

SUPPLYING THE TAX SHELTER INDUSTRY: CONTINGENT FEE COMPENSATION FOR ACCOUNTANTS SPURS PRODUCTION

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I. INTRODUCTION

The use of abusive tax shelters by major corporations has been called “the most serious compliance issue threatening the American tax system”¹ Losses to the Treasury are estimated to range anywhere from \$7 billion² to \$30 billion per year.³ Meanwhile, corporate profits have risen 23.5 percent while their corresponding tax obligation rose by only 7.7 percent.⁴ Personal income taxes, on the other hand, are up 44 percent, which represents 79 percent of the total Federal income tax and is estimated to increase to 85 percent by the year 2004.⁵ Also astounding is that the corporate tax-to-profit ratio has dropped between 1.5 and 2.9

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1. Christopher Bergin, *Corporate Shelters Are Serious Threat to System, Summers Says*, TAX NOTES TODAY, Feb. 29, 2000, LEXIS, 2000 TNT 40-1 (quoting Lawrence H. Summers, Treasury Secretary).

2. *Penalty and Interest Provisions in the Internal Revenue Code: Hearing Before the U.S. Senate Comm. on Finance*, 106th Cong. ¶ 141, (Mar. 8, 2000) (unofficial transcript), reprinted in TAX NOTES TODAY, Mar. 16, 2000, LEXIS, 2000 TNT 52-28 [hereinafter *Finance Committee Transcript*].

3. Martin A. Sullivan, *One Shelter at a Time?*, 85 TAX NOTES 1226, 1229 (1999) [hereinafter *One Shelter at a Time*].

4. See ECON. REP. OF THE PRESIDENT, 337 tbl.B-26 (Feb. 2000), available at http://www.access.gpo.gov/usbudget/fy2001/pdf/2000_erp.pdf (last visited Mar. 18, 2002).

5. See Robert S. McIntyre, *Corporate Tax Scams*, TAXONOMIST, Apr. 24, 2000, at 24.

percent, roughly translating into a decrease in corporate income tax receipts between \$13 and \$24 billion.⁶ Although the decrease in corporate tax receipts is unlikely to be attributed to a single cause,⁷ many commentators point to the growing acceptance of abusive tax shelters by large corporations as a major contributor.⁸

The growing acceptance of abusive tax shelters by large corporations has been characterized as a “race to the bottom.”⁹ The perception that competitors are actively participating in abusive tax shelters has created an environment ripe for the promotion of tax schemes promising to zero out a corporation’s taxes. The major accounting firms are using armies of professionals to promote these schemes.¹⁰ Moreover, they have developed the resources, both in expertise and manpower, to capitalize on and perpetuate the perception.¹¹ The role played by the Big Five¹² in the tax shelter industry is extensive. They have created for themselves a vested interest in the proliferation of tax shelters through the use of contingency fees.

Some, however, refuse to acknowledge a tax shelter problem at all.¹³ Kenneth Kies of PricewaterhouseCoopers has stated that the erosion of the corporate tax base is a “myth” unsupported by any “serious” economic data.¹⁴ Similarly, David Hariton of Sullivan & Cromwell LLP doubts that any substantive change in the law is necessary to combat abusive corporate

6. See Martin A. Sullivan, *Despite September Surge, Corporate Tax Receipts Fall Short*, 85 TAX NOTES 565, 565 (1999).

7. See *id.*

8. See David Cay Johnston, *Corporations’ Taxes Are Falling Even as Individuals’ Burden Rises*, N.Y. TIMES, Feb. 20, 2000, at 1 [hereinafter *Corporations’ Taxes Are Falling*].

9. *Corporate Tax Shelters: Hearing Before the House Comm. on Ways and Means*, 106th Cong. (1999) [hereinafter Statement of Jonathan Talisman] (statement of Jonathan Talisman, Treasury Acting Assistant Secretary for Tax Policy, U.S. Department of the Treasury, quoting the New York State Bar Association).

10. See David Cay Johnston, *Tax Magicians*, N.Y. TIMES, Dec. 19, 2000, at A1 [hereinafter *Tax Magicians*].

11. See discussion *infra* Part III.C.

12. The term “Big Five” will be used throughout this article despite the recent collapse of Arthur Andersen. Moreover, many of the examples explored in the article occurred while Arthur Andersen maintained a prominent position in the tax industry and therefore the term remains appropriate in this context.

13. See, e.g., *Corporate Tax Shelters: Hearing Before the House Comm. on Ways and Means*, 106th Cong. (1999) [hereinafter Statement of Kenneth J. Kies] (statement of Kenneth J. Kies, PricewaterhouseCoopers).

14. See *id.*

tax shelters.¹⁵ In a 1999 statement before the Committee on Ways and Means, Mr. Hariton stated, “[a] series of recent decisions clearly demonstrates that the courts will not permit sophisticated taxpayers to reap the unjust benefits of strictly tax-motivated transactions.”¹⁶

Nevertheless, “most agree that corporate tax shelters are a serious problem, [that] current law is inadequate to address it, and [that] a viable solution must extinguish shelters before they are entered into, rather than relying on detection through current means or legislation that attempts to attack specific transactions.”¹⁷ Peter Canellos of Wachtell, Lipton, Rosen & Katz has even stated that “[i]t requires no citations to establish what is obvious to tax professionals within and without the government: corporate tax shelters are proliferating, in both type and number”¹⁸ In fact, due to a recent decision by the Internal Revenue Service to grant amnesty to companies using abusive tax shelters, ninety-five companies have already confessed to the use of shelters that deprived the Treasury of \$4.4 billion in taxes in 2000 and \$3.7 billion in 1999.¹⁹ The IRS data calls into doubt the belief that the proliferation of tax shelters is just a myth. In addition, three recent federal appellate court decisions undermine the notion that current law sufficiently prevents sophisticated taxpayers from reaping unjust benefits.²⁰

This Note examines the role of major accounting firms in the growth of the tax shelter industry and the extent to which their involvement has been spurred by the use of contingency fees. This Note contends that a major cause of the tax shelter problem has been the use of contingency fees by the Big Five to sell abusive tax shelters. Further, this Note argues that the Big Five’s use of contingency fees acts not only as an incentive to develop and promote more tax shelters, but also encourages ever-aggressive schemes in the pursuit of larger fees. Thus, this Note proposes that any attempt to address the tax shelter problem should follow the money, that the incentives of the Big Five must be changed, and that

15. See *Corporate Tax Shelters: Hearing Before the House Comm. on Ways and Means*, 106th Cong. (1999) [hereinafter Statement of David P. Hariton] (statement of David P. Hariton, Partner, Sullivan & Cromwell LLP).

16. *Id.*

17. Roby B. Sawyers, *Registration, Listing and Disclosure of Potentially Abusive Corporate Tax Shelters*, 33 TAX ADVISER 568, 568–69 (2000).

18. 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, 47 (2001).

19. David Cay Johnston, *I.R.S. Offers Amnesty to Companies that Admit Tax Indiscretions*, N.Y. TIMES, Dec. 26, 2001, at C1 [hereinafter *I.R.S. Offers Amnesty*].

20. See discussion *infra* Part II.C.

striking at the ability to sell tax shelters on a contingency fee basis would be an effective means of accomplishing this.

Part II begins by exploring the difficulties in identifying abusive corporate tax shelters. Part II looks at the common characteristics of today's tax shelters and contrasts specific examples found to be tax shelters with those found not to constitute abusive tax shelters. Through this recounting, Part II highlights the definitional dilemma and demonstrates that such difficulties support limiting the use of contingency fees by the Big Five.

Part III then explores the "secretive" world of the tax shelter industry. It provides an overview of the major players in the industry and reasons for the industry's growth, both on the demand and supply side. With respect to the supply side, Part III focuses on the differences between the major accounting firms and their competing tax shelter promoters. It posits several potential differences and examines the extent to which contingency fees have enabled the Big Five to control the lion's share of the industry. Part III considers the subordinate role of lawyers in the tax shelter industry, adding further support to the argument that contingency fees are a major cause of abusive tax shelters. Moreover, the comparison suggests that restricting the use of contingency fees would relegate the Big Five to a level of involvement similar to that of lawyers.

Part IV then conducts an overview of the world of accountants in the tax shelter industry. It begins by looking at specific examples of shelters sold by the Big Five on a contingency fee basis. Thereafter, Part IV reviews the regulatory regime that governs accountants and presents several critiques on the inability of such regulations to reach the actions of the Big Five.

Finally, Part V suggests that more must be done to curb the use of abusive tax shelters. Part V asserts that any significant attempt to remedy the tax shelter problem requires greater scrutiny of the accounting profession, given the characteristics of accounting firms that have enabled them to dominate the market. Specifically, Part V recommends that legislation be enacted to limit the use of contingency fees and that such legislation be further supported by penalties for accountants involved in abusive transactions. Part V argues that regulation of the use of contingency fees by accounting firms would decrease the supply of abusive tax shelters, forestall the trend to develop ever-aggressive tax shelters, and diminish the perception of a "race to the bottom." Furthermore, Part V argues that competitors, or the corporate clients themselves, are unlikely to

fill the void left by the Big Five because their expertise and workforce lie in different industries, they lack the indemnity and warranty agreements provided by the Big Five, they will be subject to audits by accountants who no longer have an incentive to overlook abusive transactions, and they could be subject to the same regulations proposed in this Note.

II. DIFFICULTIES DEFINING AN ABUSIVE TAX SHELTER SUPPORTS TARGETING ACCOUNTANT COMPENSATION IN ORDER TO DECREASE INCENTIVES TO DEVELOP INCREASINGLY ABUSIVE TAX SHELTERS

Numerous factors make it difficult to identify abusive tax shelters.²¹ As a result, Congress and the Treasury have sought to rely on the use of filters to highlight potentially abusive transactions. The use of shelter profiling, however, is not foolproof, and inadequately addresses problems caused by ad hoc legislation. Thus, given the difficulties with defining abusive tax shelters and the problems with the use of filters, regulation of accountant compensation represents a more proactive remedy by targeting the source of tax shelters and discouraging the development and promotion of abusive shelters.

A. AN OVERVIEW OF THE DEFINITIONAL DILEMMA

A Pulitzer Prize winning New York Times article defined abusive tax shelters as transactions that use accounting gimmicks solely to lower tax liabilities and have no legitimate business purpose.²² In a strictly legal sense, however, the term “tax shelter” has evaded any precise, agreed-upon definition.²³ Some commentators have analogized the attempt to define the term with the attempt to define moral behavior, because the definition varies widely depending on “whether one is talking to a banker, salesman, a customer, one’s clients, opposing counsel, a judge, an IRS agent, or the

24

One of the major stumbling blocks in congressional attempts to combat abusive tax shelters has been the difficulty in agreeing on a single

21. See discussion *infra* Part II.A.

22. *Corporations’ Taxes Are Falling*, *supra* note 8.

