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TAX LITIGATION ISSUES

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

Tax Shelter Enforcement Efforts

THE BUSH ADMINISTRATION and Congress have engaged in an assault on tax shelters in the past few months that is having, and will likely continue to have, a significant impact on tax attorneys and accountants, as well as their high net-worth and corporate clients. In the words of IRS Commissioner Mark Everson, "[T]he IRS will enforce the law across all sectors, but with particular vigor in the corporate arena and for high-income individuals who enter into abusive shelters to game the system."[1] Commissioner Everson has also expressed "concern about the erosion of professional standards among some attorneys and accountants."[2]

IRS, Treasury Efforts

On Dec. 29, the Internal Revenue Service and the United States Treasury Department announced proposed amendments to Circular 230,[3] the regulations governing practice before the IRS. The main thrust of the proposed changes is to limit the use of boilerplate opinion letters that vouch for tax shelters as a defense against IRS penalties. To that end, the proposed regulations would require attorneys preparing tax opinion letters that assert that a particular tax strategy is "more likely than not" to survive an IRS audit to do the following: (1) identify and consider all relevant facts and

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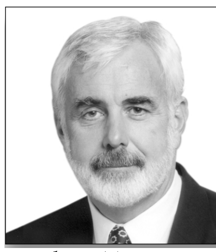

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not rely on any unreasonable factual or legal assumptions or representations; (2) relate the applicable law to the relevant facts; (3) consider and reach a conclusion as to all "material federal tax issues"; and (4) provide an "overall conclusion" as to the federal tax treatment of the tax shelter item.[4]

The proposed regulations also set forth "best practices" to be observed by all tax advisers and require professional services firms to have adequate oversight procedures in place to ensure that every member of the firm's staff follows those "best practices."[5] The "best practices" provision obligates an attorney to inform a client explicitly about what protections, if any, an opinion letter provides to them. Thus, attorneys would have to advise clients about issues that the opinion does not address and warn clients if the opinion will not protect them against penalties.[6]

The oversight procedures may have the most immediate impact on law firms. This proposed regulation requires the "practitioner who has … principal authority and responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues [to] take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with" the opinion letter requirements set forth above, or to be subject to discipline.[7] Thus, a partner heading a tax practice group could face disciplinary action because another partner or associate working in his or her group committed an infraction.[8]

Also on Dec. 29, the IRS announced the appointment of Cono Namorato, an experienced criminal tax attorney, as the director of the newly beefed-up Office of Professional Responsibility, which is charged with investigating allegations of misconduct or negligence against tax practitioners and enforcing the standards of practice for those who represent taxpayers before the IRS.[9] IRS Commissioner Mark Everson has doubled the staff of the Office of Professional Responsibility which, he has acknowledged, has historically focused on small-time abuses.[10] Commissioner Everson has also announced plans to reshuffle the IRS workforce so that he can add 2,200 employees to the tax enforcement divisions, including criminal investigators, revenue agents and revenue officers.[11]

In a separate but related move, the IRS recently announced that it has begun sharing leads on tax shelter cases with tax agencies in 45 states, the District of Columbia and New York City. This coordinated effort is the first step in transferring information since a new IRS-states partnership was formed in September 2003.[12]

These IRS and Treasury initiatives are in keeping with the Bush administration's broader efforts to crack down on abusive tax shelters and lax professional standards, a plan that Commissioner Everson has set forth on several occasions during the past year, starting with his nomination hearings.[13] The Treasury Department also recently issued a lengthy press release describing the administration's initiatives, boasting that the Bush administration "has taken aggressive action to address the abusive tax shelter problem, more so than in any period in recent memory."[14] The Bush administration is backing up its word with money (its 2005 budget proposal allocates $300 million to the Treasury Department to fund investigations, seek criminal prosecution of tax fraud cases and support IRS efforts to expand enforcement resources to target promoters and users of abusive tax shelter products).[15]

Congress' Efforts

Members of Congress have been trying to pass tax shelter legislation for several years, and several senators have taken up the cause with renewed vigor during the past few months. On Oct. 21, 2003, the Senate Finance Committee held hearings entitled, "Tax Shelters: Who's Buying, Who's Selling, and What's the Government Doing About It?", which included testimony about tax shelter abuse in the leasing and other industries.[16] One month later, the Senate Permanent Subcommittee on Investigations held a two-day hearing on the role of accountants, attorneys and financial professionals in tax shelters, with a large part of their focus on the actions of various tax professionals.[17]

On Nov. 24, Senators Max Baucus, D-Mont., and Charles Grassley, R.-Iowa, of the Senate Finance Committee introduced a bill aimed at curbing tax shelter abuse that broadens the IRS' ability to enjoin tax shelter promoters and allows the IRS to impose monetary penalties, in addition to suspension or disbarment, on disreputable tax advisors or their firms.[18] A bill containing the same language has been introduced in the House.[19]

The Courts

Several significant tax shelter cases — criminal and civil — are percolating in the courts and receiving media attention as well. Over a year before the Senate hearings last fall, the IRS began issuing summonses to accounting, investment and law firms, demanding tax shelter-related documents. To date, the IRS has launched more than 100 examinations of tax shelter promoters. Several firms have settled with the IRS, but the investigation continues.

