

Comments

LESSONS FROM *UNITED STATES V. STEIN*: IS THE LINE BETWEEN CRIMINAL AND CIVIL SANCTIONS FOR ILLEGAL TAX SHELTERS A DOT?

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“Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”

—Judge Learned Hand.†

I. INTRODUCTION.....	904
II. BACKGROUND.....	908
A. <i>The Rise of Tax Shelters</i>	909
B. <i>The Role of Opinion Letters</i>	911
C. <i>The Regulation of Opinion Letters</i>	915
D. <i>Stein: The Largest Tax Fraud Case in History</i>	920
III. ANALYSIS.....	925
A. <i>A Critique of the Government’s Theory of the Case</i>	925
B. <i>Implications</i>	936
IV. SOLUTIONS FOR REGULATING TAX SHELTERS.....	938
A. <i>Imposing Criminal Sanctions</i>	939
B. <i>Purposes of Criminal Justice System</i>	940
C. <i>Imposing Civil Sanctions</i>	942
V. CONCLUSION.....	943

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† *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

I. INTRODUCTION

In the immortal words of Judge Learned Hand, all individuals have the freedom to minimize their taxes.¹ The complexity of the tax code ensures that Americans spend billions of dollars every year doing just that.² The more complicated the tax code becomes, the more Americans will depend on professional advice. Distinguishing between legal and illegal tax planning, however, is difficult and costly for both taxpayers and the government. In 2001, the Internal Revenue Service (IRS) estimated a \$350 billion tax gap, with underreported individual incomes accounting for nearly eighty percent of the shortfall.³ In reaction, Congress enacted stricter laws and the IRS increased enforcement aimed at tax professionals, successfully recovering \$55 billion of the tax gap from 2001.⁴ Even with this sizable recovery, the estimated 2005 tax gap remains high, up to a staggering \$298 billion.⁵ Coupling the rising cost of lost tax revenues with the current trend of corporate scandal, it was only a matter of time before the government focused its attention on illegal tax shelters in a high-profile criminal investigation.⁶

In *United States v. Stein*, touted as the largest tax fraud case in history, the government filed a forty-six count indictment against sixteen former KPMG partners⁷ and two outside individuals for allegedly creating and

¹ *Id.* *Helvering v. Gregory* is one of the most cited tax cases of all time. See JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & DEBORAH A. GEIER, *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY* 860 (3d ed. 2004).

² The cost of annual compliance (recordkeeping and learning tax rules) rose from \$112 billion in 1995 to \$265 billion in 2006. Chris Edwards, *CATO Says Income Tax Too Complex, Inefficient*, TAX NOTES TODAY, Apr. 7, 2006, 2006 TNT 67-40 (LEXIS). In 2005, sixty-one percent of tax filers used a paid tax preparer and spent a total of 6.4 billion hours on tax compliance. *Id.* H&R Block revenues from United States tax preparation rose from \$740 million in 1996 to \$2.2 billion in 2005. *Id.*

³ John Cranford, *IRS Struggles to Mind the Gap*, CQ WEEKLY, Feb. 4, 2006, at 326, 326-27; Press Release, IRS, New IRS Study Provides Preliminary Tax Gap Estimate, IR-2005-38 (Mar. 29, 2005), available at <http://www.irs.gov/newsroom/article/0,,id=137247,00.html> [hereinafter IRS, The Tax Gap]; IRS, Tax Gap Facts and Figures 5 (Mar. 2005), available at http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf [hereinafter IRS, Tax Figures]. The discrepancy between the amount of tax collected and that actually due is commonly referred to as the "tax gap." Cranford, *supra*, at 326. Understated individual incomes comprise over eighty percent of individual underreporting as opposed to overstated deductions. IRS, The Tax Gap, *supra*.

⁴ See IRS, The Tax Gap, *supra* note 3.

⁵ IRS, Tax Figures, *supra* note 3, at 8.

⁶ Commentators began keeping track of corporate scandals starting in 2002. See, e.g., Penelope Patsuris, *The Corporate Scandal Sheet*, FORBES.COM, Aug. 26, 2002, <http://www.forbes.com/2002/07/25/accountingtracker.html>. In keeping with this trend, the government indicted four current and former partners at Ernst & Young for selling and marketing tax shelters in May 2007. Lynnley Browning, *U.S. Prosecutors Plan New Indictment in Tax Shelter Case*, N.Y. TIMES, Sept. 12, 2007, at C2. The government is currently working on a superseding indictment. *Id.*

⁷ The original superseding indictment named as defendants sixteen former KPMG partners and one former KPMG senior manager. Superseding Indictment at 2, *United States v. Stein*, No. S1 05 Cr. 0888 (S.D.N.Y. Oct. 17, 2005), available at <http://www.usdoj.gov/usao/nys/pressreleases/October05/taxshelterfraudsupercedingsteinetal.pdf>. Since then, two partners have agreed to a plea. Lynnley Browning & Colin Moynihan, *KPMG Partner Pleads Guilty in Tax Case*, INT'L HERALD TRIB., Mar.

marketing illegal tax shelters.⁸ From 1997 to 2001, KPMG collected \$124 million in tax shelter fees, purportedly causing the government to lose \$1.4 billion in tax revenues.⁹ As a result, the government has begun to pursue collection from KPMG clients who purchased these shelters.¹⁰ The clients,

29, 2006, at 13; Paul Davies, *Defendant in KPMG Tax Case Pleads Guilty, Agrees to Cooperate*, WALL ST. J., Sept. 11, 2007, at A16. KPMG LLP is the U.S. member firm of KPMG International, one of the Big Four accounting firms. *KPMG, L.L.P.*, in HOOVER'S IN-DEPTH COMPANY RECORDS (Hoover's, Inc. Oct. 18, 2006), available at 2006 WLNR 18059125. They offer a wide range of accounting, audit, consulting, and tax-related services to customers in industries such as banking, communications, consumer products, health care providers, insurance, and pharmaceuticals. *Id.* In 2004, they employed 18,200 people with sales of \$4.1 billion and a growth rate of roughly eight percent. *Id.* The other Big Four accounting firms are Deloitte Touche Tohmatsu, Ernst & Young, and PricewaterhouseCoopers. *Id.*

For a detailed history of KPMG's rise to the top and fall from grace, see Tanina Rostain, *Travails in Tax: KPMG and the Tax Shelter Controversy*, in LEGAL ETHICS: LAW STORIES 90 (Deborah L. Rhode & David J. Luban eds., 2006).

⁸ Superseding Indictment, *supra* note 7, at 10–11; Press Release, U.S. Attorney's Office, S. Dist. of N.Y., 19 Individuals Charged in Superseding Indictment Filed in Criminal Tax Case Related to KPMG Tax Shelters (Oct. 17, 2005), available at <http://www.usdoj.gov/usao/nys/pressreleases/October05/kpmgsupersedingindictmentpr.pdf>; see also Greg Farrell, *Former KPMG Officials to Be Arraigned in Tax Case*, USA TODAY, Oct. 24, 2005, at 3B.

This case was originally scheduled for trial in September 2006 but was stayed pending determination of the defendants' civil suit against KPMG for attorney fees. *United States v. Stein*, 461 F. Supp. 2d 201, 202, 204 (S.D.N.Y. 2006); Lynnley Browning, *Judge Delays KPMG Tax Trial Over Legal Fees Dispute*, N.Y. TIMES, Nov. 15, 2006, at C1. On May 23, 2007, the Second Circuit held that the district court did not have ancillary jurisdiction to determine the civil suit over attorney fees. *Stein v. KPMG, LLP*, 486 F.3d 753, 764 (2d Cir. 2007). Consequently, the district court dismissed the indictment against thirteen of the remaining sixteen former KPMG employees, stating that the government had improperly coerced KPMG's cooperation and interfered with the defendants' Sixth Amendment rights. *United States v. Stein*, 495 F. Supp. 2d 390, 427 (S.D.N.Y. 2007). Some speculate that the government strategically asked for dismissal so that it could immediately seek appellate review of the district court's holding that it had violated the defendants' constitutional rights. Paul Davies & David Reilly, *Prosecutors Urge Dismissal of KPMG Indictments*, WALL ST. J., June 25, 2007, at C3. The remaining four defendants were scheduled to begin trial on October 16, 2007. *United States v. Stein*, 497 F. Supp. 2d 565, 566, 571 (S.D.N.Y. 2007); Davies, *supra* note 7, at A16. Due to a conflict of interest, Judge Kaplan barred attorney Steven Bauer from representing John Larson, one of the remaining defendants. Lynnley Browning, *Judge Bars a Defense Lawyer in KPMG Case*, N.Y. TIMES, Oct. 19, 2007, at C6. As a result, the trial has been postponed indefinitely. *Id.*

⁹ David Cay Johnston, *Changes at KPMG After Criticism of Its Tax Shelters*, N.Y. TIMES, Jan. 13, 2004, at C1.

¹⁰ See *Epsolon Ltd. ex rel. Sligo (2000) Co., Inc. v. United States*, 78 Fed. Cl. 738, 741–48 (2007) (detailing IRS efforts to obtain the identities of KPMG and Sidley Austin LLP clients who utilized the tax shelters). Starting in 2002, investors began to sue accounting firms that sold them tax shelters that were later disallowed. Donald L. Korb, *Shelters, Schemes and Abusive Transactions: Why Today's Thoughtful U.S. Tax Advisors Should Tell Their Clients to "Just Say No,"* in TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2006, at 9, 76–77 (PLI Tax Law and Estate Planning Course, Handbook Series No. 9068, 2006), WL 707 PLI/TAX 9; Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 88 n.47 (2006). Since KPMG came under investigation, the IRS has declared three of the four tax shelters illegal and enforced penalty payments against taxpayers, causing numerous clients who had purchased the allegedly illegal shelters to file suit. See, e.g., *Amato v. KPMG LLP*, 433 F. Supp. 2d 460 (M.D. Pa. 2006); *Shalam v. KPMG LLP*, No. 05-112732, 2006 WL 2589917 (N.Y. Sup. Ct. Sept. 8, 2006); *Simon v. KPMG LLP*, No. 05-CV-3189, 2006 WL 1541048 (D.N.J. June 2,

in turn, have filed numerous lawsuits against KPMG for malpractice.¹¹ The government's criminal prosecution has garnered rapt media and academic attention that primarily has focused on the prosecution's tactics and the resulting conflict for defendants between maintaining attorney-client privilege and avoiding prosecution.¹²

The indictment charges each defendant with one count of conspiracy to defraud the IRS and thirty-nine counts of tax evasion.¹³ The government alleges that the defendants conspired to defraud the government by designing, marketing, and implementing four illegal tax shelters that utilized a series of transactions solely intended to produce tax losses.¹⁴ The government also claims that the defendants committed tax perjury by filing false returns,¹⁵

2006); *see also* Senate Subcommittee Minority Staff Releases Report on Tax Shelter Industry, TAX NOTES TODAY, Nov. 19, 2003, at 20, 91 n.64, 2003 TNT 223-20 (LEXIS) [hereinafter *U.S. Tax Shelter Industry*]; Lynnley Browning, *Suit Accuses KPMG and Others of Selling Illegal Tax Shelters*, N.Y. TIMES, Aug. 17, 2004, at C3. In 2005, KPMG and a law firm agreed to pay \$195 million to settle a class action brought against the firms for promoting and selling abusive tax shelters. Lynnley Browning, *Law Firm and KPMG Settle Suit by Tax Clients*, N.Y. TIMES, Sept. 30, 2005, at C1.

¹¹ See sources cited *supra* note 10.

¹² The Thompson Memorandum, issued in 2003 by the Department of Justice, sets certain policy guidelines for determining whether to charge a corporation for criminal activity. Memorandum from Larry D. Thompson, Deputy Attorney Gen., to Heads of Dep't Components and U.S. Attorneys (Jan. 20, 2003), available at http://www.usdoj.gov/dag/cftf/business_organizations.pdf. The Thompson Memorandum was replaced in part by the McNulty Memorandum in December 2006 to minimize prosecutorial discretion in using corporate prosecutions to seek waiver of attorney-client privilege. Memorandum from Paul J. McNulty, Deputy Attorney Gen., to Heads of Dep't Components and U.S. Attorneys (Dec. 12, 2006), available at http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf. The guidelines established in these two memoranda have prompted much debate regarding prosecutorial tactics and their impact on attorney-client privilege and standard corporate policies of advancing employee legal fees. Lynnley Browning, *U.S. Tactic on KPMG Questioned*, N.Y. TIMES, June 28, 2006, at C1; *see, e.g.*, Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. REV. 311, 316-26, 347-58 (2007) (arguing that the policies in the McNulty and Thompson memoranda lead the government to commandeer internal corporate investigations, turning them into government investigations that compel waiver of attorney-client privilege and violate an individual employee's constitutional rights); Rebecca Walker, *The Thompson Memo: Implications of the Stein Decision for Corporate Compliance*, in CORPORATE COMPLIANCE AND ETHICS INSTITUTE 2007, at 483, 495-96 (PLI Corp. Law and Practice, Course Handbook Series No. B-1595, 2007), WL 1595 PLI/CORP 483 (arguing that companies should reevaluate their policies of advancing legal fees given the Thompson Memorandum's corporate compliance requirements); Andrew Weissmann & David Newman, *Rethinking Criminal Corporate Liability*, 82 IND. L.J. 411, 440-45, 449-51 (2007) (arguing that the Thompson and McNulty memoranda policies regarding corporate liability delineate compliance programs that properly incentivize self-regulation and that criminal vicarious liability should not apply unless the government proves the corporation failed to implement such programs). In *Stein*, Judge Kaplan held the prosecutorial tactics employed under the Thompson guidelines were unconstitutional as applied against the defendants. *United States v. Stein*, 435 F. Supp. 2d 330, 363-65 (S.D.N.Y. 2006); Browning, *supra*, at C1.

¹³ Superseding Indictment, *supra* note 7, at 45-66. The remainder of the indictment charges defendant Ruble with four counts of tax evasion for his personal income taxes and defendants Smith, Gremminger, and Eischeid with two counts of obstruction of the IRS. *Id.* at 66-69.

¹⁴ *United States v. Stein*, 429 F. Supp. 2d 633, 637 (S.D.N.Y. 2006); Superseding Indictment, *supra* note 7, at 8-9.

¹⁵ Superseding Indictment, *supra* note 7, at 9.

and that the defendants submitted fraudulent opinion letters that inaccurately described the transactions in order to hide their true nature.¹⁶ The government argues that these transactions were shams and never occurred, and in the alternative, if the transactions did occur as described, that they lacked an economic purpose.¹⁷ The government also alleges that the issuance of the opinion letters was an affirmative act of evasion.¹⁸

A close examination of the indictment reveals that the prosecution's case is centered on the opinion letters written by the defendants.¹⁹ These letters opined on the likelihood that the four allegedly abusive tax shelters would withstand legal challenges.²⁰ Before *Stein*, the government had never sought criminal penalties against tax planning professionals for providing opinion letters.²¹ In its first attempt to do so, the government relies on civil standards regulating opinion letters to support the charge that the defendants committed a criminal act.²² The governing civil standards are uncertain and ambiguous at best.²³ Thus, this case should clarify what behavior is so egregious that criminal rather than civil sanctions are warranted. This Comment argues that the government is inappropriately seeking criminal

¹⁶ *Id.* at 9–10.

¹⁷ Government's Memorandum in Opposition to Defendants' Pretrial Motions at 8–11, *Stein*, 429 F. Supp. 2d 633 (No. S1 05 CRIM. 0888), 2006 WL 1930266 (arguing that the tax shelters are shams); *Judge Rules Against IRS in 'Son of Boss' Tax Case: A Federal Jurist Finds that the Agency Went Too Far in Retroactively Banning a Shelter that Cost the Government Billions of Dollars*, L.A. TIMES, July 21, 2006, at C4 [hereinafter *Judge Rules Against IRS*] (reporting that the government will also argue that the tax shelters lacked economic substance).

¹⁸ Superseding Indictment, *supra* note 7, at 63.

¹⁹ See Jonathan D. Glater, *8 Former Partners of KPMG are Indicted*, N.Y. TIMES, Aug. 30, 2005, at C1 (stating that KPMG acknowledged its involvement in developing and implementing tax shelters and using opinion letters to fraudulently approve and misrepresent the transaction in a statement of facts); Sheryl Stratton, *Shelters Fraudulently Designed and Concealed, Government Says in KPMG Trial*, TAX NOTES TODAY, Apr. 25, 2006, 2006 TNT 79-3 (LEXIS) (“Echoing what tax officials have been insisting since the indictments were handed down last August and October, the government maintains that the defendant's criminal conduct lies not in the merits of the shelter transactions themselves, but in the packaging.”). At the request of Judge Kaplan, the government explained in an eight-page document how the four tax shelters were designed fraudulently and how the opinion letters concealed the fraud. Stratton, *supra*. The letters misled and concealed the fraud not only in misrepresenting the factual bases of the transactions but also in applying the law to the facts and for concluding the transactions would pass the more-likely-than-not standard. *Id.*

The government also alleges that the defendants obstructed the subsequent investigations and tried to hide the nature of the transactions by “failing to register the shelters, using sham attorney-client privilege claims, and concealing documents and providing false and misleading information in response to IRS and Senate investigations.” *Stein*, 429 F. Supp. 2d at 637 (citing Superseding Indictment, *supra* note 7, at 50); see also Robert Weisberg & David Mills, *A Very Strange Indictment*, WALL ST. J., Oct. 12, 2005, at A16 (Stanford Law School professors questioning the indictment of the *Stein* defendants and the imposition of criminal liability based on providing opinion letters).