23. See, e.g., Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1776 (1999) [hereinafter *The New Market*].

24. Michael S. Powlen & Raj Tanden, *Corporate Tax Shelters or Plus ça Change, Plus C’est la Meme Chose*, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 9, 19 (PLI Tax Law and Estate Planning Course, Handbook Series No. J0-004I, 2001).

definition, let alone a statutory standard by which to measure transactions.²⁵ For instance, definitions put forth by both the Department of the Treasury and the Joint Committee on Taxation have been decried as both vague and subjective, and likely to threaten legitimate transactions undertaken in the ordinary course of business.²⁶

The Code itself posits at least four different definitions of a tax shelter.²⁷ Moreover, with each targeted anti-shelter legislative act, the challenge of distilling a single definition of an abusive tax shelter increases.

Acknowledging these difficulties,²⁸ the Department of the Treasury has focused their attention on identifying characteristics common to abusive corporate tax shelters, including “(1) lack of economic substance; (2) inconsistent financial and accounting treatment; (3) presence of tax-indifferent parties; (4) complexity; (5) unnecessary steps or novel investments;²⁹ (6) promotion or marketing; (7) confidentiality; (8) high transaction costs; and (9) risk reduction arrangements.”³⁰

In a more honest and detailed analysis,³¹ Professor Joseph Bankman of Stanford University adds three additional characteristics.³² First, tax shelters often take advantage of a flaw in the tax law that allows allocation of income in excess of economic income.³³ The over-allocated income is then absorbed by the zero-bracket taxpayer (the tax-indifferent party under the Treasury’s characterization), which leaves the domestic corporation with a loss in excess of economic loss.³⁴ Second, where the shelter does not take advantage of an internal flaw it instead plays on structural flaws involving the taxation of corporate or partnership income, or the interaction

25. See generally *Finance Committee Transcript*, *supra* note 2 (noting disagreement among U.S. Senate Finance Committee members on the proliferation of corporate tax shelters).

26. See Statement of Kenneth J. Kies, *supra* note 13.

27. See Powlen & Tanden, *supra* note 24, at 17–18 (referring to I.R.C. §§ 461(i), 6111, 6662(d)(2)(C)(iii), and 6700).

28. See U.S. TREASURY DEP’T, THE PROBLEM OF CORPORATE TAX SHELTERS 95 (1999), available at http://www.taxpolicycenter.org/TaxFacts/papers/corp_shelter.pdf (July 1999) [hereinafter U.S. TREASURY DEP’T].

29. The Joint Committee on Taxation is much more direct: the corporate taxpayer would not have entered into the arrangement if not for the tax benefits. See JOINT COMM. ON TAXATION, JCS-3-99, STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 218 (1999), available at <http://www.house.gov/jct/s-3-99.pdf> (July 22, 1999) [hereinafter JOINT COMM. ON TAXATION].

30. U.S. TREASURY DEP’T, *supra* note 28, at 12.

31. Honest in the sense that Prof. Bankman readily places some of the blame on the Code itself.

32. *The New Market*, *supra* note 23, at 1777. Prof. Bankman, however, excludes from his list of criteria the Treasury’s seventh, eighth, and ninth characteristics. See *id.*

33. See *id.*

34. *Id.*

of the U.S. tax system with foreign tax systems.³⁵ Lastly, the shelter would likely be shut down by legislative or administrative change soon after it is detected.³⁶

As the Treasury readily admits,³⁷ however, even some legitimate business transactions exhibit many such characteristics. Thus, although this set of characteristics has the appeal of being more constructive than any single definition, there is still a significant amount of ambiguity in identifying abusive tax shelters.

B. SPECIFIC EXAMPLES OF ABUSIVE TAX SHELTERS

Of course, no attempt to define abusive tax shelters would be complete without specific examples of shelters that have been identified and shut down by statute or administrative action. Therefore, an analysis of a few transactions found to be abusive sheds light on the often-complex nature, which makes the term “tax shelter” difficult to define.

In 1999, for example, the IRS shutdown the use of the Bond and Option Sales Strategy (“BOSS” transaction) by enacting 1999-52 I.R.B. 761.³⁸ Through a series of contrived steps, the BOSS transaction enabled taxpayers to claim tax losses for capital outlays that they had in fact recovered.³⁹ The Treasury estimated that BOSS transactions would have contributed to a loss to the Treasury of up to \$80 billion over a ten-year period.⁴⁰

In a BOSS transaction, a taxpayer formed a partnership that put money into a limited-liability company in a foreign country formed for the purpose of carrying out the deal. In return, the partnership received the common stock of the foreign company. “Another party, generally an entity formed by the promoter, [then] contributed additional capital to the corporation in exchange for preferred stock. Thereafter, the foreign company acquire[d] additional capital by borrowing from a bank and grant[ing] the bank a security interest in securities acquired by the [company].” The foreign company then distributed the encumbered securities to the taxpayer’s partnership.⁴¹

35. *Id.*

36. *Id.*

37. See U.S. TREASURY DEP’T, *supra* note 28, at 12 n.41.

38. See Powlen & Tanden, *supra* note 24, at 59 n.117.

39. See John D. McKinnon, *How New Tax Shelter Promised Big Savings But Finally Fell Apart*, WALL ST. J., Aug. 21, 2000, at A1 [hereinafter *New Tax Shelter*].

40. See Bergin, *supra* note 1, at 40-1.

41. Powlen & Tanden, *supra* note 24, at 58.

The partnership then claimed that the securities were encumbered by the loan from the bank, and “therefore that the amount of the distribution [was] zero and it create[d] no taxable income”⁴² for the purposes of section 301.⁴³ The claim, however, was suspect because the value of the securities is later fully restored (unencumbered) when the foreign company’s bank debt is repaid out of other assets.⁴⁴ Thus, “no part of the distribution is treated either as a dividend or as a reduction of stock basis under section 301(c).”⁴⁵ At the same time, “[t]he effect of the distribution, combined with fees and other transaction costs incurred at the corporate level, is to reduce the remaining value of the foreign corporation’s common stock to ⁴⁶ The foreign corporation is then liquidated, giving rise to a tax loss equal to the partnership’s original investment.⁴⁷

Put more simply, the taxpayer purchased shares that later became worthless, thus entitling the taxpayer to a loss (the purpose of the transaction). The loss, however, was artificial because the company had distributed securities to the taxpayer equal to his or her investment. Yet, the securities escaped taxation because they were encumbered even though they were later unencumbered by the company.

Another transaction that has been shut down by targeted legislation⁴⁸ is the Liquidating Real Estate Investment Trust (Liquidating REIT) transaction. The Liquidating REIT transaction allowed banks and other financial institutions to create a permanent tax exclusion for certain interest income by playing to inconsistencies between Code sections 332 and 561(b)(1)(B).⁴⁹ By curtailing such transactions, revenue increased by approximately \$1 billion annually.⁵⁰ In fact, one transaction alone reported a “special tax benefit” from the liquidation of an affiliate (the REIT), resulting in a permanent difference in excess of \$100 million.⁵¹

The transaction was structured so that “taxpayer[] [corporations] claimed that the liquidation of a REIT subsidiary permitted (1) the

42. *New Tax Shelter*, *supra* note 39.

43. *See* Powlen & Tanden, *supra* note 24, at 59 (§ 301 determines when the distribution of property made by a corporation to a shareholder with respect to its stock is considered part of the shareholder’s gross income).

44. *See New Tax Shelter*, *supra* note 39.

45. Powlen & Tanden, *supra* note 24, at 59.

46. *Id.* at 58.

47. *See New Tax Shelter*, *supra* note 39.

48. *See* 26 I.R.C. § 332(c) (2001) (preventing a corporation from excluding from income any liquidating distribution received from a REIT).

49. *See* Powlen & Tanden, *supra* note 24, at 62 n.119.

50. *See* JOINT COMM. ON TAXATION, *supra* note 29, at 207.

51. *See id.* at 250 n.561.

corporate shareholder to receive tax-free distributions from the REIT during the liquidation period, and (2) the REIT to claim a dividends paid deduction with respect to the same distributions.”⁵² This was possible under prior law because nothing prohibited excluding distributions from a liquidating subsidiary, which are tax-free under section 332, from taxable income.⁵³

Yet another example is an ACM-type transaction (or contingent installment sale note transaction), which enables “taxpayers, through [the] use of a tax-indifferent party, to have a high and overstated basis in a relatively liquid asset. When the U.S. corporate taxpayer sells the asset, a tax loss is generated that can be used to shelter other, unrelated income from tax.”⁵⁴ The Joint Committee on Taxation estimates that use of ACM-type transactions have cost the Treasury over \$1 billion in unpaid taxes.⁵⁵ ACM-type transactions were shut down by regulatory changes and the *ASA Investerings* and *ACM Partnership* court decisions.⁵⁶

In an ACM-type transaction, the taxpayer forms an offshore partnership with a foreign, tax-exempt entity.⁵⁷ The partnership acquires a security and then sells it (twenty-four days later in *ACM*) in exchange for contingent payments payable over a fixed term.⁵⁸ The result of the approach is a large “phantom” gain in the early years⁵⁹ that would be allocated almost entirely to the tax-exempt foreign entity.⁶⁰ “The tax-exempt entity is then redeemed out of the partnership, and the partnership subsequently recognizes taxable loss which is wholly allocated to the taxpayer and used to offset other capital gains that the taxpayer had incurred outside of the partnership.”⁶¹

52. *Id.* at 250.

53. See Powlen & Tanden, *supra* note 24, at 62.

54. U.S. TREASURY DEP’T, *supra* note 28, at 134.

55. See JOINT COMM. ON TAXATION, *supra* note 29, at 207.

56. See *ASA Investerings P’ship v. Commissioner*, 76 T.C.M. (CCH) 325 (1998); *ACM P’ship v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), *aff’d in part, rev’d in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 119 S. Ct. 1251 (1999); Powlen & Tanden, *supra* note 24, at 66.

57. See Powlen & Tanden, *supra* note 24, at 65.

58. See *id.* at 65. The payments were considered contingent because they were partly determined by reference to the London Interbank Offering Rate (“LIBOR”). See also JOINT COMM. ON TAXATION, *supra* note 29, at 180 (describing the details of the transaction, where the remaining amount paid for in installment notes would be considered contingent and therefore would fall within the special ratable basis recovery rule under section 453 regulations).

59. See Powlen & Tanden, *supra* note 24, at 65.

60. See JOINT COMM. ON TAXATION, *supra* note 29, at 180–81.

61. Powlen & Tanden, *supra* note 24, at 66. In *ACM Partnership v. Commissioner*, ACM sought to avoid a capital gain of approximately \$105 million from the sale of a subsidiary. See JOINT COMM. ON TAXATION, *supra* note 29, at 180.

C. WHAT WAS ONCE AN ABUSIVE TAX SHELTER BUT NOW IS NOT

The difficulties of identifying contemporary tax shelters are further highlighted by a recent string of appellate court cases. In each case a highly touted⁶² Treasury victory against abusive tax shelters was overturned on appeal.⁶³ Taken together, commentators have stated that courts have now drawn the line between abusive tax shelters and legitimate tax planning very narrowly.⁶⁴ Moreover, “[s]ome experts predict[] that tax shelter promoters [will] quickly take advantage of the ruling[s] to fashion new shelters for corporations to shed billions of dollars in taxes.”⁶⁵ The result of these cases demonstrates the fallibility of relying on tax shelter profiles, and reveals the need for an approach that is not reliant on a potentially pejorative label.

