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**Watchdogs That Failed to Bark:**
**Standards of Tax Review After Enron**


*Harold S. Peckron*[1]


You will come to a place where the streets are not marked. Some windows are lighted. But mostly they're darked. A place you could sprain both your elbow and chin! Do you dare to stay out? Do you dare to go in? How much can you lose? How much can you win?[2]

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2. Theodor Seuss Geisel, Dr. Seuss: Oh, The Places You'll Go! 19 (Random House 1990).

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# Watchdogs That Failed to Bark: Standards of Tax Review After Enron

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## I. INTRODUCTION

Enron Corporation, which was the seventh-largest U. S. corporation[2] prior to its collapse, will long be a case study on various corporate governance[3] and ethical[4] failures. But the most frightening aspect of Enron is that it was never designed or intended to be a massive fraudulent scheme from its inception,[5] unlike many substantial financial frauds.[6]

It began by simply trading energy futures[7] and eventually expanded to trading futures in commodities well beyond the company's expertise.[8] To continue its positive financial performance, the company required its advisors to develop "blowback" strategies ensuring continued stock price appreciation.[9]

These so-called "strategies" were largely concerned with tax and accounting planning scenarios and off-balance sheet entities.[10] The attorney and

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2. Anne Tergesen, The Fine Print: How To Read Those Key Footnotes, Bus. Wk., Feb. 4, 2002, at 94.

3. Richard W. Stevenson & Jeff Gerth, Safeguards Didn't Stop Enron's Fall To Earth, Orlando Sentinel, Jan. 20, 2002, at All. Numerous safeguards failed in the case of Enron. As Robert Litan, Director of Economic Studies at Brookings Institution stated:

> This was a massive failure in the governance system. You can look at the system as a series of concentric circles, from management to directors and the audit committee to regulators and analysts and so forth. This was like a nuclear meltdown where the core melted through all the layers.

4. Id. Enron: A Simple Question of Right and Wrong, USA Today, Jan. 22, 2002, at 12A.

5. Rich Karlgaard,Enron End Notes, Forbes, Mar. 4, 2002, at 37.

6. See Howard M. Schilit, Financial Shenanigans 2 (McGraw-Hill, 1993). The badges of fraud tend to surface early on in a financial fraud case. Such badges of fraud include recording revenue before it is earned, creating fictitious revenue, creating profits with nonrecurring transactions, shifting current year income or expenses to future years or vice versa, and failing to record or disclose liabilities. Id. See also in re ZZZZ Best Securities Litigation, 864 F.Supp. 960 (C.D. Cal. 1994). (Showing an example of a substantial financial fraud from inception).

7. A "futures" is an agreement to buy or sell a standardized asset, e.g., energy commodity, at a fixed price at a future time. See Bryan A. Garner, Handbook of Business Law Terms 273 (West Pub. Co. 1999).

8. Karlgaard, supra note 5.

9. Daniel Fisher, Blowback, Forbes, Nove. 12, 2001, at 46. The rise of "special purpose entities", i.e., partnerships, artificially boosted earnings by blowing back earnings to the corporate partner, Enron. Id.

10. Report of Investigation by the Special Investigative Committee Of the Board of Directors of Enron Corp. (Feb. 1, 2002) at 36-40, [hereinafter Report], at http://news.findlaw.com/hdocs/enron/sicreport/sicreport 020102.pdf.

accountant advisors who reviewed these prospective business transactions agreed with their ultimate design and implementation.[11] Yet, with hindsight, it is clear that such devices lacked economic substance.[12]

The purpose of this article is to examine the standards of tax review in light of Enron. In particular, a major focus will be the evolving nature of these standards and how a tax advisor should augment them. Failure to modify existing review standards may come at a very high price.[13]

It is clear that tax advisors have come to a place where the streets are not marked and have much to lose. To recognize these higher stakes of tax review, this article will survey the causes of the Enron imbroglio, pre-Enron standards of tax review, tax policy and moral considerations in establishing a standard of review and the emerging post-Enron standards of tax review.

## II. The Enron Imbroglio

To fully comprehend the magnitude of the Enron case and the failure of its advisors in terms of their standards of accounting and tax review, a background of the olio of events needs to be reviewed. In this regard, the Special Investigative Committee Report and the advisors' response under the circumstances are illuminating.

### A. *Special Investigative Committee Report*

Perhaps the seminal document on the Enron imbroglio is the Special Investigative Committee Report of the Board of Directors of Enron Corporation[14] (hereinafter Report). Therein, the substance of the most significant transactions is analyzed with their significant accounting,[15] corporate governance,[16] management oversight[17] and public disclosure[18] issues examined.

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11. Id. at 24-26, 72, 132.

12. Id. at 4-5.

13. The accounting firm of Arthur Andersen LLP was charged with criminal obstruction of justice charges by its shredding of documents, many of which pertained to the special purpose entities created by Enron. The indictment resulted in the 89 year-old firm to lose the majority of its publicly traded corporate clients and all of its international operations resulting in a financially devastated partnership. See U. S. charges Andersen with obstruction of justice at <http://www.msnbc.com/news/723939> (last visited Mar. 15, 2002).

14. Report, supra note 10.

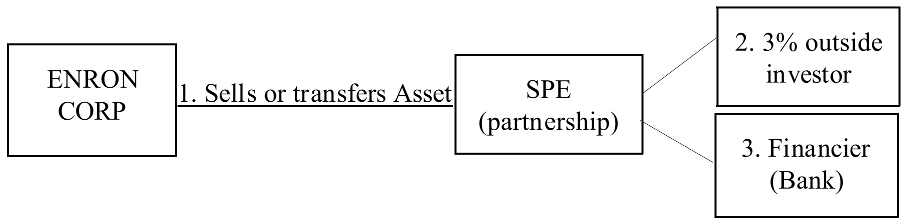
15. Report, supra note 10, at 147.

16. Report, supra note 10, at 64.

17. Report, supra note 10, at 77.

18. Report, supra note 10, at 203.

To fully understand the complexities of certain arrangements, a description of the corporate strategy will be reviewed as identified in the Report.[19] Assuming that Enron wanted to purchase other companies' stocks as an investor, it would negotiate a price to raise capital to make the purchase. Unlike this rather typical transaction, Enron created thousands[20] of special purpose entities[21] to produce gains in lieu of liabilities on its corporate books. The following steps, espoused by outside counsel and monitored by outside accountants, created this vast array of internecine entities:




STEP 1: Transfer or sale of an Enron asset to partnership (SPE) thereby creating a book gain to Enron and a transfer of the asset with its concomitant debt. Such debt is removed from Enron's balance sheet.

STEP 2: Enron controls 97% of the SPE and an outside investor owns 3% of the partnership. Pursuant to an accounting rule,[22] as

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19. Report, supra note 10, at 125-164.

20. John R. Emshwiller & Rebecca Smith, Murky Waters: A Primer on Enron Partnerships, Wall St. J., Jan. 21, 2002, at C1. In all, Enron had about 3500 subsidiaries and affiliates, many of them special purpose entities. Id.

21. Report, supra note 10, at Appendix A. A special purpose entity or vehicle is an entity created for a limited purpose, with a limited life and limited activities, and designed to benefit a single company. Id.

22. FASB, Accounting Research Bulletin No. 51, Consolidated Financial Statements (1959). Ordinarily, the majority holder of a class of equity funded by independent third parties should consolidate (assuming the equity meets certain criteria dealing with size, ability to exercise control, and exposure to risk and rewards). If there is no independent equity, or if the independent equity fails to meet the criteria, then the presumption is that the transferor of assets to the SPE or its sponsor should consolidate the SPE. This presumption in favor of consolidation can be overcome only if two conjunctive conditions are met:

interpreted by the Securities and Exchange Commission (SEC),[23] this structure allows Enron to treat the SPE on an unconsolidated basis.

STEP 3: Enron's bank acts as financier for the 97% capital interest. The partnership loan is guaranteed by Enron and generally hypothecated with Enron shares.[24] Repayment of loan was from partnership assets or their sale upon liquidation of the partnership or SPE.[25]

As long as the value of the partnership assets continues to grow, the debt owed to the bank is amortized.[26] However, once the asset value declined or the Enron shares declined in value, the SPE is in financial difficulty.[27]

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First, an independent owner or owners of the SPE must make a substantive capital investment in the SPE, and that investment must have substantive risks and rewards of ownership during the entire term of the transaction. Where there is only a nominal outside capital investment, or where the initial investment is withdrawn early, then the SPE should be consolidated. The SEC staff has taken the position that 3% of total capital is the minimum acceptable investment for the substantive residual capital, but that the appropriate level for any particular SPE depends on various facts and circumstances. Distributions reducing the equity below the minimum require the independent owner to make an additional investment. Investments are not at risk if supported by a letter of credit or other form of guaranty on the initial investment or a guaranteed return.

Second, the independent owner must exercise control over SPE to avoid consolidation. This is a subjective standard. Control is not determined solely by reference to majority ownership or day-to-day operation of the venture, but instead depends on the relative rights of investors.

Therefore, Enron's related-party transactions were constructed to meet the two part test of non-consolidation. See also FASB, Financial Accounting Series Exposure Draft: Consolidated Financial Statements: Purpose and Policy (Feb. 23, 1999) at http://www. FASB.com (last visited May 1, 2002).

23. Id.
24. Report, supra note 10, at 49.
25. Report, supra note 10, at 50.
26. Report, supra note 10, at 58-60.
27. Report, supra note 10, at 58-60.

The Report noted the internal machinations which Enron developed so that its special purpose entities were within the unconsolidated entity definition. One such "arrangement" was known as Chewco:[28]

> In 1993, Enron and the California Public Employees' Retirement System ("CalPERS") entered into a joint venture investment partnership called Joint Energy Development Investment Limited Partnership ("JEDI"). Enron was the general partner and contributed $250 million in Enron stock. CalPERS was the limited partner and contributed $250 million in cash. Because Enron and CalPERS had joint control, Enron did not consolidate JEDI into its consolidated financial statements.

In 1997, Enron considered forming a $1 billion partnership with CalPERS called "JEDI II". Enron believed that CalPERS would not invest simultaneously in both JEDI and JEDI II, so Enron suggested it buy out CalPERS' interest in JEDI. Enron and CalPERS attempted to value CalPERS' interest (CalPERS retained an investment bank) and discussed an appropriate buyout price.

In order to maintain JEDI as an unconsolidated entity, Enron needed to identify a new limited partner. Fastow initially proposed that he act as the manager of, and an investor in, a new entity called "Chewco Investments" – named after the Star Wars character "Chewbacca". Although other Enron employees would be permitted to participate in Chewco, Fastow proposed to solicit the bulk of Chewco's equity capital from third-party investors. He suggested that Chewco investors would want a manager who, like him, knew the underlying assets in JEDI and could help manage them effectively. Fastow told Enron employees that Jeffrey Skilling, then Enron's President and Chief Operating Officer ("COO") had approved his participation in Chewco as long as it would not have to be disclosed in Enron's proxy statement.

Both Enron's in-house counsel and its longstanding outside counsel, Vinson & Elkins, subsequently advised Fastow that his participation in Chewco would require (1) disclosure in Enron's proxy statement, and (2) approval from the Chairman and CEO under Enron's Code of Conduct of Business Affairs ("Code of Conduct"). As a result, Kopper, an Enron employee who reported to Fastow, was substituted as the proposed manager of Chewco. Unlike Fastow, Kopper was not a senior officer of Enron, so his role in Chewco would not

28. Report, supra note 10, at 43. The extent of the officers and advisors' hubris in forming SPEs reached its zenith when key SPEs were named after Star Wars characters, e.g., JEDI, Chewbacca, etc.

require proxy statement disclosure (but would require approval under Enron's Code of Conduct).

Enron ultimately reached agreement with CalPERS to redeem its JEDI limited partnership interest for $383 million. In order to close that transaction promptly, Chewco was formed as a Delaware limited liability company on very short notice in early November 1997. As initially formed, Kopper (through intermediary entities) was the sole member of both the managing member and regular member of Chewco. Enron's counsel, Vinson & Elkins, prepared the legal documentation for these entities in a period of approximately 48 hours. Enron also put together a bridge financing arrangement, under which Chewco and its members would borrow $383 million from two banks on an unsecured basis to buy CalPERS' interest from JEDI. The loans were to be guaranteed by Enron.

Enron employees involved in the transaction understood that the Chewco structure did not comply with SPE consolidation rules. Kopper, an Enron employee, controlled Chewco, and there was no third-party equity in Chewco. There was only debt. The intention was, by year end, to replace the bridge financing with another structure that would qualify Chewco as an SPE with sufficient outside equity. Ben F. Glisan, Jr., the Enron "transaction support" employee with principal responsibility for accounting matters in the Chewco transaction, believed that such a transaction would preserve JEDI's unconsolidated status if closed by year end.[29]

Such hyperbole to qualify an illegitimate transaction as legitimate met with the Board's conclusion in the Report that perhaps Enron employees placed their own economic or personal interests ahead of their fiduciary duty to Enron.

> Chewco played a central role in Enron's November 2001 decision to restate its prior period financial statements. In order to achieve the off-balance sheet treatment that Enron desired for an investment partnership, Chewco (which was a limited partner in the partnership) was required to satisfy the accounting requirements for a non-consolidated SPE, including having a minimum of 3% equity at risk provided by outside investors. But Enron Management and Chewco's general partner could not locate third parties willing to invest in the entity. Instead, they created a financing structure for Chewco that – on its face – fell at least $6.6 million (or more than 50%) short of the required third-party equity. Despite this shortfall, Enron accounted for Chewco as if it were an unconsolidated SPE from 1997 through March 2001.

29. Report, supra note 10, at 43-45.

> We do not know why this happened. Enron had every incentive to ensure that Chewco met the requirements for non-consolidation. It is reasonable to assume that Enron employees, if motivated solely to protect Enron's interests, would have taken the necessary steps to ensure that Chewco had adequate outside equity. Unfortunately, several of the principal participants in the transaction declined to be interviewed or otherwise to provide information to us. For this reason, we have been unable to determine whether Chewco's failure to qualify for non-consolidation resulted from bad judgment or negligence, or whether it was caused by Enron employees putting their own economic or personal interests ahead of their obligations to Enron.[30]

Finally, the Board did conclude in its Report that most of the significant transactions were designed to accomplish favorable financial statement results and not to achieve bona fide economic objectives or transfer risk.[31] In essence, the Report was stating that most of the SPE transactions lacked economic substance.[32] But it is equally clear in the Report that the structuring of the transactions, allowing for off balance sheet debt financing and superfluous transactions to offset losses which resulted in reported earnings to be inflated by almost $1 billion,[33] lay squarely at the feet of the advisors.[34]

> Enron's original accounting treatment of the Chewco and LJM transactions that led to Enron's November 2001 restatement was clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting. In other cases, the accounting treatment was likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic substance. In virtually all of the transactions, Enron's accounting treatment was determined with extensive participation and structuring advice from Andersen, which Management reported to the Board. Enron's records show that Andersen billed Enron $5.7 million for advice in

30. Report, supra note 10, at 41-42.
31. Report, supra note 10, at 4.
32. Report, supra note 10, at 4.
33. Report, supra note 10, at 4.
34. Report, supra note 10, at 5.

> connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.[35]

B. *Advisors' Response: Shredding of Documents*

The background of the Enron imbroglio would not be complete without a recognition and analysis of the "shredding" incident by Arthur Andersen, LLP, Enron's principal accountant of 16 years.[36] It also demonstrates the standard for the shredding of documents in tax and non-tax cases. Based upon a federal indictment dated March 7, 2002, the grand jury charged the following, in pertinent part:

> On or about October 16, 2001, Enron issued a press release announcing a $618 million net loss for the third quarter of 2001. That same day, but not as part of the press release, Enron announced to analysts that it would reduce shareholder equity by approximately $1.2 billion . . .
>
> By Friday, October 19, 2001, Enron alerted the Andersen audit team that the SEC had begun an inquiry regarding the Enron "special purpose entities" and the involvement of Enron's Chief Financial Officer. The next morning, an emergency conference call among high-level Andersen management was convened to address the SEC inquiry. During the call, it was decided that documentation that could assist Enron in responding to the SEC was to be assembled by the Andersen auditors.
>
> After spending Monday, October 22, 2001, at Enron, Andersen partners assigned to the Enron engagement team launched on October 23, 2001, a wholesale destruction of documents at Andersen's offices in Houston, Texas. Andersen personnel were called to urgent and mandatory meetings. Instead of being advised to preserve documentation so as to assist Enron and the SEC, Andersen employees on the Enron engagement team were instructed by Andersen partners and others to destroy

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35. Report, supra note 10, at 5. While the Report does not specifically address the issue of outside legal counsel's involvement, it is clear that Vinson & Elkins did render "sale opinion" letters reviewing business transactions (SPEs) as to their compliance with legal requirements. See, e.g., Mike France, et al. One Big Hassle, Bus. Wk., Jan. 28, 2002, at 38-39.

36. United States v. Arthur Andersen, LLP, Indictment CRH-02-121 at ¶ 3, 10-12, available at http://news.findlaw.com/hdocs/docs/enron/usandersen030702ind.pdf.

> immediately documentation relating to Enron, and told to work overtime if necessary to accomplish the destruction. During the next few weeks, an unparalleled initiative was undertaken to shred physical documentation and delete computer files. Tons of paper relating to the Enron audit were promptly shredded as part of the orchestrated document destruction. The shredder at the Andersen office at the Enron building was used virtually constantly and, to handle the overload, dozens of large trunks filled with Enron documents were sent to Andersen's main Houston office to be shredded. A systematic effort was also undertaken and carried out to purge the computer hard-drives and E-mail system of Enron-related files.
>
> In addition to shredding and deleting documents in Houston, Texas, instructions were given to Andersen personnel working on Enron audit matters in Portland, Oregon, Chicago, Illinois, and London, England, to make sure that Enron documents were destroyed there as well. Indeed, in London, a coordinated effort by Andersen partners and others, similar to the initiative undertaken in Houston, was put into place to destroy Enron-related documents within days of notice of the SEC inquiry. Enron-related documents also were destroyed by Andersen partners in Chicago.
>
> On or about November 8, 2001, the SEC served Andersen with the anticipated subpoena relating to its work for Enron. In response, members of the Andersen team on the Enron audit were alerted finally that there could be "no more shredding" because the firm had been "officially served" for documents.[37]

Such alleged response by Enron's accountants is tantamount to the intentional keeping of a double set of books.[38] Indeed, the Supreme Court concluded in *Spies v. Commissioner*[39] that an affirmative willful intent to defeat and evade tax could be inferred from the deliberate shredding of tax documents. However, no such inference arises in tax or non-tax disputes if no obligation to preserve evidence is found, but once so found, counsel should advise the client

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37. Id. at ¶ 6, 9-12.
38. See, e.g., Spies v. Commissioner, 317 U. S. 492, 499, (1943).
39. Id.

accordingly.[40] Here, the grand jury charged that Enron's accountants knowingly, intentionally and corruptly, inter alia, destroyed documents to impair their availability for use in official proceedings.[41] Such alleged knowing and purposeful destruction can result in significant sanctions.[42] Consequently, in addition to dubious advice on the many Enron SPEs, the alleged shredding of documents by the same advisors indicates a likely disregard for any moral or legal standards of review. What, then, were the operative standards of transaction review pre-Enron? There are several tax transaction standards of review that had been successfully applied in so-called "tax shelter" (SPE) cases.

## III. Pre-Enron Standards Of Tax Review

It is important from the preceding information contained in the Report that numerous consolidated techniques were employed to satisfy key accounting rules and, once discovered, efforts were allegedly made to "cover up" such planning scenarios.[43]

The tax planning used at Enron, once again endorsed by its tax advisors, is also highly suspect.[44] Indeed the Senate Finance Committee is examining Enron's federal tax returns from 1985 to 2001 to review the tax shelters and other such tax strategies it employed.[45] A perusal of SEC filings discloses that Enron located more than 140 subsidiaries in tax haven countries in the Netherlands,[46] as well as the Cayman Islands[47] and Bermuda.[48]

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40. See Turner v. Hudson Transit Lines, Inc., 142 F.R.D. 68, 79 (1991) (where corporate counsel failed to inform the client and counsel with his corporate client were joint and severally liable for damages).

41. Id. at n. 36, para. 13.

42. See, e.g., Wm. T. Thompson Co. v. General Nutrition Corp., 593 F.Supp. 1443, 1446, 1455 (C.D. Cal. 1984); Telectron, Inc., v. Overhead Door Corp., 116 F.R.D. 107-110 (S.D. Fla. 1987); Carlucci v. Piper Aircraft Corp., Inc., 775 F.2d 1440, 1443, 1454 (11th Cir. 1985).

43. Report, supra note 10.

44. Even the Report alludes to this in describing the overly complex arrangements employed by the advisors through their repeated use of off-shore SPEs. Report, supra note 10, at 68, 81.

45. The role of the Board of Directors in Enron's Collapse. S. Rep. No. 107-70 (2002 Rule 13.4(a)).

46. Enron Corp. and subsidiary Companies: Subsidiary Companies and Limited Partnerships, 10K filing (as visited May 1, 2002) available at http://www.sec.gov/Archives/edgar/data/72859/0000072859-97-000009.txt.

47. Id.

48. Id.

In addition, the Report is riddled with use of SPEs in "hedging" transactions[49] and derivatives[50] which tend to shift economic risk without loss of tax deductions.[51] And Enron was one of the first issuers of "trust preferred" securities that allowed Enron to issue debt through a subsidiary and claim the interest deduction on its tax return without reflecting the debt as a liability on its balance sheet.[52]

## A. *Standards of Tax Review*

Enron's accounting and legal tax advisors had several fundamental standards of tax review and disclosure available to them during the period covered in the Report.[53] Each pertinent standard of tax review and disclosure affecting transactions involving potential tax shelters are discussed below:

| Source of Standard | Issuer | Party Affected |
|---|---|---|
| 1. ABA Formal Opinion 85-352 and Model Rules of Professional Conduct (MRPC)[54] | American Bar Assoc. | Attorneys at law |
| 2. AICPA Statements on Responsibilities in Tax Practice (SRTP) and Code of Professional Conduct (CPC)[55] | American Inst. of CPAs | CPAs who are AICPA members |
| 3. Treasury Circular 230[56] | Internal Revenue Service | Persons who practice before the IRS |

49. Id. at 82-89, 119-128.

50. Id.

51. See generally Report, suptra note 10.

52. Though this tax planning device is permissible it does indicate the degree of aggressiveness of the Enron tax planning. See, e.g., Curt Anderson & Brad Foss, enron to release Tax Records to Senate, Toronto Star, Feb. 16, 2002, at Sports, II.

53. Report, supra note 10, at 3, 37. The Board's Special Investigative Committee was established on October 28, 2001 to conduct an investigation of related-party transactions arising from the period of the early 1990's through 2001. Id.

54. ABA Comm. or Prof'l Responsibility, Formal Op. 85-352 (1985) [hereinafter ABA Opinon 85-352]; ABA Model Rules of Prof'l Conduct (2001) [hereinafter MRPC]. Neither the MRPC or ABA Formal Opinion have the effect of law. Thus, each state has the authority via the legislature or the state supreme court to adopt the provisions of the MRPC.

55. AICPA, Statements on Responsibility in Tax Practice (1991) [hereinafter SRTP]. AICPA, Code of Professional Conduct (1997) [hereinafter CPC] <http://www.AICPA.com> (last visited May 2, 2002).

56. Practice Before The Internal Revenue Service, 31 C.F.R. pt. 10 (2002) [hereinafter Circular 230]

| Source of Standard | Issuer | Party Affected |
|---|---|---|
| 4. Treasury Regulations and 2000-01 Tax Shelter Disclosure Regulations[57] | Internal Revenue Service | Taxpayer engaged the in transactions covered by the Regulations |
| 5. Internal Revenue Code of 1986 and the civil penalty provisions[58] | U. S. Congress | All taxpayers |

1. *ABA Formal Opinion 85-352 and Model Rules of Professional Conduct* – First is the ABA tax standard of review found in ABA Opinion 85-352 and its pertinent sections of the MRPC. The standard of tax review may best be summarized as follows:

> The practitioner also owes a duty, albeit less well defined, to the tax system as a whole. The practitioner is not free to do whatever it is that the client demands, regardless of the client's willingness to incur the risk of penalty. The practitioner's duty to the system is based, in part, on a general obligation – derived from the practitioner's status as a professional – to encourage compliance with the law (including the tax laws).[59]

To this end, encouraging client compliance with the law, the MRPC dictate key rules that generally set the standard for the tax lawyer.[60] Of particular impact are Rules 1.1, 1.2(d), and 3.1 dealing with a lawyer's competence, good faith standard, and frivolous action, respectively.[61] For the tax lawyer this means that the lawyer representing a client in a tax matter, or rendering advice thereto, must be competent to do so through knowledge, skill, thoroughness and

57. Temp. Regs. § 1.6011-4T (2000); Notice 2001-51, 2001-34 I.R.B. 190.

58. IRC §§ 6651, 6654, 6662, 6663, 6672, 6674, 6682, 6694, 6695, 6701, 6702. The tax standard in criminal fraud cases, unlike the civil tax review and disclosure standards, has never varied. It is willfulness of the taxpayer's conduct and the willfulness standard requires a voluntary, intentional violation of a known legal duty, e.g., failure to pay tax is intentional and not due to negligence or mistake. See, e.g., United States v. Pomponio, 429 U. S. 10 (1976); United States v. Bishop, 412 U. S. 346 (1973).

59. Bernard Wolfman, et al., Standards of Tax Practice § 101.2 (Boston: Little, Brown and Company 1997).

60. MRPC, supra note 54.

61. MRPC, supra note 54. In general, other relevant rules for tax lawyers are found in Rules 1.3, 1.4, 1.6, 4.1, and 7.4 dealing with diligence, communication, confidentiality, disclosure and specialization, respectively. Id.

preparedness.[62] Similarly, a tax lawyer must discuss the legal consequences of any proposed (planning) course of conduct and make a good faith effort to determine the validity, scope, meaning or application of the law.[63] Finally, a tax lawyer is precluded from bringing or defending frivolous actions but must demonstrate a good faith argument for, inter alia, any modification of the law.[64]

The preceding rules address the question in tax planning scenarios of a "good faith" belief. This was defined in ABA Opinion 85-352.[65] A good faith belief required some "realistic possibility" of success if the matter is litigated. Thus, a tax lawyer has demonstrated a good faith belief in the validity of a position in accordance with the realistic possibility standard if that position is warranted in existing law or can be supported by a good faith argument for an extension, modification, or reversal of existing law.[66]

2. *AICPA Statements on Responsibilities in Tax Practice and Code of Professional Conduct* – Second is the SRTP which flows from the CPC. The CPC applies to all member CPAs in all fields of practice, e.g., tax, and contains principles[67] and rules.[68] But it is the SRTP that merits a tax CPA's attention for

62. MRPC, supra note 54, at Rule 1.1.

63. MRPC, supra note 54, at Rule 1.2(d).

64. MRPC, suptra 54, at Rule 3.1.

65. Id. in 54 supra.

66. ABA Opinion 85-352, supra note 54. Unfortunately for tax practitioners at no place in ABA Opinion 85-352 does it quantify the realistic possibility standard, e.g., if the realistic possibility is only 33% is this sufficient or must it be at least 50%? See Paul J. Sax , et al., Report of the Special Task Force on Formal Opinion 85-352, 39 Tax Law. 635, 640 (1986) (asserting that the unadopted report would suggest that a 33% rule is sufficient for the realistic possibility standard).

67. There are six principles recited in the CPC: Professional responsibility, public interest should be paramount, integrity, objectivity and independence, due care, and scope and nature of services. CPC, supra note 55.

68. CPC, supra note 55. There are eleven rules applicable to all professional accounting services, including tax:

Independence
Integrity and Objectivity
General Standards
Compliance With Standards
Accounting Principles
Confidential Client Information
Contingent Fees
Acts Discreditable
Advertising and Other Forms of Solicitation
Commissions and Referral Fees
505 Form of Organization and Name

it sets forth the acceptable standards for tax practice and review. Unlike the CPC, the SRTPs are merely advisory and lack the authority mandated by the CPC.[69]

The SRTP contains eight statements, excluding the introduction, and addresses the following tax matters: Tax Matter, Tax Return Positions,[70] Answers to Questions on Returns,[71] Certain Procedural Aspects of Preparing Returns,[72] Use of Estimates,[73] Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision,[74] Knowledge of Error: Return Preparation,[75] Knowledge of Error: Administrative Proceedings,[76] Form and Content of Advice To Clients.[77]

In addition, unlike the preceding ABA Opinion 85-352, the SRTP No. 1 contains Interpretation No. 1-1, which sets forth the tax standard known as the "realistic possibility" standard[78] and further identifies it with elaborate specificity.[79] It places the realistic possibility standard on a continuum running from a less stringent reasonable basis standard to the far more strict standards of substantial authority and more likely than not.[80]

| | | |
|---|---|---|
| Reasonable Basis Standard[81] | Realistic Possibility Standard | Substantial Authority and More Likely Than Not Standards[82] |

69. SRTP, supra note 55, at Introduction.
70. SRTP, supra note 55, at No. 1.
71. SRTP, supra note 55, at No. 2.
72. SRTP, supra note 55, at No. 3.
73. SRTP, supra note 55, at No. 4.
74. SRTP, supra note 55, at No. 5.
75. SRTP, supra note 55, at No. 6.
76. SRTP, supra note 55, at No. 7.
77. SRTP, supra note 55, at No. 8.
78. SRTP, supra note 55, at No. 1, § 2.a.
79. SRTP, supra note 55, at Interpretation No. 1-1.
80. SRTP, supra note 55, at Interpretation No. 1-1 § 5.

81. This is the standard that is higher than a non-frivolous or not patently improper standard. Thus, if a position taken on a tax return is based upon tax authorities, the return position will generally satisfy the reasonable basis standard. See Regs. § 1.6662-3(b)(3).

82. The substantial authority standard is an objective standard and is less stringent than the more likely than not standard (the standard that is met when there is greater than 50% likelihood of the position being upheld). Regs. § 1.6662-4(d)(1),(2).

Like ABA Opinion 85-352, the Interpretation chooses not to quantify the realistic possibility standard in terms of percentage odds. Rather, it sketches for the CPA what indicia are the sine qua non of the standard:

> In determining whether a tax return position meets the realistic possibility standard, [a CPA] may rely on authorities in addition to those evaluated when determining whether substantial authority exists. . . Accordingly, [CPAs] may rely on well-reasoned treatises, articles in recognized professional tax publications, and other reference tools and sources of tax analyses commonly used by tax advisors and preparers of returns.
>
> In determining whether a realistic possibility exists, [the CPA] should do all of the following:
>
> - Establish relevant background facts.
> - Distill the appropriate questions from these facts.
> - Search for authoritative answers to those questions.
> - Resolve the questions by weighing the authorities uncovered by that search.
> - Arrive at a conclusion supported by the authorities.
>
> [The CPA] should consider the weight of each authority [in order] to conclude whether a position meets the realistic possibility standard. In determining the weight of an authority, [the CPA] should consider its persuasiveness, relevance, and source. Thus, the type of authority is a significant factor. Other important factors include whether the facts stated by the authority are distinguishable from those of the [client] and whether the authority contains an analysis of the issue or merely states a conclusion.[83]

In a nutshell, a tax CPA, like his or her brethren the tax lawyer, should not take a position on a return resulting from a tax transaction, e.g., tax shelter, unless he or she has a good faith belief that the position has a "realistic possibility" of being sustained.[84] If the tax advisor fails this standard of tax review then disclosure is mandated provided the position is non-frivolous.[85]

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83. SRTP, supra note 55, at Interpretation No. 1-1.
84. SRTP, supra note 55, at Interpretation No. 1-1.
85. SRTP, supra note 55, at Interpretation No. 1-1.