²⁰ See *infra* Part II.D.

²¹ See *infra* Part II.B.

²² See *infra* Part III.A.1.

²³ See *infra* Part II.B–C.

penalties for providing opinion letters and that it should seek civil penalties instead.

To understand the significance of *Stein*, Part II paints the context in which *Stein* arises. It addresses the history of tax shelters, past attempts to regulate the industry, and the background of *Stein* itself. Part III analyzes the problems with and implications of the government's theory of the case. It concludes that the government has no basis for the tax evasion charges. Most importantly, it identifies a key problem with the government's case: the government's attempt to use nebulous civil and ethical standards as a basis for imposing criminal sanctions. Finally, Part IV provides solutions for the holes in criminal and civil regulation of tax shelters. It proposes that civil rather than criminal sanctions should be imposed because providing opinion letters is not a service that the government would like to prohibit altogether.

II. BACKGROUND

At the heart of the *Stein* controversy is the role that attorneys play in promoting and expanding the tax shelter industry. Since the 1980s, tax shelters have been a hotly contested area of regulation, and over time, financial incentives have increased the involvement of well-respected legal professionals in tax shelters. Section A traces the history of tax shelters and discusses the incentives that draw professionals into the industry. Section B describes the role of attorneys in providing opinion letters and explains how those letters encourage taxpayers to participate in tax shelter schemes. Section B also suggests that uncertainty in opinion letter standards, in conjunction with the lack of penalties for improper opinions, encourages professionals to use opinion letters abusively to promote illegal tax shelters. Section C reviews the regulatory history of tax shelter opinion letters. It focuses on attempts by courts, Congress, the IRS, and professional associations to regulate these letters, and explains why the government is now choosing criminal prosecution as a method of deterrence. Lastly, Section D discusses the government's use of *Stein* as a criminal test case. Examining the historical events that led to *Stein* and pressured KPMG to enter into a deferred prosecution agreement elucidates how the government has exercised and can continue to exercise its coercive power to prosecute the *Stein* defendants. The criminal charges in *Stein* raise the important question of how far the government can push its prosecutorial power to impose criminal liability on attorneys in the tax shelter industry.

A. *The Rise of Tax Shelters*

The line between legitimate tax planning and abusive tax shelters has been notoriously difficult to draw.²⁴ Part of the trouble with regulating tax shelters is the impossibility of knowing prior to litigation whether a transaction is an illegal tax shelter.²⁵ Because of the slippery nature of tax shelters, Congress, academics, and tax professionals cannot agree on a uniform standard or definition.²⁶ However, in an attempt to limit the scope of regulatory action, the general consensus among tax professionals is that a tax shelter is a transaction in which a significant purpose is to avoid income tax.²⁷ Current illegal tax shelters exploit the tax code by applying it in a way that is inconsistent with the “underlying substantive tax principles” of tax law.²⁸ The difficulty lies in determining when a transaction used for tax avoidance

²⁴ Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1776–77, 1782–83 (1999); James M. Delaney, *Where Ethics Merge with Substantive Law—An Analysis of Tax Motivated Transactions*, 38 IND. L. REV. 295, 315 (2005) (“At least one commentator has pointed out that the creation of the six largely unrelated attributes suggests that the IRS lacks a well-defined principle for distinguishing between legitimate and illegitimate transactions.”); W. Richard Sherman & Thomas M. Brinker, Jr., *Tax Shelter Reporting Requirements: Am I My Brother’s Keeper?*, J. INT’L TAX’N, May 2006, at 38, 41.

²⁵ A tax shelter can be a legal and appropriate method of reducing taxes. Martha Neil, *Tax Reform Reaches Out: New Rules on Shelters May Affect More than Just Tax Lawyers*, A.B.A. J., July 2004, at 62. Professors Michael Graetz and Deborah Schenk identify two categories of tax shelters, and Donald Korb, Chief Counsel for the IRS, identifies a third: (1) legitimate tax shelters; (2) gray area tax shelters; and (3) abusive tax shelters. Korb, *supra* note 10, at 15. A legitimate tax shelter involves tax-favored investments clearly identified by tax laws, such as oil exploration. *Id.* A gray area tax shelter is a preference sought by the taxpayer unintended by the tax laws, such as corporate-owned life insurance. *Id.* An abusive tax shelter involves a transaction that, if the facts were known, would not be upheld by a court. *Id.* Taxpayers play the “audit lottery,” saving on taxes if the IRS does not examine their returns. *Id.* However, if their returns are examined, the tax cost is deferred at a low interest cost. *Id.*

²⁶ Bankman, *supra* note 24, at 1776–77. Compare ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 346, at 131 n.1 (rev. 1982), reprinted in FORMAL AND INFORMAL ETHICS OPINIONS: FORMAL OPINIONS 316–348, INFORMAL OPINIONS 1285–1495 (1985) [hereinafter Formal Op. 346] (“A ‘tax shelter’ . . . is an investment which has as a significant feature for federal income or excise tax purposes either or both of the following attributes: 1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year and 2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.”), with Rostain, *supra* note 10, at 83 (identifying some common characteristics that classify a tax shelter transaction: (1) it “creates a tax loss through an investment with little financial risk and no significant potential for profit” that is readily “apparent from a close examination of the underlying economics of the transaction,” (2) “it involves a domestic corporation and a tax indifferent party,” permitting the allocation of the excess income to the tax indifferent party, giving the taxpayer an economic loss, and (3) it has been developed by a promoter and marketed to numerous taxpayers), and 26 U.S.C. § 6662(d)(2)(c)(ii) (Supp. IV 2006) (redefining tax shelter as “(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax”).

²⁷ Sherman & Brinker, *supra* note 24, at 41; see sources cited *supra* note 26.

²⁸ Rostain, *supra* note 10, at 84.

purposes is so devoid of legitimate business purposes that it constitutes an illegal tax shelter.

“Although aggressive tax planning dates back to at least the 1930s, the tax shelter industry emerged in the late 1970s and early 1980s.”²⁹ In 1986, Congress effectively eradicated certain tax shelters for individuals by passing legislation prohibiting the use of passive losses to offset regular income.³⁰ Still, corporate tax shelters flourished.³¹ The corporate tax shelter market expanded in size, eventually generating record refunds of more than \$31 billion in 1999.³² This growth led to changes in the industry that prompted accountants and tax attorneys to actively structure and mass-market tax shelters to clients instead of providing individualized advice.³³

Both accountants and attorneys have substantial incentives to participate in the industry.³⁴ Once developed, the marginal cost of selling the tax shelter product to additional clients is negligible.³⁵ Promoters can garner millions of dollars in profits because the tax shelters are sold on a value-added or contingency system based on the amount the client saves.³⁶ Moreover, client pressure and fear of losing business to competitors motivate

²⁹ *Id.* at 83.

³⁰ *Id.*; see also Sheldon D. Pollack, *Blessing Sham Shelters*, LEGAL AFF., July-Aug. 2002, at 20. A passive loss is a loss deduction from business activity the taxpayer does not materially participate in. Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1, 1 (1988).

³¹ Rostain, *supra* note 10, at 83; see also Peroni, *supra* note 30, at 81 (arguing that exemption of C corporations from passive loss limitation transfers tax sheltering activity generated from the individual tax system to the corporate tax system).

³² Pollack, *supra* note 30, at 20; see also Rostain, *supra* note 10, at 83 & n.23.

³³ Rostain, *supra* note 10, at 88–94. “Rather than providing tax planning advice to individual clients based on their particular circumstances, these transactions were developed in a way that made them easy to replicate and promote to a variety of clients and non-clients alike.” Korb, *supra* note 10, at 23. The desire by the big public accounting firms, investment bankers, and some law firms to generate revenues based on contingency or premium fees led to the development of the corporate tax shelter industry. *Id.* at 22; see also Janet Novack & Laura Saunders, *The Hustling of X-Rated Shelters*, FORBES, Dec. 14, 1998, at 198 (“[T]ax advisors are no longer just devising specific strategies to deal with a client’s tax needs as they arise [T]hey sell them methodically and aggressively, using a powerful distribution network unlike the armies of pitchmen who sold cattle and rail-car tax shelters to individuals in the 1970s and 1980s.”).

³⁴ See Korb, *supra* note 10, at 22 (noting the availability of contingency fees for corporate tax shelter products marketed by accounting firms, investment bankers, and some law firms). Accounting firms changed their business practices to offer tax services as a main service instead of being ancillary to independent audits. Rostain, *supra* note 10, at 89–90. Revenue from tax services grew by twenty percent, representing roughly \$800 million to \$1 billion in 1998. *Id.* at 91. In 2002, after the accounting firms divested their consulting services, revenues from tax services made up between twenty-one to thirty-six percent of total revenues, representing \$1.1 and \$1.6 billion. *Id.*

³⁵ Although development costs can run as high as \$1 million, promoters can recoup these costs by marketing the shelter to multiple customers. See Bankman, *supra* note 24, at 1781; Rostain, *supra* note 10, at 88.

³⁶ Bankman, *supra* note 24, at 1780–81; Rostain, *supra* note 10, at 88.

lawyers who work at law firms to take an active role in the tax shelter industry.³⁷ Most often, this role amounts to the generation of opinion letters.³⁸

B. *The Role of Opinion Letters*

In the tax shelter industry, an independent tax lawyer's main function is to provide opinion letters³⁹ that essentially state the likelihood that a transaction will pass legal muster under judicial scrutiny.⁴⁰ Client and tax promoter demand for opinion letters is based on the letter's ability to shield clients from tax penalties.⁴¹ Without this insurance, clients would be less likely to engage in risky and borderline transactions.⁴²

Under 26 U.S.C. § 6662, a taxpayer will not be penalized for underpayment of taxes if (1) she has substantial authority to support the tax treatment⁴³ or if (2) she asserts a "reasonable basis" for the tax treatment itself⁴⁴ and she discloses all relevant facts affecting the tax treatment.⁴⁵ Sec-

³⁷ Pollack, *supra* note 30, at 21. Many of the accounting firms heavily recruited tax lawyers by increasing starting salaries in the late 1990s. Rostain, *supra* note 10, at 91.

³⁸ Rostain, *supra* note 10, at 92–94.

³⁹ Bankman, *supra* note 24, at 1782. This role is juxtaposed with that of tax lawyers who act as shelter organizers and promoters and generally work in accounting firms, investment banks, or tax shelter boutiques. *Id.* at 1782–83. Since the profits mainly go to promoters and organizers, there are significant incentives for tax attorneys to forgo working in law firms and become promoters. *Id.* at 1783.

⁴⁰ There are many types of opinion letters that cover a range of industries, including "corporate law, banking, real estate transactions, securities, litigation, taxation, bankruptcy, and international law, to name a few." Anand Mohan, Current Development, *The No-Litigation Opinion Letter After Dean Foods v. Pappathanasi: Should Law Firms Be Held to Higher Ethical Standards?*, 19 GEO. J. LEGAL ETHICS 859, 861 (2006). Generally, these opinion letters are used to mitigate risks in these areas and normally are requested by a third party or the client. *Id.*

⁴¹ See *infra* text accompanying notes 42–50.

⁴² Prior to the proliferation of the modern tax shelter industry, some companies were hesitant to take advantage of the lax regulations and promote tax shelters. Novack & Saunders, *supra* note 33, at 198 (reporting that, "despite the frenzy, not all companies are biting" and that Intel's tax vice president, Robert Perlman, said he avoided the fray to maintain Intel's standard of "[i]f what we did and why appeared on the front page of the paper, would Andy Grove be embarrassed?"). This suggests that opinion letters played an important role in inducing reluctant corporations to engage in tax shelter transactions when they otherwise might not have done so.

⁴³ Substantial authority includes the tax code, other statutes and regulations, court cases, tax treaties, statements of congressional intent, and administrative pronouncements such as private letter rulings. 34 AM. JUR. 2D *Federal Taxation* ¶ 71640 (2007).

⁴⁴ The standards for complying with accuracy-related penalties include (in ascending order of heightened standards): not frivolous, reasonable basis, realistic possibility of being sustained on the merits, substantial authority, and more likely than not the proper treatment. Paul M. Predmore, *New Reasonable Basis Standard for Return Disclosure Likely to Be Troublesome*, 80 J. TAX'N 22, 23–24 (1994). Meeting the not frivolous standard merely requires a position to be arguable and not patently improper. Treas. Reg. § 1.6694-2(c)(2) 2007; see also *id.* § 1.6662-3(b)(3). The reasonable basis standard requires a position to be arguable but not necessarily likely to prevail in court. *Id.* The realistic possibility standard means a reasonable and well-informed analysis by a knowledgeable person in the tax law that the position has a one in three or greater chance of being sustained on the merits. *Id.* § 1.6694-2(b)(1). Substantial authority is an objective standard defined as "an analysis of the law and application of the law to the relevant facts." *Id.* § 1.6662-4(d)(2). Finally, the more-likely-than-not standard requires a

tion 6664 provides an exception to the § 6662 penalties if the taxpayer can show she had reasonable cause for the tax treatment and that she was acting in good faith.⁴⁶ Treasury Regulation section 1.6664-4(c) lists “reliance on opinion or advice” of a “professional tax advisor” as a reasonable cause and good faith exception to 26 U.S.C. § 6662 penalties.⁴⁷ Assuming that the lawyer meets the requirements to qualify as a “professional tax advisor,”⁴⁸ an opinion letter effectively gives clients protection from any tax penalties they may incur upon future discovery of underpayments.⁴⁹ Thus, almost every marketed tax shelter will be accompanied by an opinion letter stating its legality.⁵⁰

Because of the revenue-generating potential of these marketed tax shelters,⁵¹ some lawyers have been overly eager to provide opinion letters.⁵² More importantly, given the uncertain standards governing what a lawyer may and may not write in an opinion letter, potential liability for producing an “incorrect opinion” is relatively unlikely.⁵³ This uncertainty is rooted in the difficulty of defining tax shelters, and in the fact that an opinion letter is essentially what its name implies—an *opinion* predicting future events. Thus, two well-respected tax advisors could reasonably disagree on whether a transaction should receive favorable or negative treatment under the tax code.

position to have a greater than fifty percent chance of being sustained on the merits. *Id.* § 1.6662-4(g)(4)(i)(A).

⁴⁵ 26 U.S.C. § 6662(d)(2)(B) (Supp. IV 2006).

⁴⁶ 26 U.S.C. § 6664.

⁴⁷ Treas. Reg. § 1.6664-4.

⁴⁸ See 26 U.S.C. § 6664(d)(3)(B)(ii)–(iii) (defining a disqualified tax advisor and a disqualified opinion).

⁴⁹ Protection from penalty payments assumes that the client can show that, in deciding to enter into the transaction, she reasonably relied on both the opinion letter and the attorney’s analysis of a reasonable basis for the tax treatment. *Id.* § 6664(d)(3). The provision also prohibits penalty exclusions for transactions that are tax shelters as defined in the statute. *Id.* § 6662(d)(2)(C); see also *infra* notes 113–15 and accompanying text.

⁵⁰ Bankman, *supra* note 24, at 1782.

⁵¹ This service can cost from \$500,000 to millions of dollars per opinion letter. Pollack, *supra* note 30, at 20; Rostain, *supra* note 10, at 94; Novack & Saunders, *supra* note 33, at 198. Brown & Wood LLP earned more than \$23 million for issuing opinion letters related to the KPMG tax shelters, charging \$74,000 per letter. Carl Levin, *Sen. Levin Suggests Changes to Proposed Circular 230 Amendments*, TAX NOTES TODAY, Mar. 4, 2004, at 3, 2004 TNT 43-62 (LEXIS).

⁵² Not all lawyers agree with the actions of those who provide opinion letters. Bankman, *supra* note 24, at 1783; Rostain, *supra* note 10, at 80–81. Some are upset by the ethical issues raised by involvement in the tax shelter industry, while others simply disapprove of implicitly competing with accountants and investment bankers. Bankman, *supra* note 24, at 1783. Professor Tanina Rostain argues that the tax bar’s initiative to heighten deterrence in the tax shelter industry is “to reinforce the professional authority of elite tax lawyers, which had been eroded by the tax shelter market” and “to reassert the primacy of judicially created doctrines and, by extension, lawyers’ role in applying them.” Rostain, *supra* note 10, at 81.

⁵³ See *infra* note 65.