One of the cases, *Compaq Computer Corp. v. Commissioner*,⁶⁶ was even used by the Joint Committee on Taxation to arrive at their estimate of losses to the Treasury due to shelter abuse.⁶⁷ Compaq had taken advantage of what Raj Tanden and Michael Powlen call “foreign taxes trafficking,”⁶⁸ or “dividend stripping” according to David Hariton.⁶⁹ Although there are variations of this type of transaction, Compaq’s version was to coordinate a series of “huge, rapid-fire stock trades”⁷⁰ resulting in a net loss of \$1,486,755 but a foreign tax credit of \$3,381,870 to be offset against U.S. income taxes.⁷¹ “In a carefully arranged strategy,” Compaq purchased more than \$900 million of foreign stock that was sold within the hour at a lower price.⁷² During that hour Compaq became the recipient of a corporate dividend subject to a foreign withholding tax, which can be

62. See *Testimony of the Staff of the Joint Comm. on Taxation Before the House Comm. on Ways and Means*, available at <http://www.house.gov/jct/x-82-99> (Nov. 10, 1999) [hereinafter *Testimony of Joint Committee*] (statement of Lindy Paull, Chief of Staff of the Joint Comm. on Taxation).

63. See *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 779 (5th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350, 351 (8th Cir. 2001); *United Parcel Serv. v. Commissioner*, 254 F.3d 1014, 1016 (11th Cir. 2001).

64. See David Cay Johnston, *Two Courts Reject I.R.S. Efforts to Limit Tax Shelters*, N.Y. TIMES, June 22, 2001, at A1 [hereinafter *Courts Reject I.R.S.*].

65. David Cay Johnston, *Ruling Eases Restrictions on Tax Shelters for Companies*, N.Y. TIMES, Jan. 3, 2002, at C1 [hereinafter *Ruling Eases Restrictions*].

66. 113 T.C. 214 (1999).

67. See *Testimony of Joint Committee*, *supra* note 62, at 6.

68. Powlen & Tanden, *supra* note 24, at 69.

69. David P. Hariton, *The Compaq Case, Notice 98-5, and Tax Shelters: The Theory Is All Wrong*, 94 TAX NOTES 501, 501 (2002).

70. See *Ruling Eases Restrictions*, *supra* note 65.

71. See Powlen & Tanden, *supra* note 24, at 31.

72. *Ruling Eases Restrictions*, *supra* note 65.

claimed as a foreign tax credit for U.S. income tax purposes.⁷³ Thus, although recognizing an economic loss equal to the loss in value of the stock, Compaq was also able to claim a foreign tax credit for the amount of the withholding tax.⁷⁴

Despite the fact that Compaq had in effect purchased foreign tax credits in a transaction that was reasonably expected to eliminate typical market risks,⁷⁵ the Court of Appeals for the Fifth Circuit held that the transaction had both economic substance and a non-tax business purpose and was therefore not a sham.⁷⁶ The court stated that the transaction was not necessarily invalid even if Compaq had sought *primarily* to get otherwise unavailable tax benefits in order to offset unrelated tax liabilities and unrelated capital gains.⁷⁷ Moreover, the court stressed that although the risk involved was minimal, just the possibility of risk was enough to make the trades bona fide.⁷⁸

The Compaq decision followed two earlier rulings also diminishing recent gains the Treasury had made against abusive tax shelters. In *IES Industries, Inc. v. United States*,⁷⁹ Alliant Energy engaged in the same type of foreign tax trafficking that was involved in Compaq. Alliant Energy conducted extensive instantaneous back and forth trading of foreign stocks with a third party.⁸⁰ This enabled it to claim a foreign tax credit of \$13.5 million, a recognized capital loss of \$82.7 million (from the ADR purchases and sales) to be carried back to offset capital gains earned in 1989 and 1990, and ultimately a refund of over \$26 million.⁸¹

The Court of Appeals for the Third Circuit held that the transaction did not, as a matter of law, lack business purpose or economic substance.⁸² The court stressed that the trades were conducted at arms-length and that the transaction should not be labeled a sham for tax purposes merely because it did not involve excessive risk.⁸³ Further, the “ruling made no mention of expert testimony that all of the trades were done at prearranged

73. See Hariton, *supra* note 69, at 501.

74. See *id.*

75. See Powlen & Tanden, *supra* note 24, at 31.

76. See *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 781–82 (5th Cir. 2001).

77. *Id.* at 237.

78. See *id.* at 238.

79. 253 F.3d 350 (8th Cir. 2001).

80. See *Courts Reject I.R.S.*, *supra* note 64.

81. See *IES Indus., Inc. v. United States*, 253 F.3d 350, 353 (8th Cir. 2001).

82. *Id.* at 356.

83. *Id.* at 355.

prices that guaranteed the creation of tax losses,”⁸⁴ nor was the court suspicious of the fact that trades were executed in Amsterdam when U.S. and European markets were closed.⁸⁵ Instead, the court characterized such actions as “good business judgment” and the result of doing one’s homework.⁸⁶

Lastly, in *UPS v. Commissioner*,⁸⁷ the Court of Appeals for the Eleventh Circuit reversed a tax court’s ruling that a reinsurance transaction, which enabled UPS to avoid taxation on \$100 million of income in 1984 alone, was an abusive tax shelter since it lacked real economic effects or business purpose.⁸⁸

In an effort to avoid paying taxes on lucrative excess-value business,⁸⁹ UPS restructured its insurance program into one provided by an overseas affiliate, formed and capitalized as a Bermuda-based subsidiary.⁹⁰ UPS then purchased an insurance policy, for the benefit of UPS customers, from a third-party insurer who assumed the risk of damage to, or loss of, excess-value shipments.⁹¹ “The premiums for the policy were the excess-value charges that UPS collected.”⁹² UPS, not the insurance company, administered claims brought under the policy.⁹³ The insurance company in turn entered into a reinsurance agreement with UPS’ Bermuda-based subsidiary.⁹⁴ Under the agreement, the subsidiary assumed the risk of damage to, or loss of, excess-value shipments that the insurance company had assumed from UPS in exchange for premiums that equaled the excess-value payments the insurance company received from UPS, less commissions, fees, and excise taxes.⁹⁵ The transaction enabled UPS to exclude from income the excess-value payments, while essentially performing the same functions and activities, and recapture those payments minus the fees paid to the insurer. In effect, UPS sold off its insurance

84. *Courts Reject I.R.S.*, *supra* note 64.

85. *See IES Indus., Inc. v. United States*, 253 F.3d 350, 352 (8th Cir. 2001).

86. *See id.* at 355.

87. 254 F.3d 1014 (11th Cir. 2001).

88. *See United Parcel Serv. of Am., Inc. v. Commissioner*, 78 T.C.M. (CCH) 262 (1999).

89. Excess value business was the income derived by UPS from payments received by clients for shipping insurance. Excess value business was quite lucrative to UPS “since it never came close to paying as much in claims as it collected in charges” *United Parcel Serv. of Am.*, 254 F. 3d. at 1016.

90. *See id.*

91. *See id.*

92. *United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F. 3d 1014, 1016 (11th Cir. 2001).

93. *See id.*

94. *See id.*

95. *See id.*

business to a third-party, who in turn sold it back to UPS through UPS' tax-exempt Bermuda-based subsidiary.⁹⁶

The appellate court held that the tax court erred in considering the restructuring pointless, and instead found that it did not lack real economic effects or a legitimate business purpose.⁹⁷ Although the transaction was merely an altered form of an existing business, the court held that because the original business was bona fide it retained an adequate business purpose to neutralize any tax-avoidance motive.⁹⁸ Moreover, the court stated that even though it was more sophisticated and complex than usual transactions, its sophistication did not change the fact that there was a real business that served the genuine needs of customers and assisted UPS in lowering its liability exposure.⁹⁹

III. THE TAX SHELTER INDUSTRY

An analysis of the tax shelter industry, the players, and the reasons for its growth provides further insight into the nature of the tax shelter problem. In addition, examining the accounting profession reveals the motivation that drives them to devote enormous resources into the development and marketing of shelters, and illuminates possible alternatives that may diminish these incentives.

A. AN OVERVIEW OF THE TAX SHELTER INDUSTRY

Although abusive tax shelters are nothing new,¹⁰⁰ what was once seen as a tool only for wealthy individuals¹⁰¹ has now become a lucrative¹⁰² "new industry"¹⁰³ marked by "wildfire growth"¹⁰⁴ and includes a client list made up of the likes of Fortune 500 companies.¹⁰⁵ Media reports describe

96. *See id.* at 1016–17.

97. *See United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F. 3d 1014, 1016 (11th Cir. 2001).

98. *See id.* at 1020.

99. *See id.*

100. Powlen & Tanden, *supra* note 24, at 15.

101. *See Penalty and Interest Provisions in the Internal Revenue Code: Hearing Before the U.S. Senate Comm. on Finance*, 106th Cong. ¶ 5 (Mar. 8, 2000) (statement of Peter L. Faber), *reprinted in TAX NOTES TODAY*, Mar. 9, 2000, LEXIS, 2000 TNT 47-65 [hereinafter Statement of Peter L. Faber] (describing the shelters of the 1970s and early 1980s as predominately being used by doctors); Susan Beck, *Gimme Shelters*, AM. LAW., Nov. 1999, at 105.

102. *See New Tax Shelter*, *supra* note 39.

103. Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, FORBES, Dec. 14, 1998, at 198.

104. Beck, *supra* note 101, at 106.

105. *See, e.g.,* Novack & Saunders, *supra* note 103, at 200.

a “thriving industry . . . being peddled, sometimes in cold-call pitches, to thousands of companies.”¹⁰⁶ The transactions being marketed are described as truly aggressive¹⁰⁷ and involving tax-exempt foreign entities,¹⁰⁸ “arcane quirks in the tax code,”¹⁰⁹ and armies of professionals¹¹⁰ culminating in unjustified transactions that distort the tax system.¹¹¹ Stories of multimillion dollar tax savings, multimillion dollar fees, and now multimillion dollars in losses to U.S. investors have uncovered an industry of “hustling” and a widespread acceptance of corporate tax-avoidance.¹¹²

Furthermore, “[t]he recognition of a corporate tax shelter phenomenon is not limited to media reports. Several prominent associations representing corporate tax executives, lawyers, and accountants have voiced their concerns with the growing popularity of corporate tax shelters and its potentially harmful effects on the Federal income tax system.”¹¹³

Nonetheless, reports of the industry have been largely anecdotal.¹¹⁴ Professor Joseph Bankman attributes this to the lack of any agreed upon definition of a tax shelter, the relative newness of the industry, and the understandable desire of many of the participants for a high degree of secrecy in development and promotion of the schemes.¹¹⁵ For example, many tax shelter transactions require the taxpayer to sign a non-disclosure agreement, and in some cases the promoter will purposefully limit the sale of the shelter to only a few taxpayers in an effort to evade the scrutiny of the IRS and Treasury.¹¹⁶

What has come to light, both anecdotally and via hard data, has revealed that the corporate tax shelter industry is proliferating.¹¹⁷ Peter Faber of McDermott, Will & Emery has stated that the problem is qualitatively and quantitatively different than any other compliance

106. *Id.* at 198–99.

