methods of preventing such conduct, but "attorneys who issue these opinions [often] do not face the consequences of their unethical actions."[194] The Rules of Professional Conduct, whether in North Dakota or within a broader spectrum, will not be adhered to unless more attorneys who engage in the issuance of opinion letters for highly questionable tax-related transactions face the consequences of their actions.[195]

2. *State Bar Association*

While there are a number of measures available to battle the problem of abusive tax shelters, perhaps one of the most controversial is the implementation of strict liability for taxpayers who participate in "tax shelters that [result] in substantial understatements of tax."[196] The New York State Tax Bar has advocated for such a change.[197] One effect of a

190. N.D. RULES OF PROF'L CONDUCT R. 1.5 (2006), *available at* http://www.court.state.nd.us/rules/conduct/frameset.htm (follow "Rule 1.5 Fees" hyperlink); *see Senate PSI Report*, *supra* note 146, at 70-71 (addressing Model Rule 1.5).

191. N.D. RULES OF PROF'L CONDUCT R. 1.5 (2006) *available at* http://www.court.state.nd.us/rules/conduct/frameset.htm (follow "Rule 1.5 Fees" hyperlink); *see also Senate PSI Report*, *supra* note 146, at 71 (citing American Bar Association (ABA) Model Rule 1.5).

192. *Senate PSI Report*, *supra* note 146, at 70-71.

193. Chambers, *supra* note 5, at 118 ("[D]isbarment would seem to provide an incentive not to engage in such conduct.").

194. *Id.*

195. *See id.* (explaining that attorneys involved with issuing opinion letters do not face consequences).

196. *See* Rostain, *supra* note 2, at 106 (explaining that a "shift to strict liability" is not for the personal gain of attorneys; rather, it is an attempt to "reaffirm authority of lawyers over their clients"). Rostain argues that taxpayers are calling the shots, goading an attorney into writing an opinion letter because if that attorney does not, the large fee will go to someone that will write the letter. *Id.*

197. *See* N.Y. State Bar Ass'n Tax Section, *NYSBA Tax Section Applauds Some Anti-Corporate Tax Shelter Proposals, Rejects Others*, TAX NOTES TODAY, Apr. 9, 1999, LEXIS, 1999 TNT 82-29, at *2 [hereinafter N.Y. Tax Bar] (advocating for this "radical" reform, giving weight to the penalties in tax shelters); Rostain, *supra* note 2, at 106 ("[Strict liability] would alter the calculus of . . . taxpayers deciding whether to engage in tax shelters.").

change to strict liability is that the change puts the onus of the legitimacy of the transaction on the taxpayer.[198] The taxpayer is no longer provided with an opportunity to hide behind the opinion letter to escape penalty.[199]

Of course, there is a serious concern that accompanies a strict liability standard.[200] For one, strict liability rids the client of an opportunity to rely upon the advice of counsel, which is one of the "traditional principle[s]" of the attorney-client relationship.[201] However, one of the other pillars of the attorney-client relationship is the theory that the lawyer is called upon to advise the client.[202] This pillar, in relation to the opinion letter portion of the tax shelter industry, has been somewhat eroded because clients have distorted the reasons a taxpayer seeks an opinion letter; that reason is for penalty protection.[203] Essentially, strict liability would force taxpayers to seek actual legal advice, because instead of searching for a boilerplate opinion letter, the taxpayer would be forced to rely on the advice of the attorney.[204] Presumably, if the transaction were one that was not likely to withstand an IRS challenge, the attorney would advise the taxpayer to avoid the transaction.[205] Presently, tax shelter-seeking individuals wield much of the power since they are largely absolved from any liability.[206] However, "by creating a market for well-reasoned legal advice that addressed the legal merits of a transaction, a strict liability regime would strengthen a lawyer's capacity to dissuade clients from entering into abusive tax shelter transactions."[207] A shift to strict liability would move the weight of the decision making process from the client's pocketbook to the lawyer's expertise.[208]

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198. *See* Rostain, *supra* note 2, at 106 (believing that if taxpayers are made responsible for the advice they rely on, they will then be forced to seek actual, sound legal advice, as opposed to merely shopping for an opinion letter).

199. *Id.*

200. *Id.* at 106-07.

201. *See id.* at 107 (explaining that in the realm of tax shelters, the client is not really relying on the attorney's advice).

202. *Id.*

203. *See* Rostain, *supra* note 2, at 107 (reasoning that because clients come to lawyers for the opinion letter first, and for advice as to the merits of the transaction second, if at all, the client does not see an attorney for advice as to whether to engage in the proposed transaction).

204. *Id.*

205. *See id.* (stating that strict liability would allow lawyers to deter clients from "entering into abusive tax shelter transactions").