3. *Treasury Circular 230* – The third standard of tax review originates from the U. S. Treasury as Circular 230.[86] Circular 230 requires attorneys,[87] CPAs,[88] enrolled agents[89] and actuaries[90] to be technically competent and adhere to ethical standards.[91] Practice before the IRS, in addition to client representations, includes preparing and filing all necessary documents.[92] Of interest to taxpayer representatives is the IRS requirement of the threshold tax standard whenever a tax advisor renders advice on tax return positions.[93]

While the standard is the same as espoused by the ABA[94] and AICPA[95] positions, being one of "realistic possibility", it goes further in defining this standard and clearly identifies the likelihood of its successful application.[96]

> (a) Realistic possibility standard. A practitioner may not sign a tax return as a preparer if the practitioner determines that the return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard) unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a return, or prepare the portion of a return on which a position is taken, unless –
>
> > (1) The practitioner determines that the position satisfies the realistic possibility standard; or
> >
> > (2) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Revenue Code [of 1986] by adequately disclosing the position and of the requirements for adequate disclosure.
>
> (b) Definitions. For purposes of this section:
>
> > (1) Realistic possibility. A position is considered to have a realistic possibility of being sustained on its

86. Circular 230, supra note 56.
87. Circular 230, supra note 56, at §10.3(a).
88. Circular 230, supra note 56, at §10.3(b).
89. Circular 230, supra note 56, at §10.3(c).
90. Circular 230, supra note 56, at §10.3(d).
91. Circular 230, supra note 56, at §10.4(a).
92. Circular 230, supra note 56, at §10.2(e).
93. Circular 230, supra note 56, at §10.34.
94. ABA Opinion 85-352, supra note 55.
95. See SRTP and CPC, supra note 55.
96. Circular 230, supra note 56, at § 10.34(a)(1),(d)(1).

> merits if a reasonable and well informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits. The authorities described in 26 CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis. The possibility that a [position] will not be [challenged by the Service (e.g., because the taxpayer's return may not be audited or because the issue may not be raised on audit)]. . . may not be taken into account.[97]

Thus, the realistic possibility standard of tax review is met if the tax advisor reasonably concludes that the tax position has approximately a 33% or greater likelihood of being sustained.[98] Absent this, disclosure and a nonfrivolous standard is imposed on the advisor.[99]

Circular 230 also delineates the standard of review in tax shelter opinion cases.[100] Unlike the ABA and AICPA standards,[101] Circular 230 addresses the standard of review for an overall evaluation of a tax shelter opinion.[102] Once the tax advisor determines that he or she is being asked to render a tax shelter opinion,[103] then the question arises as to what standard the IRS will accept to evaluate the opinion on a favorable basis:

> (c) Overall evaluation.
>
> (i) Where possible, the practitioner must provide an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized. Where such an overall evaluation cannot be given, the opinion should fully describe the reasons for the practitioner's inability to make an overall evaluation. Opinions concluding that an overall evaluation cannot be provided will be given special scrutiny to determine if the stated reasons are adequate.

97. Id.

98. Id. § 10.34(d)(1).

99. Id. § 10.34(a)(2).

100. Id. § 10.33.

101. See ABA Opinion 85-352 and MRPC, supra note 54; see also SRTP and CPC, supra note 55.

102. Circular 230, supra note 56, at § 10.33(a)(5).

103. Id. § 10.33(c)(3).

> (ii) A favorable overall evaluation may not be rendered unless it is based on a conclusion that substantially more than half of the material tax benefits, in terms of their financial impact on a typical investor, more likely than not will be realized if challenged by the Internal Revenue Service.[104]

In the event that the advisor's opinion does not constitute a favorable overall evaluation, this fact must be prominently disclosed in the tax shelter offering materials.[105] The standard for tax shelter opinions rendered by an advisor is the "more likely than not" standard which means that there is greater than a 50% likelihood of the opinion being upheld.[106] This standard is a higher threshold of review than that of realistic possibility (where only a 33% likelihood is necessary on review);[107] thus, the IRS in Circular 230 is stating that tax shelter opinions must comply with far greater scrutiny than a tax return position.

It is interesting to note that the IRS recently proposed amendments to Circular 230 in the area of tax shelter opinions.[108] The IRS proposes that the advisor be far more circumspect in relying on client provided information.[109] Now, every item in the opinion must be addressed and comply with the more likely than not standard.[110] In essence, a tax advisor must now, perhaps correctly so, be responsible for client inaccuracies which he or she relied upon in rendering the tax shelter opinion as opposed to establishing a good faith belief in such items.[111]

4. *Treasury Regulations and the 2000-01 Tax Shelter Regulations Disclosure* – Fourth are the standards set forth in the Treasury Regulations that specifically address both tax review of taxpayer positions[112] and tax shelter disclosures.[113] Standards of tax review regulations are largely addressed at the accuracy related penalty provisions of section 6662.[114] The accuracy related penalty may adhere if a tax advisor fails to meet the substantial authority

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104. Id. at § 10.33(a)(5)(i)-(ii).
105. Id. at § 10.33(a)(5)(iii)
106. See, e.g., Regs. § 1.6662-4(d)(2).
107. Circular 230, supra note 56, at § 10.34(d)(1).
108. 66 Fed. Reg. 3276, 3295 (Proposed Jan. 12, 2001).
109. Id.
110. Id. at § 10.33(a).
111. Compare Circular 230, supra note 56 at § 10.33(a)(1)(ii) with 66 Fed. Reg. 3276, §10.33(a)(1)(ii).
112. See Regs. §§ 1.6662-3, 4.
113. Notice 2001-51, 2001-34 I.R.B. 190, supra note 57.
114. Regs. §§ 1.6662-3, 4.

standard[115] – which is more stringent than either the reasonable basis standard[116] or the realistic possibility standard,[117] as set forth in the ABA,[118] AICPA[119] and Circular 230[120] pronouncements. Therein lies the quandary.

An attorney has a duty to zealously represent a client and obtain the most efficacious tax result for the taxpayer.[121] For example, a client has suggested an intuitive tax treatment of an item that results in a lower tax liability based on a review of the regulations. This intuitive approach followed by the client is, however, contrary to another final regulation. The possibility of a section 6662 accuracy related penalty exists because of the higher standard. Hence, section 6662 regulations would allow the zealous tax lawyer's inconsistent position provided it was nonfrivolous[122] and fully disclosed on the client's tax return. However, this will, in all likelihood, invite an audit of the taxpayer's return. So while the lawyer's realistic possibility standard is met, the higher standard of substantial authority trumps it assuring potential involvement with the IRS.

The preceding example can be exacerbated if the tax treatment of the item involves a tax shelter.[123] Then numerous Treasury Regulations are triggered, regardless of the standard of review, that mandate disclosure.[124] These so-called "tax shelter" regulations set a higher standard of tax disclosure if the subject matter of the item is classified as a tax shelter. To be exact, there are two principal sets of tax shelter disclosure regulations known as the 2000[125] and 2001[126] tax shelter regulations.

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115. Regs. §§ 1.6662-4(d)(1),(2), 1.6662-4(a).

116. Regs. §§ 1.6662-3(b)(3).

117. See, e.g., Circular 230, supra note 56, at § 10.34.

118. Id. See ABA Opinion 85-352 and MRPC, supra note 54.

119. See SRTP and CPC, supra note 55.

120. See Circular 230, supra note 56.

121. See MRPC, supra note 54, at Rule 3.1.

122. See Regs. § 1.6662-3(b)(3).

123. According to the 2003 regulations at Temp. Regs. §301.6111-2T, a confidential corporate tax shelter is defined as:

> any transaction (i) A significant purpose of the structure of which is the avoidance or evasion of Federal income tax. . . . for a direct or indirect corporate participant; (ii) That is offered to any potential participant under conditions of confidentiality. . .; and (iii) For which the tax shelter promoters may receive fees in excess of $100,000 in the aggregate. . .

124. See, e.g., notice 2001-51, 2001-34 I.R.B. 190, supra note 57.

125. Temp. Regs. § 1.6011-4 T (2000) (before amendments in 2001 and 2002).

126. See Notice 2001-51, 2001-34 I.R.B. 190, supra note 57.

The two sets of regulations establish sixteen[127] itemized tax shelter transactions that must be disclosed[128] on the taxpayer's tax return.[129] In

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127. The 2000 tax shelter regulations listed ten tax shelter transactions and six additional were included in the 2001 regulations. Id.

128. The "persons" subject to disclosure are any taxpayers who are corporations, promoters, solicitors, organizers, and those responsible for registering confidential corporate tax shelters. Such disclosure standard is comprehensive; it not only requires tax return disclosure but also amended returns, filing statements, foreign entity involvement, e.g., offshore corporations or trusts, etc. Id. at § 4T(a)-(d).

129. The sixteen listed tax shelter transactions subject to a disclosure standard are set forth at Notice 2001-51, 2001-34 I.R.B. 190, as follows:

> 1. Rev. Rul. 90-105, 1990-2 C.B. 69 (transactions in which taxpayers claim deductions for contributions to a qualified cash or deferred arrangement or matching contributions to a defined contribution plan where the contributions are attributable to compensation earned by plan participants after the end of the taxable year (identified as "listed transactions" on February 28, 2000));
> 2. Notice 95-34, 1995-1 C.B. 309 (certain trust arrangements purported to qualify as multiple employer welfare benefit funds exempt from the limits of §§419 and 419A of the Internal Revenue Code (identified as "listed transactions" on February 28, 2000));
> 3. Notice 95-53, 1995-2 C.B. 334 (certain multiple-party transactions intended to allow one party to realize rental or other income from property or service contracts and to allow another party to report deductions related to that income (often referred to as "lease strips") (identified as "listed transactions" on February 28, 2000));
> 4. Transactions described in Part II of Notice 98-5, 1998-1 C.B. 334 (transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits (identified as "listed transactions" on February 28, 2000));
> 5. Transactions substantially similar to those at issue in ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), and ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998) (transactions involving contingent installment sales of securities by partnerships in order to accelerate and allocate income to a tax-indifferent partner, such as a tax-exempt entity or foreign person, and to allocate later losses to another partner identified as "listed transactions" on February 28, 2000);
> 6. Treas. Reg. §1.643(a)-8 (transactions involving distributions described in §1.643(a)-8 from charitable remainder trusts (identified as "listed transactions" on February 28, 2000));
> 7. Rev. Rul. 99-14, 1999-1 C.B. 835 (transactions in which a taxpayer purports to lease property and then purports to immediately sublease it back to the lessor (that is, lease-in/lease-out or LILO

general terms, a disclosure standard is required for a reportable transaction.[130] This is a listed transaction that satisfies the projected tax effects test.[131] Such test mandates disclosure whenever the tax benefit or savings exceeds certain dollar

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transactions) (identified as "listed transactions" on February 28, 2000));
8. Notice 99-59, 1999-2 C.B. 761 (transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered (identified as "listed transactions" on February 28, 2000));
9. Treas. Reg. § 1.7701(1)-3, (transactions involving fast-pay arrangements as defined in § 1.7701(1)-3(b) (identified as "listed transactions" on February 28, 2000));
10. Rev. Rul. 2000-12, 2000-11 I.R.B. 744 (certain transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions (identified as "listed transactions" on February 28, 2000));
11. Notice 2000-44, 2000-36 I.R.B. 255 (transactions generating losses resulting from artificially inflating the basis of partnership interests (identified as "listed transactions" on August 11, 2000));
12. Notice 2000-60, 2000-49 I.R.B. 568 (transactions involving the purchase of a parent corporation's stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual liquidation or sale of the subsidiary (identified as "listed transactions" on November 16, 2000));
13. Notice 2000-61, 2000-49 I.R.B. 569 (transactions purporting to apply §935 to Guamanian trusts (identified as "listed transactions" on November 21, 2000));
14. Notice 2001-16, 2001-9 I.R.B. 730 (transactions involving the use of an intermediary to sell the assets of a corporation (identified as "listed transactions" on January 18, 2001));
15. Notice 2001-17, 2001-9 I.R.B. 730 (transactions involving a loss on the sale of stock acquired in a purported §351 transfer of a high basis asset to a corporation and the corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes (identified as "listed transactions" on January 18, 2001)); and
16. Notice 2001-45, 2001-33 I.R.B. 129 (certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock is purported to shift to a U.S. taxpayer (identified as "listed transactions" on July 26, 2001)).

Notice 2001-51, 2001-34 I.R.B. 190, supra note 57.

130. Temp. Regs. § 1.6011-4T(a). See also 65 FR 11205-02 at 11206.

131. Temp. Regs. § 1.6011-4T(a).

thresholds[132] (reduction of tax liability by $1 million in a taxable year or by $2 million for any combination of taxable years).

A second category of reportable transactions subject to disclosure entered into after February 28, 2000 – which need not be a listed transaction – are those expected to reduce tax liability by more than $5 million in a taxable year or more than $10 million in any combination of taxable years[133] provided the tax shelter either participated in a confidential transaction[134] or contracted for the downside protection that the tax benefits may not be obtained.[135] These regulatory tax review and disclosure standards impose a higher threshold on tax advisors, particularly in the area of tax shelters, and demand that the advisor weigh the client's proposed transaction far more carefully.

5. *Internal Revenue Code of 1986 and the Civil Penalty Provisions* – Last are the civil penalty provisions set forth in the Internal Revenue Code of 1986.[136] As discussed earlier, the tax review standard, as set forth in the Treasury Regulations,[137] identifies the reasonable basis,[138] substantial authority,[139] and more likely than not[140] standard (especially in tax shelter cases). The realistic possibility standard[141] is used in the preparer civil penalty statute at section 6694.[142] Under the regulations of that section the realistic possibility standard of tax review is defined as requiring that a reasonable and well-informed person, knowledgeable in the tax law, would conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.[143] Hence, the statutory authority of the civil penalty provisions generally involve a determination of the appropriate tax review or disclosure standard by identifying the underlying regulatory guidance.

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132. Id.

133. Id.

134. Id. See also Temp. Regs. § 301.6111-2T(c) as to the definition of confidentiality.

135. Temp. Regs. § 1.6011-4T(a).

136. IRC §§ 6651, 6654, 6662, 6663, 6672, 6674, 6682, 6694, 6695, 6701, 6702.

137. See, e.g., Temp. Regs. § 1.6662-4(d)(1),(2).

138. See Regs. § 1.6662-3(b)(3).

139. See Regs. § 1.6662-4(d)(1), (2).

140. Id.

141. See Regs. § 1.6694-2(b)(1).

142. IRC § 6694.

143. Regs. § 1.6694-2(b)(1) Compare the Circular 230 identical realistic possibility standard with the preceding IRC § 6694 standard. See Circular 230, supra note 56, at § 10.34(a)(2).