107. Beck, *supra* note 101, at 110.

108. *See, e.g.*, U.S. TREASURY DEP’T, *supra* note 28, at 17 (stating that corporate tax shelters typically involve exceedingly complex transactions and structures to facilitate the exploitation of tax law inconsistencies, and to cloak the tax shelter transaction from detection).

109. Novack & Saunders, *supra* note 103, at 199.

110. *See Tax Magicians*, *supra* note 10.

111. *See* Beck, *supra* note 101, at 110.

112. *See, e.g.*, U.S. TREASURY DEP’T, *supra* note 28, at 28; Novack & Saunders, *supra* note 103, at 198.

113. JOINT COMM. ON TAXATION, *supra* note 29, at 205.

114. *See, e.g.*, *The New Market*, *supra* note 23, at 1780.

115. *See id.*

116. *See* Beck, *supra* note 101, at 110.

117. *See* U.S. TREASURY DEP’T, *supra* note 28, at xii.

problem.¹¹⁸ Qualitatively different in that both the parties involved and the actual tax shelters are much more sophisticated in comparison to the shelters of the 1970s and early 1980s.¹¹⁹ The shelters exploit flaws in the statutes and regulations, enabling them to create artificial tax benefits that do not reflect economic reality even though they may literally comply with the law.¹²⁰ Not only are the new shelters much more subtle, but promoters are even devising ways to help taxpayers coverup the use of tax shelters.¹²¹

In addition, the tax shelters being developed are no longer client specific as they had been in the past.¹²² Today's tax shelter promoters, largely comprised of the Big Five, "parse the numerous weaknesses in the tax code and devise schemes that can be pitched as 'products' to corporate prospects. Then [the promoters] sell them methodically and aggressively, using a powerful distribution network not unlike the armies of pitchmen who sold cattle and railcar tax shelters to individuals in the 1970s and 1980s."¹²³ Perhaps thinking that the analogy to cattle and railcar tax shelters was too conservative, one expert has stated that the "tax products" are "being marketed like toothpaste."¹²⁴ Moreover, acceptance of the industry is so widespread that one member of the Big Five has placed advertisements for the development and marketing of "tax products."¹²⁵

The "product" is a device that exists solely to avoid taxes.¹²⁶ It promises to zero out a company's taxes,¹²⁷ and it comes with an opinion that provides insurance against tax penalties in case of a successful IRS attack.¹²⁸ Promoters are developing the products at such a rate that the IRS cannot keep up with them,¹²⁹ and they have become so nimble that they easily sidestep court rulings and IRS determinations.¹³⁰ In fact, some promoters require their staffers to come up with one new idea a week.¹³¹

118. See Statement of Peter L. Faber, *supra* note 101, at ¶ 3.

119. See *id.* at ¶¶ 3, 5, 7.

120. See *id.* at ¶ 5.

121. See *New Tax Shelter*, *supra* note 39 (describing a new trust that was being marketed that would effectively launder shelter transactions, so that large losses they produce wouldn't have to be reported separately on returns and raise suspicion).

122. See, e.g., Novack & Saunders, *supra* note 103, at 202.

123. *Id.* at 200.

124. See Statement of Peter L. Faber, *supra* note 101, at ¶ 11.

125. See *id.*

126. See *Tax Magicians*, *supra* note 10.

127. See Novack & Saunders, *supra* note 103, at 198.

128. See *The New Market*, *supra* note 23, at 1782.

129. See Beck, *supra* note 101, at 106.

130. See Ken Rankin, *Accountants Get Blamed for Tax Shelter 'Hustling,'* ACCT. TODAY, Feb. 7, 2000, at 5.

131. See *id.*; Novack & Saunders, *supra* note 103, at 203.

“[The promoters] work . . . every angle. They tell the companies to do it. They argue with the IRS that [the tax products] ought to be allowed. And they lobby the Congress to try to make them legal.”¹³²

B. THE PLAYERS

The result is a new industry “thought to revolve around a few . . . shelter creators and/or promoters.”¹³³ This small group of developers, or promoters, is made up of large accounting firms, investment banks, and law firms.¹³⁴ Recent data from an amnesty-induced confession of tax-avoidance has revealed that of twenty-eight promoters, seven were accounting firms, seven were investment banks, and the other fourteen were not characterized.¹³⁵

Nevertheless, “[m]any, if not most, observers believe that accounting firms hold the lion’s share of the market.”¹³⁶ Some accounting firms even have partners and employees whose sole purpose is to develop tax shelters and others whose purpose is to sell the products.¹³⁷ For example, PricewaterhouseCoopers admitted to having two databases of about one thousand “mass-market” tax saving ideas, some aggressive and some mainstream.¹³⁸ In addition to the mass-marketed products, PricewaterhouseCoopers also admitted to selling complex “black box” products and unique strategies that are not widely publicized.¹³⁹ The black box products are pitched to a limited number of companies to avoid being detected by the IRS and Treasury, and are estimated to generate from tens of millions to hundreds of millions of dollars in tax savings.¹⁴⁰ Moreover, “[a]ll of the Big Five accounting firms,” Ernst & Young, PricewaterhouseCoopers, Deloitte & Touche, KPMG, and Arthur Andersen, are designing and selling tax shelters.¹⁴¹

In addition to economic data indicating a proliferation of abusive corporate tax shelters,¹⁴² an analysis of the growth of the Big Five is also

132. David S. Hilzenrath, *Accountants’ Tax Services Draw Fire*, WASH. POST, Feb. 7, 2002 (quoting Robert McIntyre of Citizens for Tax Justice).

133. *The New Market*, *supra* note 23, at 1780.

134. *See id.*

135. *I.R.S. Offers Amnesty*, *supra* note 19.

136. *The New Market*, *supra* note 23, at 1780.

137. *See* Statement of Peter L. Faber, *supra* note 101, at ¶ 10.

138. *See* Novack & Saunders, *supra* note 103, at 202.

139. *See id.* at 203.

140. *See id.*

141. *Tax Magicians*, *supra* note 10.

142. *See supra* Part I.

suggestive of the scope of their involvement and increased acceptance of corporate tax shelters. A survey of the Big Five's net revenue for 2001 indicates that tax services accounted for more than \$6.9 billion in revenue, comprising 30 percent of total revenue for the firms.¹⁴³ Although tax services consist of anything from the preparation of client's returns to the sale of tax shelters, the sale of mass-marketed shelters for \$20 million¹⁴⁴ and \$7 million¹⁴⁵ would likely make up a large part of the revenue derived.

Although not the focus of this Note, investment banks are likely to be operating in much the same manner as the accounting firms.¹⁴⁶ Merrill Lynch denotes its team of shelter developers "financial engineers."¹⁴⁷ Merrill Lynch was also one of the developers behind the ACM-type transactions, and had sold the same idea to at least ten¹⁴⁸ other companies including AlliedSignal Inc.,¹⁴⁹ American Home Products Corp.,¹⁵⁰ Borden Inc.,¹⁵¹ Brunswick Corp., Dun & Bradstreet Corp., Paramount Communications Inc.,¹⁵² and Schering-Plough Corp.¹⁵³

Likewise, "[m]any law firms have a hand in 'tax product' work . . . [A] handful of firms—including New York's Skadden, Arps, Slate, Meagher & Flom; Atlanta's King & Spaulding; and New York's Shearman & Sterling—are known for maintaining some of the most active

¹⁵⁴ In fact, a marketing brochure put out by PricewaterhouseCoopers, which was meant to persuade prospective clients that the firm had more expertise in a specific transaction, listed law firms that had been involved in structuring the transaction for some of the nation's biggest banks.¹⁵⁵

143. *Tax Magicians*, *supra* note 10.

144. *See* Hilzenrath, *supra* note 132.

145. *See* *Tax Magicians*, *supra* note 10.

146. *See* *The New Market*, *supra* note 23, at 1780.

147. *Tax Magicians*, *supra* note 10, at A1.

148. *See id.*

149. Allied Signal became part of Honeywell International Inc. in 1999.

150. The IRS victory in *American Home Products Corp.* was reversed recently by a U.S. District Court in Washington D.C. *See* Randall Smith, *IRS Is Reversed on AHP Shelter*, WALL ST. J., Oct. 12, 2001, at C13 (reporting that it was Merrill Lynch & Co.'s first victory in four suits involving transactions that had been found to be impermissible tax-avoidance transactions by tax courts in 1997).

151. Borden Inc. is owned by Kohlberg Kravis Roberts & Co.

152. Paramount Communications Inc. is now part of Viacom Inc.

153. *See* Randall Smith, *IRS, Merrill Reach Pact on Shelters*, WALL ST. J., Aug. 29, 2001, at C1.

154. Beck, *supra* note 101, at 106.

155. *See id.* at 109–10.

¹⁵⁷ Instead, law firms are more commonly engaged in the process of writing the legal opinions by which promoters insure their corporate prospects against audit penalties.¹⁵⁸

The subordinate role of lawyers¹⁵⁹ is attributable to a number of factors. First, accounting firms can be said to be at the “ground level,” in that their auditing functions make them privy to large gains that corporations may desire to shelter. Second, they have at their disposal a ready-made client base that they are routinely able to evaluate.¹⁶⁰ Third, accounting firms have invested enormous resources into their tax product work. For example, PricewaterhouseCoopers employs approximately six hundred top-notch tax professionals in its Washington D.C. office alone,¹⁶¹ while the largest U.S. law firm has only twenty-eight.¹⁶² Lastly, different cultures exist in law firms and accounting firms.¹⁶³ Selling tax shelters on a contingency fee basis fosters a willingness to develop and sell ever-aggressive transactions within the accounting profession.¹⁶⁴ In comparison, lawyers’ tax product work is often charged on an hourly basis, which translates into a lower willingness to engage in such transactions.¹⁶⁵ Moreover, a lawyer’s hourly fee does not justify the risk to one’s reputation if the transaction is disallowed, or even the initial costs to develop and market the shelter. In other words, the subordinate role of lawyers in the industry suggests that hourly fees are not a sufficient financial incentive to develop and promote abusive tax shelters, and thus further supports restricting the Big Five’s use of contingency fees.

156. See *id.* at 106.

157. Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. Rev. 149, 153 (2001) [hereinafter *The Business Purpose*].

158. See Beck, *supra* note 101, at 106; discussion *infra* Part III.C.

159. See *The Business Purpose*, *supra* note 157, at 153 (stating that lawyers profit only indirectly from shelter work and that in the long run shelters are bad for the legal tax practice since they are “often promoted by accounting firms, who compete with law firms for tax business”).

160. Telephone Interview with Greg Jenner, Deputy Assistant Secretary for Tax Policy, U.S. Dep’t of the Treasury (Mar. 7, 2002). Please note that Mr. Jenner’s statements were made in an entirely individual capacity in response to specific questions from the author.

161. *Id.*

162. See NATIONAL ASS’N FOR LAW PLACEMENT, NALP LAW FIRM QUESTIONNAIRE, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP – NEW YORK (2001).