In essence, tax shelters capitalize on areas of tax law that are ill-defined while generally complying with the literal language of the governing statute, administrative ruling, or case law.⁵⁴ If challenged, the transaction's legality usually turns on whether it has the requisite business or economic purpose or whether it is motivated solely by tax avoidance.⁵⁵ How a court will view a specific transaction is impossible to predict with any certainty. Not only is the case law contradictory,⁵⁶ but one judge's determination may not be relevant in predicting what another judge will do in a similar, but not necessarily identical, situation.⁵⁷ An opinion on whether a transaction would receive favorable treatment by the courts is largely dependent on the individual attorney's subjective methods of interpreting the relevant law at the time of the opinion.⁵⁸

Murky opinion letter standards are an additional source of ambiguity. Depending on the nature of the transaction, opinion letters must meet different confidence levels in opining whether the transaction would be legal.⁵⁹ Although tax shelters generally fall into the more-likely-than-not category,⁶⁰ tax attorneys can and do disagree on how to categorize a specific transaction.⁶¹ Under the more-likely-than-not standard, a tax advisor must conclude that a transaction has at least a fifty-one percent likelihood of passing judicial scrutiny.⁶² Deciding whether a transaction has a fifty-one percent chance versus a forty-nine percent chance of passing muster is arbitrary and difficult, adding to the potential that two lawyers will disagree.⁶³

Until *Stein*,⁶⁴ tax advisors believed they faced limited liability stemming from the issuance of incorrect opinions because of the lack of definite

⁵⁴ Bankman, *supra* note 24, at 1782.

⁵⁵ See Sherman & Brinker, *supra* note 24, at 42 (noting that the primary problem with attacking tax shelters using judicial doctrines is "arguing that the tax shelter lacked economic substance or a business purpose").

⁵⁶ See *infra* Part II.C.

⁵⁷ See Bankman, *supra* note 24, at 1782 (quoting a practitioner as stating, "You can guess how [the judge that decided a similar case] will rule on the deal, but what about the next judge?").

⁵⁸ *Id.* (stating that though variance could be due to different interpretive theories, even attorneys with the same interpretive approach will disagree); see also Pollack, *supra* note 30, at 20 ("Given the complexity of the tax code, that means a lot of close calls.").

⁵⁹ Tax shelter opinions require a confidence level of more likely than not while non-tax shelter transactions only require a confidence level of a reasonable possibility of success. 31 C.F.R. §§ 10.33–34 (1997); see *supra* note 44 and accompanying text for definitions.

⁶⁰ See 31 C.F.R. § 10.35(c)(4)(ii), (e)(4) (2007).

⁶¹ Considering the difficulty in even defining a tax shelter, two tax attorneys could disagree on (1) whether a specific transaction is a tax shelter, and (2) if it is a tax shelter, whether it is similar enough to a listed transaction that disclosure is required. See *infra* notes 101, 104.

⁶² 31 C.F.R. § 10.35(b)(4)(i) (2007); Bankman, *supra* note 24, at 1782.

⁶³ Bankman, *supra* note 24, at 1782.

⁶⁴ See *supra* note 10 and accompanying text.

opinion letter standards.⁶⁵ Theoretically, tax advisors could be liable to their clients for writing unsupported opinions. In reality, courts rarely imposed penalties on taxpayers, even when the courts found that tax advisors understated their clients' taxes.⁶⁶ Even when a court imposed penalties, its decision might not have provided the client with a basis for a malpractice suit.⁶⁷ Furthermore, the taxpayer might have had difficulty establishing her reliance on the opinion letter in deciding whether to enter into the transaction in the first place.⁶⁸ Thus, cases in which clients sued their advisors prior to *Stein* were few and far between.⁶⁹

Because of this perceived limited liability, prior to *Stein* only self-imposed ethical standards stood between a tax attorney and her involvement in the abusive tax shelter industry. But because many lawyers have failed to regulate themselves, Congress, the IRS, and the American Bar Association (ABA) have all recognized the important role opinion letters play in promoting potentially abusive tax shelters and thus have advocated the imposition of stricter regulations.⁷⁰

⁶⁵ See Bankman, *supra* note 24, at 1783 (“[T]he ‘more likely than not’ standard and the confused nature of the tax law work against any potential liability. ‘It really comes down to a malpractice standard,’ notes one tax lawyer. ‘You opine the likelihood of success is 51-49 but it turns out that maybe it really was 45-55. Is being 6 points off malpractice?’” (internal quotation marks added)).

⁶⁶ Delaney, *supra* note 24, at 312; see also Spitz v. Comm’r, 2006 T.C.M. (RIA) ¶ 2006-168, at 1144, 1150–51. Courts are more likely to impose penalty provisions in modern tax shelter marketing. See Ackerman v. Schwartz, 947 F.2d 841, 846–48 (7th Cir. 1991) (noting that an attorney is liable to investors who relied on an opinion letter even when the letter was written for a client and tax shelter promoter rather than for the investors). Still, because promoters employ independent firms, these cases raise concerns about the independent attorney’s duty and the investor’s reliance on the opinion letter. See *id.*

⁶⁷ For example, assume that because the client knew of a false representation in the transaction, she could not have reasonably relied on the opinion letter, and accordingly, the court imposed penalty payments. If the attorney drafted the opinion letter in reliance on the client’s representation of the facts, the client would have a difficult time arguing malpractice. This scenario would have had to occur prior to the changes in the regulations requiring heightened standards of due diligence. See *infra* Part II.C. There are also other factors restricting the likelihood of recovery, such as the statute of limitations. Jacob L. Todres, *Investment in a Bad Tax Shelter: Malpractice Recovery from the Tax Advisor Is No Slam-Dunk*, 107 TAX NOTES 217 (2005).

⁶⁸ See, e.g., Charlton v. Comm’r., 1990 T.C.M. (P-H) ¶ 90,402, at 1903, 1938 (“We have examined the tax opinion and find that it is replete with cautions and waivers. Based on language contained in the tax opinion, the Charltons could not have believed that they would have more than a 50–percent chance of prevailing in the event of litigation.”).

⁶⁹ See, e.g., Ackerman, 947 F.2d at 846–48 (holding that an attorney could not avoid responsibility to investors who purchased a fraudulent tax shelter based on the grounds that the attorney owed no duty to the investors); Gregory v. Home Ins. Co., 876 F.2d 602, 603, 606 (7th Cir. 1989) (holding that an attorney could be sued for drafting a tax and security opinion letter when the IRS disagreed with the letter about the predicted tax advantages). Although a number of cases do exist, they are not well known, and lawyers generally do not anticipate being liable for writing opinion letters. See Rostain, *supra* note 10, at 94 n.79; see also Susan Beck, *Gimme Shelters*, AM. LAW., Nov. 1999, at 106 (“No one interviewed for this article could point to a law firm sued by a client or penalized by the government.”).

⁷⁰ See *infra* notes 92, 94, 108 & 110 and accompanying text.

C. *The Regulation of Opinion Letters*

Because tax shelters are difficult to define and identify, Congress, the Treasury Department, and the IRS face a challenge in designing and implementing effective laws and regulations. Accordingly, courts have developed judicial doctrines to draw lines between legitimate and abusive tax shelters, Congress has enacted codes to close loopholes, and the ABA and the IRS have established ethical guidelines and standards governing tax shelters—all with varying degrees of success. The earliest form of regulation was litigation, through which the courts created five judicial doctrines to differentiate between legitimate and illegal tax shelters.⁷¹ Following in the Judiciary's footsteps, the ABA Committee on Ethics and Professional Responsibility created model ethical rules prescribing standards governing attorney conduct.⁷² To address tax shelter abuse, the IRS and Congress adopted the ABA model rules in regulations and statutes, respectively.⁷³ As *Stein* suggests, all efforts have thus far been ineffective in stymieing the tide of tax fraud abuse.

To determine whether a transaction is legitimate, courts have developed five doctrines that each utilize a “substance over form principle.”⁷⁴ Although this approach is unsupported by specific statutory provisions, courts interpret the statutes and Treasury regulations in light of congressional intent.⁷⁵ Because these doctrines all try to discern whether a transaction has an underlying legitimate economic purpose, the methods of applying each doctrine inevitably overlap.

The first approach, the substance over form doctrine, requires a court to focus on a transaction's underlying substance rather than the formal steps taken in the transaction.⁷⁶ Thus, if two transactions apply different legal steps but achieve the same economic result, the transactions should be taxed in the same manner.⁷⁷ The second approach, the economic substance doc-

⁷¹ See *infra* notes 74–90.

⁷² Formal Op. 346, *supra* note 26.

⁷³ See *infra* notes 94–95.

⁷⁴ DODGE, FLEMING & GEIER, *supra* note 1, at 861 (stating that if a transaction lacks a business purpose, the government can argue that it should be taxed “as though it were structured in a less favorable form that better reflects the ‘substance’ of the transaction”).

⁷⁵ Daniel J. Glassman, “*It’s Not a Lie if You Believe It*”: *Tax Shelters and the Economic Substance Doctrine*, 58 FLA. L. REV. 665, 681–82 (2006) (stating that the Supreme Court found that the statute did not require that a transaction have economic substance for the statute to apply and that the Court was attempting to analyze congressional intent instead of applying statute as written); see Kristin E. Hickman, *Of Lenity, Chevron, & KPMG*, 26 VA. TAX REV. 905, 924–33 (2007) (using *Stein* as an example and arguing that criminalization of tax shelters may result in less deference by courts to Treasury interpretation of the tax code in the civil context because courts tend to apply the rule of lenity rather than the Chevron doctrine to statutes that have both criminal and civil sanctions). See generally Steven A. Dean & Lawrence M. Solan, *Tax Shelters and the Code: Navigating Between Text and Intent*, 26 VA. TAX REV. 879 (2007).

⁷⁶ DODGE, FLEMING & GEIER, *supra* note 1, at 861.

⁷⁷ Korb, *supra* note 10, at 32.

trine, requires a transaction to have a real “economic substance independent of tax considerations.”⁷⁸ This doctrine also applies the substance over form approach, but it has stricter requirements than the first doctrine in requiring that the transaction have an economic purpose.⁷⁹ The third approach, the business purpose doctrine, adds to the economic substance doctrine a subjective inquiry into the taxpayer’s motives, creating a two-prong test.⁸⁰ First, the court examines the taxpayer’s motives in entering into the transaction, and second, the court examines whether the transaction lacks economic substance.⁸¹ To avoid liability, the transaction must have an economic substance that is “compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached.”⁸² The fourth approach, the sham doctrine, applies to transactions that do not actually occur and are—as the name suggests—shams.⁸³ Although the sham doctrine originally applied only to factual shams, some courts have incorporated the economic substance doctrine and extended the sham doctrine to transactions that take place but lack economic substance.⁸⁴ The final approach is the step transaction doctrine, which applies to transactions that do not have a sharply defined beginning or end. This approach allows the IRS to recharacterize seemingly separate transactions as one

⁷⁸ *Id.* at 30 (emphasis omitted). *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), is the most oft-cited case for establishing the foundation of this doctrine. Since then, many modern cases have followed this approach. *See, e.g.*, *ACM P’ship v. Comm’r*, 157 F.3d 231, 246–48 (3d Cir. 1998) (noting that the transaction satisfies all elements of the relevant statute, but the court must look beyond the form of transaction because if the transaction lacks economic substance, it is not recognized for federal taxation purposes).

⁷⁹ *See supra* note 76 and accompanying text. Under the economic substance doctrine, a court generally examines whether the transaction has an economic purpose aside from the tax benefits, and this doctrine requires the court to balance the risks of the transaction against the potential profits. Korb, *supra* note 10, at 30–31.

⁸⁰ *Rice’s Toyota World, Inc. v. Comm’r*, 752 F. 2d 89, 91–95 (4th Cir. 1985). Although the Fourth Circuit states that it is using a “sham inquiry,” commentators have cited this case as implementing the business purpose test. *See Barnette v. Comm’r*, 63 T.C.M. (CCH) 3201 (1992); Korb, *supra* note 10, at 31.

⁸¹ *See supra* note 80 and accompanying text.

⁸² Korb, *supra* note 10, at 31 (quoting *Frank Lyon Co. v. United States*, 435 U.S. 561, 583–84 (1978)) (internal quotation marks omitted).

⁸³ In *United States v. Knetsch*, the Supreme Court affirmed the trial court, finding that “[w]hile in form the payments to Sam Houston were compensation for the use or forbearance of money, they were not in substance. As a payment of interest, the transaction was a sham,” 364 U.S. 361, 365 (1960) (quoting the district court opinion) (internal quotation marks omitted), in “disallowing deductions for prepaid interest on a nonrecourse, riskless loan to purchase deferred annuity savings bonds.” Korb, *supra* note 10, at 28–29.

⁸⁴ Korb, *supra* note 10, at 29; *see Goodstein v. Comm’r*, 267 F.2d 127, 131 (1st Cir. 1959) (holding that a taxpayer is not entitled to a tax deduction for interest on a loan when the interest was never paid); *see also Goldstein v. Comm’r*, 364 F.2d 734, 737–40 (2d Cir. 1966) (holding that the loans were not clearly shams, but the deduction was not allowed because the transactions lacked economic substance).

transaction for tax purposes.⁸⁵ Courts have used three different tests in applying this doctrine, but the transaction need only fail one of the tests for a court to find it an illegal tax shelter.⁸⁶ A series of transactions is treated as one when (1) there is a binding commitment at the first step to undertake the later steps;⁸⁷ (2) the transactions are “pre-arranged parts” of a single transaction intended from the outset to reach the ultimate result⁸⁸; or (3) the “steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.”⁸⁹

These five doctrines examine the underlying economic purpose of the transaction to determine whether it is a tax shelter. However, because there is no clear delineation of how much economic purpose a transaction must have to be legitimate, different courts vary in their treatment of similar transactions.⁹⁰ The resulting jurisprudence is a myriad of seemingly contradictory decisions.⁹¹

The ABA’s regulatory angle differs from that taken by courts in that it focuses on the attorney’s conduct rather than the substance of the transaction. Prompted by the prevalence of tax shelters, the ABA issued Formal Opinion 346 in 1982.⁹² The opinion sets forth general standards that practicing tax attorneys should meet in issuing opinion letters, including making factual investigations to ensure accuracy, relating the law to the facts while stating any assumptions, and giving an overall evaluation of the likely outcome on the merits of the transaction.⁹³

The IRS gave these rules legal force when it adopted them as regulations in 1984, later revised in 1994.⁹⁴ The regulations, referred to as Circu-

⁸⁵ Korb, *supra* note 10, at 32–33.

⁸⁶ Penrod v. Comm’r, 88 T.C. 1415, 1429–30 (1987).

⁸⁷ *Id.* This test is normally called the “binding commitment test.”

⁸⁸ *Id.* This test is called the “end result test.”

⁸⁹ *Id.* (quoting Redding v. Comm’r, 630 F.2d. 1169, 1177 (7th Cir. 1980)) (internal quotation marks omitted). This is known as the “interdependence test.”

⁹⁰ Cases in which the government won include *ACM Partnership v. Commissioner*, 157 F.3d 231, 246–48 (3d Cir. 1998) and *Long Term Capital Holdings, L.P. v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004). Cases in which it lost include *Compaq Computer Corp. & Subsidiaries v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); and *United Parcel Service v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001). See Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1946–47 (2005) (stating that the government almost lost the *ACM* case, winning by a split decision on the luck of the judicial draw, and that there are “rumblings that the courts may deny the very existence of the [economic substance] doctrine”); Glassman, *supra* note 75, at 683–702 (analyzing contradictory application of the economic substance doctrine); Korb, *supra* note 10, at 33–36 (providing a comprehensive list of cases won and lost by the IRS).

⁹¹ See cases cited *supra* note 90.

⁹² See Formal Op. 346, *supra* note 26.

⁹³ *Id.*

⁹⁴ 31 C.F.R. § 10.33 (1984) (requiring practitioners who write tax opinions to exercise responsibility in establishing the accuracy of facts, applying the law to those facts, and providing an evaluation of the likely outcome); 31 C.F.R. § 10.34 (1994) (updating Circular 230 in 1994 to add new standards for tax

lar 230, identified specific confidence standards and due diligence requirements that opinion letters must meet.⁹⁵ Section 10.33 of Circular 230 required an opinion letter for a tax shelter to conclude that the transaction would “more likely than not” be sustained on the merits.⁹⁶ However, non-tax shelter transactions only had to possess a “realistic possibility” of being sustained on the merits.⁹⁷

The due diligence standards also differed depending on the type of transaction. For tax shelters, a practitioner was required to inquire into all relevant facts. However, she could accept as true her client’s assertions without an audit or independent verification, unless she had reason to believe that the statements were false.⁹⁸ For a non-tax shelter transaction, an attorney could rely in good faith on the representation of another lawyer without inquiry.⁹⁹ Despite these initial regulatory efforts aimed at limiting abusive tax shelters, the tax shelter industry continued to grow.

The IRS revised Circular 230 in 2005.¹⁰⁰ The modifications added new regulations for all tax advice, dividing it into “covered opinions”¹⁰¹ and “written advice.”¹⁰² The revisions imposed heightened due diligence standards and disclosures for covered opinions, as well as increased penalties for violations.¹⁰³ The IRS also created a clearinghouse, the Office of Tax Shelter Analysis (OTSA), to track tax shelter activity including listed transactions (transactions identified by the IRS as abusive)¹⁰⁴ and reportable

returns that conform with the standards set in section 6694 of the Internal Revenue Code of 1986); see also Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583, 626 (2006) (stating that the ABA model rules lack legal force unless adopted by another authority).