206. *Id.*

207. *Id.* (positing that a move to strict liability would shift the market forces that were initially in favor of the taxpayer to the attorney). Without strict liability, taxpayers dictate the market for legal advice in relation to opinion letters through the large fees. *Id.* However, if taxpayers were denied the protection of the opinion letter, the attorneys who gave the best legal advice as to the merits of the transaction would then be in demand. *Id.*

208. *Id.*

VI. RECOMMENDATIONS

The proliferation of abusive tax shelters in recent years has contributed to the erosion of the public's confidence in the United States' tax system.[209] Contingency fees for an accountant's services, along with opinion letters sought from an attorney to avoid penalties, create an environment where taxpayers are able to shelter their money in an illegal manner.[210] While governmental agencies have taken important steps to ameliorate this problem, there are several missing links in the fight against abusive tax shelters, some of which can be filled by the lawmakers of North Dakota.[211] More specifically, the North Dakota legislature has the opportunity to shore up the battle against tax shelters by passing legislation that limits how accountants and lawyers are permitted to operate.

A. CLEARER DEFINITION OF A TAX SHELTER

The fight against abusive tax shelters will not become any easier until the definition of a tax shelter is more clearly understood.[212] A definition that is neither over-inclusive nor under-inclusive needs to be created.[213] Of course, there is the potential that any change in the definition of a tax shelter will result in a new wave of creative efforts by individuals and corporations to design new shelters around the new definition.[214] Regardless of this concern, enforcement can be made more simplistic if a more user-friendly definition exists.[215] Therefore, the definition should include the taxpayer's purpose for entering into the transaction, and not much more.[216] Ultimately, the transaction should be examined by determining whether the United States Congress intended the tax result.[217] Therefore, a tax shelter

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209. *See* Levin, *supra* note 9, at *1 (indicating that tax shelters deprive the Treasury of income).

210. *See, e.g.*, Wang, *supra* note 6, at 1249-58 (discussing the rise of the tax shelter industry).

211. *See* Chambers, *supra* note 5, at 123-27 (highlighting the potential impact of the American Jobs Creation Act and the effects it will have on abusive tax shelters); *see also* Rostain, *supra* note 2, at 113-15 (discussing the effects of a shift towards strict liability for taxpayers involved with tax shelters).

212. *See* Wang, *supra* note 6, at 1268 (opining that the definitional problem in curtailing abusive tax shelters has "become one of [the effort's] major stumbling blocks").

213. *See* Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 329 (2002) (explaining that a purpose-oriented approach fails to include some transactions that were only entered into for the tax result yet excludes others that were entered into specifically for the tax result).

214. Wang, *supra* note 6, at 1268.

215. *Id.* at 1241-43.

216. *See* Schler, *supra* note 213, at 332 (explaining that the definition should have a "well-defined target").

217. *Id.* at 331-32.

should be defined as follows: a tax shelter is any transaction designed to achieve an abnormally beneficial tax treatment where Congress did not intend for the result.[218] This may seem broad, but the more specific the definition becomes the more creative tax professionals become in attempting to circumvent the definition.[219]

B. A PROHIBITION AGAINST CONTINGENCY FEES

Because the contingency fee is the cog that drives the tax shelter wheel, any attempt at addressing the tax shelter problem without eliminating the contingency fee will be largely ineffective.[220] After all, accountants will have less incentive to develop and market their various tax products if they are no longer able to collect a percentage of the tax saved by the client.[221] Therefore, it is necessary that both the AICPA and the North Dakota lawmakers adopt a provision prohibiting the use of contingency fees in tax planning services.[222] While the AICPA and North Dakota have provisions regulating the use of contingency fees, there is no regulation that addresses the rules' general use in relation to tax shelters.[223]

North Dakota law regulates contingency fees by prohibiting them to audit clients.[224] However, prohibition should be expanded to include non-audit clients.[225] Furthermore, the prohibition against contingency fees only addresses half of the problem in the fight against tax shelters.[226] While the North Dakota State Board of Accountancy, in connection with the AICPA, requires that contingency fees will not be allowed when dealing with an audit client, this requirement fails to address one glaring concern: the spread of abusive tax shelters that are aided by an accountant's contingency fee through a nonaudit client.[227] Therefore, the regulations governing the use of contingency fees should make no distinction between those charged

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218. *See id.* (explaining that a tax shelter should be defined by examining three factors: whether it complies with the Code; whether a tax motivation exists; and whether the "result [is] unintended by Congress").

219. Wang, *supra* note 6, at 1268.

220. *Id.* (stating that by "regulating accountant compensation," the "race" to zero out taxes will be seriously impaired).