163. See *The Business Purpose*, *supra* note 157, at 152.

164. See *id.* at 153.

165. See discussion *infra* Part III.C.

The Big Five are aggressively marketing¹⁶⁶ the tax products to “Fortune 500 companies and, less commonly, to privately held companies controlled by individuals of substantial wealth.”¹⁶⁷ Feeling the pressure to generate greater economic returns¹⁶⁸ and perceiving that competitors are actively engaging in tax-avoidance,¹⁶⁹ corporations that were once reluctant to engage in tax-avoidance schemes are now engaged in what the New York State Bar Association describes as a “race to the bottom.”¹⁷⁰ As related by Professor Bankman, “[t]here isn’t a Fortune 500 Company that

171

C. REASONS FOR THE GROWTH OF THE TAX SHELTER INDUSTRY

Speculation as to the reasons for the growth of the tax shelter industry predominately falls into two groups. The first naturally focuses on the demand side of the shelter industry, and both the external and internal factors that drive corporations to engage in such transactions. The second examines the externalities attributable to the supply side, the developers, and with respect to this Note, the role of large accounting firms.

On the corporate level, the main external factors¹⁷² contributing to the growth of the tax shelter industry include the low risk of being audited, the complexity of tax laws, globalization, financial innovation, and the merger boom of the 1980s and 1990s.¹⁷³ Review of the demand side of the tax

166. See, e.g., Hilzenrath, *supra* note 132.

167. *The New Market*, *supra* note 23, at 1776.

168. See Powlen & Tanden, *supra* note 24, at 21.

169. See U.S. TREASURY DEP’T, *supra* note 28, at 3.

170. See Statement of Jonathan Talisman, *supra* note 9 (quoting the New York State Bar Association).

171. *The New Market*, *supra* note 23, at 1776 (quoting “Investment Banker”).

172. The analysis of factors influencing growth on the demand side of the shelter industry excludes the influence of promoters, which will be addressed later in Part III.C. See discussion *infra* Part III.C.

173. See U.S. TREASURY DEP’T, *supra* note 28, at 25–31. As audit rates for large corporations have fallen dramatically, corporations have learned that the chance of being audited is low. See *id.* at 29. For example, between 1980 and 1997 the chance of being audited dropped by forty-two percent. See *id.* Moreover, as the ABA recently testified: “[A]ll parties to these transactions [corporate tax shelters] know there is substantial likelihood that the device employed . . . will not be uncovered by IRS agents even if the corporation is audited . . .” JOINT COMM. ON TAXATION, *supra* note 29, at 212–13 (quoting testimony by the ABA).

The complexities of tax laws, particularly in relation to business transactions, also allow aggressive taxpayers to find and exploit discontinuities that become the foundations for corporate tax shelters. See JOINT COMM. ON TAXATION, *supra* note 29, at 207; U.S. TREASURY DEP’T, *supra* note 28, at 29–30. Tax shelters may take advantage of flaws in the tax law or inconsistencies in the way the tax law applies to economically equivalent transactions, play to unrelated, incongruous Code provisions in connection with a single transaction that results in consequences never intended by Congress, or

shelter industry reveals that many of the factors are either desirable or would represent an enormous challenge to overcome and therefore necessitate focus on the role of accountants.

Moreover, despite the constructive benefits of focusing on specific contributing factors on the demand side, the fact that money ultimately drives the industry cannot be overlooked.¹⁷⁴

It is also obvious that the majority of corporations are not acting alone in designing ways to avoid paying their fair share of taxes. It is perhaps more effective, therefore, both specifically in decreasing tax-avoidance and more broadly in minimizing any collateral effects (such as those that would inevitably occur with substantive changes in the code),¹⁷⁵ to focus on the economic factors that drive promoters, particularly the Big Five, to develop

capitalize on misguided administrative and judicial interpretations of the law. See JOINT COMM. ON TAXATION, *supra* note 29, at 207–08. Furthermore, the complexity adds to the ineffectiveness of the audit threat as only a painstaking analysis by a well-informed auditor would catch the complex financial arrangements, which invoke very sophisticated provisions of the tax law. See *id.* at 202–13.

In addition, the increasing sophistication and globalization of financial markets have enabled taxpayers to facilitate tax-avoidance through the use of foreign entities and technological advances in financial product development. See U.S. TREASURY DEP'T, *supra* note 28, at 30. For example, both the ACM-type and BOSS transactions funneled taxable income through foreign entities. See discussion *supra* Part II.B. Further, many of the new tax shelters have benefited from the growth of derivatives and employ devices such as “swaps, collars, straddles, and preferred stock as building blocks.” Novack & Saunders, *supra* note 103, at 198.

The merger booms of the 1980s and 1990s also created tax-planning opportunities as companies sought ways to offset significant capital gains from the sale of companies. See U.S. TREASURY DEP'T, *supra* note 28, at 30–31. In addition, legislation eliminating popular “tax-saving techniques with respect to mergers and acquisitions may have led to increased emphasis on corporate tax shelters.” *Id.* at 31.

Several factors within the tax system have contributed to the increased incentive to use tax shelters and a shift in corporate attitudes. For example, the Tax Reform Act of 1986 eliminated many corporate tax preferences, such as accelerated depreciation, the investment tax credits, and the *General Utilities* doctrine, which has given corporations greater incentives to look elsewhere in the Code in search of techniques to reduce their taxes. See *id.* at 26. In addition, other factors such as drops in interest rates and reduced benefits from interest deductions have had a similar effect. See *id.* at 31.

Even more troubling is the general trend among corporate executives to view the corporate tax department as a profit center rather than as a general administrative support facility. See, e.g., *id.* at 28–29. Tax departments are viewed as having an “obligation to more or less aggressively reduce the tax burden.” *Corporations' Taxes Are Falling*, *supra* note 8 (quoting Treasury Secretary Lawrence H. Summers). In fact, tax executives at major corporations report that they are getting “pitched” more and more “aggressive” transactions and are under increasing pressure to approve transactions with little non-tax business purpose or economic substance. See *Testimony of Joint Committee*, *supra* note 62; at 6; Statement of Peter L. Faber, *supra* note 101, at ¶ 14.

174. See Novack & Saunders, *supra* note 103, at 203.

175. See *One Shelter at a Time*, *supra* note 3, at 1226 (stating that targeted legislation actually creates a market for new shelters in that it can be used to whipsaw the IRS when applied mechanically to unintended situations, it can signal that transactions not covered by the targeted rules are permissible, and it does not have the flexibility to address a new generation of shelters that may develop in the future).

and mass-market these products. Additionally, the extent of the Big Five's involvement may be a large contributor to the perception of widespread acceptance and the resulting "race to the bottom."

The involvement of accounting firms in the creation of tax products is itself a product of many of the same external and internal factors that create corporate demand. Clearly, the low probability of an audit, complexity of tax laws, globalization, financial innovation, and changing attitudes have a similar incentive effect on accounting firms. Nonetheless, there are a number of factors specific to the accounting industry that have created a greater interest in the use of shelters than their own corporate clients.

First, and perhaps the largest driving force behind the wildfire growth of the tax shelter industry, is the use of contingency fees to sell tax shelter products.¹⁷⁶ Accounting firms have been reported to demand up to 30–40 percent of the anticipated tax savings offered to corporations.¹⁷⁷ For example, PricewaterhouseCoopers will charge anywhere from 8–30 percent depending on the product and its originality.¹⁷⁸ Considering the size of contingency fees and the potential tax savings,¹⁷⁹ it is clear why all of the Big Five have rushed to develop these products.¹⁸⁰ After all, "major accounting . . . firms [would not] maintain large departments staffed with highly compensated professionals who devote all their efforts to generating tax shelter products . . . if it were not lucrative."¹⁸¹

Moreover, because the shelters are "products" in the sense that little effort is required to sell additional shelters, accountants have a greater incentive to sell the shelters based on a contingency fee. In comparison, lawyers may not have as great an incentive to promote the shelters because compensation based on an hourly fee may not be worth the risk of audits, the possible damage to their reputation, or the initial costs to develop and market the shelter.¹⁸² The sale of shelters on a contingency fee basis by the accounting firm vitiates any such concerns.¹⁸³

176. See Novack & Saunders, *supra* note 103, at 205–06.

177. See *id.*; Statement of Peter L. Faber, *supra* note 101, at ¶ 8.

178. See Novack & Saunders, *supra* note 103, at 202.

179. See *supra* text accompanying notes 139–140 (discussing sale of "black boxes" by PricewaterhouseCoopers that are estimated to save tens of millions to hundreds of millions of dollars in tax).

180. See *Tax Magicians*, *supra* note 10.

181. *Canellos*, *supra* note 18, at 48.

182. See *id.* at 55–57; discussion *supra* Part III.B.

183. See *The Business Purpose*, *supra* note 157, at 153.

Of course, behind the enormous profits to be made by promoters is the internal pressure on staff members of the Big Five to develop and sell tax products.¹⁸⁴ The pressure on partners in the Big Five to maximize revenue has translated into a push to sell contingency-fee-based products¹⁸⁵ rather than “rely[ing] on counseling clients on the tax consequences of normal business transactions, for which they may only be able to bill at hourly rates.”¹⁸⁶ That both Ernst & Young and Deloitte & Touche reported a 29 percent jump in revenue from “tax services”¹⁸⁷ for 1997, while “ordinary” tax work¹⁸⁸ remained flat suggests that the pressure is producing the intended results.¹⁸⁹ In fact, the million dollar fees derived from shelter sales buoy up the tax departments of the Big Five,¹⁹⁰ in part because the firms are using their audit services as loss leaders.¹⁹¹

Another aspect of the internal pressure for increased revenues has been the evolution of multidisciplinary practices in the Big Five. This transition is both indicative of the opportunities accounting firms see in shelter development and sales and also is another reason why the shelter industry has grown. The Big Five has been actively recruiting lawyers, both at the entry level and the prestige level.¹⁹² “The Big Five have successfully courted tax partners at leading law firms and senior IRS and Treasury officials . . . In fact, Arthur Andersen [was] the largest private employer of lawyers in the United States.”¹⁹³ These lawyers are used to “dream[ing] up tax saving ideas,”¹⁹⁴ and the advice is so valuable that the accounting firms are luring away these lawyers to the tune of multimillion dollar five-year contracts.¹⁹⁵ The increasing sophistication of the accounting firms, as a result of this recruitment, has led to decreased

184. See Statement of Peter L. Faber, *supra* note 101, at ¶ 8–12.

185. See Robert Eli Rosen, *As the Big 5 Become Multi-Disciplinary Practices, Opportunities Abound for Tax Executives*, 51 TAX EXECUTIVE 147, 148 (1999).

186. Statement of Peter L. Faber, *supra* note 101, at ¶ 8.

187. Note, however, that tax services range from preparing returns to developing and selling shelters.

188. “Ordinary” tax work presumably refers to audit work.

189. See Novack & Saunders, *supra* note 103, at 203. The authors also note that since 1993, tax revenues for the Big Five have grown at a 10 percent average, which is more than twice the rate of audit revenues. See *id.* at 206.