⁹⁵ 31 C.F.R. § 10.33 (1984); *id.* § 10.34 (1994).

⁹⁶ *Id.* § 10.33 (1984).

⁹⁷ *Id.* § 10.34 (1994).

⁹⁸ *Id.* § 10.33(a)(ii) (1984).

⁹⁹ *Id.* § 10.34 (1994).

¹⁰⁰ The revisions were in response to the American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 811–822, 118 Stat. 1418 (codified as amended in scattered sections of 26 U.S.C.). Because the revisions were enacted in 2005, they do not apply to *Stein*.

¹⁰¹ A covered opinion includes an opinion for a transaction that either (1) is substantially similar to a listed transaction; (2) has a principal purpose of avoiding or evading tax; or (3) has a significant purpose of avoiding or evading tax and satisfies a few additional requirements. 31 C.F.R. § 10.35(b)(2) (2005). Under the last category, to be considered a covered opinion, the opinion must be either a reliance opinion (more-likely-than-not opinion), a marketed opinion (to be used in promoting or marketing a transaction), or subject to conditions of confidentiality or contractual protections. *Id.*

¹⁰² Written advice is any opinion that is not a covered opinion. *Id.* § 10.35(f)(2).

¹⁰³ *Id.* § 10.35(e); *id.* § 10.52 (stating that a practitioner may be censured, suspended, or disbarred for willfully violating any regulations other than § 10.33 covered in this part, or for recklessly or through gross incompetence violating § 10.34 or § 10.35); see also Michael I. Saltzman, *Circular 230: Proposed and Final Regulations (Revised)*, IRS PRACTICE AND PROCEDURE ¶ 1.12[4][a]–[b] (2007 Cumulative Supp. No. 2).

¹⁰⁴ 26 U.S.C. § 6707A(c) (Supp. IV 2006) (defining “listed transaction”).

transactions (transactions that require disclosure under 26 U.S.C. § 6011).¹⁰⁵ Further, as part of a program to increase disclosures, the IRS implemented a series of amnesty and settlement programs in which it promised to waive penalties if taxpayers disclosed the tax shelters they used.¹⁰⁶ The program had two goals: (1) to collect additional revenue, and (2) to gather information on how shelters operate and on the players involved in designing and selling them.¹⁰⁷

In conjunction with the IRS's efforts, Congress increased penalties for violations of tax laws. On October 22, 2004, Congress enacted the American Jobs Creation Act of 2004 (AJCA).¹⁰⁸ One of Congress's primary goals in passing the AJCA was to create a financial inducement for taxpayers and advisors to disclose information on their use of tax shelters.¹⁰⁹ The AJCA replaced the original §§ 6111 and 6112 registration rules.¹¹⁰ The penalties to individuals for failing to register a reportable transaction under the AJCA are \$10,000 for an unlisted transaction and \$100,000 for a listed transaction.¹¹¹ Prior to the enactment of the AJCA, there was no penalty for an individual's failure to disclose a reportable transaction.¹¹² The AJCA also increased accuracy-related penalties for taxpayers whose taxes are understated because of reportable transactions under § 6662A.¹¹³ Even larger penalties are imposed on taxpayers who, in addition to understating their taxes by using a reportable transaction, fail to disclose the transaction.¹¹⁴

¹⁰⁵ See *id.* (making listed transactions reportable transactions); see also I.R.S. Announcement 2000-12, 2000-12 I.R.B. 835 (announcing creation of the OTSA to "serve as the focal point for efforts to gather information relating to tax shelter activity and coordinate appropriate responses"); Korb, *supra* note 10, at 36-40; Rostain, *supra* note 10, at 95-96 (noting that the 1999 Clinton Administration recommended a more systematized approach to regulating tax shelters, including "increasing disclosures," "strengthening the penalty scheme," and "imposing sanctions on . . . promoters"). The IRS requires taxpayers to make disclosures for listed transactions in accordance with Treasury Regulation § 1.6011-4 (2006) and 26 U.S.C. §§ 6011, 6707A (Supp. IV 2006). Korb, *supra* note 10, at 36-40.

¹⁰⁶ Sherman & Brinker, *supra* note 24, at 43-44; see Douglas v. United States, No. C 03-04518 JW, 2006 WL 2038375, at *1-2 (N.D. Cal. July 17, 2006).

¹⁰⁷ Sherman & Brinker, *supra* note 24, at 44.

¹⁰⁸ The American Jobs Creation Act of 2004, Pub. L. 108-357, §§ 811-822, 118 Stat. 1418 (codified as amended in scattered sections of 26 U.S.C.).

¹⁰⁹ Sherman & Brinker, *supra* note 24, at 45 (quoting Richard A. Shaw, *Enhanced Reporting Penalties Are the Newest IRS Weapons*, BUS. ENTITIES, Mar.-Apr. 2005, at 6, 17).

¹¹⁰ Sections 6111 and 6112 were originally enacted in the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494. Korb, *supra* note 10, at 41-42 (stating that the IRS and Treasury Department revised §§ 6111 and 6112 to reflect the statutory revisions that require material advisors to disclose reportable transactions).

¹¹¹ 26 U.S.C. § 6707A (Supp. IV 2006).

¹¹² Korb, *supra* note 10, at 62.

¹¹³ 26 U.S.C. § 6662A(a) (imposing a twenty percent penalty on a taxpayer if she has a reportable understatement).

¹¹⁴ *Id.* § 6662A(c) (imposing a thirty percent penalty if a taxpayer fails to disclose the reportable transaction). These penalties are in addition to the penalty imposed under § 6662. Delaney, *supra* note 24, at 313.

Like § 6662, § 6662A provides a reasonable cause exception from tax penalties.¹¹⁵ However, this exception applies only to a taxpayer who acted in good faith, shows reasonable cause for using the transaction, made adequate factual disclosure for reportable transactions, had substantial authority for the tax treatment, and reasonably believed that the treatment was more likely than not proper.¹¹⁶ Finally, the AJCA increased penalties on promoters of illegal tax shelters to fifty percent of the gross income derived from their activity.¹¹⁷ Compared to previous penalties of \$1000,¹¹⁸ this penalty increase reflects Congress's commitment to reforming the tax shelter industry.

In sum, Congress and the IRS have attempted to control the use of abusive tax shelters by regulating the activities of professionals engaged in the industry while the judiciary has focused on routing out substanceless transactions.¹¹⁹ Because of its recent enactment in 2004, the effects of the AJCA remain to be seen. In the meantime, the government is attempting a new regulatory approach using criminal penalties in *Stein*.

D. *Stein: The Largest Tax Fraud Case in History*

After journalists Janet Novack and Laura Saunders exposed the prevalence of corporate tax shelters in their 1998 article, *The Hustling of X Rated Shelters*,¹²⁰ media and congressional attention soon followed.¹²¹ In 2002, at the direction of then-chairman Senator Carl Levin, the United States Senate Permanent Subcommittee on Investigations (Committee) began an inquiry into the development and marketing of abusive tax shelters by accounting

¹¹⁵ 26 U.S.C. § 6662A(c) (imposing a thirty percent penalty if the transaction meets requirements of 26 U.S.C. § 6664(d)(2)(A)).

¹¹⁶ *Id.* § 6664(d)(3); see also Delaney, *supra* note 24, at 314. A taxpayer cannot rely on an opinion letter to establish "reasonable belief" if the tax advisor is a material advisor or the opinion is a disqualified opinion. Delaney, *supra* note 24, at 314–15. A material advisor is a promoter or a person who is involved in organizing the transaction. *Id.* A disqualified opinion is an opinion that is based on unreasonable factual assumptions or taxpayer representations, or fails to identify and consider all the relevant facts. *Id.*; see also 26 U.S.C. § 6664(d)(3)(B)(iii).

¹¹⁷ 26 U.S.C. § 6700(a)(2)(B).

¹¹⁸ Delaney, *supra* note 24, at 317. The AJCA also includes a penalty for aiding and abetting in the understatement of tax liability, but the penalty amounts to \$1000 per taxable period. 26 U.S.C. § 6701.

¹¹⁹ For an in-depth analysis of how the IRS has increased regulation of tax shelters by focusing on tax professionals, see Armando Gomez, Victor Hollender & Brian Duncan, *Detection & Dissection: How the IRS Identifies and Combats Tax Shelters and Regulates Those Who Advise on Aggressive Transactions*, in TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2007, at 807 (PLI Tax Law and Estate Planning Course, Handbook Series No. 11539, 2007) WL 758 PLI/TAX 807.

¹²⁰ Novack & Saunders, *supra* note 33, at 198.

¹²¹ Rostain, *supra* note 10, at 78–79 n.2.

firms, banks, investment advisors, and law firms.¹²² The Committee issued subpoenas and document requests, collecting information on tax product descriptions, marketing materials, transactional documents, manuals, and correspondence relating to tax products from representatives of the targeted professional groups and firms.¹²³ Based on the evidence collected in the investigation, the Committee eventually focused on four tax shelters designed and promoted by KPMG¹²⁴: Foreign Leverage Investment Program (FLIP), Offshore Portfolio Investment Strategy (OPIS), Bond Link Investment Strategy (BLIPS), and S-Corporation Charitable Contribution Strategy (SC2).¹²⁵ These tax shelters were only four out of five hundred tax products in KPMG's inventory.¹²⁶ The Committee issued an initial report of its findings in 2003¹²⁷ and a second report offering new details in 2005.¹²⁸

Throughout the investigation, KPMG resisted requests to turn over documents, resulting in several court-enforced summonses.¹²⁹ Following the U.S. Senate Finance Committee's hearings on abusive tax shelters in November 2003,¹³⁰ the Justice Department convened a grand jury in February 2004.¹³¹ Narrowly escaping indictment, KPMG settled with the gov-

¹²² *U.S. Tax Shelter Industry*, *supra* note 10, at 3. According to the Superseding Indictment, the IRS also began investigating KPMG around the same time, at the end of 2001. Superseding Indictment, *supra* note 7, at 36–37.

¹²³ *U.S. Tax Shelter Industry*, *supra* note 10, at 4.

¹²⁴ *Id.*

¹²⁵ *Id.* Three of the tax shelters—OPIS, BLIPS and SC2—were chosen from a list of KPMG's nineteen top revenue-producing tax products. *Id.* at 20. FLIP, an earlier tax product, a precursor to OPIS and BLIPS that KPMG stopped selling in 1999, was also added for further study. *Id.* The defendants in *Stein* were eventually indicted for their involvement in designing and promoting BLIPS, FLIP, OPIS, and Short Option Strategies (SOS, and a replacement of BLIPS). *Id.* at 46; *see also* Superseding Indictment, *supra* note 7, at 10–11; Lynnley Browning, *Prosecutors Lay Out the Case Against KPMG Defendants*, N.Y. TIMES, Apr. 24, 2006, at C2; Press Release, *supra* note 8, at 3.

¹²⁶ *U.S. Tax Shelter Industry*, *supra* note 10, at 4.

¹²⁷ *Id.*

¹²⁸ Lynnley Browning, *Report Gives New Details on KPMG Shelters*, N.Y. TIMES, Feb. 11, 2005, at C3.

¹²⁹ KPMG's resistance to requests for documents that included the names of tax-shelter clients lasted for several years. Lynnley Browning, *KPMG Ordered to Disclose Data on Tax-Shelter Buyers*, N.Y. TIMES, May 5, 2004, at C8. The nine summonses were first issued between January 28, 2002 and May 3, 2002. Korb, *supra* note 10, at 59. KPMG was so effective in stonewalling the IRS that the Justice Department filed a civil lawsuit in December 2002 to force it to comply. *United States v. KPMG LLP*, 316 F. Supp. 2d 30 (D.D.C. 2004); *United States v. KPMG LLP*, No. 02-0295, 2003 WL 22336072 (D.D.C. Oct. 10, 2003); *United States v. KPMG LLP*, 237 F. Supp. 2d 35 (D.D.C. 2002). Some have speculated that KPMG's resistance was one of the reasons the government decided to pursue criminal charges against the firm and its employees. Lynnley Browning, *How an Accounting Firm Went from Resistance to Resignation*, N.Y. TIMES, Aug. 28, 2005, at 1 [hereinafter Browning, *Resistance to Resignation*]. Ernst & Young was under similar investigation but agreed to settle a civil claim with the IRS for a \$15 million penalty in 2003. *Id.*

¹³⁰ Michael Rozbruch, *Timeline Shows Stronger Scrutiny by IRS of Cheats*, SAN FERNANDO VALLEY BUS. J., Mar. 13, 2006, at 27.

¹³¹ Browning, *Resistance to Resignation*, *supra* note 129, at 1.

ernment and entered into a deferred prosecution agreement (DPA) on August 26, 2005.¹³² Perhaps fearing a fate similar to that of Arthur Andersen,¹³³ KPMG agreed to a “one-count Information . . . charging KPMG with participating in a conspiracy” to defraud the United States and commit tax evasion.¹³⁴ KPMG agreed to pay the government \$456 million, including disgorgement of \$128 million in fees received from its tax shelter business and \$228 million in restitution to the IRS for actual losses suffered.¹³⁵ The firm also agreed to limit its future tax practice to comply with government specified guidelines.¹³⁶ Furthermore, the DPA required KPMG to fully cooperate with any investigation about which KPMG had knowledge or information.¹³⁷

After KPMG entered into the DPA, the government indicted nineteen individuals: seventeen former KPMG employees, a former partner at Brown & Wood LLP,¹³⁸ and a former financial executive.¹³⁹ The indictment

¹³² KPMG Deferred Prosecution Agreement, Aug. 26, 2005, available at <http://www.usdoj.gov/usao/nys/pressreleases/August05/kpmgdpagmt.pdf> [hereinafter DPA].

¹³³ See Jonathan D. Glater & Lynnley Browning, *U.S. Weighs Prosecutions in Tax Shelter Investigation*, N.Y. TIMES, Aug. 4, 2005, at C3 (stating that the indictment of Arthur Andersen “destroyed that firm”). Arthur Andersen was indicted and prosecuted for obstruction of justice based on its involvement in covering up the Enron scandal. See Kurt Eichenwald, *Prosecution Concludes Case in U.S. Trial of Andersen*, N.Y. TIMES, May 28, 2002, at C1.

¹³⁴ DPA, *supra* note 132, at 1. The case was referenced as *United States v. KPMG*, 05 Cr. 903 (LAP) (S.D.N.Y. Aug. 29, 2005), in the Government’s Opposition to Defendants’ Pretrial Motions. Government’s Memorandum in Opposition to Defendants’ Pretrial Motions, *supra* note 17, at 39.

¹³⁵ DPA, *supra* note 132, at 2–3.

¹³⁶ *Id.* at 4–9.

¹³⁷ *Id.* at 9–12. This last requirement has been a significant source of controversy and criticism. The government has used it to coerce KPMG into departing from its longstanding practice of paying its employees’ legal fees for actions arising from their activities on behalf of the firm. See *supra* note 12 and accompanying text. A district court in the Southern District of New York held that the government violated the Fifth and Sixth Amendment rights of the defendants. *United States v. Stein*, 435 F. Supp. 2d 330, 336 (S.D.N.Y. 2006) (“KPMG refused to pay because the government held the proverbial gun to its head.”). Commentators were concerned that the government would use this last requirement to force KPMG and its personnel to agree to the government’s statement of facts regardless of their relevant perspective in the *Stein* trial. Decision of Interest, *Government Has Interest in Preventing Firm’s Undermining of Agreement Accepting Its Guilt*, N.Y. L.J., Apr. 13, 2006, at 21; Ben Vernia, *Here’s Your Story, And You’re Sticking to It: When Contradicting the Deal Can Mean Prosecution, Companies Must Step Carefully*, LEGAL TIMES, Aug. 21, 2006, at 38. In the DPA, KPMG was required to admit and accept the government’s version of the statement of facts. DPA, *supra* note 132, at 2; see Statement of Facts, attached as Ex. C to DPA (Aug. 26, 2005), available at <http://www.usdoj.gov/usao/nys/pressreleases/August05/kpmgstatementoffacts.pdf>. However, the government has since dismissed the criminal charge against KPMG, stating that KPMG met its obligations under the DPA. Bloomberg News, *Judge Drops KPMG Charge in Tax Case*, N.Y. TIMES, Jan. 4, 2007, at C3.