As a general rule, the standard of review and disclosure supporting the statutory authority is that of substantial authority[144] and realistic possibility[145] for tax review and more likely than not[146] for tax shelter disclosures. The Code with its regulatory authority places the tax advisor in the position of first identifying the highest possible standard of review or disclosure and then meeting such standard. This decision rule appears to offer the greatest prophylactic from applying a lesser standard espoused by a private regulatory body.[147] But even with these standards of review, courts have chosen to find acceptable and nonacceptable tax shelter constructs as the following cases demonstrate.

### B. *Application of the Standards To Tax Shelter Cases*

To fully discern how the realistic possibility standard and, in the case of tax shelter opinions, the more likely than not standard are applied to prospective transactions, recently decided tax shelter cases provide a hindsight reflection of their successful application by tax advisors. Recent special purpose entity and corporate tax shelter cases have met with varying success.[148]

It is not sufficient that a tax advisor merely apply a standard because in tax shelter transactions disclosure is generally mandated.[149] Rather, an advisor should review the relevant case authorities in identifying and classifying the appropriate jurisdictional and jurisprudential response to the standard. That is, in a proposed corporate tax shelter transaction is there a 33% or greater (realistic

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144. See Regs. § 1.6662-4(d)(1), (2).

145. See Regs. § 1.6694-2(b)(1).

146. See Regs. § 1.662-4(d)(2), (5).

147. A decision rule is merely a statement of the condition. For instance, what is the appropriate Standard of review or disclosure and it identifies the condition of rejection (a lower Standard) versus the condition of non rejection (a higher Standard) in a tax planning context. However, such "threshold" rules should not be applied without considering the surrounding facts and ultimate flexibility in the planning situation. For more discussion on threshold decision rules, see J. Edward Russo & Paul J. H. Schoemaker, Decision Traps 123-128 (Doubleday 1989).

148. Compare UPS v. Commissioner, 254 F.3d 1014 (11th Cir. 2001), with Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001) Cert. denied, 122. S. Ct. 1537 (2002). Focus hereunder is on corporate tax shelters. Individual taxpayer shelters were virtually eliminated through the enactment of IRC § 465 (at-risk rules), and IRC § 469 (passive activity loss rules), though only the most blatant forms of individual tax (evasion) shelters persist. Examples include tax exempt trusts and business structuring; offshore accounts, banks, businesses, trusts and foundations; "Dropping out" of the system by stopping all withholding and Social Security taxes; tax-exempt "private" insurance companies; and charity-like or religious entities established for personal use <http://finance.senate.gov/040501jntest.pdf>.

149. Temp. Regs. § 1.6011-4T(a).

possibility) or greater than 50% (more likely than not) likelihood that the tax shelter will be sustained on its merits? Apparently the various court's views of this likelihood may differ substantially from that of the tax advisors.[150]

With this in mind, a taxpayer profile of successful versus unsuccessful tax shelter cases needs to be developed. Such a profile will facilitate a perspective on the complexities inherent in the "typical" corporate tax shelter. Tax Court, District and Appellate Court cases are highlighted in the table below with the tax shelter profiled in each case.

| Pro-Taxpayer Cases | Tax Shelter Profile |
|---|---|
| *Salina Partnership LP, FPL Group, Inc. v. Commissioner*[151] | Repurchase Agreement Corporate Inversion |
| *Boca Investerings Partnership v. United States*[152] | Contingent Installment Sale Notes |
| *Compaq Computer Corp. v.Commissioner*[153] | Multi-Party Dividend Stripping Transactions |
| *IES Industries, Inc. v. United States*[154] | Dividend Stripping Transactions |
| *UPS v. Commissioner*[155] | Offshore Special Purpose Entities |

| Pro-Government Cases | Tax Shelter Profile |
|---|---|
| *ACM Partnership v. Commissioner*[156] | Contingent Installment Sale Notes |
| *Nicole Rose Corp. v. Commissioner*[157] | Equipment Leasing Trusts |
| *Winn-Dixie Stores, Inc. v. Commissioner*[158] | Corporate Owned Life Insurance |

1. *Pro-Taxpayer Cases* – Taxpayers have been successful in at least five significant tax shelter cases of recent vintage. Perhaps a common thread will emerge in their review thereby making application of a prospective tax review standard, viz., realistic possibility, less onerous.

150. Id.
151. 80 T.C.Memo (CCH) 686 (2000), T.C. Memo (RIA) § 54122 (2000).
152. 167 F.Supp. 2d 298 (D.C. Cir. 2001).
153. 277 F.3d 778 (5th Cir. 2001).
154. 253 F.3d 350 (8th Cir. 2001).
155. 254 F.3d 1014 (11th Cir. 2001).
156. 157 F.3d 231 (3d Cir. 1998).
157. 117 T.C. 328 (2001).
158. 254 F.3d 1313 (11th Cir. 2001), cert. denied, 122 S. Ct. 1537 (2002), T.C. Memo (RIA) § 54122 (2002).

### a. *Repurchase Agreement (REPO) Corporate Inversion*

In the special purpose entity case of *Salina Partnership LP, FPL Group, Inc. v. Commissioner*,[159] the tax shelter device successfully employed was a REPO corporate inversion.[160] This shelter is specifically designed to offset unrelated capital gains while creating a built-in loss on the partnership basis.[161]

Here, a large publicly traded utility company, FPL, incurred corporate restructuring capital losses in excess of $581 million on the sale of an unrelated subsidiary.[162] FPL's investment banker suggested a REPO inversion structured as follows:

- FPL would purchase a 98% limited partnership interest in Salina, a domestic limited partnership.
- A tax haven jurisdiction (Netherlands) would be the location of the two percent foreign general partner.
- Salina would then enter into short-sale agreements for U. S. securities where their face exceeded the REPO sales price.
- Salina would secure the borrowed securities by an amount less than their face value.

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159. Salina P'ship LP v. Commissioner, 80 T.C. Memo (CCH) 686 (2000).

160. The Tax Court defined these as follows:

> Repurchase agreements (repos) and reverse repurchase agreements (reverse repos) are frequently used by dealers in government securities, financial institutions, and others as methods for temporary cash management, interest rate arbitrage, or the borrowing of securities used in the course of a dealer's business. In a repo transaction, the first party (e.g., a dealer) sells securities (generally U. S. Treasury and Federal agency securities) to a second party (e.g., a customer) and simultaneously agrees to repurchase a like amount of the same securities at a stated price (generally greater than the original sales price) on a fixed, future date. Repo transactions, from the viewpoint of the seller (such as a dealer), provide financing to acquire newly issued government securities or other portfolio assets; from the viewpoint of the purchaser, a repo transaction provides a means by which funds can be invested for a desired period while holding as collateral a virtually risk-free asset in the event the seller breaches its agreement to repurchase. See Price v. Commissioner, 88 T.C. 860, 864 n. 9 (1987). Id at 690 n. 4.

161. Id. at 693-694.

162. Id. at 688.

- Between the borrowing date and the REPO option date, Salina would then purchase the securities from a third party at a lower price, and
- At the REPO date, when the short-sale is closed, Salina would realize a short-term capital gain.[163]

Under partnership tax rules, the short rule is treated as a technical termination of the partnership.[164] But since the legal life of the partnership continues, it is treated as a constructive capital contribution to the partnership by the respective partners.[165] Now the partner's outside basis[166] reflects this increase and the U. S. partner (FPL) simply takes its distributive share of the shortterm capital gain (ordinary income) of Salina amounting to over $344 million, which it then offsets against losses carried over from prior years.[167]

The IRS challenged the $344 million short-term gain for the taxable year ending in 1992 contending that the Salina entity was a mere sham and the outside basis of the partner was improperly computed.[168] The issue before the Tax Court was twofold: whether the special purpose entity, the Salina partnership, was a mere sham and whether its short sales of partnership investments that gave rise to the substantial outside basis of FPL proved in error.[169]

Under the sham transaction doctrine, a transaction albeit proper in form, may lack economic substance.[170] Application of the more likely than not standard, substantial authority standard or even the realistic possibility standard would all necessitate a finding of a non sham transaction in a tax shelter case.

In that regard, the Tax Court had no difficulty in finding precisely that result.[171]

> Considering all the facts and circumstances, we conclude that FPL entered into the Salina transaction to achieve a valid business purpose independent of tax benefits. The record

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163. Id. at 688-90.

164. Id at 695. Since the short sale constituted more than 50% of the partnership's capital and profits, it is a termination.

165. See IRC § 721.

166. A partnership has technically two bases in relation to a partner, i.e., the partner's basis in the partnership interest (outside basis) and the partnership's basis in the partnership property (inside basis). See IRC §§ 722, 723. See also 1 William S. McKee et al., Federal Taxation of Partnerships and Partners 6.01 at 6-3 (Warren, Gorham & Lamont. 3d ed. 1997).

167. *Salina*, 80 T.C. Memo (CCH) at 692.

168. Id. at 693.

169. Id. at 693-696.

170. Karr v. Commissioner, 924 F.2d 1018, 1022-1023 (11th Cir. 1991).

171. *Salina*, 80 T.C. Memo (CCH) at 695.

> demonstrates that FPL entered into the Salina partnership for the primary purpose of enhancing the return on its short-term investments. Each of FPL's representatives testified convincingly on this point. Moreover, their testimony was bolstered by their detailed review and consideration of the proposed investment and the minutes of the board of director's meeting approving the investment.[172]

The Court then disposed of the short sales of the partnership investments as being allowable under IRC section 752.[173] That section allows for an increase in the outside basis when liabilities are assumed.[174] Since the investments by the partnership were legitimate liabilities pursuant to section 752(a), despite its highly technical nature as a repurchase agreement (REPO) corporate inversion tax shelter, the transaction is permissible for tax purposes.[175]

This tax shelter device, the REPO corporate inversion tax shelter, generally will be sustained as a planning arrangement.[176] It satisfies the more likely than not standard and realistic possibility standard provided, taxpayer did not intend, as here, to create a sham.[177] Rather, this case points to a legitimate economic transaction designed by taxpayer's investment banker and operated as an investment vehicle until its termination.[178] Thus, a cogent business purpose must be evident for its success.[179]

b. *Contingent Installment Sale Notes*

*Boca Investerings Partnership v. United States*[180] was yet another unique form of tax shelter. This shelter's construct was clearly identified by the District Court: the seven proposed steps are generally the same, and are summarized as follows:

> (1) Partnership is formed among a United States company, a subsidiary of that United States company (which together would

172. Id.
173. Id. at 700.
174. Id. at 696.
175. Id. at 700.
176. Id.
177. Id. at 695. Of course once the more likely than not standard is satisfied, it trumps the realistic possibility standard. Compare Regs. § 1.6662-4(d) with Circular 230 at § 10.34.
178. Id. at 694.
179. Id.
180. 167 F.Supp. 2d 298 (D.C. Cir. 2001).

> initially own 10% of the partnership) and a foreign financial institution (which would initially own 90% of the partnership;
> (2) Partnership purchases corporate bonds/capital assets;
> (3) Partnership sells corporate; bonds/capital assets in exchange for cash and an installment note;
> (4) United States companies increase their partnership interest by purchasing portion of foreign company's interest;
> (5) United States companies contribute additional assets to the partnership;
> (6) Partners' interests are partially redeemed by distributing installment note to United States companies and cash to foreign company; and
> (7) United States companies sell installment note to a third party.[181]

Once again, under partnership tax rules, the sale of a high basis asset by the partnership triggered a capital loss and the sale of the partnership interest by the U. S. taxpayer partner resulted in a gain.[182] Thus, this shelter, much like the REPO corporate inversion model, generates both losses and gains.[183]

And, like the Salina[184] case the Commissioner argued that the special purpose entity (partnership) was a mere sham.[185] The District Court viewed the formation and operation of the partnership as legitimate and with economic substance:

> The foregoing discussion establishes that the "four basic attributes" of a partnership identified in *S & M Plumbing Co. v. Commissioner* are present here. The record in this case establishes that (i) all four partners intended to, and did, organize Boca as an investment partnership, (ii) all four contributed substantial capital to the partnership, (iii) all four participated on the Partnership Committee and jointly controlled Boca, since the agreement of owners of 95% of the Partnership was required in order to take action, and (iv) all four jointly shared in the income, gain, losses, and expenses from Boca's investments pursuant to the Partnership Agreement. See also *Luna v. Commissioner*, 42 T.C. at 1077-78. In addition, there was a legitimate business purpose for the creation of the

181. Id. at 311.
182. Id.
183. Id.
184. *Salina*, 80 T.C. Memo (CCH).
185. *Boca Investerings*, 167 F.Supp.2d at 364.

> partnership. Since there was a legitimate partnership and legitimate business purposes for its creation, organization and investments, it is irrelevant if AHP was motivated in part to organize Boca as a partnership by a device to reduce taxes.[186]

In further elucidating its vision of the economic substance of the partnership's activities, the District Court noted:

> The controlling authority with respect to economic substance in this Circuit is *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992). In Horn, the D. C. Circuit set forth the following test for determining whether a transaction should be considered a sham for tax purposes.
>
> "To treat a transaction as a sham, the court must find (1) that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (2) that the transaction has no economic substance because no reasonable possibility of profit exists."

*Horn v. Commissioner*, 968 F.2d at 1237 (quoting *Friedman v. C.I.R.*, 869 F.2d 785 (4th Cir. 1989). The questions to ask are whether the transaction had "a reasonable prospect, ex ante, for economic gain (profit)" and "whether the transaction was undertaken for a business purpose other than the tax benefits.[187]

The decision in Horn also makes plain that a transaction is not a sham and will be recognized for tax purposes if the taxpayer satisfies either part of the test for economic substance – if either (1) using a subjective analysis, the transaction has a nontax business purpose, or (2) using an objective analysis, the transaction has a reasonable possibility of generating a profit.[188]

In this case, plaintiffs have established by a preponderance of the evidence that the transactions financing the purchase and sale of the PPNs had economic substance because those transactions had a non-tax business purpose. Since satisfaction of either prong of the test is sufficient to demonstrate that a transaction has economic substance, the Court need not draw any conclusions regarding the second prong – whether, using an objective analysis, the transactions had a reasonable prospect of making a profit.

That said, the Court does find that the great weight of evidence, including the expert testimony presented at trial – particularly that of Ms. Rahl and Mr.

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186. Id. at 372-373.
187. Id. at 375.
188. Id. at 376.

Fong – support plaintiffs' position that the transactions in this case also satisfy the second prong of the sham transaction/economic substance test. As plaintiffs' experts testified at length, there was – from an objective, ex ante perspective – a reasonable possibility that the transactions at issue could have turned a profit.[189]

Therefore, this elaborate contingent installment sales tax shelter, with its purchase and sale of privately placed notes[190] and LIBOR notes,[191] did demonstrate economic substance and compliance with Section 453.[192] Such legal conclusion by the court[193] supports the realistic possibility[194] and the more likely than not[195] standards of tax review.

c. *Dividend Stripping Transactions*

Two cases use a tax shelter technique known as "dividend stripping." In *IES Industries, Inc. v. United States*[196] and *Compaq Computer Corp. v. Commissioner*[197] the multi party dividend stripping with foreign stock transactions was employed.[198] Unlike Salina[199] and Boca,[200] however, this tax shelter arrangement was fairly direct. Taxpayer entered into a tax arbitrage[201]

189. Id. at 377.

190. Id. at 328, 331.

191. Id.

192. IRC § 453. See also Regs. § 15A.453-1(c)(3).

193. *Boca Investerings*, 167 F.Supp.2d at 387-388.

194. Circular 230, supra note 56, at § 10.34(a)(2).

195. See n. 109 supra.

196. 253 F.3d 350 (8th Cir. 2001).

197. 277 F.3d 778 (5th Cir. 2001).