190. See *The Business Purpose*, *supra* note 157, at 153.

191. See *Rosen*, *supra* note 185, at 147.

192. See N.Y. STATE BAR ASS'N, REPORT OF SPECIAL COMMITTEE ON MULTI-DISCIPLINARY PRACTICE AND THE LEGAL PROFESSION 10, available at <http://www.nysba.org/multidiscrpt.html#> (last visited Nov. 20, 2000).

193. *Id.*

194. Statement of Peter L. Faber, *supra* note 101, at ¶ 10.

195. See *Beck*, *supra* note 101, at 106.

costs¹⁹⁶ in shelter production and hence a greater supply of products to deliver to the market.¹⁹⁷

The means by which the Big Five have managed to dominate the market also contributes to the growth of the tax shelter industry.¹⁹⁸ The Big Five have been able to leverage both their connections with corporate executives and their marketing capabilities to take market share away from competitors.¹⁹⁹ For example, for each mass-marketed product that PricewaterhouseCoopers chooses to actively promote, it prepares a marketing briefing book and assigns product managers, called “product champions,” to coordinate sales.²⁰⁰ Teams of professional salesmen, who pitch the ideas to companies that are not current clients, then conduct the sales.²⁰¹

The ease by which accounting firms can acquire a “more likely than not” tax opinion for its tax products has also added to the growth of shelter production.²⁰² Professor Bankman points out that legal ambiguity and different interpretive attitudes of lawyers make it easy for a promoter to “shop” an opinion until a favorable lawyer is found.²⁰³ The temptation on lawyers is immense as promoters offer \$1 million for such letters,²⁰⁴ promise future business,²⁰⁵ and in some cases offer to share in up to 15 percent of the promoter’s fee.²⁰⁶ As recognized by both the ABA and the New York State Bar Association (“NYSBA”), the temptation on lawyers has deteriorated tax opinion-writing standards, thereby facilitating the rise of corporate tax shelters.²⁰⁷

196. It is interesting to note that tax shelters are generally considered relatively inexpensive to develop when one considers the ability to amortize development costs due to the “product” aspect of contemporary tax shelters. See U.S. TREASURY DEP’T, *supra* note 28, at 27. However, Professor Bankman states that, individually, tax shelters are surprisingly expensive to develop given the fact that the shelter must produce a noneconomic loss for tax purposes and at the same time avoid the same loss for accounting purposes. See *The New Market*, *supra* note 23, at 1780-81.

197. See U.S. TREASURY DEP’T, *supra* note 28, at 20.

198. See *The New Market*, *supra* note 23, at 1780.

199. See *id.*

200. See Novack & Saunders, *supra* note 103, at 202.

201. See *id.*

202. See *The New Market*, *supra* note 23, at 1782.

203. See *id.*

204. See *Tax Magicians*, *supra* note 10, at A1.

205. See *The New Market*, *supra* note 23, at 1782.

206. See Beck, *supra* note 101, at 111.

207. See U.S. TREASURY DEP’T, *supra* note 28, at 86.

Lastly, as will be addressed in Part V, the weak standards and lax enforcement of the accounting industry increase the development and promotion of abusive tax shelters.²⁰⁸

IV. THE BIG FIVE AND THEIR INVOLVEMENT IN THE INDUSTRY

The preceding Part's focus on the factors that have given the Big Five their incentives and enabled them to successfully penetrate the market sheds some light on the extent of their involvement in the industry. This Part attempts to overcome the anecdotal element prevalent in reports on the Big Five's involvement, and discusses specific examples of the development and sale of tax shelter products. Additionally, this Part analyzes various regulations that impact the accounting industry and examines whether the purposes of the regulations are being met, and if they are not, how the Big Five are circumventing them.

A. EVIDENCE OF THEIR INVOLVEMENT

Although it is common knowledge that accounting firms are deeply involved in the tax shelter industry,²⁰⁹ evidence of their involvement is scant. Nonetheless, a few specific occurrences of their involvement have come into the public's hands.

First, the discovery of PricewaterhouseCoopers' development and promotion of the BOSS shelter²¹⁰ was described as "one of the hottest skirmishes in an intensifying battle over tax shelters between the federal government and the private sector, particularly big accounting firms."²¹¹ The transaction was brought to light after an anonymous whistleblower mailed a confidential PricewaterhouseCoopers' opinion letter detailing the structure of the BOSS shelter to the Treasury Department.²¹² The document outlines the "dauntingly complex"²¹³ structure of the BOSS shelter, conducts an analysis of whether it would withstand IRS scrutiny,²¹⁴

208. See discussion *infra* Part IV.C.

209. See, e.g., *Canellos*, *supra* note 18, at 47–48.

210. See discussion *supra* Part II.B.

211. *New Tax Shelter*, *supra* note 39.

212. See *id.*

213. *Id.*

214. See Lee A. Sheppard, *Another Corporate Tax Shelter, Another Tax Court Decision*, 85 TAX NOTES 1229, 1234 (1999).

and finally promises to indemnify the parties involved from potential penalties in the event of disallowance.²¹⁵

By the time the IRS announced that it regarded BOSS as improper, PricewaterhouseCoopers had already accepted fees from clients in anticipation of the huge tax savings that were promised.²¹⁶ PricewaterhouseCoopers was forced to unwind the deal, which led to complaints by clients stating that they were not made whole.²¹⁷ By calculating backwards, some of the clients may have contributed somewhere between \$9.5 million and \$16 million.²¹⁸

Second, an article in *Forbes* uncovered the promotion of a tax shelter being sold by Deloitte & Touche whereby the firm promised to zero out a company's taxes for a contingency fee of 30 percent of the tax savings.²¹⁹ In addition, the firm "promise[d] to defend its 'strategy' in an IRS audit—but not in court—and to refund a piece of the fee if back taxes [came]"²²⁰ Although *Forbes* did not disclose the nature of the transaction being promoted,²²¹ the letters sent by Deloitte & Touche making such promises is clear evidence that shelters are being sold on a contingency fee basis.

Third, KPMG exposed its own role in the industry when it filed breach of contract claims against three Connecticut banks for refusing to pay \$560,000 in contingency fees.²²² A spokesperson for the firm stated that they had provided the banks with a "valuable and confidential tax refund"²²³ KPMG had discovered a loophole in Connecticut tax law pertaining to the taxation of state bonds and had pitched the idea to an undisclosed number of banks.²²⁴ The firm alleged that the banks took advantage of the strategy, yet failed to compensate the firm for the agreed upon 25 percent contingency fee on refunds.²²⁵

215. See PRICEWATERHOUSE COOPERS, BOND & OPTION SALES STRATEGY ¶ 14 (Mar. 4, 1999), reprinted in TAX NOTES TODAY, Dec. 6, 1999, LEXIS, 1999 TNT 233-58.

216. See *New Tax Shelter*, *supra* note 39.

217. See *id.*

218. See *id.*

219. See Novack & Saunders, *supra* note 103, at 198.

220. *Id.*

221. See *id.*

222. See *id.* at 206; Louis Whiteman, *KPMG Suing 3 Connecticut Banks, Claiming Fees on Tax Refund*, AM. BANKER, Jan. 7, 1998, at 6.

223. Whiteman, *supra* note 222, at 6 (quoting George Ledwith, spokesman for KPMG Peat Marwick LLP).

224. See *id.*

225. See Novack & Saunders, *supra* note 103, at 206; Whiteman, *supra* note 222, at 6.

B. REGULATIONS ON AN ACCOUNTANT'S COMPENSATION

As accountants,²³² the activities of the Big Five are subject to both government regulation and their own body of professional codes. Although there are arguments that the Big Five's development and promotion of tax shelters are outside the scope of certain government regulations,²³³ the primary regulations applicable to their use of contingency fees to sell tax shelters are the Treasury's Circular No. 230 ("Circular 230")²³⁴ and the American Institute of Certified Public Accountants' ("AICPA") Code of Professional Conduct.²³⁵ As this Note will discuss, however, not only do these regulations inadequately address the current tax shelter problem, but in some circumstances they may in fact be wholly inapplicable.

First, Circular 230 derives its authority from section 330 of title 31 of the United States Code. This section authorizes the Secretary of the Treasury to regulate the practice of representatives before the

226. The transactions occurred before Pricewaterhouse became known as PricewaterhouseCoopers.

227. See Kmart Props., Inc., N.M. Id. No. 01-287446-006, Conclusion ¶¶ 1-59 (Jan. 31, 2000), reprinted in ST. TAX TODAY, Feb. 11, 2000, LEXIS, 2000 STT 29-27.

228. See *id.*; Hilzenrath, *supra* note 132.

229. See Kmart Props., *supra* note 227, at ¶ 20.

230. 362 U.S. 207 (1960).

231. Kmart Props., *supra* note 227, at ¶ 29.

232. It is unclear the extent to which an accountant acting as a consultant would be subject to Circular 230. See discussion *infra* Part IV.C.

233. See *id.*

234. See JOINT COMM. ON TAXATION, *supra* note 29, at 216-18. The regulations are found in 31 C.F.R. § 10. See Circular 230, 31 C.F.R. § 10 (2003).

235. AICPA CODE OF PROF'L CONDUCT ET § 302 (2003), available at <http://www.aicpa.org/about/code/index.htm> (last visited Mar. 22, 2002).

Department²³⁶ and to suspend or disbar from practice before the Department those representatives who are incompetent, disreputable, or who violate regulations prescribed under section 330.²³⁷ Of particular importance to tax shelters are sections 10.28 (regulating fees),²³⁸ section 10.33 (regulating tax shelter opinions),²³⁹ and section 10.34 (listing standards for advising with respect to tax return positions and for preparing or signing returns).²⁴⁰

From time to time the regulations have been amended.²⁴¹ Pursuant to possible amendment the Treasury published advance notices of proposed rulemaking on June 15, 1999, and May 8, 2000, requesting comments on the amendments to the regulations.²⁴² Many of the proposed amendments were in response to the perception that corporate tax shelters are proliferating.²⁴³ In particular, the Treasury proposed that section 10.28²⁴⁴ be amended to prohibit practitioners from charging a contingent fee for preparation of an original tax return and for advice rendered in connection with a position taken or to be taken on an original tax return.²⁴⁵

236. "Practice Before the IRS" comprehends all matters connected with the presentation to the IRS or any of its officers or employees relating to a client's rights, privileges, or liabilities under the laws or regulations administered by the IRS. Such presentations include the preparation and filing of necessary documents, correspondence with and communications to the IRS, and the representation of a client at conferences, hearings, and meetings. Circular 230, 31 C.F.R. § 10.2(d) (2003).

237. 31 U.S.C. § 330 (1994) (stating that representatives may only be suspended or disbarred after notice and an opportunity for a proceeding).

238. Circular 230, 31 C.F.R. § 10.27 (2003). Section 10.27 of Circular 230 regulates the use of contingency fees when representing a client in a matter before the IRS. More generally, the law bars practitioners from charging an "unconscionable fee," defines "contingent fees," and regulates when a practitioner can and cannot use contingency fees. *Id.* at § 10.27(a)-(b).

