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Tax Shelter Malpractice Cases and Their Implications for Tax Compliance

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Abstract
In malpractice lawsuits, taxpayers prevailed in courtrooms, around arbitration tables, and in settlement negotiations against peddlers of abusive tax shelters. This analysis illustrates how the tax shelter malpractice experience embodies many virtues that yield tax compliance. From these virtues emerge several important lessons on how to curb aggressive tax planning. Evident from these virtues and lessons is that malpractice litigation is a powerful tool in the sphere of tax compliance, and, where possible, reforms should be instituted to further promote its use.

Keywords
Tax shelter malpractice, Tax planning, Tax compliance
TAX SHELTER MALPRACTICE CASES
AND THEIR IMPLICATIONS FOR
TAX COMPLIANCE

JAY A. SOLED

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INTRODUCTION

Over the last several years, taxpayers who invested in failed tax shelters have brought an avalanche of malpractice cases against their advising lawyers and accountants.1 In conjunction with more stringent statutory penalties,2 heightened disclosure requirements in the tax and securities regulatory regimes,3 and stricter ethical

1. It is impossible to determine with any specificity the actual number of tax shelter malpractice suits, if only because most of the disputes were resolved by terms of arbitration agreements or otherwise settled. If one accounts for class action suits, the number of published cases, both federal and state, run into the hundreds. This figure surely, however, undercounts the number of disputes. Indeed, the take-up rate associated with IRS amnesty programs for tax shelter participants indicates that tax shelter malpractice disputes numbered into the thousands. These amnesty programs and global settlements allowed taxpayers who participated in abusive tax shelters to come forward and pay the tax and interest owed on back taxes. In return, the IRS typically refrained from applying otherwise associated penalties. See I.R.S. Announcement 2005-80, 2005-46 I.R.B. 967–71 (stating that taxpayers who settled had to pay 100% of taxes owed, interest, and, depending on the transaction, either one-quarter or one-half of the penalty the IRS otherwise would seek). Huge numbers of taxpayers seized the opportunity for amnesty, with 2000 (out of an estimated 4000) investors in twenty-one different tax shelters turning themselves in and paying over $2 billion in back taxes and interest. Stephen Joyce, About 2,000 Taxpayers to Pay $2 Billion in Global Settlement Initiative, Everson Says, 59 DAILY TAX REP. (BNA) G-2 (Mar. 28, 2006). More impressive still, approximately 85% of taxpayers known by the IRS to have purchased the “Son of BOSS” tax shelter elected to settle under a different program rather than litigate the issue with the government, coughing up more than $4 billion. I.R.S. News Release IR-2005-72 (July 11, 2005); I.R.S. Announcement 2004-46, 2004-21 I.R.B. 964.

2. It is reasonable to assume that a significant number of these former shelter investors subsequently sued their tax advisers for malpractice to recoup, at the very least, fees associated with the failed tax shelter advice. See Denney v. Deutsche Bank AG, 443 F.3d 253, 262 (2006) (revealing that “class counsel for over 1000 claimants argue [for immediate settlement acceptance]”); see also Cassell Bryan-Low, Unhappy Returns: Accounting Firms Face Backlash over the Tax Shelters They Sold, Suits by Users Being Audited Are Multiplying, and IRS Steps Up Its Regulation, WALL ST. J., Feb. 7, 2003, at A1 (reporting that disgruntled clients were initiating lawsuits against their former accounting firms for advice related to questionable tax shelter investments); David Cay Johnston, Wealthy Sue Accountants over Shelters: Disputes on Tax Moves That I.R.S. Disallowed, N.Y. TIMES, Feb. 7, 2003, at C1 (predicting a “flood” of malpractice cases); Allen Kenney, Korb Predicts Shelter Malpractice Suits, 2005 TAX NOTES TODAY 216-2 (stating that in the aftermath of the successful settlement initiatives, the IRS chief counsel predicted “a rash of malpractice suits against tax advisers”).