198. See IES Industries, 253 F.3d at 351; Compaq, 277 F.3d at 779.

199. See Salina P'ship LP, FPL Group, Inc. v. Commissioner, 80 T.C. Memo (CCH) 686 (2000), T.C. Memo (RIA) ¶ 54122 (2000).

200. See Boca Investerings P'ship v. United States, 167 F.Supp.2d 298 (D.C. Cir. 2001).

201. Arbitrage is the simultaneous buying and selling of securities, e.g. ADRs, in different markets seeking a favorable price differential. Tax arbitrage occurs when differential tax rates on different kinds of income are used to a taxpayer's advantage. See, e.g., Alan Gunn & Larry D. Ward, Federal Income Taxation 389. See also G. Hirt & S. Block, Fundamentals of Investment Management 493.

transaction using American Depository Receipts or ADRs.[202] As the Fifth Circuit Court in Compaq Computer so eloquently described ADRs:

> An ADR is a trading unit, issued by a trust, that represents ownership of stock in a foreign corporation. Foreign stocks are customarily traded on U.S. stock exchanges using ADRs. An ADR transaction of the kind at issue in this case begins with the purchase of ADRs with the settlement date at a time when the purchaser is entitled to a declared dividend – that is, before or on the record date of the dividend. The transaction ends with the immediate resale of the same ADR with the settlement date at a time when the purchaser is no longer entitled to the declared dividend – that is, after the record date. In the terminology of the market, the ADR is purchased "cum dividend" and resold "ex dividend."[203]

Like the preceding case, taxpayer was approached by an investment firm (the same investment firm, Twenty-First Securities Corporation, proposed this shelter in both cases).[204] The Compaq Computer shelter had the following elements:

- Taxpayer's investment firm purchased $887 million in ADRs cum dividend from its Netherlands client Royal Dutch and immediately resold $868 million in ADRs ex dividend to the same client.[205]
- The net dividend (after payment of $3.4 million in Netherlands tax) of $19 million was paid to taxpayer.[206]
- On Compaq's 1992 income tax return it reported $20.7 million in capital losses on the purchases and resales, $22.5 million in gross dividend income, and a foreign tax credit of $3.4 million for the Netherlands tax withheld.[207]

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202. American Depository Receipts, or ADRs, allow U. S. investors to trade foreign company stock by trading ADRs on listed U. S. stock exchanges. ADRs are not foreign stocks, per se, but represent interests in foreign stocks through trust certificates held in foreign bank trusts. See, e.g., Scott Besley & Eugene F. Brigham, Essentials of Managerial Finance 648 (12th ed. 2000).

203. Compaq, 277 F.3d at 779.

204. See id. at 780.

205. Id.

206. Id.

207. Id.

- Compaq then used the capital loss to offset a $231.7 million capital gain it had realized on an unrelated transaction.[208]

The Commissioner contended that the multi party dividend stripping transactions lacked economic substance and the Tax Court agreed.[209] That Court condemned the transaction as lacking economic substance because it gave the illusion of profit while simultaneously resulting in a tax credit of $3.4 million – far in excess of Compaq's tax liability of $640,000, allowing for a tax credit offset against unrelated transactions.[210] Moreover, there was no tangible evidence of substantive ownership of Royal Dutch ADRs and was solely motivated by the expected tax benefits.[211]

In reversing the Tax Court, the Fifth Circuit found that the Eight Circuit Court had ruled as a matter of law in IES Industries[212] that an ADR dividend stripping transaction identical to the case at hand did not lack economic substance.[213] Thus, the Fifth Circuit Court found that the transaction, like the Eighth Circuit, embodied a valid business purpose.

> [A]s to business purpose: even assuming that Compaq sought primarily to get otherwise unavailable tax benefits in order to offset unrelated tax liabilities and unrelated capital gains, this need not invalidate the transaction. See Frank Lyon Co., 435 U.S. at 580, 98 S.Ct. at 1302. Yet the evidence in the record does not show that Compaq's choice to engage in the ADR transaction was solely motivated by the tax consequences of the transaction. Instead, the evidence shows that Compaq actually and legitimately also sought the (pre-tax) $1.9 million profit it would get from the Royal Dutch dividend of approximately $22.5 million less the $20.7 million or so in capital losses that Compaq would incur from the sale of the ADRs ex dividend. Although, as the Tax Court found, the parties attempted to minimize the risks incident to the transaction, those risks did exist and were not by any means insignificant.
>
> In light of what we have said about the nature of Compaq's profit, both pre-tax and post-tax, we conclude that the

208. Id.
209. Compaq Computer Corp. v. Commissioner, 113 T.C. 214 (1999).
210. Id. at 222.
211. Id. at 223-225.
212. IES Industries, Inc. v. United States, 253 F.3d 350 (8th Cir. 2001).
213. Compaq, 277 F.3d at 782-783.

> transaction had a sufficient business purpose independent of tax considerations.[214]

Therefore, in both IES[215] and Compaq[216] the respective Appellate Courts found that the dividend stripping transaction had economic substance and a valid business purpose thereby supporting this type of tax shelter under future tax review standards on similar facts.[217]

d. *Offshore Special Purpose Entities*

The case of *UPS v. Commissioner*[218] illustrates how a business exigency can create a tax planning opportunity and, consequently, a tax shelter. This business exigency was clearly stated by the court:

> UPS, whose main business is shipping packages, had a practice in the early 1980s of reimbursing customers for lost or damaged parcels up to $100 in declared value. Above that level, UPS would assume liability up to the parcel's declared value if the customer paid 25¢ per additional $100 in declared value, the "excess-value charge." If a parcel were lost or damaged, UPS would process and pay the resulting claim. UPS turned a large profit on excess-value charges because it never came close to paying as much in claims as it collected in charges, in part because of efforts it made to safeguard and track excess-value shipments. This profit was taxed; UPS declared its revenue from excess-value charges as income on its 1983 return, and it

214. Id. at 786-787.

215. 253 F.3d 350.

216. 277 F.3d 778.

217. These multiparty dividend stripping tax shelter transactions are not without their critics. See, e.g., Marc D. Teitelbaum, Compaq Computer and IES Industries – The Empire Strikes Back, 20 Tax Notes Int'l 791 (2000); David P. Hariton, Sorting Out the Tangle of Economic Substance, 52 Tax Law. 235, 273 (1999); 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, 54 (2001); George K. Yin, Getting Serious About Corporate Tax Shelters: Taking a Lesson From History, 54 SMU L .Rev. 209, 222 (2001); Daniel N. Shaviro, Economic Substance, Corporate Tax Shelters, and the Compaq Case, 88 Tax Notes 221 (2000); David A. Weisbach, The Failure of Disclosure as an Approach to Shelters, 54 SMU L. Rev. 73, 79 (2001).

218. 254 F.3d 1014 (11th Cir. 2001).

> deducted as expenses the claims paid on damaged or lost excess-value parcels.[219]

Like Salina,[220] Boca,[221] Compaq,[222] and IES,[223] it was an independent third party that suggested an economic plan with a tax shelter dimension to reduce the risk of economic exposure.[224] Unlike the preceding cases, however, here the third party was the taxpayer's insurance broker[225] (not a securities firm). The broker proposed an offshore special purpose entity.[226]

> UPS could avoid paying taxes on the lucrative excess-value business if it restructured the program as insurance provided by an overseas affiliate. UPS implemented this plan in 1983 by first forming and capitalizing a Bermuda subsidiary, Overseas Partners, Ltd. (OPL), almost all of whose shares were distributed as a taxable dividend to UPS shareholders (most of whom were employees; UPS stock was not publicly traded). UPS then purchased an insurance policy, for the benefit of UPS customers, from National Union Fire Insurance Company. By

219. Id. at 1016.

220. Salina P'ship LP, FPL Group, Inc. v. Commissioner, 80 T.C. Memo (CCH) 686, T.C. Memo (RIA) ¶ 54122 (2000).

221. Boca Investerings P'ship v. United States, 137 F.Supp.2d 298 (D.C. Cir. 2001).

222. Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001)

223. IES Industries Inc. v. United States, 253 F.3d 350 (8th Cir. 2001).

224. It is the risk identification and risk inherent in the business transaction that each taxpayer in these cases attempted to mitigate. Indeed this was the sine quo non of the business purpose that gave economic substance to the transaction – notwithstanding the favorable tax consequences. See, e.g., Boca, 167 F.supp. At 351-352. Wherein the District Court recited the credit, default, credit downgrade, liquidity and interest rate risks present in the contingent installment sale notes shelter.

225. UPS v. Commissioner, 254 F.3d 1014, 1016 (11th Cir. 2001).

226. Offshore tax havens, generally formed as special purpose entities, i.e., limited partnerships, international business corporations, etc. are used throughout the business community.

For instance, the Pritzker family, owners of the Hyatt hotel chain, use multiple chains of offshore entities that afford the chain significant tax deferral mechanisms. Among the chains are Hyatt International Pritzker (Wilmington, Del), Baku Hotel Dev. LP (Cayman Is.), Settlement Investors, Inc. (Bahamas), Baku Hotel Corp. (Cayman Is.), Park Hyatt Baku (Azerbaijan). See Glenn R. Simpson, Island Tax Haven May Aid Pritzkers, Wall St. J., May 13, 2002; see also Reuven S. Avi-Yonah, U.S. International Taxation 394-396.

> this policy, National Union assumed the risk of damage to or loss of excess-value shipments. The premiums for the policy were the excess-value charges that UPS collected. UPS, not National Union, was responsible for administering claims brought under the policy. National Union in turn entered a reinsurance treaty with OPL. Under the treaty, OPL assumed risk commensurate with National Union's, in exchange for premiums that equal the excess-value payments National Union got from UPS, less commissions, fees, and excise taxes. Under this plan, UPS thus continued to collect 25¢ per $100 of excess value from its customers, process and pay claims, and take special measures to safeguard valuable packages. But UPS now remitted monthly the excess-value payments, less claims paid, to National Union as premiums on the policy. National Union then collected its commission, excise taxes, and fees from the charges before sending the rest on to OPL as payments under the reinsurance contract. UPS reported neither revenue from excess-value charges nor claim expenses on its 1984 return, although it did deduct the fees and commissions that National Union charged.[227]

The Commissioner argued that the excess-value payment remitted ultimately to OPL was, in reality, gross income to UPS. A Tax Court memorandum opinion[228] upheld the Commissioner's contention that the arrangement was a mere sham transaction, lacking in economic substance. The Eleventh Circuit noted the basis for the Tax Court's holding:

> Three core reasons support this result, according to the court: the plan had no defensible business purpose, as the business realities were identical before and after; the premiums paid for the National Union policy were well above industry norms; and contemporary memoranda and documents show that UPS's sole motivation was tax avoidance. The revenue from the excess-value program was thus properly deemed to be income to UPS rather than to OPL or National Union. The court also imposed penalties.[229]

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227. UPS, 254 F.3d at 1016-1017.
228. UPS V. Commissioner, 78 T.C. Memo (CCH) 262 (1999).
229. UPS, 254 F.3d at 1017.

In reversing the Tax Court, the Eleventh Circuit responded to the issue of whether the excess-value plan had the kind of economic substance that removes it from "shamhood," even if the business continued as it had before in the affirmative.[230]

The Eleventh Circuit initially addressed the question of whether the excess-value plan, with its offshore Bermuda special purpose entity, OPL, was a mere sham. Focusing on the nature of the business risk and the degree of control over the offshore entity, the court found:

> The tax court dismissed these obligations because National Union, given the reinsurance treaty, was no more than a "front" in what was a transfer of revenue from UPS to OPL. As we have said, that conclusion ignores the real risk that National Union assumed. But even if we overlook the reality of the risk and treat National Union as a conduit for transmission of the excess-value payments from UPS to OPL, there remains the fact that OPL is an independently taxable entity that is not under UPS's control. UPS really did lose the stream of income it had earlier reaped from excess-value charges. UPS genuinely could not apply that money to any use other than paying a premium to National Union; the money could not be used for other purposes, such as capital improvement, salaries, dividends, or investment. These circumstances distinguish UPS's case from the paradigmatic sham transfers of income, in which the taxpayer retains the benefits of the income it has ostensibly forgone. Here that benefit ended up with OPL. There were, therefore, real economic effects from this transaction on all of its parties.[231]

Most enlightening is the court's treatment of the business purpose – something which touches directly on the prospective tax planning aspects of the transaction:

> It may be true that there was little change over time in how the excess-value program appeared to customers. But the tax court's narrow notion of "business purpose" – which is admittedly implied by the phrase's plain language – stretches the economic-substance doctrine farther than it has been stretched. A "business purpose" does not mean a reason for a

230. Id.
231. Id. at 1018-1019.

> transaction that is free of tax considerations. Rather, a transaction has a "business purpose," when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business. See *ACM P'ship v. Comm'r*, 157 F.3d 231, 251 (3d Cir. 1998). This concept of "business purpose" is a necessary corollary to the venerable axiom that tax-planning is permissible.
>
> The Code treats lots of categories of economically similar behavior differently. For instance, two ways to infuse capital into a corporation, borrowing and sale of equity, have different tax consequences; interest is usually deductible and distributions to equityholders are not. There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the taxpayer lacks a "business purpose." To conclude otherwise would prohibit tax-planning.[232]
>
> The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive. True, UPS's restructuring was more sophisticated and complex than the usual tax-influenced form-of-business election or a choice of debt over equity financing. But its sophistication does not change the fact that there was a real business that served the genuine need for customers to enjoy loss coverage and for UPS to lower its liability exposure.[233]

e. *Pro-Taxpayer Synopsis*

A review of the recent pro-taxpayer corporate tax shelter cases demonstrates a common thread for the application of the realistic possibility and more likely than not standards. Thus, when a prospective corporate tax shelter is proposed, the tax advisor, in order to satisfy the appropriate standard of review, should consider the following jurisprudential criteria:

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232. Id. at 1019.
233. Id. at 1020.

- Proposal of the tax shelter arrangement should be by a third party, e.g., investment banker,[234] insurance broker,[235] etc.;
- Sound economic realities that result in risk transfer or risk reduction;[236]
- Tax and financial leverage employed to facilitate a business purpose and not materially achieved solely to reduce the tax burden;[237] and
- A business purpose founded on a real, tangible business enterprise engaged in a profit-seeking activity.[238]

Although the preceding criteria are not dispositive in every conceivable case, they do meet the "likelihood of success" of the tax shelter arrangement found in the standards and applied by the tax advisor. It follows, a fortiori, therefore that to disregard these criteria is at the tax advisor's peril as the pro-government cases attest.

2. *Pro-Government Cases*

Taxpayers have been unsuccessful in at least three notorious tax shelter cases of recent years. As with the pro-taxpayer cases, a jurisprudential nexus among these cases can be identified for application of the tax review standards.

a. *Contingent Installment Sale Notes*

Like Boca,[239] the type of corporate tax shelter used in *ACM Partnership v. Commissioner*,[240] was a contingent installment sale note. However, unlike Boca, the arrangement lacked a liability management purpose.[241]

234. While this criterion was never specifically addressed as a determining factor, it did weave through all of the pro-taxpayer cases and clearly supported the lack of a pure tax avoidance nature. See Salina P'ship LP, FPL groud, Inc. v. Commissioner, 80 T.C. Memo (CCH) 686, 688 (2000), T.C. Memo (RIA) ¶ 54122 (2000); Boca Investerings P'ship v. United states, 167 F.Supp.2d 298, 309; (D.C. Cir. 2001); Compaq Computer Comp. v. Commissioner, 277 F.3d 778, 779 (5th Cir. 2001).

235. See IES Industries, Inc. v. United States, 253 F.3d 350, 352, 355 (8th Cir. 2001).

236. See UPS, 254 F.3d at 1019-1020.

237. See Salina, 80 T.C. Memo (CCH) at 695; Boca, 167 F.Supp.2d at 373; Compaq, 277 F.3d at 787.

238. See UPS, 254 F.3d at 1019-1020.

239. 167 F.Supp.2d 298.

