

ABUSIVE TAX SHELTERS: ETHICAL PITFALLS FOR LAWYERS

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Recent IRS enforcement actions, civil litigation and congressional hearings have shone spotlights on the obscure realities of the development and marketing of abusive tax shelters, complex investment vehicles through which the very wealthy seek to shield income and gains from taxation. The main players include major accounting firms (and sometimes law firms) which develop the shelter strategies, major law firms which provide opinion letters blessing the shelters, and banks and investment firms which conduct the investment transactions required by the strategies. To be effective in avoiding taxes, the strategy must have some actual economic substance. Where, instead, the main objective is tax avoidance or evasion, the shelter is deemed abusive and taxpayers who used the shelter will face payment of the taxes that were avoided, interest and penalties of up to 40%.

The litigation that has been spawned by the IRS crackdown on abusive tax shelters has included several battles between the IRS and accounting, law and investment firms over disclosure of tax shelter client identities. The courts have fairly consistently turned away claims of privilege¹ and enforced the IRS summonses for some combination of the following reasons:

- client identity is not a privileged communication.
- the clients did not have a reasonable expectation of confidentiality in any “communication” that might be indirectly revealed by disclosure of the fact that they became clients of the tax professionals for purposes of employing a particular shelter because the Internal Revenue Code required firms involved in promoting particular shelters to maintain and provide to the IRS upon demand lists of clients who use those shelters; and
- the evidence refuted claims that fiduciary relationships existed between the clients and the tax professionals.²

Reasons given by the courts in reaching the third conclusion included the following:

- Because the lawyers provided basically form letters opining that a certain tax shelter would pass IRS muster, production of the identities of the clients to whom the letters were given would not directly or indirectly disclose the substance of information communicated by any client or the substance of specific advice a lawyer gave to any client.³

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¹ In addition to attorney-client privilege, courts have addressed the application of the privilege accorded to taxpayer communications under 26 U.S.C.A. Section 7525, a copy of which is attached.

² *United States v. BDO Seidman*, 337 F3d 802 (7th Cir. 2003); *United States v. Sidley, Austin, Brown & Wood, LLP*, 2004 WL 816448 (N.D.Ill. 2004); *John Doe #1 v. Wachovia Corp.*, 268 F.Supp. 627 (W.D.N.C. 2003); *United States v. KPMG*, 316 F.Supp.2d 30 (D.D.C. 2004); *but see United States v. BDO Seidman, LLP*, 2004 WL 1470034 (N.D.Ill. 2004).

³ *United States v. Sidley, Austin, Brown & Wood, LLP*, 2004 WL 816448 (N.D.Ill. 2004).

- There was no attorney-client relationship between investors and the law firm that developed a particular tax shelter strategy where the agreement between the firm and the investors explicitly provided that neither would be deemed to be the agent or fiduciary of the other, where the strategies were not uniquely tied to any individual investor's financial situation, where apparently no investor ever spoke with an attorney from the law firm (the bank distributed the investment packages), and where the tax shelter package itself did not reveal any individual investor's confidential information.⁴ The court pointedly observed that the attorney-client privilege is not intended to permit an attorney to conduct his client's business affairs in secret, nor may a client "buy" a privilege by retaining a lawyer to do what a nonlawyer could do just as well.⁵
- Communications between the accounting firm that developed certain shelters and the law firm that provided opinion letters blessing the shelters were not privileged where the evidence showed that the law firm was a business partner of the accounting firm, not its legal adviser. Evidence included e-mail exchanges between partners of the law firm and the accounting firm confirming discussions that the firms would work together to market the tax shelters, as well e-mails internal to the accounting firm wherein partners explained to one another that every investor was required to purchase an opinion from the law firm. In one exchange, accounting firm partners debated whether an investor could be made to pay for the law firm's opinion letter when the investor said he had never talked to anyone at the law firm and had no interest in obtaining an opinion letter, and where the partners opined that an opinion letter issued after the investor had filed the tax return might not be of any value to him.⁶

In the last case, upon review of the opinion letters provided by the law firm, the judge concluded:

"The Court finds these opinion letters to be boiler-plate templates that are almost, if not completely, identical except for date, investor name, investor advisor, and dates and amounts of investment transactions. There is little indication that these are independent opinion letters that reflect any sort of legal analysis, reasoned or otherwise. In fact, when examined as a group, the letters appear to be nothing more than an orchestrated extension of KPMG's marketing machine."⁷

Our panel will use the above findings as context for our discussion of the ethical issues that are posed by the phenomenon of the abusive tax shelter industry. Our discussion will include:

I. What is an abusive tax shelter and what roles have lawyers been playing in the development or promotion of those shelters?