¹³⁸ Brown & Wood LLP merged with Sidley Austin to form Sidley Austin Brown & Wood LLP in 2001. In 2006, the firm changed its name to Sidley Austin LLP. See Sidley Austin LLP, About Sidley, <http://www.sidley.com/about/about.asp> (last visited Nov. 12, 2007). The firm has agreed to pay a \$39.4 million fine to avoid a criminal indictment for its role in promoting allegedly abusive tax shelters. Jeremiah Coder, *Sidley Austin to Pay \$39.4 Million Tax Shelter Penalty*, TAX NOTES TODAY, May 24, 2007, 2007 TNT 101-3 (LEXIS).

charges the defendants with one count of conspiracy to defraud the IRS and thirty-nine counts of tax evasion.¹⁴⁰ The indictment alleges the defendants conspired to defraud the IRS between 1996 and 2005 by “designing, marketing and implementing illegal tax shelters.”¹⁴¹ KPMG marketed the tax shelters to individuals with income or capital gain income in excess of \$10 million in 1997, and \$20 million from 1998 to 2000.¹⁴² Taxpayers could choose how much income they wished to shelter, and they paid defendants a fee of five to seven percent of the sheltered income¹⁴³ for designing an investment transaction that appeared legitimate but was in substance a phony transaction with no economic benefit.¹⁴⁴ To conceal the nature of the tax shelters, the defendants provided opinion letters that fraudulently stated that the transactions would more likely than not survive an IRS challenge.¹⁴⁵ The defendants falsely stated, among other things, that (1) the transactions would more likely than not prevail on an IRS challenge based on the “step transaction” doctrine; (2) there was a legitimate investment strategy and program; and (3) the taxpayer paid money for an investment component.¹⁴⁶

¹³⁹ The first indictment originally charged eight KPMG partners and one lawyer. Sealed Indictment, *United States v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006) (No. S1 05 Cr. 0888) [hereinafter Original Indictment], available at http://www.usdoj.gov/usao/nys/pressreleases/August05/kpmg_individualsind.pdf; Press Advisory, U.S. Attorney’s Office, S. Dist. of N.Y. (Aug. 29, 2005) (announcing a “significant white collar matter”), available at <http://www.usdoj.gov/usao/nys/pressreleases/August05/whitecollarannouncement.pdf>; see also Glater, *supra* note 19, at C1. The government then added eight more KPMG partners, one former KPMG senior manager, and a former financial executive to the case in a superseding indictment filed on October 17, 2005. Superseding Indictment, *supra* note 7, at 2, 4–8; Press Release, *supra* note 8, at 1–3.

¹⁴⁰ Superseding Indictment, *supra* note 7, at 45–69; Press Release, *supra* note 8, at 9.

¹⁴¹ Superseding Indictment, *supra* note 7, at 8–10 (charging the defendants with “devising, marketing, and implementing fraudulent tax shelters, by preparing and causing to be prepared, and filing and causing to be filed with the IRS false and fraudulent U.S. individual income tax returns containing the fraudulent tax shelter losses, and by fraudulently concealing from the IRS those shelters”); Press Release, *supra* note 8, at 3.

¹⁴² Superseding Indictment, *supra* note 7, at 9.

¹⁴³ *Id.*; Press Release, *supra* note 8, at 3. The specific shelters allegedly used were FLIP, SOS, OPIS, and BLIPS. Superseding Indictment, *supra* note 7, at 10–12. The government alleges that FLIP was marketed and sold to at least eighty individuals from 1996 to 1999, generating at least \$1.9 billion in phony tax losses. *Id.* at 11. OPIS (the FLIP successor) was marketed and sold to at least 170 individuals from 1998 to 1999, generating at least \$2.3 billion in phony tax losses. *Id.* The OPIS successor, BLIPS, was marketed and sold to at least 186 individuals from 1999 to 2000 and generated at least \$5.1 billion in phony tax losses. *Id.* SOS was marketed and sold to at least 165 individuals from 1998 to 2002, resulting in at least \$1.9 billion in phony tax losses. *Id.* at 11–12.

¹⁴⁴ *United States v. Stein*, 429 F. Supp. 2d 633, 638 (S.D.N.Y. 2006) (“The government intends to prove, for example, that the BLIPS transactions—which defendants claim involved nonrecourse premium loans to tax shelter clients to finance seven-year, multi-stage investments in emerging market currencies—actually were ‘designed to be terminated before year-end for tax purposes’ and to involve ‘no real loan premium’, no realistic possibility of making a reasonable pre-tax profit, no contingency to the obligation to repay the loan premium, and no purpose for the purported borrowing except to generate a tax loss.”).

¹⁴⁵ Superseding Indictment, *supra* note 7, at 9.

¹⁴⁶ *Id.* at 14–17.

The government also alleges that the opinion letters were essentially form letters in which the defendants substituted the appropriate names, dates, participating entity, and dollar amounts involved in each transaction.¹⁴⁷ KPMG's top leaders approved the opinion letters "despite significant warnings from KPMG tax experts" that the "shelters were close to frivolous and would not withstand IRS scrutiny" and that failing to register them could result in criminal investigation.¹⁴⁸ Finally, the government alleges that the defendants failed to register the shelters, as required by law.¹⁴⁹

Commentators have addressed various questions that arise from this case.¹⁵⁰ However, they often fail to address whether the defendants actually committed a crime.¹⁵¹ Based on the evidence already uncovered, which was publicized during the Senate hearings, the defendants arguably violated some ethical or civil standards of conduct, or both, but it is unclear whether those actions also constitute criminal violations.¹⁵² This Comment argues that writing false opinion letters does not fit within the tax evasion statutes and that defendants should not be held criminally liable for that specific behavior.

¹⁴⁷ *Id.* at 14.

¹⁴⁸ Press Release, *supra* note 8, at 4–5.

¹⁴⁹ Superseding Indictment, *supra* note 7, at 31–33 ("The defendants John Lanning and Jeffrey Stein and their co-conspirators decided not to register FLIP, OPIS, or BLIPS based on a 'business decision' that to register the shelters would hamper KPMG's ability to sell them, and that the IRS penalties applicable to a failure to register would be dwarfed by the lucrative fees KPMG stood to collect from selling unregistered tax shelters.").

¹⁵⁰ *Stein* raises issues regarding prosecutorial discretion, attorney-client privilege, and undue prosecutorial influence via use of a deferred prosecution agreement. See *supra* note 12 and accompanying text.

¹⁵¹ Although several law professors and other academics have commented on this issue briefly in op-ed pieces and blogs, or simply in passing when discussing other topics relevant to tax shelters, no one has actually analyzed what the defendants did, whether criminalization is appropriate, or what impact the outcome of this case could have on tax planning in the future. See Darryll K. Jones, *Criminalizing Tax Shelters and the 'Damn-Well' Reflex*, 110 TAX NOTES 285, 285–87 (2006) (responding to *Wall Street Journal* editorial, *KPMG in Wonderland*, criticizing criminalization of *Stein* defendants); Weisberg & Mills, *supra* note 19, at A16 (Stanford Law School professors questioning indictment of *Stein* defendants and use of criminal law); Editorial, *KPMG in Wonderland*, WALL ST. J., Oct. 6, 2005, at A14 (criticizing use of criminal system against *Stein* defendants); Posting of Peter Henning & Ellen Podgor to White Collar Crime Prof Blog, http://lawprofessors.typepad.com/whitecollarcrime_blog/2005/10/is_the_kpmg_tax.html (Oct. 13, 2005) (entitled "Is the KPMG Tax Partner Indictment Bad?" and in response to Weisberg and Mills's article in the *Wall Street Journal*). Although Lee Sheppard addresses whether the defendants committed a crime, she does not address the government's reliance on civil standards for opinion letters or the appropriateness of using criminal sanctions. Lee A. Sheppard, *KPMG: Has the Prosecution Overcharged the Crime?*, 112 TAX NOTES 405, 411–16 (2006).

¹⁵² See *supra* notes 149 & 151; but see Calvin Johnson, *Tales from the KPMG Skunk Works: The Basis-Shift or Defective-Redemption Shelter*, 108 TAX NOTES 431 (2005) (arguing that the FLIP/OPIS tax shelters were illegal shelters and that the defendants should be held criminally accountable for knowingly marketing and selling illegal shelters). It is important to note that Calvin Johnson was the expert witness for plaintiffs in a civil class action against KPMG for the tax shelters analyzed. Johnson, *supra*, at 443 n.34.

III. ANALYSIS

Close scrutiny of the government's case reveals several serious flaws.¹⁵³ First, given the ambiguities in tax shelter regulations, the government will have a difficult time proving that the defendants acted with intent to violate the tax code in writing the opinion letters.¹⁵⁴ The novel theory of imposing criminal liability for providing opinion letters conflicts with due process and notice requirements. Second, even if the government were to prove intent, whether the government should be allowed to rely on civil and ethical standards to impose criminal liability is highly questionable.¹⁵⁵ Section A discusses the problems with the government's theory of its case. Section B considers what the imposition of criminal liability on the *Stein* defendants will mean for professionals and for the future of tax planning. A conviction of these defendants would produce even greater ambiguity as to what constitutes criminal activity in the tax shelter industry.

A. *A Critique of the Government's Theory of the Case*

An examination of the government's case reveals several critical faults in its claims that the defendants committed tax evasion and conspiracy.

To prove the tax evasion charges under 26 U.S.C. § 7201, the government must establish (1) that the tax shelters were illegal,¹⁵⁶ thus causing a

¹⁵³ The indictment itself is confusingly written, causing Judge Kaplan to require the government to file a "bill of particulars" explaining its theory of the case. Lynnley Browning, *Judge Questions Clarity of Prosecution's Tax-Shelter Case*, N.Y. TIMES, Mar. 31, 2006, at C4 (reporting that Judge Kaplan was confused about the conspiracy charges, asking whether "'the fraud and evasion [were] in the execution or design' of the shelters").

¹⁵⁴ Even assuming the government did prove intent, a source of contention among members of the tax bar is whether criminal liability is warranted or even appropriate in this case. See *supra* note 151 and accompanying text.

¹⁵⁵ From the emails uncovered during the Committee's investigation, it seems fairly clear that the defendants' acts were on the border of acceptable behavior under the regulations at the time. See *supra* note 149. Because the alleged acts took place between 1996 and 2002, the stricter requirements of the AJCA do not apply. Superseding Indictment, *supra* note 7, at 8–11 (stating that, even though the indictment references tax fraud from 1996 to 2005, which includes the allegations of obstruction, the laws in effect in 1997 are the relevant standard). Emails produced during discovery demonstrate internal debates regarding whether BLIPS met the technical requirements of the law. *U.S. Tax Shelter Industry*, *supra* note 10, at 8. These emails also show that the senior KPMG partners considered the opinion letters to be risky and questioned whether they added enough appropriate limiting "bells and whistles" and whether the partnership was being paid enough to offset the risk of liability because at least one partner considered the transaction to be one that "the IRS would view as falling squarely within the tax shelter orbit." *Id.* at 8–9; see also Johnson, *supra* note 152, at 442 ("KPMG seems to have lost its internal compass as what was fair game[,] . . . selling shelters that were below professional standards because the fees were large enough."). However, although they violated the standards for submitting opinion letters, as argued later in this Comment, this does not give the government license to squeeze that type of violation into the statutory language of the United States criminal code.

¹⁵⁶ The government's theory of tax evasion is vague and unclear. Although it filed a bill of particulars with the court, the bill has not been made available to the public. Defendants also claim the government has changed its theory three times as of March 17, 2006. Memorandum of Law in Reply to

tax deficiency, and (2) that each defendant committed an overt act with the intent to commit tax evasion.¹⁵⁷ For tax evasion under § 7206(1) and (2), the government needs to establish (1) that defendants filed or caused to be filed tax returns that were false as to material matters, and (2) that defendants did not believe that the tax returns were true as to every material fact.¹⁵⁸

To prove the conspiracy charge under 18 U.S.C. § 371,¹⁵⁹ the government must demonstrate that (1) the conspirators agreed to create tax shelters to commit tax fraud and to use the opinion letters and false statements to hide the nature of the transactions, (2) each defendant intended to enter into this agreement, and (3) at least one defendant committed some overt act in furtherance of this scheme.¹⁶⁰

Government Opposition to Pretrial Motions at 8–9, *United States v. Stein*, 429 F. Supp. 2d 633 (S.D.N.Y. 2006) (No. 05 Cr. 0888), 2006 WL 1868188. In its Opposition to Defendants' Pretrial Motions, the government alleges that it is seeking to impose criminal liability because defendants knowingly described the tax shelters in a way that was contrary to how they really operated. Government's Memorandum in Opposition to Defendants' Pretrial Motions, *supra* note 17, at 4–5. Although Judge Kaplan accepted this theory for purposes of denying Defendants' Motion to Dismiss Substantive Counts of the Indictment, based on the government's argument in its brief as well as the facts alleged in the indictment, the court must still evaluate the substance of the tax shelters to determine whether a sham occurred, essentially deciding whether the tax shelters were illegal or legal as described. *Stein*, 429 F. Supp. 2d at 637–38 (stating that the government would not need to show whether the tax shelters as described in the opinion letters are legal).

For example, the government alleges that the transactions were shams because they involved, for instance, in the case of BLIPS, “no real loan premium”, no realistic possibility of making a reasonable pre-tax profit, no contingency to the obligation to repay the loan premium, and no purpose for the purported borrowing except to generate tax loss.” *Id.* at 638. To resolve these issues, a court must evaluate the economic substance of the transactions under the sham transaction doctrine. Subsequent to this ruling, the IRS indicated the government would be pursuing an alternative theory “challenging the tax shelter on the grounds that it violated a so-called economic substance test, which demanded that tax shelters have an economic purpose other than just reducing tax liability.” *Judge Rules Against IRS*, *supra* note 17, at C4.

¹⁵⁷ 26 U.S.C. § 7201 (2000). Violation of § 7201 requires (1) tax deficiency, (2) willfulness, and (3) an affirmative act constituting tax evasion or attempted tax evasion. *Sansone v. United States*, 380 U.S. 343, 351 (1965); *see generally* Keith J. Benes et al., *Tax Violations*, 35 AM. CRIM. L. REV. 1219, 1230–39 (1998) (discussing the elements and nuances of § 7201 liability).

¹⁵⁸ The elements of tax perjury include the following: (1) defendants made or assisted in preparing returns that were false as to material facts; (2) defendants committed these actions under penalty of perjury; (3) defendants did not believe the statements to be true as to every material matter; and (4) defendants did so willfully with intent to violate the law. 26 U.S.C. § 7206(1)–(2); *see also* Benes et al., *supra* note 157, at 1248–55. In this case, the government will need to first show that the transactions were shams in order to allege that the defendants filed or caused to be filed fraudulent tax returns.

¹⁵⁹ 18 U.S.C. § 371 (2000); Superseding Indictment, *supra* note 7, at 45–69; Press Release, *supra* note 8, at 9. There are two types of conspiracies referenced under this statute: (1) offense clause—an agreement to accomplish the goals of the conspiracy, and (2) defraud clause—conspiracy to defraud the United States. 18 U.S.C. § 371. Presumably, the government is alleging conspiracy under the second prong. Superseding Indictment, *supra* note 7, at 8 (stating that the defendants schemed to defraud the IRS by devising, marketing, and implementing fraudulent tax shelters).

¹⁶⁰ To prove conspiracy under the defraud clause, the government must establish three elements: (1) an agreement between two or more people to accomplish an illegal objective against the United

The government will likely have difficulty proving that the defendants, in providing opinion letters, intended to commit tax evasion. As a result, the government's conspiracy of tax evasion charge is also problematic because it is dependent on the tax evasion charges. Based on the current laws, however, the government could convict the defendants for conspiracy. This conflicting result begs the question whether convicting on conspiracy is appropriate if the government cannot convict the defendants of the underlying substantive crime.

1. Willfulness Requirement for Tax Evasion.—The government's theory of the case for tax evasion contains several serious weaknesses. First, the charges of tax evasion run afoul of the *Cheek v. United States* jurisprudence of intent.¹⁶¹ Under *Cheek*, to be convicted of tax evasion, a jury must find that the defendant intentionally and willfully violated a known legal duty in addition to willfully committing the act itself.¹⁶² The tax code's complexity inevitably leads to uncertainty about the appropriate tax treatment in complicated transactions.¹⁶³ Because of this complexity, courts al-

States; (2) the defendant knowingly and intentionally became part of the conspiracy; and (3) one member knowingly committed an overt act in furtherance of the collective goal. *Ingram v. United States*, 360 U.S. 672, 677–680 (1959); IAN M. COMISKY, LAWRENCE S. FELD & STEVEN M. HARRIS, *TAX FRAUD & EVASION* ¶ 3.05[1] (6th ed. 2006); see also Benes et al., *supra* note 157, 1257–58.

Although the alleged agreement at the base of the conspiracy charge involves two separate acts of tax evasion and tax perjury, the act of tax perjury is predicated on the existence of tax evasion. See *supra* notes 157–58 and accompanying text. Thus, the conspiracy charge is dependant on the existence of at least one defendant committing an act that is in furtherance of the scheme to evade taxes. See *supra* note 159 and accompanying text. However, the conspiracy charge can also be based on the allegations of obstruction of the IRS investigation.

¹⁶¹ 498 U.S. 192, 199–200 (1991). This discussion assumes the government's tax evasion case is based on the argument that the transactions lacked economic substance. As stated earlier, although the government's theory of tax evasion has changed several times, the way in which the facts are alleged and the information available to the public thus far suggests that lack of economic substance is its current theory. See *supra* note 156 and accompanying text. However, if the government is alleging that the transactions never occurred in fact and are instead shams, the intent requirement has been met since the factual inaccuracies should be apparent to the defendants.