221. *Id.*

222. *See id.* at 1270 (arguing that while some believe that a blanket provision prohibiting contingency fees will impede consumer choice, the disallowance of contingency fees will have a greater impact on the abusive tax shelter industry than it will on consumer choice).

223. N.D. ADMIN. CODE § 3-04-04-02 (2007).

224. *Id.*

225. *Id.*

226. Wang, *supra* note 6, at 1271.

227. *Id.*

to audit and nonaudit clients, disallowing contingency fees to both types of clients in regard to an accounting firm's tax services.[228]

Furthermore, North Dakota must amend its existing contingency fee regulations in order to address any creative terminology efforts employed by the accountant, broadening the types of fees that are not permitted.[229] Instead of only prohibiting the use of contingency fees, prohibiting "value-based" or "value-added" fees would prevent an accounting firm from charging audit clients a fee contingent upon a desired result.[230] In the end, any fee that is based upon a percentage of taxes saved must be eliminated, regardless of what it is called.[231] The prohibition of contingency and value-based fees would address the auditor-independence problem when contingency fees are charged to audit clients.[232]

C. STRICT LIABILITY FOR A TAXPAYER'S RELIANCE ON AN OPINION LETTER IN RELATION TO TAX SERVICES

Taxpayers have traditionally obtained an opinion letter for a tax-related transaction in order to shield themselves from a penalty, should any nonconformity in the method of the tax result.[233] Because taxpayers are concerned primarily with obtaining an opinion letter, and less with its content, a shift toward strict liability would return some authority to "lawyers over their clients."[234] By following the lead of the New York State Bar Association's Tax Section, taxpayers would be required to rely upon the advice of the attorney giving it, since failure to do so would result in personal liability for the taxpayer.[235] As a result, lawyers would no longer be patronized for a token opinion letter, but rather, would be sought for their legal expertise.[236]

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228. *Id.*

229. *See id.* at 1272 (explaining that the "Big Four" attempted to "circumvent the AICPA's prohibition on contingency fees with audit clients" by reclassifying them).

230. *Id.*

231. *Id.* at 1267.

232. Stratton, *supra* note 88, at *2-3.

233. Rostain, *supra* note 2, at 92-93; *see also* Chambers, *supra* note 5, at 117-18 (clarifying that the attorney's role in the tax shelter industry is to issue an opinion letter).

234. Rostain, *supra* note 2, at 106.

235. N.Y. Tax Bar, *supra* note 197, at *2; Rostain, *supra* note 2, at 107.

236. Rostain, *supra* note 2, at 107-09.

D. ENFORCING THE RULES OF PROFESSIONAL CONDUCT

The blind-eye approach that attorneys have taken in regard to writing illegitimate opinion letters has persisted without repercussions for too long.[237] While the possible consequences of issuing suspect opinion letters should be sufficient to dissuade those from the action, few attorneys face the consequences of issuing "fraudulent opinion letter[s]," even though the penalties for such conduct include public censure or even disbarment.[238] The North Dakota State Bar Association has an opportunity to impair the continuance of tax shelters, an area where other state bar associations have failed simply by enforcing their rules of professional conduct.[239] This need not be done in an overly aggressive manner, but rather in a manner that represents to the public that the state bar association is aware of the problem and is seeking to halt the injustices it causes.[240]

VII. CONCLUSION

The abusive tax shelter problem is not a new one.[241] Regulatory agencies have struggled to combat such shelters as long as they have struggled to define them.[242] While individuals and corporations will always seek new ways to hide or lower their tax liabilities, such efforts can be minimized by attacking the parties that make such efforts possible.[243] Therefore, by removing the contingency fee from the accountant's arsenal, and ensuring that an attorney-authored opinion letter is valid, the tax shelter industry will be greatly impaired.[244] These steps are necessary to restore the integrity of the nation's tax system. [245]

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237. Paul Streckfus, *Professional Responsibility: Whither Bond Attorneys,* 2004 TAX NOTES TODAY, Dec. 14, 2004, LEXIS, 2004 TNT 240-23, at *5.

238. Chambers, *supra* note 5, at 118.

239. *Id*. at 118-19.

240. *Id*.

241. Korb, *supra* note 4, at 13.

242. Wang, *supra* note 6, at 1241-42.

243. *Id*. at 1252-56.

244. *See id*. at 1252 (discussing the argument to prohibit contingency fees); *see also* Rostain, *supra* note 2, at 107 (advocating for a change towards strict liability for taxpayers).

245. *See* Levin, *supra* note 9, at *1 (discussing how abusive tax shelters shift the burden of taxes from the wealthy to the middle class).

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