Dear Senator Moynihan:

At the March 8 Senate Finance Committee hearing on tax shelters, you focused on what we think is a key element of the tax shelter problem -- the lack of professionalism by some tax advisors. Peter Faber of New York, a former chair of our Section of Taxation, described the issue in stark terms. He said a firm that is both selling a tax product and giving an opinion that it works “is deceiving the client and misrepresenting its role. The ‘opinion’ is not a professional opinion, it is a sales document.”

From the outset, we have expressed alarm about the ethical failing – the lack of professionalism -- that is clearly a factor in the tax shelter problem. It is particularly manifest in the opinions delivered by tax professionals in the sale and implementation of so-called “tax products.” In a statement delivered to the Ways and Means Committee on March 10, 1999, my predecessor, Stefan Tucker, said that we had “witnessed with growing alarm the aggressive use by large corporate taxpayers of ‘tax products’ that have little or no purpose other than the reduction of federal income taxes.” Mr. Tucker went on to say:

We are particularly concerned about this phenomenon because it appears that the linchpin of these transactions is the opinion of the professional tax advisor. The opinion provides a level of assurance to the purchaser of the tax plan that it will have a good chance of achieving its intended purpose. Even if the taxpayer ultimately loses, the existence of a favorable opinion is generally thought to insulate the taxpayer from penalties for attempting to understate its tax liability . . . .

Because of our concern that opinions of tax professionals are playing such a key role in the increased use of corporate tax shelters, the Tax Section has
established a task force to consider amendments to the American Bar Association’s rules for standards of practice of our members. We undertook a similar project in the early 1980’s when so-called retail tax shelters proliferated. That effort resulted in the promulgation of ABA Formal Ethics Opinion 346 and in the adoption of a similar standard in Treasury’s Circular 230, which contains the ethical standards that tax professionals must comply with under threat of losing the right to practice before Treasury and IRS. We expect that our task force will recommend changes in these disciplinary rules to address the current tax shelter phenomenon.

As promised, our task force did prepare a suggested revision of Treasury’s Circular 230 and we supplied our recommendations to Treasury on October 29, 1999. A copy of our recommendations is enclosed with this letter.

In addition, in my statement to the Ways and Means Committee of November 10, 1999, I made the following observation about our Circular 230 recommendations.

Our recent action, recommending amendments to Circular 230, reflects a longstanding view of the Tax Section that the professions, including the legal profession, must do what they reasonably can to assure appropriate conduct of their members. We are confident that if the Treasury Department adopts our recommended changes to Circular 230, we will see a higher standard of conduct by all tax practitioners who render corporate tax shelter opinions affected by the recommended amendments.

Appropriate changes in Circular 230 designed to address specifically the role of opinions by tax professionals in the modern tax shelter phenomenon will, we think, have a significant impact. We full well recognize that the IRS’s Office of the Director of Practice has almost no staff and little funding and therefore cannot effectively enforce the Circular 230 rules. Nevertheless, the major law firms and the Big Five accounting firms will pay attention to the letter and intent of amendments to Circular 230. Experience suggests that the opinion committees of these firms will take care to
see that their opinions do not violate the new rules. They will be concerned that Circular 230 will be applied in civil litigation to set the standard of care in malpractice actions and about the potential for suspension or disbarment of the entire firm under the “vicarious disqualification” doctrine, an unacceptable risk, however remote.

In addition, there are, of course, thousands of tax professionals in private practice and in corporations who want to do the correct thing. Clearly drafted amendments to Circular 230 will provide these well-meaning tax professionals with guidance on what they can do and what they cannot do, thus providing them with excellent and easily explained reasons for refusing to condone unsavory transactions. Please keep in mind that without amendments to Circular 230 such well-meaning tax professionals can only point to judicially-developed doctrines such as economic substance, sham transaction, and the like in refusing to condone an overly-aggressive transaction presented to their client’s chief financial officer or chief executive officer. It might appear that proper ethical conduct would be easily ascertained in such transactions, but plainly-stated rules can be of immense help in assisting the well-meaning professional to simply say no.

I should also mention that amending Circular 230 to make it apply specifically to current tax shelter opinion activity would cover not only true opinions, but would cover what Mr. Faber referred to as “sales documents,” i.e., an opinion “delivered by a firm that is selling an accompanying product for a percentage of the tax savings if it works.”

While we obviously think changes to Circular 230 are very important, we do not think legislation to implement these changes is necessary or even desirable. Secretary Summers has indicated his firm intent to revise Circular 230 within six months and we are confident that process is underway. Nonetheless, a strong statement from the Finance Committee to the Treasury and the IRS expressing the Committee’s interest in seeing Circular 230 revised and enforced would be helpful.