¹⁶² *Cheek*, 498 U.S. at 199–200. Although there has been debate over whether the subjective willfulness standard is warranted, this line of jurisprudence has been followed fairly uniformly. See Joshua Stein, *Criminal Liability for Willful Evasion of an Uncertain Tax*, 81 COLUM. L. REV. 1348, 1362–64 (1981); Katherine Tromble, *Humpty Dumpty on Mens Rea Standards: A Proposed Methodology for Interpretation*, 52 VAND. L. REV. 521, 538–39 (1999); Mark D. Yochum, *Cheek is Chic: Ignorance of the Law is an Excuse for Tax Crimes—A Fashion That Does Not Wear Well*, 31 DUQ. L. REV. 249, 252–54 (1993); Note, *Mens Rea in Federal Criminal Law*, 111 HARV. L. REV. 2402, 2405–07, 2416–19 (1998).

¹⁶³ See *supra* Part II.B–C; see also *Cheek*, 498 U.S. at 199–203 (stating that Congress did not intend an individual to be held criminally liable for a bona fide misunderstanding of his tax liabilities because the tax laws make it difficult for an average citizen to decipher their legality (citing *United States v. Murdock*, 290 U.S. 389 (1933))); *United States v. Harris*, 942 F.2d 1125, 1135 (7th Cir. 1991) (“[C]riminal prosecutions are no place for the government to try out ‘pioneering interpretations of tax law’” (quoting *United States v. Garber*, 607 F.2d 92, 100 (5th Cir. 1979))); *United States v. Mallas*, 762 F.2d 361, 363–65 (4th Cir. 1985) (holding that when a point of law is vague or uncertain, no criminal liability can attach); *United States v. Dahlstrom*, 713 F.2d 1423, 1429 (9th Cir. 1983) (holding that no

low a “mistake of law” defense to charges of willfulness.¹⁶⁴ In *United States v. Murdock*, the Court recognized that

Congress did not intend that a person, by reason of a bona fide misunderstanding as to his liability for the tax, as to his duty to make a return, or as the adequacy of the records he maintained, should become a criminal by his mere failure to measure up to the prescribed standard of conduct.¹⁶⁵

This uncertainty-in-the-law defense is rooted in the fundamental principle of due process that “a criminal statute must give fair warning of the conduct that it makes a crime.”¹⁶⁶ The right to due process has often led the Supreme Court to facially void criminal statutes for vagueness, arguing that nobody should be required to guess at the meaning of a statute when “life, liberty, or property” are at peril.¹⁶⁷ Statutes should explicitly state the conduct proscribed and “give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden.”¹⁶⁸ Even if the statute is explicit, a judicial construction that expands the scope of the statute also violates due process.¹⁶⁹ This is especially true of regulatory infractions such as tax evasion because regulatory offenses are not universally reprehensible crimes.¹⁷⁰

In this case, the legality of the tax shelters was never determined by a court.¹⁷¹ For the government to prove tax evasion in *Stein*, it must demon-

criminal liability attaches when no statute, regulation, or court decision gives fair warning that the tax shelter would result in criminal prosecution).

¹⁶⁴ *Cheek*, 498 U.S. at 199–200. Ignorance has long been considered excusable when the law is unclear, vague, or ambiguous. *United States v. Batchelder*, 442 U.S. 114, 123 (1979); *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972); *McBoyle v. United States*, 283 U.S. 25, 27 (1931); *Connally v. Gen. Constr. Co.*, 269 U.S. 385, 391 (1926); *Harris*, 942 F.2d at 1132.

¹⁶⁵ *Murdock*, 290 U.S. at 396.

¹⁶⁶ *Bouie v. City of Columbia*, 378 U.S. 347, 350–52 (1964); see also Colleen Yamaguchi, *Uncertainty in the Law: An Uncertain Defense in Criminal Tax Prosecutions*, 39 TAX LAW. 387, 392 n.35 (1986) (noting that the uncertainty-in-the-law defense is based on due process underpinnings that are premised on the “judicial concern that a criminal conviction should only result from violation of a known legal duty”).

¹⁶⁷ *Bouie*, 378 U.S. at 351 (quoting *Lanzetta v. New Jersey*, 306 U.S. 451, 453 (1939)) (internal quotation marks omitted).

¹⁶⁸ *United States v. Harris*, 347 U.S. 612, 617 (1954).

¹⁶⁹ *Bouie*, 378 U.S. at 352 (stating that violation of due process is greater when the statute’s uncertainty is not revealed until the court’s decision and “a person is not even afforded an opportunity to engage in such speculation before committing the act in question”).

¹⁷⁰ It is a well-established principle that no person has an obligation to pay the maximum amount of taxes. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934). It is difficult to square this mentality with finding criminal liability in situations where the defendant has met the strict literal requirements of the law. Historically, statutory regulations have required an element of intent because they are seen as less reprehensible than common law crimes: they are offenses that are “not as universally condemned” and do not represent “generally acknowledged wrongs.” Lydia Pallas Loren, *Digitization, Commodification, Criminalization: The Evolution of Criminal Copyright Infringement and the Importance of the Willfulness Requirement*, 77 WASH. U. L.Q. 835, 880–82 (1999).

¹⁷¹ *RJT Investments X, LLC v. Comm’r*, No. 011769-05, 2006 WL 2504035 (T.C. Apr. 18, 2006) (holding the Son of Boss tax shelter, of which BLIPS is a variant, illegal for lack of economic purpose in

strate that the defendants were aware that the transactions they designed were fraudulent *before* a court ruling *or* notice from the IRS designated them as such.¹⁷² Given the uncertainty in judicial determinations of the legality of tax shelters,¹⁷³ it will be difficult for the government to demonstrate that the defendants (or anyone) knew that the tax shelters that KPMG designed and marketed were illegal.¹⁷⁴

The government will also have trouble asserting that the defendants committed tax evasion in failing to register the tax shelters. The IRS did not issue notices declaring its position that the tax shelters were reportable until *after* defendants started using them.¹⁷⁵ The IRS released Notice 2000-44, regarding the SOS and BLIPS shelters, in 2000,¹⁷⁶ and Notice 2001-45, regarding the FLIP and OPIS shelters, in 2001.¹⁷⁷ Once on notice, KPMG stopped selling the products.¹⁷⁸ Considering that the IRS had internal trouble determining whether some of the shelters were reportable, the government cannot expect the defendants to have known and anticipated the agency's position.¹⁷⁹

2006—almost eight months after the defendants were indicted); see Lynnley Browning, *Court Rejects Tax Shelter Once Sold by KPMG*, N.Y. TIMES, Feb. 2, 2007, at C4; Lynnley Browning, *U.S. Judge Backs I.R.S. Ruling Invalidating Tax Shelter, Possibly Aiding U.S. Criminal Case*, N.Y. TIMES, Apr. 22, 2006, at C3.

¹⁷² The time period the government focuses on is prior to both a court ruling that the tax shelters were illegal and IRS notice that the tax shelters should be registered. Although there is evidence that the defendants believed the transactions in question would be considered tax shelters by the IRS, *U.S. Tax Shelter Industry*, *supra* note 10, at 8, that does not negate the uncertainty about how the tax shelters would be treated by the IRS.

¹⁷³ See *supra* Part II.B–C.

¹⁷⁴ See *United States v. Mallas*, 762 F.2d 361, 363–64 (1985) (holding that when a point of law is vague or uncertain, no criminal liability can attach). Defendants may have had doubts and they may have violated the professional standards set by the ABA and the IRS, but that does not mean they knew with certainty that their actions constituted tax evasion.

¹⁷⁵ I.R.S. Notice 2000-44, 2000-2 C.B. 255 (identifying tax avoidance using an artificially high basis as a listed transaction); I.R.S. Notice 2001-45, 2001-2 C.B. 129 (identifying basis-shifting tax shelters as listed transactions); *U.S. Tax Shelter Industry*, *supra* note 10, at 25. BLIPS and SOS are tax shelters that utilize an artificially high basis and were specifically listed in I.R.S. Notice 2000-44 as potentially abusive tax shelters. Government's Memorandum in Opposition to Defendants' Pretrial Motions, *supra* note 17, at 13; *U.S. Tax Shelter Industry*, *supra* note 10, at 25, 45–46, 81. FLIP and OPIS are basis-shifting tax shelters that were identified as illegal transactions in 2001 by the IRS. Johnson, *supra* note 152, at 433. The government alleges the defendants sold FLIP from 1996 to 1999, OPIS from 1998 to 1999, BLIPS from 1999 to 2000, and SOS from 1998 to 2002. See *supra* note 143 and accompanying text.

¹⁷⁶ I.R.S. Notice 2000-44, 2000-2 C.B. 255; Government's Memorandum in Opposition to Defendants' Pretrial Motions, *supra* note 17, at 13.

¹⁷⁷ I.R.S. Notice 2001-45, 2001-2 C.B. 129; Government's Memorandum in Opposition to Defendants' Pretrial Motions, *supra* note 17, at 13.

¹⁷⁸ *U.S. Tax Shelter Industry*, *supra* note 10, at 25, 45–46. KPMG stopped selling FLIP in 1999, several years prior to the issuance of the IRS notice. *Id.* at 20.

¹⁷⁹ A 2004 document revealed internal debate among employees of the IRS over whether KPMG was required to register BLIPS. Lynnley Browning, *Document Could Alter KPMG Case*, N.Y. TIMES, Sept. 15, 2006, at C1.

In 2003 the IRS issued a temporary regulation banning the use of the BLIPS and SOS, and made the regulation retroactive to transactions starting in 1999.¹⁸⁰ However, in a civil case, the Eastern District of Texas held that the IRS has no authority to retroactively ban a tax shelter based on a temporary regulation.¹⁸¹ If uncertainty prevents the IRS from retroactively applying civil penalties,¹⁸² it stands to reason that uncertainty also negates the government's argument that the *Stein* defendants had the requisite knowledge for criminal conviction.

The government's theory of criminal liability for tax evasion also focuses on the false opinion letters. The government alleges that the defendants willfully issued false opinions¹⁸³ in order to insure taxpayers against civil penalties, and thus encouraged tax evasion.¹⁸⁴ This theory is problematic because the government cannot demonstrate the requisite *Cheek* intent,¹⁸⁵ further, criminal liability in this situation would fail to satisfy due process requirements. Whether the defendants intentionally issued false opinion letters for the purpose of committing tax evasion is predicated on a jury determination that (1) the tax shelters were illegal, and (2) the defendants knew they were illegal prior to issuing the opinion letters.¹⁸⁶ As explained above, the government will have difficulty proving prior knowledge

¹⁸⁰ Government's Memorandum in Opposition to Defendants' Pretrial Motions, *supra* note 17, at 13–14.

¹⁸¹ *Kalamath Strategic Inv. Fund, LLC ex rel. St. Croix Ventures, LLC v. United States*, 440 F. Supp. 2d 608, 622–23 (E.D. Tex. 2006) (holding that temporary Treasury regulation expanding liability of partners in partnership did not apply to conduct before August 2000); *Judge Rules Against IRS*, *supra* note 17, at C4. The regulation did not become effective until 2005. Treas. Reg. § 1.752-6 (2005).

¹⁸² *Kalamath*, 440 F. Supp. 2d at 624 (stating it was “significant” that plaintiffs could have restructured their transactions if they had “notice of the Service’s intentions” in finding that the regulation was not retroactive).

¹⁸³ These opinion letters are allegedly false for misrepresenting the factual underpinnings of the tax shelters and erroneously concluding that the transactions would more likely than not survive an IRS challenge. Superseding Indictment, *supra* note 7, at 15–17 (describing false statements in the opinion letters for the FLIP and OPIS tax shelters). The falseness depends on the presumption that the tax shelters lack economic substance.

¹⁸⁴ *Id.* at 8–29. Because opinion letters are not signed under penalty of perjury, this is the only theory in which the government can allege the opinion letters are an overt act in furtherance of tax evasion. Weisberg & Mills, *supra* note 19, at A16.

¹⁸⁵ *Cheek v. United States*, 498 U.S. 192, 199–200 (1991).

¹⁸⁶ Under the government's theory, issuing the opinion letters is an affirmative act of tax evasion because the letters encouraged taxpayers to partake in these shelters. Superseding Indictment, *supra* note 7, at 63; *see also* Government's Memorandum in Opposition to Defendants' Pretrial Motions, *supra* note 17, at 28. However, this theory rests on the assumptions that the taxpayers owed taxes to begin with and that the defendants knew this prior to issuing the opinion letters. Whether an opinion letter consists of true or false statements does not in itself determine whether the underlying transaction results in tax liability. Saying otherwise allows the tail to wag the dog.

of the tax shelters' illegality because of the uncertainty of the status of tax shelters under the relevant laws and regulations at the time.¹⁸⁷

Moreover, prior to filing this case, the government had never charged an attorney with criminal liability for issuing allegedly false opinion letters. In fact, until 2003, the IRS had never even investigated an attorney for violating Circular 230, much less subjected an attorney to civil penalties for its violation.¹⁸⁸ Although the defendants arguably violated ethical and professional standards of conduct, it is unclear whether they believed that issuing false opinion letters could result in criminal liability.¹⁸⁹ Under the *Cheek* subjective intent standard, mistake of law is a defense and a court would allow the defendants to introduce evidence that they did not believe the opinion letters were in violation of the tax evasion standards.¹⁹⁰ Because the standard is subjective, the outcome will not depend on whether their position is legally accurate.¹⁹¹ Thus, it will be difficult for the government to prove that the defendants intentionally falsified their opinion letters in order to promote tax evasion under the *Cheek* standard of intent.

Another problem with the government's theory is that opinion letters merely protect the taxpayer from penalty payments and do not result directly in a tax deficiency.¹⁹² Providing opinion letters cannot constitute an act of tax evasion just because it gives the taxpayer an incentive to use a tax shelter.¹⁹³ This reasoning is a weak basis for imposing criminal liability, and the government will likely be unable to prove the defendants' guilt on this theory.

¹⁸⁷ An opinion letter is only worth something to the taxpayer when the law is uncertain. Once the law is definitive, if the law is in the taxpayer's favor, the opinion letter is not needed. If the law is not in the taxpayer's favor, reliance on an opinion letter may not save a taxpayer from penalties given the requirements of disclosure and factual investigation under Circular 230. 31 C.F.R. § 10.35 (2006); see *supra* Part II.B–C.

¹⁸⁸ Until Cono Namorato became the director of the IRS's Office of Professional Responsibility in December 2003, the office had never brought cases against attorneys or accountants for violations of Circular 230 through involvement with abusive tax shelters. Andrew Parker, *Firms in Line of Fire Over Advice: Tax Avoidance: The U.S. Internal Revenue Service Is Cracking Down on Accountants and Lawyers Who Promote Unacceptable Tax Schemes*, FIN. TIMES, June 9, 2005, at 12. Now the office has thirty ongoing investigations, but no attorney has yet been charged with civil penalties. *Id.*

¹⁸⁹ Lawyers treated the practice of issuing opinion letters as virtually free of liability prior to 2002. See *supra* notes 65–69 and accompanying text.

¹⁹⁰ *Cheek*, 498 U.S. at 199–200.

¹⁹¹ *Id.*

¹⁹² Tax penalties and interest are not considered a "tax deficiency." *United States v. Wright*, 211 F.3d 233, 236 (5th Cir. 2000).

¹⁹³ *Weisberg & Mills*, *supra* note 19, at A16. This distinction is important when the government is alleging that defendants are liable for their clients' tax deficiencies instead of personal ones. To show that defendants are liable for another's tax deficiency, it stands to reason the government must show that the defendants, rather than another source, actually created that deficiency. Note that this reasoning only applies to the tax evasion charges for marketing and structuring the tax shelters. Superseding Indictment, *supra* 7, at 62–66. It does not apply to, for instance, the charges against Raymond Ruble for personal tax evasion. *Id.* at 66–68.

The most alarming deficiency in the government's theory of the case is its use of civil and ethical standards of conduct as a basis for criminal liability.¹⁹⁴ As discussed earlier, the standards that govern the issuance of opinion letters are vague and ambiguous.¹⁹⁵ Given the haziness of these standards, imposing criminal liability based solely on the issuance of these letters arguably violates notions of due process because defendants did not have fair warning that their conduct would result in criminal liability.¹⁹⁶ Tax practitioners cannot be expected to anticipate when their conduct is in such flagrant violation of these standards that it would expose them to criminal liability—especially when their conduct may not even expose them to civil liability.¹⁹⁷ This point is particularly crucial in *Stein*, where an older version of Circular 230 governs the defendants' behavior.¹⁹⁸ Compared to the current version, the old guidelines regarding what is required of tax practitioners are spartan.¹⁹⁹

This is not to say that the government can never use civil standards as a basis for criminal liability. For example, in antitrust law, the Sherman Act provides the same standard for civil and criminal penalties.²⁰⁰ However, there are several key differences in the way that courts apply criminal and civil liability in antitrust suits.

¹⁹⁴ The government alleges that defendants falsely and fraudulently claimed the transactions would meet the more-likely-than-not standard if they were to be challenged by the IRS. Superseding Indictment, *supra* note 7, at 17.