Clients have filed lawsuits as well, against accounting firms and banks it worked with in promoting the shelters, including Wachovia and Deutsche Bank.[20] The banks carried out trading and lending for the tax shelters set up and sold by accounting and law firms — on this basis, they too could be held to be promoters of tax shelters and subject to penalties or disciplinary actions by regulators.[21]

Law firms have not escaped IRS scrutiny or client lawsuits. The IRS last year received court permission for the first time to issue special "John Doe" summonses to law firms. John Doe summonses were served on Sidley Austin Brown & Wood in October and on Dallas-based Jenkens & Gilchrist in June, asking the firms to identify clients who may have participated in potentially illegal tax shelters. With a John Doe summons, if clients' names are not turned over within six months, the three-year statute of limitations on audits is tolled until they are. For the law firms, the John Doe summonses raise significant attorney-client privilege issues.[22]

(1) Prepared testimony of Mark Everson, Joint Review on IRS Reform, May 20, 2003, available at http://www.irs.gov/pub/irsutl/rra98_joint_review_final_written.pdf.

(2) IRS Press Release IR-2003-148, "New Director Named for IRS Office of Professional Responsibility" (Dec. 29, 2003), available at http://www.irs.gov/newsroom/article/0,,id=118962,00.html.

(3) 31 CFR part 10.

(4) 31 CFR §10.35.

(5) 31 CFR §§10.33, 10.36.

(6) See IRS Press Release IR-2003-147, "Treasury Issues Rules to Increase Transparency and Halt Abusive Tax Avoidance Transactions" (Dec. 29, 2003), available at http://www.irs.gov/newsroom/article/0,,id=118955,00.html (interpreting 31 CFR §10.33).

(7) 31 CFR §§10.36.

(8) See Lily Henning, "Proposed IRS Regulations Take Aim at Lawyers," NYLJ, Jan. 8, 2004.

(9) IRS Press Release IR-2003-148.

(10) See David Cay Johnston, "IRS Unit Will Focus on Lawyers and Accountants," N.Y. Times, Dec. 29, 2003.

(11) IRS Press Release IR-2004-3, "IRS Plans New Steps to Improve Operations, Shift Jobs to Front-Line Positions" (Jan. 7, 2004), available at http://www.irs.gov/newsroom/article/0,,id=119136,00.html.

(12) IRS Press Release IR-2004-19, "IRS, States Move Forward in Fight Against Abusive Tax Avoidance" (Feb. 10, 2004).

(13) See "IRS Commissioner Everson on Tax Shelters," at irs.gov/irs/article/0,,id=111208,00.html; see also John D. McKinnon, "Tax Shelters May Face Tough Rules," Wall St. J., Dec. 30, 2003.

(14) United States Treasury Press Release JS-1184, "Bush Administration's Aggressive Actions to Combat Abusive Tax Shelters" (Feb. 19, 2004), available at ustreas.gov/press/releases/js1184.html; see also "Combating Abusive Tax Shelters: A Summary," at http://www.irs.gov/newsroom/article/0,,id=117990,00.html (outlining steps taken by IRS and Treasury as of November 2003).

(15) See Office of Management and Budget, Department of the Treasury 2005 Budget Overview, at www.whitehouse.gov/omb/budget/fy2005/treasury.html.

(16) See Hearings Before the Senate Committee on Finance, "Tax Shelters: Who's Buying, Who's Selling, and What's the Government Doing About It?", 108th Cong. (Oct. 21, 2003), available at finance.senate.gov/sitepages/hearing102103.htm.

(17) See Hearing Before the Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals," 108th Cong. (Nov. 18 & 20, 2003), available at http://govt-aff.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=132; see also Minority Staff Report, Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals: Four KPMG Case Studies," available at govt-aff.senate.gov/_files/sprt10834tax_shelters.pdf.

(18) S. 1937, 108th Cong. (2003).

(19) H.R. 3650, 108th Cong. (2003).

(20) See Cassell Bryan-Low, "Audit Firms Face Heavy Fallout From Tax Business," Wall St. J., Feb. 25, 2004.

(21) See Lynnley Browning, "A Spotlight on Deutsche Bank's Tax Shelter Role," N.Y. Times, Feb. 1, 2004.

(22) See *In re Tax Liabilities of: John Does*, No. 03C 4190, 2003 WL 21791551 (N.D. Ill. June 19, 2003); United States Treasury Press Release JS-922, (Tax Shelter Fact Sheet) (Oct. 20, 2003), available at www.ustreas.gov/press/releases/js922.html; United States Treasury Press Release JS-489, (Statement by Treasury Assistant Secretary for Tax Policy Pam Olson on John Doe Summonses Issued to Jenkens & Gilchrist) (June 20, 2003), available at ustreas.gov/press/releases/js489.htm; Lily Henning, "Proposed IRS Regulations Take Aim at Lawyers," NYLJ, Jan. 8, 2004; Janet Novack, "Sorry IRS! Your Time Is Up," Forbes, Dec. 22, 2003; John D. McKinnon & Cassell Bryan-Low, "U.S. Government Sues Sidley Austin On Tax Shelters," Wall St. J., Oct. 16, 2003.