240. 157 F.3d 231 (3d Cir. 1998).

241. Id. at 254-256.

To shelter its $105 million capital gain from the sale of a subsidiary, its investment banker suggested that taxpayer, Colgate-Palmolive Co., form a partnership (ACM) with a foreign (Netherland Antilles) bank.[242] Colgate would own 17% and the bank 82% with an approximate 1% ownership by the U.S. investment bank.[243] The partnership purchased $205 million in corporate notes and three weeks later sold $175 million of the notes on an installment basis under Section 453.[244]

Like Boca, ACM realized its share of the basis loss ($111 million) on the installment note which was used to offset the entire $105 million in capital gain.[245]

The Tax Court found that the transaction was a mere sham and that taxpayer was not entitled to recognize a phantom loss wholly devoid of economic substance.[246] The Third Circuit Court agreed holding that the tax shelter transaction by a business that would not have occurred, in any form, but for tax avoidance reasons lacked a valid business purpose.[247]

Apparently the distinguishing feature of this shelter, unlike its related cousin in Boca, is that the sale transaction was deficient in a corporate liability management purpose and existed solely for tax avoidance goals.[248] It was obviously designed for pure tax avoidance motives and not to shift liability risk as in Boca.[249]

b. *Equipment Leasing Trusts*

In *Nicole Rose Corp. v. Commissioner,*[250] a unique form of corporate tax shelter was devised largely to shelter an $11 million gain on the sale of taxpayer corporation's assets.[251] Unfortunately for taxpayer, this case is a

242. Id. at 233.

243. Id. at 239.

244. Id. at 239-240.

245. Id. at 240-244.

246. ACM P'ship v. Commissioner, 73 T.C. Memo (CCH) 2189, 2215, T.C. Memo (RIA) ¶ 97, 115 (1997).

247. ACM, 157 F.3d at 262.

248. See Steven M. Surdell, ACM Partnership – A New Test for Corporate Tax Shelters?, 75 Tax Notes 1377 (June 9, 1997); Jennifer D. Avitabile, Note, Corporate Tax Shelter Lacked Economic Substance: ACM Partnership v. Commissioner, 51 Tax Law. 385 (1998).

249. Compare ACM, 157 F.3d 231 with Boca Investerings P'ship v. United States, 167 F.Supp.2d. 298 (D.C. Cir. 2001).

250. 117 T.C. 328 (2001).

251. Id. at 330.

blueprint for tax avoidance verging on tax evasion.[252] It is also instructive to review this case and be amazed at how the complicated tax-oriented maneuvers ever approached a realistic possibility Standard.

In an effort to generate $22 million in ordinary business expense deductions (to offset a related $11 million gain) and to produce additional tax refunds of $1.8 million through the use of a claimed $9 million net operating loss carryback,[253] taxpayer corporation's controlling shareholder (Wolf) devised the following tax-oriented arrangements.

Attorney Wolf was the controlling shareholder in an equipment leasing firm, IPG.[254] To facilitate the sale of assets of an unrelated corporation, IPG formed a (shell) corporate entity which purchased the stock of Quintron Corporation, which had pre-acquisition taxable income.[255] It then merged the acquiring corporation and Quintron, with the latter as the surviving entity.[256] This surviving entity became petitioner-taxpayer corporation and it purchased the assets of Loral corporation triggering an $11 million gain.

To offset this gain and transform the preacquisition taxable income into tax refunds using net operating loss carrybacks, Wolf had a UK partnership, known as Atrium,[257] transfer to petitioner a $400,000 equipment trust fund obligation, equipment leases and residual value certificates (RVCs).[258] Petitioner then simultaneously transferred these same items, except for the residual trust certificates, to another Dutch Bank, Wildervank.[259]

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252. Respondent's expert testified that independent of the production of claimed tax deductions, there was no purpose to, and no substance for, the transfer of petitioner's leasing trust interests. Id. at 338.

253. Id. at 335.

254. Id. at 329.

255. Id.

256. Id.

257. Atrium Partnership was the sub lessor and assignee of an equipment lease from a Dutch bank known as ABN. It, in turn, was the seller and lessee of equipment from a separate Brussels Airport Company that was financed by ABN's subsidiary, Pierson, N.V. The Atrium Partnership was paid $25 million for the leaseback which it deposited in an equipment leasing trust fund that acted as security for the Pierson loan (the latter being the trustee and beneficiary of the trust fund). Id. at 332.

258. Id. at 334. These latter residual value certificates obligated the Dutch Bank, ABN, to pay the Atrium Partnership an unspecified amount equal to 200% of the fair market value of the leased equipment in excess of $5 and 2 million due on November 30, 1996 and November 30, 1998, respectively. Id. at 333 But at the time of this restructuring in 1993 no appraisal of the equipment's value was obtained. Id. at 335.

259. Id. at 335.

On its fiscal year end tax return of January 1, 1994, petitioner-taxpayer claimed the following:

- Taxable income of $11 million from the sale of assets to Loral corporation;
- Section 162 ordinary business deductions of $400,000 for the transfer to Wildervank of the leasing obligation of future rent payments and $22 million for the transfer to Wildervank representing the equipment leasebacks and trust fund;
- Capital loss of $2.1 million on a transfer to Wildervank from ten shares of an unrelated corporation; and
- Net operating loss of $8.9 million.[260]

The Commissioner denied all the section 162 deductions and the $8.9 million net operating loss, but allowed the capital loss.[261] Since the net operating loss was a result of the excess section 162 deductions, their transactional basis was the issue. Petitioner contended, and respondent refuted, inter alia,

> that it is entitled to the $22 million claimed ordinary business expense deductions relating to its transfer to Wildervank of its interest in the trust fund and the $400,000 in cash. Petitioner's apparent theory of deductibility is that the value of petitioner's interest in the trust fund was equal to the $21.8 million balance in the trust fund and therefore that when petitioner transferred to Wildervank its interest in the trust fund, plus the $400,000 in cash, the transfer should be treated as a "payment" by petitioner to Wildervank of $22 million in exchange for the cancellation of petitioner's obligation on an onerous lease.
>
> Petitioner claims that the RVC it received and retained had significant value, that petitioner had the opportunity to realize significant profit from the RVC, and that this profit potential explains and supports petitioner's participation in a legitimate for-profit transaction.
>
> Respondent claims that the transfer to Wildervank of petitioner's interests in the Brussels leaseback, in the trust fund, and in the $400,000 in cash, in exchange for Wildervank's assumption of petitioner's obligations relating to the Brussels

260. Id.
261. Id.

> Leaseback and the Trust Fund lacked business purpose and economic substance and should be disregarded. We agree with respondent.[262]

In finding no economic substance and a lack of business purpose, the Tax Court noted:

> The record establishes that no credible business purpose and that no viable economic substance existed for the transfer to Wildervank of petitioner's interests in the Brussels leaseback, in the trust fund, and in the $400,000 in cash. The complicated nature of these transactions fails to mask the lack of business purpose and economic substance in key aspects of the transactions and the tax avoidance objectives thereof. In September of 1993, when it participated in these transactions, petitioner never had any genuine obligation with respect to the Brussels leaseback and the trust fund. Even petitioner's payment of the $400,000 in cash we regard as not supported by a valid business purpose and economic substance. That payment is tainted by petitioner's sole tax motivation for participating in these transactions.
>
> Petitioner's only purpose for transferring to Wildervank its interests in the Brussels leaseback and in the trust fund was to create the claimed tax deductions. As respondent's expert testified at trial, independent of the production of claimed tax deductions, there was no purpose to, and no substance for, the transfer to Wildervank of petitioner's interests in the Brussels leaseback and in the trust fund.[263]

Finally, it is quite clear from the Tax Court's holding that participation of professional tax advisors in constructing such an obtuse, overly complicated, attempt at tax avoidance will result in the section 6662(a) accuracy related penalty since the reasonable basis standard of Regulations section 1.6662-3(b)(3) is violated.[264]

> The evidence is clear that petitioner had no valid business purpose for the transfer to Wildervank of its interests in the

262. Id. at 337.
263. Id. at 338.
264. See Regs. § 1.6662-3(b)(3).

> trust fund and in the Brussels leaseback and for the transfer to Wildervank of the $400,000 in cash. Other than claimed tax benefits, petitioner received nothing of value. The transactions lacked business purpose and economic substance, and the transactions are to be disregarded for Federal income tax purposes.
>
> Section 6662 imposes a penalty of 20% on underpayments of tax attributable to negligence or to disregard of rules or the regulations. For purposes of section 6662(a), negligence constitutes a failure to make a reasonable attempt to comply with the Internal Revenue Code. Sec. 6662(c).
>
> The accuracy-related penalty under section 6662(a) will not apply to any part of petitioner's underpayments of tax if, with regard to that part of the underpayments, petitioner establishes reasonable cause and if petitioner acted in good faith. Sec. 6664(c).
>
> The participation of highly paid professionals provides petitioner no protection, excuse, justification, or immunity from the penalties in issue. Petitioner participated in a clear and obvious scheme to reap the benefits of claimed ordinary business expense deductions that had no business purpose and no economic substance. The facts and circumstances of this case reflect no reasonable cause and no good faith for petitioner's participation in the transactions before us. Petitioner is liable for the accuracy-related penalties under section 6662(a).[265]

This case illustrates how far a taxpayer will "push the envelope" to obtain illicit tax deductions by constructing obtuse tax shelter arrangements. More importantly, it highlights how a clear failure of such an arrangement violates the realistic possibility standard, i.e., the one in three likelihood of success.

c. *Corporate Owned Life Insurance*

Yet another dismal attempt at generating tax deductions to offset taxable income is the case of *Winn-Dixie Stores, Inc. v. Commissioner.*[266] Where a

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265. Nicole Rose, 117 T.C. at 340-341.

266. 254 F.3d 1313 (11th Cir. 2001), cert. denied 122 S. Ct. 1537 (2002).

burgeoning type of tax shelter known as company or corporate owned life insurance (COLI) or "janitor's insurance"[267] was employed.[268] This COLI shelter was summarized by the Eleventh Circuit Court as follows:

> In 1993, Winn-Dixie embarked on a broad-based company-owned life-insurance (COLI) program whose sole purpose, as shown by contemporary memoranda, was to satisfy Winn-Dixie's "appetite" for interest deductions. Under the program, Winn-Dixie purchased whole life insurance policies on almost all of its full-time employees, who numbered in the tens of thousands. Winn-Dixie was the sole beneficiary of the policies. Winn-Dixie would borrow against those policies' account value at an interest rate of over 11%. The high interest and the administrative fees that came with the program outweighed the net cash surrender value and benefits paid on the policies, with the result that in pre-tax terms Winn-Dixie lost money on the program. The deductibility of the interest and fees post-tax, however, yielded a benefit projected to reach into the billions of dollars over 60 years.[269]

The Commissioner determined a deficiency attributable to taxpayer's 1993 interest and fee deductions. The Tax Court rejected petitioner's contention that the COLI shelter had a valid business purpose.[270] It found that these were mere sham loans and that any deductions were expressly disallowed.

On appeal, petitioner argued that Congress expressly authorized the deduction of interest and fees on borrowings against whole life[271] insurance

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267. The term janitors insurance as a substitute for COLI means that the employer takes out life insurance on its workers with itself as beneficiary and typically remains in force even when workers quit, retire or get fired. See, e.g., Ellen E. Schultz & Theo Francis, Why Are Workers In Dark? Wall St. J., April 24, 2002, at C1.

268. Winn-Dixie, 254 F.3d at 1315.

269. Id. at 1314-1315.

270. See 113 T.C. 254 (1999).

271. The life insurance contracts used in COLI tax arbitrage shelters are known as whole life contracts, i.e., a form of life insurance coverage whereby premiums pay for term (pure life insurance) protection in the early years, with the balance paid into cash reserves (against which the owner can borrow) that rises in value over the life of the contract. In contrast, group term life insurance contracts cover a particular number of years with no cash surrender value and would be inappropriate for a COLI program. See Richard A. Westin, WG&L Tax Dictionary at 789, 845 (Warner, Gorham & LaMont 2000).

policies' cash value pursuant to code section 264(c)(1).[272] Therein, the deductibility of interest and fees on policy loans is allowable provided no part of the annual premium is financed by a policy loan in four of the first seven years.[273] All of petitioner's policy loans qualified for this exception.[274] Alternatively, petitioner contended that the Tax Court misinterpreted the economic substance and business purpose doctrines.[275]

In rejecting petitioner's points, the Eleventh Circuit Court relied on the U. S. Supreme Court case of *Knetsch v. United States*.[276] It applied the rule that where the contract[277] is used as a tax shelter with no financial benefit other than its tax consequences any indebtedness was not bona fide and such interest therefrom nondeductible under section 163(a).[278] Knetsch can apply, therefore, to the deduction of interest under a sham transaction doctrine notwithstanding the application of the section 264 exception.[279]

In affirming the Tax Court, the Eleventh Circuit Court noted the utter lack of any business purpose or economic substance – other than the production of tax benefits:

> The tax court found, without challenge here, that the program could never generate a pretax profit. That was what Winn-Dixie thought as it set up the program, and it is the most plausible explanation for Winn-Dixie's withdrawal after the 1996 changes to the tax law threatened the tax benefits Winn-Dixie was receiving. No finding of the tax court suggests, furthermore, that the broad-based COLI program answered any business need of Winn-Dixie, such as identifying it for loss of key employees. Nor could it have been conceived as an employee benefit, because Winn-Dixie was the beneficiary of the policies. Under Kirchman, therefore, the broad-based COLI program lacked sufficient economic substance to be respected

272. Generally the benefits afforded life insurance contracts (defined at IRC § 7702) are untaxed and the appreciation is tax deferred pursuant to IRC §§ 101(a)(1),72(e), respectively. Similarly, interest on policy loans is generally nondeductible under IRC § 163(a) unless the exception of IRC § 64(c)(1) is operative.

273. This is the 4-of-7 year exception set forth at IRC § 264(c)(1).

274. Winn-Dixie, 254 F.3d at 1315.

275. Id.

276. 364 U. S. 361, (1960).

277. In Knetsch the contract was another form of insurance product known as an annuity contract which is materially similar to the COLI product hereunder. Id.at 362-363.

278. Id. at 366.

279. Id. at 367.

> for tax purposes, and the tax court did not err in so concluding.[280]

While COLI shelters are still used in various firms despite the 1996 tax law changes,[281] it is an unchallenged fact that the realistic possibility standard of tax review would be voided for such shelters unless they are restructured. In this regard, Winn-Dixie is informative. Thus, a COLI shelter does exhibit economic substance and a business purpose where, for instance, the employer corporation uses the proceeds to fund employee fringe benefit plans.[282]

#### d. *Pro-Government Synopsis*

A review of the recent pro-government corporate tax shelter cases demonstrates a common thread for the application of the realistic possibility and more likely than not standards. Thus, to run the gauntlet of IRS scrutiny, the tax advisor should recognize the following traps in tax shelter review:

- Documentation underlying the transaction fails to recognize the economic effects and focuses solely on tax avoidance;[283]
- Develop no profit-making incentive in the tax shelter;[284]
- Ignore the law of parsimony in the tax shelter arrangement thereby emphasizing a transaction's complexity;[285] and
- Use as many offshore special purpose entities as possible ignoring their economic role in the transaction.[286]

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280. Winn-Dixie, 254 F.3d at 1316-1317.