¹⁹⁵ See *supra* Part II.B–C. The nebulous standards of Circular 230 have made many tax practitioners extremely nervous because the basis of liability is so uncertain. Albert B. Crenshaw, *Putting Tax Advisors on the Line*, WASH. POST, June 5, 2005, at F1. For example, whether an opinion qualifies as a covered opinion is extremely ambiguous. *Id.*

¹⁹⁶ Yamaguchi, *supra* note 166, at 392 n.35 (uncertainty in the law defense based on due process concerns).

¹⁹⁷ Crenshaw, *supra* note 195, at F1 (reporting that the IRS “keep[s] saying ‘Trust us, we’re not going to look at you for minor infractions,’” and “‘the scary thing is, your whole livelihood is at stake if you make a bad call’”). The Treasury and Congress’s speed in continuously heightening regulations and increasing penalties on tax practitioners beginning in the 1980s created anxiety for tax practitioners because of the uncertainty of what standards apply to tax practitioners in executing tax opinions. See Dennis J. Ventry, Jr., *Filling the Ethical Void: Treasury’s 1986 Circular 230 Proposal*, 112 TAX NOTES 691, 697 (2006) (reviewing changes in regulations governing tax shelter opinions in the 1980s and stating that the “Treasury’s guidance on [the 2005] Circular 230 revisions that said practitioners should ‘just use common sense’” and “‘just use reasonable care’ were not reassuring,” and that “[m]ixed signals . . . contributed to practitioner anxiety”).

¹⁹⁸ 31 C.F.R. § 10.33 (1997). The government alleges in its indictment that the laws of 1997 are the applicable standards. Superseding Indictment, *supra* note 7, at 10.

¹⁹⁹ Compare 31 C.F.R. § 10.33 (1997), with 31 C.F.R. § 10.35 (2007). For example, under the 1997 guidelines, when drafting tax shelter opinions, a tax practitioner has no duty to independently investigate a client’s factual representation unless she reasonably believes that it is false. 31 C.F.R. § 10.33 (1997).

²⁰⁰ Sherman Act, 15 U.S.C. § 1 (2000); *United States v. Gypsum Co.*, 438 U.S. 422, 438 (1978) (stating that the Sherman Act is not interpreted just as a criminal statute: both civil and criminal sanctions are authorized for the same generalized conduct).

First, acts subjecting the defendant to civil versus criminal penalties are differentiated on the basis of intent.²⁰¹ Second, criminal sanctions apply only in situations where the law is relatively clear.²⁰² Although antitrust jurisprudence is not devoid of some of the contradictory case law that frequently characterizes common law methods, courts typically follow general rules of case categorization. Certain types of behavior, such as horizontal price-fixing and boycotts, are considered per se violations of antitrust law.²⁰³ These defined rules give defendants adequate guidance on what behavior would expose them to criminal liability. Third, Congress intended criminal application of the antitrust laws,²⁰⁴ whereas the IRS did not anticipate criminal sanctions in drafting the Circular 230 guidelines.²⁰⁵ These differences suggest that violations of antitrust statutes inherently encompass a greater degree of criminal culpability than do violations of Circular 230. Further, because the drafters of the antitrust laws intended to allow criminal sanctions to be imposed under the statute, they probably considered whether the statute adequately described conduct that would warrant criminal liability. On the other hand, the IRS and ABA, in drafting Circular 230 and Formal Opinion 346, did not consider whether the standards they were drafting would clearly define behavior that would result in criminal liability because they have no power to do so.²⁰⁶ Thus, this comparison demonstrates the

²⁰¹ *Gypsum*, 438 U.S. at 439.

²⁰² *Id.* (stating that criminal sanctions should be used only in situations where “the law is clear and the facts reveal a flagrant offense and plain intent to unreasonably restrain trade” (quoting REPORT OF THE ATTORNEY GENERAL’S NATIONAL COMMITTEE TO STUDY THE ANTITRUST LAWS 349 (1955))).

²⁰³ Per se cases include: *United States v. Topco Associates Inc.*, 405 U.S. 596 (1972), where territorial allocation of a cooperative buying association was a horizontal restraint and a per se violation of the Sherman Act; *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940), where major oil companies fixing the price of gasoline was a per se violation; and *United States v. Trenton Potteries Co.*, 273 U.S. 392 (1927), where price-fixing of sanitary pottery was a per se violation when agreements were made among horizontal competitors. Boycott cases include: *Federal Trade Commission v. Superior Court Trial Lawyers Association*, 493 U.S. 411 (1990), where private defense lawyers boycotting taking indigent defendants from district court was a per se violation because the aim of the boycott was to increase hourly compensation—a form of price-fixing—and lawyers are horizontal competitors; and *Fashion Originators’ Guild of America v. Federal Trade Commission*, 312 U.S. 457 (1941), where it was per se illegal for defendants to collectively refuse to sell their products because defendants were horizontal competitors.

²⁰⁴ Sherman Act, 15 U.S.C. § 1; *Gypsum*, 438 U.S. at 438 (holding Sherman Act is not interpreted as just a criminal statute but that both civil and criminal sanctions are authorized for the same generalized conduct).

²⁰⁵ Considering that the IRS derived opinion standards from the ABA’s ethical guidelines without providing much guidance, it is reasonable to assume that in drafting the guidelines, the IRS did not anticipate that the government would use them to impose criminal liability. See *supra* notes 94 & 197 and accompanying text.

²⁰⁶ The greatest punishment an attorney can receive for violating the guidelines of Circular 230 is disbarment from practicing before the IRS. 31 C.F.R. § 10, 50 (2007). While disbarment is a serious penalty, there is a distinct difference between disbarment and imprisonment. See, e.g., 26 U.S.C. § 7201 (2000) (imprisonment not to exceed five years); 26 U.S.C. § 7206 (imprisonment not to exceed three years); 18 U.S.C. § 371 (2000) (imprisonment not to exceed five years).

flaws in *Stein* and provides an example of criteria the government could use to determine when to impose criminal or civil sanctions.

2. *Conspiracy Charges*.—The government’s second allegation charges the defendants with conspiracy to defraud the IRS.²⁰⁷ The government argues that a conspiracy charge can stand alone—even if the defendants are acquitted of tax evasion charges—because the conspiracy statute does not require tax deficiency or willfulness.²⁰⁸ Although cases where a defendant has been convicted of conspiracy but acquitted of tax evasion exist,²⁰⁹ the Supreme Court has held that “[c]onspiracy to commit a particular substantive offense cannot exist without at least the degree of criminal intent necessary for the substantive offense itself.”²¹⁰ Thus, to convict for conspiracy, the government must prove that the defendants were aware of the criminality of their actions,²¹¹ but it does not need to establish that the “conspiracy succeeded or that the government was actually harmed.”²¹² In other words, the government merely needs to show that the defendants intended to defraud the government.²¹³

In *Stein*, whether the jury finds that the opinion letters support a conspiracy charge for tax evasion should depend on whether it finds that the tax shelters were legal.²¹⁴ If the jury finds that the tax shelters were legal, it should also conclude that the opinion letters and the tax returns could not have been used to “conceal the true facts” from the IRS because they are accurate.²¹⁵ However, because the government need not prove the defendants actually committed tax evasion, a jury could find that opinion letters that are false on an element that does not influence the legality of a tax shelter still support a conspiracy charge for tax evasion, even if the underlying tax shelters were legal. Additionally, the government alleges that the defendants’ failure to register the tax shelters constitutes an act in furtherance

²⁰⁷ See *supra* notes 139–49 and 159–60.

²⁰⁸ Government’s Memorandum in Opposition to Defendants’ Pretrial Motions, *supra* note 17, at 31–38.

²⁰⁹ *United States v. Klein*, 247 F.2d 908 (2d Cir. 1957). *Klein* established the standards for what is commonly referred to as a “*Klein* conspiracy.” See, e.g., *United States v. Fletcher*, 322 F.3d 508, 513 (8th Cir. 2003).

²¹⁰ *Ingram v. United States*, 360 U.S. 672, 678 (1959) (quoting *Developments in the Law—Criminal Conspiracy*, 72 HARV. L. REV. 920, 939 (1959)) (internal quotation marks omitted).

²¹¹ This references the *Cheek* level of intent required for tax evasion charges. *Cheek v. United States*, 498 U.S. 192 (1991).

²¹² David Gomez & Keith Schomig, *Tax Violations*, 44 AM. CRIM. L. REV. 1025, 1064–66 (2007); *Ingram*, 360 U.S. at 677–78.

²¹³ *Klein*, 247 F.2d at 916 (conspiracy to defraud includes preventing the IRS from collecting money through “deceit, craft or trickery, or at least by means that are dishonest” (citation omitted)); see also Gomez & Schomig, *supra* note 212, at 1064–66 (noting that there is no need to prove a defendant committed an overt act if the government already proved that a coconspirator did so).

²¹⁴ This position assumes the opinion letters were not written based on a factual sham.

²¹⁵ Government’s Memorandum in Opposition to Defendants’ Pretrial Motions, *supra* note 17, at 5.

of the conspiracy to evade taxes. Despite the uncertainty surrounding registration requirements,²¹⁶ a jury may see this as an overt act in furtherance of a conspiracy to defraud because the *Cheek* intent requirement of willful violation of a known legal duty does not apply.²¹⁷ Therefore, even if the tax evasion charges are dismissed because the court finds the transactions were not fraudulent, a conspiracy charge based on the failure to register or on providing false opinion letters could succeed.²¹⁸

Recall that two of the indicted defendants have already pled guilty,²¹⁹ and that KPMG is named as a conspirator in the pending indictment.²²⁰ There is also evidence that the defendants did not believe that the tax shelters would pass the more-likely-than-not standard.²²¹ With two witnesses to support the claims of the conspiracy, and the existing evidence regarding the defendants' failure to register and the knowing issuance of false opinion letters, the remaining factor the government must prove for a jury to find all the defendants guilty on the conspiracy charge is that all the defendants were part of the conspiracy.²²² Thus, it is likely that the government will be able to demonstrate that there was a conspiracy to defraud.²²³

²¹⁶ Even the IRS internally debated the registration requirements. See Browning, *supra* note 179, at C1.

²¹⁷ *Cheek v. United States*, 498 U.S. 192, 199–200 (1991). This is especially true when the government has evidence that shows that at least some of the defendants believed they were required to register the tax shelters but chose not to do so for business reasons. See *U.S. Tax Shelter Industry*, *supra* note 10, at 12. Since the *Cheek* intent requirements do not apply, defendants would be unable to argue uncertainty in the law or subjective belief regarding the state of the law as defenses because they were unaware at the time that the IRS had doubts about whether registration was required. See Browning, *supra* note 179, at C1. All the government would need to show is that the defendants intended to hide the transaction from the IRS. 18 U.S.C. § 371 (2000); see also *Klein*, 247 F.2d at 916.

²¹⁸ See *Klein*, 247 F.2d 908; see also COMISKY, FELD & HARRIS, *supra* note 160, ¶ 3.05[6][c] (noting that a *Klein* conspiracy only requires proof that the defendants were aware of liability for federal taxes and agreed to interfere with government's ability to collect those taxes, for example, by falsifying IRS documents). Furthermore, the government alleges that defendants committed fraudulent acts to obstruct the IRS investigation. Government's Memorandum in Opposition to Defendants' Pretrial Motions, *supra* note 17, at 7. The question becomes whether or not the conspiracy can encompass all of the defendants and whether the government would be able to show a collective agreement to interfere with the IRS's ability to collect taxes.

²¹⁹ David Rivkin, a former KPMG partner, pled guilty in March 2006 to charges of conspiracy and tax evasion. Browning & Moynihan, *supra* note 7, at 13. David Makov also pled guilty in September 2007 to one count of conspiracy to commit tax fraud. Davies, *supra* note 7, at A16.

²²⁰ Government's Memorandum in Opposition to Defendants' Pretrial Motions, *supra* note 17, at 41.

²²¹ See *supra* note 155.

²²² See *supra* notes 159–60 and accompanying text.

²²³ Considering that registration requirements are difficult to determine and assuming that the tax evasion charges are dismissed, the *Stein* case raises the question whether a conviction for conspiracy to defraud is appropriate when no actual act of tax evasion occurred. Academics have commented extensively on the increase in corporate fraud cases that result in convictions for charges other than the substantive underlying crime, including perjury, obstruction of justice, conspiracy, and false statements. See, e.g., Stuart P. Green, *Uncovering the Cover-Up Crimes*, 42 AM. CRIM. L. REV. 9 (2005); Geraldine

B. Implications

Stein has presented a multitude of questions. Some will be answered by the outcome of the case while others will remain open. The purpose of this Comment is to examine what the post-*Stein* basis of criminal liability will be and should be for practitioners in the tax shelter industry, especially for attorneys whose involvement is limited to providing opinion letters. An examination of the government's theory of the case is useful as a starting point, but the more pertinent question is how aggressively the government will pursue criminal prosecutions in the future. An additional query is what impact *Stein* will have on the future of tax planning. This Comment posits that a finding of criminal liability in *Stein* will further cloud the already ambiguous definition of criminal activity in the tax shelter context.

1. *Professionals.*—The *Cheek* intent requirement sets a high bar for the government to prove liability. Although it is unlikely that a tax professional would be convicted of tax evasion for providing tax shelter opinion letters, there are limited circumstances in which the *Cheek* standard would be satisfied.

If the transaction at issue was a sham, the prosecution would have less trouble proving that a defendant tax professional acted with the intent necessary for liability to attach. For example, assume a series of transactions are purported to have occurred, but in reality, no money ever exchanged hands, or it was not an arms' length transaction. Although the attorneys involved were aware of the sham, they marketed and sold the transactions to clients and provided opinion letters falsely stating the transactions would more likely than not survive an IRS challenge. In this scenario, the sham factor is apparent, and a finding of intent is not dependant on a court's previous determination that the tax shelter is illegal.

Under the government's theory of liability in *Stein*, however, an attorney could also be held criminally liable for any false statements regarding

Szott Moohr, *What the Martha Stewart Case Tells Us About White Collar Criminal Law*, 43 HOUS. L. REV. 591 (2006); Chris William Sanchirico, *Detection Avoidance*, 81 N.Y.U. L. REV. 1331 (2006).

This case also illustrates the potential use of deferred prosecution agreements to convict the individual employees of a corporation of criminal conspiracy. Because KPMG has already admitted to one count of conspiracy to defraud the IRS, the government merely needs to prove that each defendant was part of the agreement to satisfy the elements of the conspiracy charge. DPA, *supra* note 132, at 1–2. Using the *Stein* case as an example, academics and practitioners have started writing on the impact of deferred prosecution agreements in imposing criminal liability. See Earl J. Silbert & Demme Doufekias Joannou, *Under Pressure to Catch the Crooks: The Impact of Corporate Privilege Waivers on the Adversarial System*, 43 AM. CRIM. L. REV. 1225 (2006); Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 AM. CRIM. L. REV. 1095 (2006); see also William R. McLucas, Howard M. Shapiro & Julie J. Song, *The Decline of the Attorney-Client Privilege in the Corporate Setting*, 96 J. CRIM. L. & CRIMINOLOGY 621 (2006).

material facts.²²⁴ Since Congress passed the AJCA and the IRS revised Circular 230 to reflect the AJCA's standards, an attorney has a heightened duty to investigate all material facts.²²⁵ Even though tax evasion charges require proof of intent to violate the tax code, the government can now advance a theory of willful blindness to negate the *Cheek* standard.²²⁶ In other words, because the defendant has an obligation to verify all material facts, failure to investigate would be a violation of a known legal duty, and a jury could interpret it as willful blindness. Thus, in some cases, the government could successfully prosecute an attorney for tax evasion on the basis of the opinion letters that the attorney wrote.

Although a jury could find an attorney guilty of tax evasion under the government's theory in these above scenarios, the attorney would be guilty of violations of known duties. The important question is whether the government can hold opinion letter writers who are not guilty of tax evasion criminally liable for conspiracy to defraud, as it is trying to do in *Stein*.²²⁷ If so, the ambiguities in the governing standards for opinion letters are an additional source of concern because a violation of the standards could result in a conviction for conspiracy. Though revised Circular 230 provides more guidelines than the original version does, practitioners must still worry about the overall vagueness of the guidelines and the potential liability that could result from violating them.²²⁸ Additionally, despite specific requirements regarding due diligence standards for particular types of opinion letters, determining how to categorize a transaction or opinion is still open to interpretation in most cases.²²⁹ How a transaction is categorized—such as whether it is a reportable or listed transaction—determines the disclosures required.²³⁰ In *Stein*, the ambiguity surrounding the registration requirements for tax shelters is one basis for the charge of conspiracy to defraud.²³¹

²²⁴ See *supra* Part III.A.2. The relevant facts are determined at the practitioner's discretion. 31 C.F.R. § 10.35(c) (2007).

²²⁵ Compare 31 C.F.R. § 10.35(c) (2007), with 31 C.F.R. § 10.33(a) (1997).

²²⁶ COMISKY, FELD & HARRIS, *supra* note 160, ¶ 3.05[3] (noting that a "willful blindness" instruction is appropriate for conspiracy to commit tax evasion when evidence shows defendants were "deliberately ignorant of the illegal goals, objects or purposes of the conspiracy"). The willful blindness instruction has been applied in tax evasion cases. *United States v. Martin*, 773 F.2d 579, 584 (4th Cir. 1985) (upholding willful blindness jury instruction stating that knowledge could be inferred from willful blindness satisfying the intent requirements for tax evasion).