⁴ John Doe #1 v. Wachovia Corp., 268 F.Supp. 627, 633-636 (W.D.N.C. 2003).

⁵ *Id.* at 635.

⁶ United States v. KPMG, 316 F.Supp.2d 30, 38-40 (D.D.C. 2004).

⁷ *Id.* at 40.

Our discussion will assume that the audience is not composed of tax lawyers schooled in the intricacies of the Internal Revenue Code, and that most of us would prefer to remain unschooled in tax intricacies.⁸

II. What dangers lurk for the lawyers who are involved?

The panel will discuss the extent to which the reported conduct of lawyers involved in the development and marketing of abusive tax shelters may traverse professional standards, including:

- Are these lawyers engaged in assisting clients in perpetrating a tax fraud or are they simply providing nonfrivolous legal advice in a highly technical complex area that should not be questioned, especially by those of us who do not understand the complexities of tax law and high-end financial transactions?
- Do the relationships between the lawyers and the accounting and investment firms create conflicts of interest? Should the lawyers be disclosing those relationships to clients?
- Are the legal fees lawyers charge for the opinion letters defensible?⁹ What, if anything, should the lawyers have to disclose to the clients to explain their fees? Need they disclose how many other clients have paid for the same letter? How much time went into development of the opinion? Any information about relationships with shelter developers or marketers which might impact upon an IRS determination of whether the letter should be treated as an impartial and independent opinion?
- Are lawyers able to protect client communications and information within the context of the relationships they have structured?

III. What regulatory responses are underway? What regulatory options are likely to be effective?

⁸ For context, see 26 U.S.C.A. Sec. 6662, which defines a tax shelter as a partnership, any other entity, or any investment plan or arrangement for which a significant purpose is the avoidance or evasion of Federal income tax [Sec. 6662(d)(2)(C)(iii)] and provides for publication by the IRS of a list of tax strategies for which the IRS believes there is not substantial authority and which affect a significant number of taxpayers [Section 6662(d)(2)(D)]; and 26 U.S.C.A. 6212 which requires tax advisors to maintain and provide upon written request by the IRS a listing of persons whom the advisor has advised on reportable transactions.

⁹ News stories report that the fees for some opinion letters averaged \$75,000 per letter. ABA/BNA 21 Law.Man.Prof.Conduct 122, 123 (March 9, 2005); “How Lawyers Helped Drive Tax Shelter Boom,” *The Wall Street Journal*, August 18, 2004, page one. One of the more notorious lawyers involved in developing such opinions was Raymond J. “R.J.” Ruble, formerly of Brown & Wood. Testimony before a Congressional Committee investigating tax shelters, co-chaired by Michigan Senator Carl Levin, indicated that Mr. Ruble wrote opinions on three shelters marketed by KPMG (180 opinions on BLIPS, 72 opinions supporting OPIS, and 62 opinions supporting FLIPS) and collected fees of \$23 million for those 314 opinions. “How Lawyers Helped Drive Tax Shelter Boom,” *The Wall Street Journal*, August 18, 2004, page one.

The panel will discuss actions and positions being taken by the IRS Office of Professional Responsibility, which regulates the professionals who appear before the IRS on behalf of taxpayers, on ethical concerns that have arisen in the context of the abusive tax shelter industry.¹⁰

The panel will also describe the civil and criminal liability some lawyers are facing as a result of their participation in the development and marketing of abusive tax shelters, the extent to which that liability will be effective in regulating conduct in the area, and the likely impact of how courts determine to assign responsibility for the costs of defending in either forum.

And the panel will comment on the extent to which state attorney disciplinary authorities should have any role in addressing abuses that have arisen in this arena.

IV. What are the lessons?

Panelists will be asked to offer their opinions on the extent to which the conduct that has occurred in the context of abusive tax shelters is isolated to that arena or, instead, represents new trends in practice particularly in boom economies, and their opinions on what regulatory adjustment would be required to adequately address the most troublesome abuses.

¹⁰ See amended Circular 230 addressing what were perceived as abuses in the field.