239. Circular 230, 10 C.F.R. § 10.33 (2003). Section 10.33 of Circular 230 regulates tax shelter opinions, requiring among other things that a practitioner inquire into all relevant facts, have a reasonable belief in asserted facts, relate law to actual facts, identify and ascertain that all material federal tax issues have been considered, provide an opinion on each material issue, and provide an overall evaluation of whether the material tax benefits will be realized. 10 C.F.R. § 10.33(a)(1)-(5).

240. Circular 230, 10 C.F.R. § 10.34 (2003). Section 10.34 of Circular 230 bars practitioners from signing a tax return as a preparer if the practitioner determines that the tax return does not have a "realistic possibility" of being sustained on its merits. *See id.* This section lists situations where a practitioner may advise a client to take a position on a tax return, including when the position is not frivolous or when the practitioner determines that the position satisfies the reasonable possibility standard. *Id.* Further, this section regulates when a practitioner should advise clients on potential penalties and when a practitioner may rely on information furnished by clients. *Id.*

241. Prop. Treas. Reg. § 111835-99 ¶ 12, 31 C.F.R. pt. 10 (2000), reprinted in TAX NOTES TODAY, May 9, 2000, LEXIS, 2000 TNT 90-6.

242. *See id.*

243. *See* U.S. TREASURY DEP'T, *supra* note 28, at xii.

244. In the proposed amendment, Section 10.28 is to be renumbered Section 10.27.

245. *See* Prop. Treas. Reg. *supra* note 241, at ¶ 12. In addition, a contingent fee would be defined to include any fee that is based, in whole or in part, on whether or not a position taken on a tax return or

In response, the AICPA expressed concerns that the amendments would unduly restrict fee arrangements and unreasonably undercut consumer choice in violation of the Federal Trade Commission Act.²⁴⁶ Similarly, the NASBA urged for a narrowing of the proposed amendment. The NASBA would only prohibit contingent fee arrangements for services specifically mentioned and would hold that a fee was not contingent just because it is based on the amount of tax liability or refund shown, or because of value-billing.²⁴⁷

Second, the AICPA's Code of Professional Conduct also regulates the activities that the Big Five can engage in. "[T]he AICPA Code recognizes that accounting firms can provide professional services, such as tax or consulting services, that involve client advocacy, and that advocacy on behalf of a client does not necessarily compromise the firm's [auditing] independence regarding the client."²⁴⁸ In a study conducted by the Independent Standards Board, however, a majority of practitioners perceived increasing challenges to auditor objectivity and independence due to the shift in focus from auditing services to other services.²⁴⁹

With respect to the use of contingent fees, the AICPA Code of Professional Conduct prohibits the use of contingent fees²⁵⁰ in three circumstances: (1) for the performance of an audit or review of a financial statement; (2) for the performance of a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the statement and the compilation does not disclose a lack of independence; or (3) an examination of prospective financial information.²⁵¹

in a refund claim is sustained, or an indemnity agreement, a guarantee, rescission rights, insurance or any other arrangement by which the practitioner will compensate or reimburse the taxpayer or another person if a position taken on a tax return or refund claim is not sustained. *Id.*

246. See Prop. Treas. Reg. § 111835-99 cmt. of AICPA ¶ 3 (Apr. 23, 2001), reprinted in TAX NOTES TODAY, Apr. 27, 2001, LEXIS, 2001 TNT 82-34 [hereinafter *Comment of AICPA*].

247. See Prop. Treas. Reg. § 111835-99 cmt. of ABA (Aug. 13, 2001), reprinted in TAX NOTES TODAY, Aug. 13, 2001, LEXIS, 2001 TNT 158-15.

248. Sheryl Stratton, *SEC Looks at the Sale of Aggressive Products to Audit Clients*, 87 TAX NOTES 13, 16 (2000).

249. See Independent Standards Board, *ISB Memo on a Conceptual Framework for Auditor Independence*, TAX NOTES TODAY, Apr. 3, 2000, LEXIS, 2000 TNT 64-90 ¶ 24; Stratton, *supra* note 248, at 16.

250. The AICPA defines contingent fees as:

[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 will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependant upon the finding or result of such service.

AICPA CODE OF PROF'L CONDUCT, *supra* note 235, at ET § 302.01.

251. *Id.*

C. A CRITIQUE OF REGULATIONS ON ACCOUNTANT'S COMPENSATION

As suggested by the Treasury's proposed amendments, there is the belief that Circular 230 in its current state is inadequate to cope with the tax shelter industry.²⁵² In addition, although reliance on the AICPA's own Code of Professional Conduct may provide additional deterrence to the promotion of tax shelters, in practice it has not proven to be much of an obstacle.²⁵³ Thus, any attempt to diminish the use of abusive tax shelters requires significant modification of the regulations.

As addressed in Part II.A–B, the inability to agree upon a single definition for an abusive tax shelter has been a major stumbling block in decreasing abusive tax shelters.²⁵⁴ Reliance on common characteristics of abusive tax shelters may provide some relief, and in fact the Treasury's recent disclosure requirements relying on the use of "filters" to alert the Treasury of possibly abusive transactions have already uncovered a number of shelters.²⁵⁵ As recognized by section 10.27,²⁵⁶ however, efforts to combat corporate tax shelters require not only focus on the demand side of the industry but also the supply side.²⁵⁷

Nonetheless, current section 10.28 is an ineffective deterrent to the promotion of tax shelters. The scope of section 10.28 is too limited to address the circumstances involved with contemporary tax shelters. In fact, section 10.28 is silent with regards to the promotion of tax shelters, as it only attempts to regulate the use of contingency fees in return preparation.²⁵⁸ Further, it is unclear when, and if, any substantive change to section 10.28 will occur.

On a broader level, some argue that the Big Five's involvement in the promotion of tax shelters does not even bring them within the scope of Circular 230.²⁵⁹ Specifically, Circular 230 encompasses the following:

Circular 230 sets forth the rules, duties, and conduct of practitioners 'relating to authority to practice before the Internal Revenue Service.' . . .

252. See U.S. TREASURY DEP'T, *supra* note 28, at 34–46.

253. See Stratton, *supra* note 248, at 16; *Tax Magicians*, *supra* note 10.

254. See JOINT COMM. ON TAXATION, *supra* note 29, at 226.

255. *I.R.S Offers Amnesty*, *supra* note 19.

256. Circular 230, 31 C.F.R. § 10.27 (2003).

257. See JOINT COMM. ON TAXATION, *supra* note 29, at 6.

258. See *id.*

259. See *id.* at 215.

If a practitioner's tax practice consists of advising taxpayers with respect to corporate tax shelters, the practitioner's activity may not constitute 'practice before the Internal Revenue Service.' Thus, the significance of the Circular 230 standards (and the effectiveness of the disciplinary sanctions) is greatly diminished.²⁶⁰

Moreover, even if the actions of promoters are within the scope of Circular 230, "[a] perception exists that enforcement of the Circular 230 standards is not as vigilant as it should be [This] diminish[es] the importance with which practitioners regard Circular 230."²⁶¹ Practitioner penalties are easily waived if the practitioner establishes that his or her actions were reasonable and made in good faith.²⁶² Further, "the Director of Practice does not have the authority to impose monetary sanctions on a practitioner for a violation of the Circular 230 standards."²⁶³

Lastly, lack of public information regarding any enforcement efforts undertaken by the Office of Director of Practice further dilutes the deterrence function of Circular 230.²⁶⁴

Reliance on the AICPA's Code of Professional Conduct is equally problematic. The AICPA "has not issued standards of practice specifically related to tax shelter arrangements. [The] AICPA Statements on Responsibilities in Tax Practice (1991 Revision) represent general guidance for AICPA members, but do not constitute enforceable standards. Rather, the statements are considered only educational and advisory in nature."²⁶⁵

Also, Rule 302.01 only prohibits the use of contingency fees in three narrow situations.²⁶⁶ It does not consider situations in which the Big Five are selling tax shelters to non-audit clients.²⁶⁷ Clint Stretch, Director of Tax Policy at Deloitte & Touche, admits that there is much greater latitude in the types of fees charged with non-audit clients.²⁶⁸ In fact, the sale of

260. *Id.* at 216 (emphasis omitted). JCT argues that the scope of Circular 230 be expanded if it is to play a meaningful role in regulating corporate tax shelter activity. JCT contends that Circular 230 standards should apply to any individual who issues an opinion with respect to a corporate tax shelter, or is required to register a corporate tax shelter under section 6111. *Id.*

261. *Id.* at 217.

262. *Id.*

263. *Id.*

264. *Id.* at 217-18.

265. *Id.* at 200.

266. AICPA CODE OF PROF'L CONDUCT, *supra* note 235, at ET § 302.01. *See also* discussion *supra* Part IV.B.

267. *See* AICPA CODE OF PROF'L CONDUCT, *supra* note 235, at ET § 302.01. *See also* discussion *supra* Part IV.B.

268. *See* Stratton, *supra* note 248, at 14.

tax shelters on a contingency fee basis to non-audit clients not only makes it easier to get around rules prohibiting the use of contingency fees,²⁶⁹ but it also “sticks a different auditor with the tough issue of—and liability for—whether a company should set up reserves in its reported earnings for the possibility that the IRS will detect and disallow the tax gimmick.”²⁷⁰ Also, the growing trend of the Big Five to spin off their consulting divisions alleviates the Big Five of any such fee restrictions.

Furthermore, ambiguity exists as to what exactly constitutes a contingency fee.²⁷¹ Clearly, a fee based on a percentage of tax savings is a contingent fee, but accounting firms may be charging clients on a “value-pricing”²⁷² or “value-based”²⁷³ system. “Value-based” or “value-priced” fees play to the gray area of contingent fees, setting the price for the tax product not on an hourly fee but on how much a client would be willing to pay to recognize the promised tax savings.²⁷⁴ Also, it is unclear whether a warranty or indemnity of projected tax savings, or a deferral of a portion of the fee until the tax year is closed without disallowance of the projected tax savings is necessarily a contingent fee.²⁷⁵ In addition, the Big Five’s indemnities or warranties may not be in the form of explicit contingency provisions; rather, the firms may be reimbursing clients by adjusting their annual audit fees.²⁷⁶ The ambiguity of what constitutes a contingent fee and what may be deliberate attempts by the Big Five to recharacterize their fees effectively defeat prohibition on the use of contingent fees with audit clients as provided for in Rule 302.01.

V. RECOMMENDATIONS

Efforts to remedy the tax shelter problem have insufficiently addressed the role of accountants in the tax shelter industry. Accountants, and most importantly the Big Five, play such a dominant role in the industry that they have become, to a large extent, keepers of the industry.

As discussed in Part III.C, perhaps the most important reason for the Big Five’s extensive involvement in the tax shelter industry is accountant

269. See Novack & Saunders, *supra* note 103, at 202 (stating that promoters in fact prefer sales to non-audit clients since it makes it easier to get around SEC and state prohibitions on contingency fees).

270. *Id.* at 202–03.

271. See Stratton, *supra* note 248, at 14.

272. *Tax Magicians*, *supra* note 10.