281. For interest paid or accrued after October 13, 1995, under COLI policy loan plans, the interest deduction was repealed when the plan covered officers, employees, or financially interested individuals. However, there is a stated exception for debt on key person contracts up to a $50,000 debt cap. See 1996 Tax Legislation: Law and Explanation at para. 258 (Commerce Clearing House 1996).

282. See, e.g., Winn-Dixie, 254 F.3d at 1314-1315.

283. In Winn-Dixie the written memorandum, obtained upon discovery, belied any economic effects of the COLI plan. Id.

284. This was the fatal error in the Colgate-Palmolive Co. shelter amid the contingent installment sale transaction. ACM P'ship v. Commissioner, 157 F.3d 231 (3d Cir. 1998).

285. Tax planning that is so patently complex fails to mark the lack of business purpose and economic substance. Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001).

286. Id.

Once again, the preceding items do not guarantee an audit or failure to meet the requisite tax standard of review. Nevertheless, one or more of them indicates that the tax shelter arrangement has a proclivity aimed at more tax avoidance (and in egregious cases tax evasion) than economic substance. But surely there must exist public policy and moral considerations that an ethical tax advisor should recognize in applying the relevant tax standard of review in addition to these jurisprudential guidelines.

## IV. PUBLIC POLICY AND MORAL CONSIDERATIONS AFFECTING STANDARDS REVIEW

A tax advisor, in addition to legislative, regulatory, and judicial interpretations of tax review standards, needs to be aware of the public policy treatment of proposed legislation that will impact such standards. Moreover, it would be myopic of the tax advisor to operate in an amoral environment in assessing a client's proposed tax transaction; even when a review standard admits the efficacy of the transaction it may not be a moral choice. Hence, both public policy and ethical dilemmas impinge upon tax review standards.

Good tax review standards should meet stated criteria that are universally accepted. While each nation or jurisdiction may have its own conception of a legitimate tax standard,[287] it is noteworthy to identify the guiding principles of sound tax policy. Similarly, in those multitudinous gray areas in tax transaction review where the 33% or more than 50% standards are difficult to assess, the tax advisor should be cognizant of his or her overriding moral or ethical call. Like a clarion gently whispering in the wind of transaction complexity, the advisor should recognize when moral or ethical norms are in jeopardy. To these ends, therefore, the following concerns will impact the "black letter" standards of tax review.

1. *Public Policy Dimensions* – It was Adam Smith in 1776 who first set forth the requisite of sound tax policy in the public environment.[288] According to Smith, a good tax should be equitable in form and substance, including its application, administratively convenient, and economical in collection.[289] Unfortunately in the 21st century Smith's pure standards have been adulterated

287. For a discussion of how the world community views the fairness and application of U. S. exclusion corporations under the new tax regime for foreign sales, see Harold S. Peckron, Uniform Rules of Engagement: The New Tax Regime For Foreign Sales, 25 Hastings Int'l & Comp. L. Rev. 1 (2001).

288. See Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 887-890.

289. Id.

with political expediency.[290] While Congressional and special interests espouse mandates, however oblique, there are some guiding principles that establish sound tax policy. These "macro" public policy guidelines lay the groundwork for the "micro" tax review standards. Thus, the tax advisor should have these macro guidelines ever in mind by recognizing his or her duty to participate in the tax policy debate. These tax principles are:

- Equity and Fairness. Similarly situated taxpayers should be taxed similarly.[291]
- Certainty. The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.[292]
- Convenience of Payment. A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.[293]
- Economy in Collection. The costs to collect a tax should be kept to a minimum for both the government and taxpayers.[294]
- Simplicity. The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost efficient manner.[295]
- Neutrality. The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.[296]
- Economic Growth and Efficiency. The tax system should not impede or reduce the productive capacity of the economy.[297]
- Transparency and Visibility. Taxpayers should know that a tax exists and how and when it is imposed upon them and others.[298]

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290. See, e.g., Sheldon D. Pollack, The Failure of U.S. Tax Policy: Revenue and Politics, 73 Tax Notes 341 (Oct. 21, 1996).

291. AICPA, Tax Policy Concept Statement at 9 (AICPA, Inc. New York, 2001). This principle addresses the concept of horizontal and vertical equity. Horizontal equity is where taxpayers in similar circumstances are taxed in similar ways. Vertical equity, on the other hand, is where taxpayers in different circumstances are taxed differently, e.g., higher income taxpayers would pay a higher tax based upon vertical equity. See J. S. Newman, Federal Income Taxation: Cases, Problems and Materials 24-25 (1998).

292. AICPA, Tax Policy Concept Statement at 10 (AICPA Inc., New York 2001).

293. Id.

294. Id.

295. Id.

296. Id.

297. Id.

298. Id.

- Minimum Tax Gap. A tax should be structured to minimize noncompliance.[299]
- Appropriate Government Revenues. The tax system should enable the government to determine how much tax revenue will likely be collected and when.[300]

With these public policy principles in mind, and the recognition that not all ten can be achieved in any given tax proposal, the challenge to the tax advisor is to voice criticism of such proposals that will affect the micro tax planning review standards.

For instance, the mandatory reporting of sixteen different tax shelter transactions[301] supports the equity and minimum tax gap principles but militates against the economic growth and efficiency principle because disclosure invites IRS audits and taxpayers will be disinclined to invite such scrutiny. As a tax advisor under the more likely than not tax shelter opinion standard, this disclosure edict raises the bar on certain shelters by either reinventing the shelter (as was the case with COLI shelters after the 1996 tax law changes)[302] or recommending their nonuse.

Public policy dimensions of tax proposals will continue unabated. Their impact on existing tax review standards, e.g., the realistic possibility standard, can never be underestimated. It is the tax advisor's duty to the client in evaluating a tax transaction that micro tax proposals be viewed in this larger context.

2. *Moral Considerations*

Inspector Javert, the incorruptible policeman in Hugo's Les Miserables,[303] endorsed a mindless, insane tenacity in his belief in moral duty.[304] And it is not so much his morality as it was that of society's of the time – an unquenchable thirst for dogmatic, Kantian,black letter law.[305] In the end, Javert could no longer reconcile his intractable moral duty against the protagonist's sense of justice so he succumbed to a self-inflicted death.[306]

299. Id.

300. Id.

301. Notice 2001-51, 2001-34 I.R.B. 190, supra note 57. See also Notice 2002-25, 2002-21 I.R.B. 992.

302. Supra note 283 and accompanying text.

303. Victor Hugo, Les Miserables (Charles E. Wilborn trans., Modern Library 1992).

304. See Frank Magill, Masterpieces of World Literature 537 (Harper Collins 1989).

305. Id.

306. Hugo, supra note 303, at 1147.

This classic of literature has much to say about the current moral climate in business, where law is sometimes exalted over ethics, as in the Enron case:

> Just look at what Enron, often with the blessing of Andersen, managed to accomplish, apparently within the comfortable confines of today's laws:
>
> - For nearly five years, Enron inflated earnings by a total of almost $600 million. This "legal" practice forced investors to make decisions about the value of Enron's stock using bogus profit figures.
> - Using off-the-books partnerships and maddeningly opaque accounting, with Andersen's approval, Enron shielded about $500 million in debt. That helped keep Enron's credit rating high, but at the expense of misleading anyone foolish enough to trust the numbers coming from the company and the private credit-ratings agencies.

To be sure, at least one high-level Enron official tried to do the right thing. But since everything looked legal on paper, those asking pointed questions were ignored.

> Even if the nation's laws weren't so permissive, Enron very well may have met the same end. In a free-market economy, no business is guaranteed a successful future. Had everyone involved used an ethical compass rather than a strictly legal one, investors would have been armed with accurate information about Enron's business and the risks it entailed when deciding whether or not to buy its stock.[307]

Metaphorically, in the room of life, law is the floor and ethics is the ceiling. To do what is "legally correct" may be terribly deficient of any moral base. So how do moral considerations impact tax advisors in the application of legal tax review standards of proposed transactions? In several ways.

First, an action can be illegal but morally right.[308] For example, the assistance to Jewish families to escape certain death at the hands of the Nazis or

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307. Enron: A Simple Question of Right and Wrong, supra note 4.

308. Id. See also Martin Luther King, Jr., "Letter from Birmingham Jail" in Why We Can't Wait 85 (Harper & Row 1963).

the nonviolent protests of the 1960s in the South against segregation[309] were moral actions albeit illegal.

Second, an action can be legal, but morally wrong.[310] For instance, this was the Enron case in its advisor approved legal use of special purpose entities. In the Report, Committee noted:

> Overall, Enron failed to disclose facts that were important for an understanding of the substance of the transactions. The Company did disclose that there were large transactions with entities in which the CFO had an interest. Enron did not, however, set forth the CFO's actual or likely economic benefits from these transactions and, most importantly, never clearly disclosed the purposes behind these transactions or the complete financial statement effects of these complex arrangements. The disclosures also asserted without adequate foundation, in effect, that the arrangements were comparable to arm's-length transactions. We believe that the responsibility for these inadequate disclosures is shared by Enron Management, the Audit and Compliance Committee of the Board, Enron's in-house counsel, Vinson & Elkins, and Andersen.[311]

Third, persons must be morally responsible for their past actions. This means that an advisor should have the competency to make moral or rational decisions on one's own.[312] Once again, this requires that even corporations, like Enron, or partnerships like Arthur Andersen, can make rational and moral decisions on their own – if they are treated as moral agents – then such entities can demonstrate moral responsibilities to others, e.g. shareholders and employees.[313]

Last, the question of self-interest is crucial to any moral decision. Or, when does self-interest trump moral duty? In ethics this is known as prudential versus moral reason.[314] Every lawyer or accountant, at one time or another in their career, has had to consider prudential reasons (considerations of self-

309. King, supra note 308, at 8.

310. King, supra note 308, at 9.

311. Report, supra note 10, at 178.

312. King, supra note 308, at 161.

313. King, supra note 308, at 162. While Arthur Andersen may or may not be criminally liable for its employee actions of shredding thousands of documents, under this moral responsibility theory, it is morally accountable as a firm for this immoral act.

314. King, supra note 308, at 295.

interest) versus moral reasons (considerations of the interests of others) in making a decision.[315]

As a general rule, if prudential concerns outweigh moral ones, then the decision maker may do what is in their own best interest.[316] On the other hand, if moral reasons override prudential ones, then the decision maker should honor their obligations to others.[317]

Consider the case of Enron once again. Its payment of accounting and legal fees for advice was substantial.[318] What type of pressure did the managing client partner of the accounting firm, David Duncan, experience in "going along" with suspect tax shelter transactions and special purpose entity creations?[319] The following is illuminating:

> In 1999 Enron Chief Financial Officer Andrew Fastow approached Mr. Duncan about a "special purpose vehicle" the CFO wanted to set up. It turned out to be LJM, a partnership that, it was revealed last fall, had brought Mr. Fastow millions of dollars in compensation and helped Enron hide millions in debt off its balance sheet.
>
> Mr. Duncan consulted Andersen's Professional Standards Group, the firm's source of advice on tricky accounting issues. It balked. "Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view," wrote Benjamin Neuhausen, a member of the standards group, in an Email to Mr. Duncan on May 28, 1999. "Conflicts of interests galore. Why would any director in his or her right mind ever approve such a scheme?" he wrote.
>
> Mr. Neuhausen also told Mr. Duncan the standards group would be "very uncomfortable" with Enron's recording gains on sales of assets to the Fastow-controlled entity or immediate gains on any transactions.

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315. King, supra note 308, at 295.

316. King, supra note 308, at 294.

317. King, supra note 308, at 294.

318. The Report noted that Arthur Andersen was paid $5.7 million for its assistance in designing controversial special purpose entities, viz., partnerships. Report, Supra note 10, at 5.

319. Anita Raghavan, Accountable: How a Bright Star at Andersen Fell Along with Enron, Wall St. J., May 15, 2002, at A1.

> "I'm not saying I'm in love with this either," Mr. Duncan replied in a June 1 Email, referring to the recording of gains. "But I'll need all the ammo I can get to take that issue on."
>
> Mr. Duncan told the standards group member that "on your point 1, (i.e. the whole thing is a bad idea), I really couldn't agree more." But he made clear the issue was by no means dead. He said he had told Mr. Fastow that Andersen would sign off on the transaction only if Mr. Fastow got chief executive and board approval at Enron, among other things. Enron ultimately approved setting up the partnership, with Mr. Fastow in charge.
>
> Andersen's total fees from Enron for auditing, business consulting and tax work were $46.8 million that fiscal year ending August 31, 1999. The next year the fees leapt to $58 million. They were between $50 million and $55 million in fiscal 2001.[320]

This final ethical venue demands a balancing act. It is, in essence, a kind of character or personality audit, in that the decision maker must strive for a balance between prudential and moral interests.[321] Indeed, the very welfare of society is at issue.[322] Numerous cases, some blatant attempts at pure self-interest, litter the landscape of professional advice[323] and pose a challenge for any tax advisor rendering advice to continue to keep these balancing concerns uppermost in his or her mind.

Armed with these legislative, regulatory, judicial, public policy and moral considerations, the post-Enron impact on tax review and disclosure standards has begun to emerge. Yet, it is "a place where the streets are not marked, some windows are lighted but mostly they're darked."[324]

320. Id.

321. Id. King, supra note 308, at 297.

322. Id. King, supra note 308, at 297.

323. See, e.g., W. Steve Albrecht, Ethical Issues In The Practice of Accounting, xi (1992).

324. Geisel, supra note 1.

## V. POST-ENRON STANDARDS OF TAX REVIEW

In light of the Enron debacle, existing standards of tax review will be augmented by stronger disclosure[325] and regulatory[326] rules. All tax advisors, those who render legal opinions and those who furnish accounting information on proposed tax shelter transactions, will be subject to these new enhancements.

### A. *Enhanced Regulatory Review*

A harbinger of the nature of these enhancements, as suggested by the Chairman of the Securities and Exchange Commission, translates into greater regulation and supervision by existing and proposed government bodies.

> Our disclosure and financial reporting system is still the best in the world, but it has long needed improvement. Its inadequacies are more visible after Enron's failure, and the need for change cannot be ignored any longer. This is not a problem that arose overnight. Investors here and abroad are entitled to rely upon our system as the finest in the world. We intend to fulfill that responsibility.
>
> We initially envision a new body dominated by public members, with two primary components – discipline and quality control. Let me speak to those two elements:
>
> 1. *Discipline*
>
> a. The system should be subject to a new body that is dominated by public membership.
> b. The SEC should decide whether conduct should be pursued as violations of law (in which case the SEC would handle it), or pursued as violations of ethical and/or competence standards (in which case they would be handled by the private sector regulatory body).
> c. The body should be empowered to perform investigations, bring disciplinary proceedings, publicize results, restrict individuals and firms from auditing public companies.

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325. Temp. Regs. § 1.3011-4T(a).

326. SEC Chairman Harvey L. Pitt has recommended on January 17, 2002 a proposal for a new regulatory body to supervise the accounting industry. See <http://www.see.gov/news/speech/spch 535.htm> (last visited May 17, 2002).

d. The disciplinary proceedings should proceed expeditiously.
e. Disciplinary actions should be subject to SEC oversight.