²²⁷ See *supra* note 223 and accompanying text.

²²⁸ Crenshaw, *supra* note 195, at F1.

²²⁹ 31 C.F.R. §§ 10.33–35 (2007); Crenshaw, *supra* note 195, at F1.

²³⁰ See *supra* notes 94–118 and accompanying text.

²³¹ Of course, it is possible that *Stein* presents a unique case because the government had access to a plethora of KPMG's internal documents. See Johnson, *supra* note 152, at 433 (noting that the KPMG shelters provide a relatively rare window of documentation and internal discussions about a specific tax shelter); *U.S. Tax Shelter Industry*, *supra* note 10, at 3 (stating that, during the investigation, staff reviewed 235 boxes and thousands of pages of electronic discovery that included correspondence, tax product descriptions, transactional documents, and marketing materials). The likelihood that the gov-

Assuming the government can prove its case on conspiracy, the implications for the future of tax planning are similarly grim.

2. *Tax Planning*.—The impact *Stein* will have on tax planning depends largely on its outcome. For now, observers speculate that large accounting firms have shied away from aggressive tax planning and that boutique firms are conducting the majority of tax shelter work.²³² National firms are concerned primarily with whether the government can indict the firm itself instead of pursuing only individual employees.²³³ The apparent lesson from *Stein* is that tax professionals are not safe from all criminal liability just because the government cannot prove criminal liability for tax evasion.²³⁴ These implications demonstrate the need to reform the tax shelter regulations for clarity and to inform attorneys about what activities could expose them to criminal sanctions.

IV. SOLUTIONS FOR REGULATING TAX SHELTERS

Despite the problems with the government's case in *Stein*, concern over the proliferation of tax shelters is legitimate. The IRS estimates that in 2001, tax revenues fell short by as much as \$350 billion.²³⁵ Accounting for returns from audits, this represents roughly fifteen percent of total tax revenues collected.²³⁶ Given prior failed attempts to regulate the use of illegal tax shelters,²³⁷ it is not surprising that the government has turned to criminal penalties as a new means to deter the professionals involved. Still, to impose criminal penalties for providing false opinion letters, the government must implement a method that addresses the problems with its theory of the case in *Stein*.²³⁸ This Part proposes several solutions that would allow the government to impose criminal sanctions, but argues that civil sanctions

ernment will have evidence of the same type in other cases is remote unless the company is under investigation.

²³² Howard Gleckman, Amy Borrus & Mike McNamee, *Inside the KPMG Mess: Why Eight Partners May be Facing Jail Time—and What the Justice Dept.'s Suit Could Mean for the Tax-Shelter Business*, BUS. WEEK ONLINE, Sept. 12, 2005, http://www.businessweek.com/bwdaily/dnflash/sep2005/nf2005091_2144_db016.htm (reporting that the Big Four accounting firms and large law firms, worried about civil suits by clients, have limited their involvement in tax shelter marketing).

²³³ Commentary on the *Stein* case has focused on prosecutorial discretion and the influence of deferred prosecution agreements. See *supra* notes 12 & 223 and accompanying text.

²³⁴ The government here is using conspiracy as a catch-all to impose criminal liability on individuals who would otherwise escape it, using the statute like Professor Albert Alschuler has argued the government has used federal mail fraud and RICO statutes. Albert W. Alschuler, *The Mail Fraud & RICO Racket: Thoughts on the Trial of George Ryan*, 9 GREEN BAG 2d 113, 115 (2006) (arguing that prosecutors use the RICO and mail fraud statutes to prosecute state crimes, turning federalism on its head).

²³⁵ See *supra* note 3 and accompanying text.

²³⁶ See sources cited *supra* note 3.

²³⁷ See *supra* Part II.C.

²³⁸ See *supra* Part III.A. Although the government can potentially impose criminal liability for so-called cover-up crimes, imposing criminal sanctions on the substantive crime would be a much better method of regulation.

should be applied instead. Section A suggests the solutions that will allow the imposition of criminal sanctions. Section B argues that imposing criminal sanctions on tax professionals does not fulfill the purposes of the criminal justice system and that civil sanctions are the proper means of preventing abusive tax shelters. Section C proposes a system of civil sanctions that would be more effective than current tax shelter regulation is.

A. *Imposing Criminal Sanctions*

Scholars have suggested several means to eliminate the existing barriers to imposing criminal sanctions on tax professionals for their role in proliferating tax shelters. First, Congress could modify the *Cheek* intent standard by discarding the judicially created requirement of a willful violation of a known legal duty. The new standard could require only willfulness to commit the act itself, such as intentionally providing false opinion letters. This change would nullify the uncertainty-in-the-law defense.²³⁹ Although this is a tempting option,²⁴⁰ it does not address some fundamental due process issues. Nothing has changed since the courts first implemented the heightened requirement; the tax code is still as confusing and vague as it was in the 1930s.²⁴¹ Even worse, the regulations that are used as the basis for criminal liability are also vague, which adds a second layer of ambiguity to an already confused area of the law.²⁴² Although the uncertainty-in-the-law defense may allow some tax evaders to avoid penalties, it provides protection to those who made a good faith effort to navigate the confusing waters of the tax code and simply picked the wrong side of a close argument. As seen in *Stein*, the uncertainty-in-the-law defense is the only thing preventing attachment of criminal liability for providing false opinion letters.²⁴³

Other scholars have suggested that Congress should codify the economic substance doctrine.²⁴⁴ Although this suggestion has been proposed and rejected in the context of civil penalties,²⁴⁵ it may be an appropriate response to the issues raised by the criminal charges in *Stein*. Codifying the

²³⁹ See *supra* Part III.A.

²⁴⁰ A number of scholars have criticized the *Cheek* standard of intent. See, e.g., Yamaguchi, *supra* note 166, at 402–03 (stating that the uncertainty defense would remove the threat of criminal liability for creative tax evaders); Yochum, *supra* note 162, at 252 (wishing that the *Cheek* Court had recognized that the tax statute is no longer arcane and its fundamental obligations are well known).

²⁴¹ See, e.g., *United States v. Murdock*, 290 U.S. 389 (1933); see also *supra* Parts II.B–C, III.A.

²⁴² See *supra* Part II.B–C.

²⁴³ See *supra* Part III.

²⁴⁴ See Chirelstein & Zelenak, *supra* note 90, at 1951–62 (proposing a provision that would “disallow noneconomic losses and noneconomic deferrals through the use of foreign (and other tax-indifferent) counterparties”); Rostain, *supra* note 10, at 109–11 (providing an overview of the tax bar’s resistance to codifying the economic substance doctrine).

²⁴⁵ See, e.g., Chirelstein & Zelenak, *supra* note 90, at 1951–62 (proposing a variation of a codification of the economic substance doctrine); Rostain, *supra* note 10, at 109–11 (discussing the tax bar’s rejection of codifying the economic substance doctrine).

economic substance doctrine and preventing the deduction of noneconomic losses except where specifically allowed by the tax code would effectively eliminate these unintended uses of the code. Although this would not necessarily eradicate all tax shelters—some do have nominal economic losses—it would address the intent problems raised in *Stein*.²⁴⁶

Alternatively, Congress could pass legislation imposing criminal sanctions for providing false opinion letters and explicitly state that a tax professional who intentionally provides false opinions, regardless of the type of opinion letter, is subject to criminal penalties. The statute could specify when it would apply by defining what constitutes a false opinion, for example, the falsification of a material fact. This approach would alleviate the current ambiguity of what violations subject a person to criminal liability.

Finally, Congress could require tax attorneys to sign opinion letters under penalty of perjury. This would bring opinion letters within the sanctions of the tax perjury statute.²⁴⁷ Although this solution does not explicitly address the issue of ambiguous standards in the tax shelter context, it would address the intent issue because under § 7206, the government does not need to demonstrate a tax deficiency.²⁴⁸ Thus, Congress could take action to heighten criminal liability for tax professionals who aid their clients in evading taxes.

B. Purposes of Criminal Justice System

Although potentially viable solutions to the policy issues that *Stein* raises do exist, one problem still unaddressed is whether the criminal justice system is the appropriate means of regulating tax shelter activity. None of the solutions described above address the issue of culpability or whether criminal sanctions are appropriate given the goals of criminal law. The question remains whether the culpability of the *Stein* defendants, and similar defendants, is so high that it warrants criminal sanctions.²⁴⁹

Under the government's theory in *Stein*, a defendant with a relatively small degree of culpability could still be convicted of tax evasion. Suppose tax practitioner *A* determined that a tax shelter had a forty-nine percent chance of passing judicial scrutiny, instead of the requisite fifty-one percent chance. However, under pressure from his firm, *A* decided to provide a positive opinion letter anyway. In this situation, *A* has intentionally pro-

²⁴⁶ See Chirelstein & Zelenak, *supra* note 90, at 1951–62 (proposing a solution that would reach the § 469 level of effectiveness in eradicating modern day tax shelters, but noting that some illegal shelters would remain); Rostain, *supra* note 10, at 109–11 (explaining that a codification would require fact-intensive analysis to distinguish economic losses versus tax-driven losses).

²⁴⁷ 26 U.S.C. § 7206 (2000).

²⁴⁸ *Id.*; see *supra* note 158 and accompanying text.

²⁴⁹ See Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 LAW & CONTEMP. PROBS. 401, 422–25 (1958) (discussing the purpose of criminal liability and its intersection with strict liability criminal statutes).

vided a “false” opinion letter that, under the government’s theory, subjects him to criminal liability, even though the client is not necessarily evading taxes. Although *A* has certainly violated ethical and professional standards, whether this is a serious enough infraction to warrant criminal liability—especially when the projected harm is uncertain—is questionable at best. The answer is dependent on varying philosophies of the criminal justice system’s purpose.

Some scholars argue that imposing criminal liability is the only method of combating a business ethos that lacks an inherent moral compass.²⁵⁰ This argument follows the Devlin philosophy of legal moralism, which stands for the proposition that “inherently immoral acts can be criminalized irrespective of the harm caused.”²⁵¹ Under this approach, criminal laws can be used to maintain social order.²⁵²

Under the Hart philosophy, criminal law should only apply in cases where there is actual harm.²⁵³ To do otherwise blurs the line between civil and criminal penalties, weakening the overall impact of criminal sanctions as a means of implementing social order.²⁵⁴ The Hart school argues that the line between criminal and civil penalties should rest on the distinction between price and prohibition.²⁵⁵ Civil sanctions extract a price to force actors to internalize the externalities caused by their behavior, but these sanctions do not prohibit the behavior altogether.²⁵⁶ Criminal sanctions are imposed when the behavior should be prohibited because the behavior has no social benefits.²⁵⁷

In tax law, it is difficult to state the harm a violation causes.²⁵⁸ It is similarly difficult to articulate the moral harm inherent in violations of tax laws, considering the longstanding tradition that taxpayers have no obligation to pay more than the law requires.²⁵⁹ Keeping in mind the Hart philosophy, an examination of the Treasury regulations indicates that providing opinion letters is not a behavior that the Treasury would like to prohibit altogether. Taking into account that Treasury Regulation § 1.6664-

²⁵⁰ William H. Widen, *Enron at the Margin*, 58 BUS. LAW. 961, 999–1001 (2003).

²⁵¹ J. Kelly Strader, *The Judicial Politics of White Collar Crime*, 50 HASTINGS L.J. 1199, 1263 (1999) (arguing that the Hart-Devlin debate is the classic dividing line between liberalism and legal moralism).

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ John C. Coffee, Jr., *Does “Unlawful” Mean “Criminal?” Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 193–94 (1991).

²⁵⁵ John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can be Done About It*, 101 YALE L.J. 1875, 1882–84 (1992).

²⁵⁶ *Id.* at 1884.

²⁵⁷ *Id.* at 1885–86.

²⁵⁸ See Strader, *supra* note 251, at 1266 (arguing that it is often difficult to identify the harm or victim(s) of many white collar crimes).

²⁵⁹ See *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

4 allows taxpayers to rely on opinion letters to avoid penalty payments of understated taxes, opinion letters do fulfill an important social function.²⁶⁰ This social function is more readily understood in the context of the IRS's longstanding history of taxpayer abuse.²⁶¹ The history of the IRS's aggressive tax collection without accountability further justifies the need for some safety measures to protect taxpayers and professionals who make good faith mistakes in interpreting the complex tax code.²⁶² In this light, criminal sanctions are not the most cost-efficient method of regulating opinion letters. Civil sanctions should be used instead.

C. *Imposing Civil Sanctions*

Civil sanctions are a superior method for regulating the tax shelter industry, as they extract a cost from violators of the tax law without destroying the important social function that opinion letters serve. Scholars have proposed and discussed numerous civil solutions, from codifying the economic substance doctrine to increasing penalties.²⁶³ A better solution, however, is not to merely increase civil penalties for professionals, but to tie the increase to the tax penalties imposed on the client for understating her taxes. Thus, for each client, in addition to the current regulatory penalties, if an attorney is found to have intentionally violated a legal duty, and the taxpayer is found to have relied in good faith on the attorney's advice, the penalties for understatement that would normally be imposed on the taxpayer should be imposed on the attorney instead.²⁶⁴ Not only will this force attorneys to internalize the external costs generated by their misconduct, but it will also be cost efficient for courts because a taxpayer will no longer

²⁶⁰ 26 C.F.R. § 1.6664-4 (2007).

²⁶¹ Following a series of inflammatory hearings regarding IRS abuse, Congress passed the IRS Restructuring and Reform Act of 1998. Pub. L. No. 105-206 § 1, 112 Stat. 685 (1998) (codified in scattered sections of the U.S.C.). Both scholars and journalists have commented on this abuse by the IRS. See Eric A. Lustig, *IRS, Inc.—The IRS Oversight Board—Effective Reform of Just Politics? Some Early Thoughts From a Corporate Law Perspective*, 42 DUQ. L. REV. 725, 731–32 (2004); Cranford, *supra* note 3, at 327 (noting that congressional hearings in the late 1990s showed IRS agents were overly abusive, aggressive, and worse).

²⁶² See *supra* note 261 and accompanying text.

²⁶³ See, e.g., Chirelstein & Zelenak, *supra* note 90, at 1951–62; Delaney, *supra* note 24, at 338–41; Glassman, *supra* note 75, at 707–10; Rostain, *supra* note 10, at 100–13; *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2270 (2004).

²⁶⁴ A gross negligence standard may suffice, but considering the ambiguity in the current standards, it seems that a degree of intent should be included. Some may argue that this revision would result in overdeterrence and that professionals would refuse to provide opinion letters. However, given the proliferation of tax shelters and the difficulty in imposing sanctions, stricter regulations are necessary. Though shifting the penalties from the taxpayer to the tax professional may seem harsh, it is less harsh than criminal sanctions and there are just as many safeguards, such as the *Cheek* intent standard, that will protect good faith mistakes. Furthermore, it is not necessarily true that the tax bar would oppose such a solution, given Professor Tanina Rostain's argument that the tax bar has generally been in favor of stricter regulations to maintain its position as gatekeeper for the tax system. See generally Rostain, *supra* note 10.

need to bring a civil suit against the attorney for malpractice or breach of duty.²⁶⁵ Thus, the proposed civil sanctions would not only regulate the tax shelter industry more efficiently, but also preserve the benefits of opinion letters that the IRS originally envisioned.

V. CONCLUSION

Stein has raised serious questions regarding the government's ability to criminalize the issuance by attorneys of opinion letters that fall short of professional standards. It demonstrates the problems with using ambiguous ethical standards as a means of applying criminal liability. *Stein* also elucidates the power of the conspiracy charge to criminalize behavior that may not otherwise be criminalized under the substantive tax evasion statutes. In the context of tax shelter regulation, it is not surprising that the government has turned to criminal penalties in response to arguments that penalties for misconduct should be higher. Still, ethical and civil provisions are far from appropriate standards to use for imposing criminal sanctions. If the government insists on pursuing criminal penalties to stem the tide of tax shelter abuse, the standards it uses should not be based on ethical guidelines.

Further, there are many persuasive reasons why criminal sanctions are not an appropriate method of regulating tax shelter abuse at all. In light of the purposes of our criminal justice system, criminal penalties are not warranted given the low degree of culpability of the defendants in cases like *Stein*. Instead, the government should focus on increasing civil penalties in a way that causes tax practitioners to internalize the externalities that their questionable behavior imposes on others. In doing so, the government will balance effective regulation of abusive tax shelter practices with preservation of the safeguards that protect taxpayers from the complexities of the tax code.

²⁶⁵ In this situation, the taxpayer is "made whole" because the understatement was what the taxpayer owed to begin with. Allowing her to avoid penalty payments is already benefiting her by giving her an interest-free loan in the form of deferred tax payments. Furthermore, the fee she paid to the attorney for the opinion letter is properly placed on the taxpayer so that she internalizes any costs that are associated with misplaced reliance on an attorney simply because she knows she will not be subject to penalties.