273. Stratton, *supra* note 248, at 14.

274. See *id.*; *Tax Magicians*, *supra* note 10.

275. See Stratton, *supra* note 248, at 14.

276. See *id.*

compensation in the form of contingency fees. The millions of dollars in revenue generated by the sales of tax shelter products on a contingency fee basis have given the Big Five both an incentive to dominate the market and to expand the market. Further, using contingency fees to sell shelter products is highly problematic in that it raises independence issues, promotes the development of increasingly aggressive shelter schemes, perpetuates the “race to the bottom,” and breeds disrespect for the tax system.²⁷⁷

Any effective regulation of tax shelters must consider the form of an accountant’s compensation. The minor role of lawyers in the tax shelter industry provides prima facie evidence that without the use of contingency fees there are insufficient incentives to develop and promote tax shelters.²⁷⁸ Thus, regulating accountant compensation would drastically undercut the Big Five’s incentives and thereby reduce the supply of abusive tax shelters.

Additionally, focus on an accountant’s compensation circumvents the inherent difficulties in defining what is an abusive tax shelter, which has recently become one of the major stumbling blocks. Although it seems strange to regulate tax shelters without specifically defining an abusive tax shelter, history has demonstrated that developing a specific definition may lead to new shelters that exploit the definition. The opportunities for exploitation are evident in that every ad hoc remedial Treasury notice can potentially be flipped on its head to generate a new group of abusive tax shelters.²⁷⁹

Targeting accountant compensation also has the appeal of simplicity. Unlike adding to the complexity of the tax code, regulating accountant compensation does not require a Treasury ruling or exceptions to the code sections that are being abused. By striking at the financial motivation to abuse the tax system, regulating compensation would drastically restrict abusive tax shelter development and promotion. Moreover, such an approach is not only simple but also flexible. By not having to target specific tax transactions, the approach maintains its applicability to future generations of tax avoidance schemes.

Diminishing the Big Five’s incentives to participate in the industry would not only reduce the number of tax shelters on the market but would also diminish the corporate perception that their competitors are actively engaging in such schemes. Involvement in such transactions may cease to

277. See U.S. TREASURY DEP’T, *supra* note 28, at 3.

278. See discussion *supra* Part III.B.

279. See *supra* note 175.

be considered a necessity to compete in the market, thereby forestalling the “race to the bottom.”

Moreover, certain factors suggest that it is unlikely that removing the Big Five from the tax shelter industry will result in development shifting in-house. The Big Five’s corporate clients may in some instances be engaging in abusive transactions on their own; however, the fact that the Big Five hold a dominant position in the industry suggests that corporations lack the resources or the desire to go at it alone. The fact that corporations are willing to pay hundreds of millions of dollars in fees further supports such a conclusion. Corporations also may be unwilling to invest in such resources because their expertise and resources are directed to a different industry. It is unlikely that a corporation would employ a full-time department dedicated to shelter development given the costs and the likelihood that a corporation would probably not engage in the amount of shelters that a full-time division would produce. In-house development of tax shelters would also lack the indemnity or warranty agreements that are often provided by the Big Five’s use of opinion letters. Lastly, it is unlikely that corporations would be very successful with such transactions because they will be subject to audits by accountants who will no longer have a financial incentive to overlook abusive transactions.

Given the deficiencies of both Circular 230 and the AICPA’s Code of Professional Conduct with respect to the deterrence of tax shelters, however, it seems clear that if tax-avoidance transactions are something to be discouraged, the current regulations cannot be relied upon. This is not to say that the Treasury’s efforts to date have been wholly ineffective,²⁸⁰ only that any attempt to deal with the tax shelter problem requires a multifaceted approach that will include scrutiny of the role of the Big Five in the tax shelter industry. Moreover, the Treasury readily admits that their results to date are “just the tip of the iceberg.”²⁸¹

Rather, one method of changing the calculus for promoters would be to adopt the proposed amendment to section 10.28,²⁸² thereby eliminating the use of contingency fees and indemnity agreements for advice rendered in connection with a position taken or to be taken on an original tax return.²⁸³

280. See *infra* Part I (discussing recent Treasury efforts that have persuaded many corporations to voluntarily disclose the use of such shelters).

281. *I.R.S. Offers Amnesty*, *supra* note 19.

282. See Prop. Treas. Reg. 111835-99, *supra* note 241.

283. See *id.*

Commentators have objected to the proposed amendments on grounds that it would unreasonably undercut consumer choice and is unnecessary when there is a reasonable expectation that the Treasury will review the transaction.²⁸⁴ As discussed in Part II.B, however, the complexity of contemporary tax shelters combined with the inability of the Treasury to keep pace with shelter development makes it unlikely that the transaction's abusive nature will be discovered, even if the transaction is reviewed. Also, just as the Big Five have exploited the reasonableness requirement of tax shelter opinions, it is doubtful that the requirement of a reasonable expectation of substantial review will do any better to deter the development and promotion of the shelters.²⁸⁵ After all, the use of contingency fees is generally seen as unduly influencing the determination of what is and is not a reasonable belief.

The argument that prohibiting contingency fees would overly restrict consumer choice is also questionable. A prohibition may prevent smaller businesses from using the services of the Big Five, but it is unlikely that these businesses currently use the Big Five or that the Big Five even consider such businesses their market. Any effect on services available to large businesses would also be minimal because they can more easily absorb large hourly fees. Moreover, those arguing for more consumer choice must consider whether that is desirable when the choices are either aggressive tax shelters or more aggressive tax shelters. Lastly, this argument is counterintuitive because only five, and possibly soon only four, major firms dominate the market.

An amendment to section 10.28 alone would not be very effective, however, without a corresponding modification to Circular 230 explicitly encompassing shelter development and promotion activities by accountants. The difficulties in modifying Circular 230 lie in determining exactly what transactions would bring an accountant, or consultant for that matter, within the scope of Circular 230. Clearly, the literal interpretation of "practice before the Internal Revenue Service" is insufficient. Likewise, it is problematic to say that Circular 230 should apply to those involved in the development of tax shelters, as this would return to the difficulties of defining a tax shelter. Also, any transaction with tax implications should not necessarily make the parties involved subject to the heightened scrutiny of Circular 230. Therefore, out of necessity and administrative ease, the Treasury may have to consider drawing a bright line stating that parties

284. See *Comment of AICPA*, *supra* note 246, at ¶¶ 3, 37.

285. See *supra* note 169.

whose actions implicate positions on tax returns over a certain dollar amount in tax benefits are subject to Circular 230. Although arbitrary, it has the appeal of being realistic about the fact that aggressive tax shelters are unlikely to be employed to generate minimal tax savings. Further, being subject to Circular 230 does not mean that an accountant's freedom to pursue their livelihood is taken away, rather the accountant would merely be required to use heightened diligence in the specific transaction.²⁸⁶

In addition, AICPA Code 302.01 should be modified to include both audit and non-audit clients. Although the focus on audit clients is presumably intended to produce an unbiased review of a corporation's financials, the prohibition exclusion for non-audit clients suggests that although it is not all right to allow audit clients to engage in abusive transactions, it is acceptable to assist non-audit clients in abusing the tax system. This distinction runs counter to the goal of providing investors with accurate information. By allowing the possibility of abuse as long as it is a non-audit client, the AICPA Code shrugs the responsibility onto another firm, and although some may consider this a cynical view, that firm may have an incentive to overlook the abuse in the interests of maintaining the tax shelter industry. This situation perpetuates the belief that such transactions are standard business practices. Thus, the duty on accountants to ensure the accuracy of investor information should likewise be extended to non-audit clients.

The definition of a contingency fee should also be broadened to encompass efforts to disguise contingent fees. As discussed in Part IV.C, there are several techniques that the Big Five use to recharacterize their fees in a deliberate attempt to circumvent the AICPA's prohibition on contingency fees with audit clients. These techniques include value-billing, the use of indemnity agreements to insure against disallowance, and rebate adjustments via annual audit fees.

An expanded definition of contingency fees could encompass any fee structure that makes an accountant's compensation, or some part of it, contingent on the tax strategy surviving any challenges. Such a definition, however, raises the concern of being over-inclusive despite intentionally being more inclusive. Again, the definition could be limited to apply to situations where the sought after tax benefits would exceed a certain dollar limit. Yet in this situation the use of a bright line dollar limit may not be

286. See Telephone Interview with Greg Jenner, *supra* note 160.

preferable because rather than just being subject to heightened diligence, the result here is an absolute prohibition.

As an alternative, the definition of contingency fee could be deliberately broad but with certain explicit exceptions. This method may be preferable because it would apply to future innovative fee structures meant to circumvent the contingency prohibition. Further, specific transactions that the Treasury has deemed acceptable would be excused from the prohibition, thereby diminishing the concern of over-inclusiveness.

Lastly, in addition to decreasing the financial incentives of the Big Five, their reputation should be negatively impacted if they are involved in promoting a tax shelter. As demonstrated in the legal profession, the incentive to engage in the development and promotion of abusive tax shelters is diminished when one's reputation is at risk and the fees do not sufficiently justify the costs or the risk to reputation. Similarly, incentives to develop and promote abusive tax shelters will decrease if the accountant risks damaging his or her reputation. This could be accomplished by requiring all of the accountant's clients to be subject to an audit, labeling the accountant as automatically suspect in any dealings with the IRS, or subjecting the accountant to annual audits for a specified number of years. The Big Five's incentive to engage in abusive transactions would diminish because they would not want to subject themselves or their clients to in-depth scrutiny by the IRS or the costs associated with an audit. Therefore, fee regulations on the Big Five should also contain a reputation component.

VI. CONCLUSION

Although economic data does not conclusively establish the extent of the tax shelter industry, both anecdotal evidence and actual examples of the Big Five's involvement in the industry demonstrate that tax shelters are a problem.²⁸⁷ Commentators argue that the proliferation of tax shelters depletes the income tax base, places a greater burden on individual taxpayers, breeds disrespect for the tax system, and wastes precious resources.²⁸⁸

Efforts to curb the use of abusive corporate tax shelters have generally focused on the corporations that use such transactions to shelter huge

287. See, e.g., Statement of Peter L. Faber, *supra* note 101, at ¶ 5.

288. See, e.g., JOINT COMM. ON TAXATION, *supra* note 29, at 205–08.

2003]

SUPPLYING THE TAX SHELTER INDUSTRY

1273

capital gains. More focus, however, must be directed to the suppliers, particularly the Big Five.

The Big Five play a dominant role in the development and promotion of tax shelters.²⁸⁹ It is in their interest that corporations perceive that their competitors are using tax shelters, which gives their clients incentives to take part in the “race to the bottom.” What drives their production is, of course, money—the ability to make tens to hundreds of millions of dollars in fees per shelter sold. Moreover, the “product” nature of contemporary tax shelters only further encourages the sale, the push, and peddling of such products.

Therefore, in what must be a multifaceted approach to tax shelters, the elimination of the ability to charge on a contingency fee basis or pseudo-contingency fee basis should be considered. Not only will such measures immediately decrease the financial benefits to the Big Five, but they may also decrease the incentive to develop increasingly aggressive shelter ideas and force a reconsideration of whether the costs of disallowance are outweighed by the traditional hourly fee.

289. See discussion *supra* Part III.B.