2. *Quality Control*

a. There should be a reform of the current peer review process that avoids firm-on-firm review.
b. The new process should replace the current triennial firm-on-firm peer review with more frequent monitoring of audit quality and competence designed to produce better audits in the future.
c. The staff should be deployed and overseen by the new publicly dominated body and its staff.[327]

B. *Enhanced Due Diligence*

While it was the lawyer's responsibility to evaluate Enron's disclosures in reference to their compliance with the law, such review required due diligence as proposed by existing tax standards. Under the new Circular 230 standard of review[328] every item in the tax shelter opinion must be addressed within the highest standard of review, i.e., a greater than 50% likelihood of the opinion being upheld.[329] Client inaccuracies will no longer be the sole responsibility of the client but shared with the tax lawyer who fails in his or her stricter standard of due diligence.[330]

Tax shelter opinions rendered in the post-Enron time must address all material Federal tax issues.[331] What is considered a "material" Federal tax issue for Circular 230 purposes? It would be <u>any</u> statutory, regulatory, or judicial doctrine that could impinge upon the tax shelter.[332] Thus, a careful review of recent (and perhaps not-so-recent) tax shelter cases is advisable. And legal conclusions can no longer be latent but must be prominently displayed on the initial page of the opinion.[333] To the extent that tax lawyers rely upon another professional's estimates of financial performance, they bear the burden to demonstrate that their reliance is based upon a reasonable belief.[334]

327. Id.
328. See 66 FR 3276 2001 WL 27422 (proposed Jan. 12, 2001).
329. Id. at 3294.
330. Id at 3291-3295.
331. 31 C.F.R. § 10.33(a)(3) (2002).
332. Id.
333. 31 C.F.R. § 10.33(a)(5)(iii).
334. 66 Fed. Reg. 3276, 3292 (proposed Jan. 12, 2001).

C. *Enhanced Policy and Ethical View*

Furthermore, it is clear that all tax advisors should be held to public policy and ethical norms, as discussed in the preceding section of this article. The pre-Enron legal threshold requirement will be, in all likelihood, woefully deficient in the post-Enron world. For example, assuming arguendo that some of the Enron special purpose entities that shifted debt off the balance sheet met the realistic possibility Standard, still their ethical impact on third parties (e.g. shareholders, creditors, etc.) should have been considered.

This does present the tax advisor with a unique set of random variables in the post-Enron milieu. If a proposed tax shelter "fits" within the new Circular 230 review, then should other variables be considered? For instance, is it ethically necessary to now consider the impact of the debt-shifting special purpose entity shelter on the publicly traded company's stock price? And, if so, is that ethical obligation sated through the Treasury's recent sixteen disclosure "listed transactions"[335] regulation?

Perhaps the days of the "black letter" Code lawyer will meet the same fate as the green eyeshade accountant – dinosaurs that have become extinct through dramatic changes in their environment. The challenges in the post-Enron world require the tax advisor to incorporate in his or her tax review standard new regulatory bodies, higher tax review and shelter disclosure standards and greater sensitivity to public policy and ethical dimensions, as the following paradigm demonstrates.

D. *Paradigm: Janitors Insurance Tax Shelter*[336]

1. *Factual Background* – First Financial Corporation (FFC), a publicly traded bank holding company, proposes a bank owned life insurance or BOLI program, modeled after the highly successful corporate owned life insurance program or COLI.

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335. See n. 129 supra.

336. This composite paradigm is based upon an actual series of articles dealing with major banks in the United States presently using bank owned life insurance (BOLI) or janitors insurance. See Ellen E. Schultz & Theo Francis, Where to Put Dead Peasants, Wall St. J., April 19, 2002; Theo Francis & Ellen E. Schultz, Why Secret Insurance on Employees Pays Off, Wall St. J., April 25, 2002; Theo Francis & Ellen E. Schultz, Many Banks Boost Earnings with Janitors' Life Insurance, Wall St. J., April 26, 2002; Theo Francis & Ellen E. Schultz, Big Banks Quietly Pile up Janitors' Insurance, Wall St. J., May 2, 2002; Ellen E. Schultz & Theo Francis, The Economy: Senator to Target Tax Boon to Firms Insuring Workers, Wall St. J., May 3, 2002.

The reason it seeks to establish the BOLI for its rank-and-file employees is two-fold. First, to receive significant tax free amounts. Second is to increase its earnings using a newly developed smoothing technique. As FFC's chief financial officer explains it, the build-up of cash value in the policies is tax free and the eventual payment of the death benefit to FFC, as sole beneficiary, is also tax free. Also, with an earnings smoothing technique the BOLI will always reflect positive earnings on the income statement. Projections from BOLI are expected to be 15% of FFC's net income.

No SEC, Comptroller of the Currency, or other accounting rule require any disclosure, including no disclosure to the rank-and-file upon whose lives the BOLI is written. Death benefits are to be used to fund some employee benefits programs but the lion's share will be used for FFC's capital acquisition program. Moreover, FFC desires to write the life insurance policies on permanent, temporary, retired, and terminated employees. The chief financial officer asks what tax problems may arise in this area and whether, as the bank's outside legal tax advisor, you can recommend this shelter.

2. *Tax Advisor's Review* – The initial concern is identification of the correct tax review standard. Since this is an unambiguous example of a tax shelter and because it will be scrutinized by the IRS, the more likely than not standard[337] or greater than 50% likelihood of taxpayer's position being upheld is appropriate.[338] A review of the sixteen "listed transactions" in the regulations that mandate a disclosure standard indicate that disclosure of this particular shelter may not be required.[339]

Judicial authorities are manifest in disallowing this shelter if it lacks economic substance or a valid business purpose.[340] Since no tax deductions are occurring to FFC's benefit, expressly disallowed since the 1996 tax amendments,[341] the tax free investment build-up and death benefit exclusions are allowable.[342]

However, while the technical Code and regulations standards of tax review appear to allow this tax shelter arrangement, public policy and ethics may demand a further analysis before it is green-lighted. There is a definite ground swell of anti-COLI/BOLI sentiment growing in Congress, with several senators introducing bills to prevent all companies from obtaining janitors insurance

337. Reg. § 1.6662-4(d)(1), (2).

338. Id.

339. See supra note 129.

340. See, e.g., Boca Investerings P'ship v. United States, 167 F.Supp.2d 298 (D.C. Cir. 2001).

341. See supra note 281.

342. See supra note 272.

simply to glean tax-free income.[343] The IRS, of course, has been fighting COLI of all sorts since their virtual inception.[344] So it appears that public policy may treat the BOLI shelter as a mere sham. Whether the Congressional bill becomes law and, if so, whether it will have retroactive effect (a rare occurrence in tax law for obvious reasons) needs to be carefully weighed.

Assuming arguendo that the present value of the tax benefits outweigh the tax cost attendant to public policy, there is still the moral question. What is disturbing in the majority of COLI or BOLI cases is that employees (some of which are neither permanent nor current) are treated as means to an end, i.e., manipulated without their consent or, for that matter, their knowledge. This unethical result of the BOLI shelter places prudential reasoning (FFC's self-interest) above that of moral reasoning (employee's interest).[345] Armed with this tax review standard and all its enhancements, what should the advisor recommend?

3. *Advisor's Recommendation* – It is clear that the client, FFC, has legitimate business reasons for establishing the BOLI and the fact that favorable tax consequences result is not determinative of its ultimate success under the more likely than not standard.[346] But since this tax shelter review is a la post-Enron, the enhancements must be considered.

First, if a new public regulatory body reaches fruition will nondisclosure become mandated? Second, what is the degree of confidence that the advisor vests in the client's estimates, i.e., is it sufficient for enhanced due diligence? Last, and most disturbing to the review, what of the public policy initiatives in Congress and the IRS alongside the ethical failure of the proposal?

Alas, unless the tax shelter proposal can be restructured it seems that the advisor should recommend against it. How to restructure? Serious consideration should be given to disclosure. Not only in footnote disclosure on the financial statements but, a fortiori, to the rank-and-file employees. Indeed, it should be pointed out that ethical companies not only disclose but also obtain the employees' consent.[347]

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343. See Ellen E. Schultz & Theo Francis, Senator To Target Tax Boom To Firms Insuring Workers (May 3, 2002).

344. Id. See also Winn-Dixie Stores Inc. v. Commissioner,254 F.3d 1313 (11th Cir. 2001).

345. Raghavan, supra note 319.

346. See, e.g., Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001).

347. South Trust Corp. with $935 million in BOLI assets and Washington Mutual Inc. with $1.5 billion in BOLI assets both disclosed and obtained employee consents. See Ellen E. Schultz & Theo Francis, Many Banks Boost Earnings with Janitors' Life Insurance, Wall St. J. April 26, 2002.

The recommendation should go further by requiring that the death benefits be used principally for funding employee benefit plans. This aids in both a stronger tax motive of economic substance and moral motive. With these modifications a "revised" BOLI tax shelter plan could be recommended – one that addresses the technical Code and regulation tax shelter review standard and its enhancements. Had such an approach been employed by the accounting and legal advisors to Enron it is unlikely that the result would have been the same.

## VI. CONCLUSION

"[H]uman understanding is like a false mirror, which, receiving rays irregularly, distorts and discolors the nature of things by mingling its own nature with it, i.e., perceptions cloud reality."[348] It was the perceptions of greed that largely resulted in the demise of Enron and its tax advisors.

This article attempted to make sense of this tangled web of perceptions by tracing the Enron imbroglio as seen through the eyes of the Special Investigative Committee of the Enron Board of Directors.[349] As if the creation of special purpose entities[350] which acted as tax shelters[351] and off-balance sheet financing vehicles[352] was not sufficient, Enron's accounting firm allegedly shred thousands of documents, some of which were pertinent to a pending SEC investigation.[353] It is this dramatic series of events that triggers the question of what impact such events will have on tax review standards.

A summary of pre-Enron standards of tax review discloses that various sources of standards exist: ABA Opinion 85-352 and MRPC,[354] SRTP and CPC Circular 230,[355] Treasury Regulations,[356] and the Internal Revenue Code.[357] Emerging from these sources are four discrete standards.[358] The standards of tax

348. Francis Bacon, The New Organon 48 (Fulton H. Anderson ed., 1960).

349. See Report, supra note 10.

350. See Report, supra note 10, at Appendix A.

351. See n.n. 22-27 supra.

352. Id.

353. United States v. Arthur Andersen, LLP, Indictment.

354. ABA Opinion 85-352 and MRPC, supra note 54.

355. See Circular 230, supra note 56.

356. Temp. Regs. § 1.6011-4T (2000); Notice 2001-51, 2001-34 I.R.B. 190.

357. Regs. §§ 6651, 6654, 6662, 6663, 6672, 6674, 6682, 6694, 6695, 6701, 6702.

358. See Regs. §§ 1.6662-3(b)(3), 1.6662-4(1),(2); see also SRTP, supra note 55.

review can be viewed along a continuum from the least stringent (reasonable basis)[359] to the most strict (more likely than not).[360]

It is, however, two of these tax standards that demand greater recognition. Those are the realistic possibility[361] and the more likely than not[362] standards. To place these in perspective, the former deals with tax review of proposed tax transactions where the tax advisor reasonably concludes that the tax position has approximately a 33% or greater likelihood of being sustained.[363] On the other hand, the more likely than not standard applies primarily to tax shelter transactions and requires that the proposed tax shelter opinion rendered by the tax advisor has a greater than a 50% likelihood of the opinion being upheld.[364]

As to the latter standard, it is corporate tax shelters, as some of the Enron special purpose entities were described by its Special Investigative Committee of the Board,[365] whereby the IRS has issued specific mandatory disclosure standards assuming that such tax shelter transactions fall within 16 "listed transactions." Thus, tax shelters have achieved a unique status in the tax review standards arena – mandated disclosure in many cases and stricter substantive review overall on a more likely than not basis.

To view the tax standards in the context of recent tax shelter disputes, several Tax Court, District Court and Appellate Court cases were examined.[366] These cases were analyzed in relation to pro-taxpayer versus pro-government stances noting their respective tax shelter profiles. What emerged from some of these highly complex and intricate shelters is the added enhancement of the realistic possibility and the more likely than not standards. That is, regardless of the shelter's construct it must exhibit economic substance[367] and a valid business purpose.[368] Failure to adequately address these judicial tax doctrines guarantees failure of the standards and demise of the tax shelter.[369]

But the jurisprudential analysis of shelters is still "technical analysis" of the skeleton of a proposed tax shelter transaction. Is such technical analysis

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359. Regs. § 1.6662-3(b)(3).

360. Regs. § 1.6662-4(d)(1),(2).

361. SRTP, supra note 55.

362. Regs. § 1.6662-4(d)(2).

363. Circular 230, supra note 56, at § 10.34(d)(1).

364. 66 Fed. Reg. 3276, 3295 (proposed Jan. 12, 2001).

365. See n. 353 supra.

366. generally supra n.n. 151-158.

367. See, e.g., IES Industries, Inc. v. United States, 253 F.3d 350 (8th Cir. 2001).

368. See, e.g. ACM P'ship v. Commissioner, 157 F.3d 231, 253-255 (3d Cir. 1998).

369. See, e.g., Boca Investerings P'ship v. United states, 167 F.Supp.2d 298 (D.C. Cir. 2001).

comprised of statutory, regulatory, and judicial sources sufficient in the post-Enron milieu? Not in all likelihood will it carry the day for the tax advisor. No, in today's volatile environment where new regulatory bodies are being proposed,[370] new disclosure standards enacted,[371] and new enhancements of tax review standards from public policy[372] and ethical norms,[373] the black-letter technical analysis is no longer the destination but merely the path to the ultimate advisor's conclusion.

And a gossamer path it is. Public policy now more than ever demands that a tax advisor scrutinize proposals for curtailing or even eliminating specific tax shelter transactions.[374] Then the advisor must consider the prudential self-interest of the corporate client who seeks to obtain improved financial results and concomitant tax benefits while balancing this against the moral third party interests.[375]

One conclusion arising from this post-Enron tax review standards analysis is that emerging tax policy[376] and ethical considerations[377] will play an even greater role in augmenting the strict technical analysis of tax shelter transactions. Of course, clients and tax advisors will forever develop new and creative ways to legally circumvent existing[378] and proposed[379] tax law. It was, after all, Justice Learned Hand of the Second Circuit who best expressed the tax doctrine that there is nothing inherently illegal or immoral in the avoidance of

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370. 66 Fed. Reg. 3276 (proposed Jane. 12, 2001).

371. Notice 2001-51, 2001-34 I.R.B. 190, supra note 57; see also Notice 2002-35, 2002-21 I.R.B. 992, supra note 302.

372. See, e.g., text accompanying n.n. 293-302.

373. King, supra note 308, at 8.

374. Raghavan, supra note 319.

375. King, supra note 308, at 294.

376. Raghavan, supra note 318.

377. King, supra note 308, at 294.

378. See UPS v. Commissioner, 254 F.3d 1014 (11th Cir. 2001).

379. Congress is considering tax legislation to block companies from incorporating in Bermuda to lower their taxes. Even before this provision becomes law Pricewaterhouse Coopers, an international accounting firm, has devised a means of navigating around this roadblock. See John D. McKinnon, Pricewaterhouse's Spinoff Discovers Bermuda Loophole, Wall St. J., May 9, 2002, at A6.

taxation.[380] And, in reality, even the term "tax shelter" is a denotative neutral term[381] that, unfortunately, has acquired a pejorative connotation.[382]

So if in the post-Enron planning world the typical tax advisor has become more circumspect and exercises greater due diligence[383] in the review of proposed tax shelter transactions, can this be an entirely bad outcome? Perhaps now tax lawyers and accountants will consider anew how much they can lose and how much they can win.

380. See Commissioner v. Newman, 159 F.2d 848, 851 (2d Cir. 1947).

381. In its broadest sense, a tax shelter is any transaction arrangement which has its primary objective the minimization of Federal income tax. See generally Daniel Q. Posin, Tax Shelters: How They Work and the Changes Wrought by the 1976 Act, 1 Rev. Tax. Indiv. 195 (1977).

382. The pejorative connotation is fostered by "abusive" tax shelters that meet judicial and regulatory definitions. See id. See also Reg. §§ 301.6111-2T(a)(3), (b)(1).

383. See, e.g., 66 Fed. Reg. 3276, 3295 (proposed Jan. 12, 2001).