2. See I.R.C. § 6662 (Supp. 2005) (imposing a 20% penalty for understatements of tax pertaining to any listed transaction and any other reportable transaction (with the penalty increasing to 30% if certain disclosure requirements are not met)); I.R.C. § 6707A (Supp. IV 2004) (imposing a series of monetary penalties for failure to include on any return or statement any information required to be disclosed under I.R.C. § 6011 with respect to a reportable transaction); I.R.C. § 6695A (West 2008) (imposing a penalty on appraisers equal to the lesser of (1) the greater of $1000 or 10% of the amount of tax underpaid by reason of the incorrect valuation or (2) 125% of the gross income received by the person who prepared the appraisal).

3. See I.R.C. § 6111 (Supp. 2005) (requiring each material adviser with respect to any reportable transaction to register the transaction with the IRS); § 6707A(e)(2) (explaining that if the taxpayer paid certain tax shelter-related penalties and is also required to file periodic reports under section 13 or section 15(d) of the Securities Exchange Act of 1934 or is required to be consolidated with another person for
standards for tax practitioners, these civil lawsuits have fundamentally transformed the nature of tax practice. The risk of potential tax shelter malpractice claims, particularly in the aftermath of several high-profile congressional and Treasury Department investigations, has prompted tax professionals in law and accounting firms to impose strict governance procedures and internal controls. In particular, these firms and their members have instituted rigorous new procedures governing the issuance of legal opinions supporting aggressive tax-planning strategies, as well as stringent oversight of practitioner adherence to new ethical standards. Furthermore, as an

purposes of those reports, the taxpayer must disclose these payments on future Security and Exchange Committee submissions).


6. The most important and largest shake-up involved the deferred prosecution agreement that the accounting firm KPMG signed in August 2005 with the Department of Justice as part of the government’s multi-billion dollar criminal tax fraud investigation involving abusive tax shelters. See Letter from David N. Kelley, U.S. Attorney, S. Dist. of N.Y., U.S. Dep’t of Justice, to Robert S. Bennett, Attorney, Skadden, Arps, Slate, Meagher & Flom L.L.P. (Aug. 26, 2005), available at http://www.usdoj.gov/usao/nys/pressreleases/August05/kpmgdpagmt.pdf. The signed agreement is a remarkable document and imposes permanent restrictions on KPMG’s tax practice, including requiring the firm to cease (with limited exceptions) its private client tax practice as well as its compensation and benefits practice. Id. at 4–9. It also requires KPMG (1) to refrain from developing, marketing, selling, or implementing prepackaged tax products; (2) to restrict severely its tax preparation services; and (3) to apply significantly elevated standards to its tax practice. Id. In addition, as a result of the government’s preliminary investigation into its tax shelter activities, KPMG dismissed a number of senior tax officials. See I.R.S. News Release IR-2005-83 (Aug. 29, 2005); Lynnley Browning, How Accounting Firms Went from Resistance to Resignation, N.Y. TIMES, Aug. 28, 2005, at A1; Sheryl Stratton, KPMG Sacrifices Tax Leadership in Ongoing Shelter Controversy, 2004 TAX NOTES TODAY 28, 28; see also PERM. SUBCOMM. ON INVESTIGATIONS, THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY, S. REP. NO. 109-54, at 93–96 (2005) (reporting the various changes made by PwC). Similarly, as part of a $10 million settlement with the Treasury Department in 2002, agreed with the Department of Justice to overhaul its internal quality-control procedures. Senate PSI Report Targets Firms Involved in Tax Shelter Industry, 2005 TAX NOTES TODAY 28, 28; see also PERM. SUBCOMM. ON INVESTIGATIONS, THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY, S. REP. NO. 109-54, at 93–96 (2005) (reporting the various changes made by PwC).

7. Firms expend time and resources discussing, debating, and reevaluating their conduct and advice vis-à-vis these standards, which are promulgated by the
additional measure of protection, these firms have ceased (at least for the time-being) aggressive, large-scale, coordinated client solicitations for marketed tax shelters.\(^8\)