New penalties on outside advisors and promoters

Another change we have recommended that would deal with the questionable conduct of some tax professionals in connection with modern corporate tax shelters is that in appropriate cases penalties should be imposed on promoters and tax advisors. We have recommended that in cases where the substantial understatement penalty of existing law is imposed on a taxpayer, a penalty should likewise be imposed on outside advisors and promoters who actively participate in the sale, planning or implementation of the tax shelter. We have recommended that such a penalty be set at
levels commensurate with the fees or benefits such parties stand to realize if the transaction is successful. We have also suggested that separate procedural rules should be provided to assure such parties of due process, similar to the rules applicable in case of penalties on tax return preparers. Finally, we do not think such penalties should be imposed on advisors who render opinions that comply with our proposed Circular 230 amendments.

Imposing such penalties on advisors and promoters is obviously significant. We are concerned, however, that tax professionals are permitting the good names of their firms, their abilities as highly-trained and capable professionals, and the general complexity of the “tax product” transactions to be used in a manner that is inconsistent with their ethical duties as tax professionals. It is our belief that in such a setting the tax professional should not be free of any meaningful downside risk if the transaction is ultimately found to merit application of the substantial understatement penalty to the taxpayer.

As you heard at the hearings, the consensus is that the penalty structure of current law does not represent a deterrent adequate to stop improper practices in the tax shelter area. Everyone seems to advocate additional penalties on taxpayers who engage in transactions that are found wanting. We, along with the staff of the Joint Committee on Taxation, the Treasury Department and others, think that penalties on promoters and tax advisors would be a significant additional deterrent to the promotion of the issuance of favorable tax opinions on transactions that have little or no substance.

The professional duty of the CFO

The CFO or other senior corporate officer overseeing a tax shelter transaction does not have the same obligations as those imposed on a tax professional. If a reputable law or accounting firm advises the taxpayer the transaction works as intended under the Code, it is often difficult to fault a company for taking advantage of it. The ethical duty of these parties is to comply with the law, and if there are gaps in the Code, they are entitled to take advantage of them to their benefit.

On the other hand, the taxpayer and its senior officers are not totally free of responsibilities in such endeavors. They obviously cannot – ethically or legally – misstate or hide the true facts, or even consciously remain ignorant of the true facts by insufficient due diligence. Economic objective and business purpose are matters that must be properly understood, with professional advice where necessary. It appears that a common denominator in many tax shelter transactions is a failing of senior corporate officers in this regard; the due diligence is often far less than would be
performed in a normal business transaction such as a public offering of securities. We think if it were clear that a senior business officer had a duty to investigate thoroughly the facts, factual assumptions and the law on which a contemplated tax shelter transaction is based, often he or she would decide not to engage in transactions that have little or no economic purpose.

It is for that reason we have recommended to the Committee that a new section 6115 of the Internal Revenue Code be adopted that would require tax return disclosure for “large tax shelters,” and that such disclosure include specifically the following:

A statement signed under penalties of perjury by the taxpayer’s chief financial officer or comparable senior corporate officer with a detailed knowledge of the business or economic purposes or objectives of the transaction that the facts are true and correct as of the date the return is filed, to the best of such person’s knowledge and belief. If the actual facts varied materially from the facts, assumptions or factual conclusions relied upon, the statement would need to describe such variances.

Such a certification requirement will clearly impose corporate and personal accountability on a senior business officer. It is, we think, a critical component of the return disclosure requirement. Because these transactions are by definition large (we have suggested a $10 million reporting threshold) and because they are very aggressive, we think it is appropriate to encourage the taxpayer’s senior management to personally consider the proposed transaction. If the chief financial officer knows that he or she will be required to execute a certification, we expect the officer will be much more interested in being personally advised of the transaction and of its risk before it is consummated.

In sum, we think such a certification will strongly encourage the senior corporate officers overseeing tax shelter transactions to perform what is clearly their duty to their corporation and to the tax system.

We would be happy to work with you and your staff on these and other issues related to the tax shelter problem.
Finally, let me note that, as stated in my testimony to the Senate Finance Committee, the positions expressed in that testimony and in this letter are presented on behalf of the Section of Taxation. Neither our testimony nor this letter has been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly should not be construed as representing the policy of the Association.

Sincerely,

Paul J. Sax
Chair, Section of Taxation

Enclosure

cc: William V. Roth, Jr., Chairman, Senate Finance Committee
Members, Senate Finance Committee
Mark Prater, Chief Tax Counsel, Senate Finance Committee
Russell Sullivan, Minority Chief Tax Counsel, Senate Finance Committee
Thomas Roesser, Tax Counsel, Senate Finance Committee
Lindy L. Paull, Chief of Staff, Joint Committee on Taxation
Jonathan Talisman, Acting Assistant Secretary (Tax Policy), Department of the Treasury