While tax shelter malpractice litigation is nothing new,\(^9\) the generation of cases that arose after the passage of the Tax Reform Act of 1986 (“1986 Act”) stands apart from its predecessors.\(^10\) The

professional associations as well as the Treasury Department. For example, pursuant to Circular 230, the Treasury regulations governing tax practice, every piece of written correspondence and electronic e-mail produced by tax practitioners now includes a ubiquitous “no penalty reliance” legend, which tells the recipient that she cannot rely on the communication or its contents for the ultimate validity of the benefits or for purposes of avoiding tax penalties. See Sheryl Stratton, Circular 230 E-Mails, T-Shirts Attain ‘Legendary’ Status, 2005 Tax Notes Today 127-1. For additional examples of how Circular 230 has influenced daily tax practice, see, for example, Susan T. Edlavitch & Brian S. Masterson, Circular 230 “Best Practices” and Written Advice Standards, in Representing the Growing Business: Tax, Corporate, Securities, and Accounting Issues 775 (ALI-ABA 2007); Bruce D. Pingree, Circular 230 and Tax Shelter Issues in Benefits, in Current Pension and Employee Benefits Law and Practice 1059 (ALI-ABA 2006); Dan W. Holbrook, Imagine the Worst the U.S. Treasury Could Do to Us—They’ve Done It: Revenge of the IRS: Circular 230 Changes Law Practice, Tenn. B.J., Aug. 2005, at 28; Edward M. Manigault & Steve R. Akers, Circular 230—How It Changed Our Lives (or at Least Our Practices), Prob. & Prop., May–June 2006, at 32.

8. See, e.g., S. Rep. No. 108-34, at 23 (2003) (indicating that KPMG disbanded its sales group formerly responsible for promoting abusive tax shelters); Sheryl Stratton, Nine Tax Professionals Indicted; KPMG Admits Shelters Were Fraudulent, Tax Notes Today, Aug. 30, 2005, at 167-1 (reporting that the agreement between the government and KPMG obliges the firm to place “permanent restrictions on [its] tax practice, including the termination of two practice areas: providing tax advice to wealthy individuals, and KPMG’s compensation and benefits tax practice,” and noting that the agreement requires “permanent adherence to higher tax practice standards regarding the issuance of some tax opinions and the preparation of tax returns”).

9. See, e.g., Ackerman v. Schwartz, 947 F.2d 841, 843 (7th Cir. 1991) (finding that tax shelter investors commenced malpractice action against an attorney whose opinion letter was used by tax shelter promoters to evidence a transaction’s supposed legitimacy); Newmyer v. Philatelic Leasing, Ltd., 888 F.2d 385, 387 (6th Cir. 1989) (finding that failed tax shelter investor commenced malpractice action against promoter); Alvett v. Shafer, No. 89 Civ. 0839, 1991 WI 222130, at *1 (S.D.N.Y. Oct. 24, 1991) (explaining that taxpayers sued accountant, claiming malpractice for involving them in eight failed tax shelters).

10. The difference between pre– and post–1986 Act tax shelter malpractice cases may, in part, be due to the changed nature of the tax shelter industry. See Bernard Wolfman et al., Standards of Tax Practice § 208.1, at 139 (6th ed. 2004). In detailing the differences between earlier individual tax shelters and the present-day corporate tax shelter, Wolfman notes that the tax shelters of the 1970s and 1980s were largely based on the use of tax preferences (e.g., ACRS, tax credits and the like) to create noneconomic losses. . . . In contrast, many of today’s tax shelters . . . instead rely on exploitation of a technical defect in a Code or Regulation provision to create a tax benefit that arguably was not intended (or at least not contemplated) by Congress.

Id. Thus, in the 1970s and 1980s, taxpayers and tax practitioners were more like co-conspirators in trying to exploit tax preferences. When the IRS invalidated these shelters, taxpayers and practitioners were equally culpable, and, thus, few malpractice cases ensued. In contrast, the more recent vintage of tax shelters
financial recoveries involved in the recent cases were stunning, often in the multimillion dollar range. Moreover, the defendants involved in these cases were not two-bit promoters from the underbelly of the legal, accounting, and banking professions; instead, they were partners and managers at white-shoe law firms, accounting firms, and financial institutions. And unlike tax shelter malpractice cases involving the application of pre–1986 Act law, the recent wave of professional malpractice cases attracted considerable public attention and generated feature stories in the national media.

Though tax shelters employ diverse methods and devices to shelter income from taxation, malpractice cases involving abusive shelters share a similar factual underpinning. At the risk of oversimplifying, tax shelter investors in the 1990s and early 2000s experienced large taxable gains attributable to the sale or disposition of business enterprises or securities. On the advice of their attorneys and
accountants, these taxpayers invested in tax-planning strategies that generated huge tax losses to offset sizable taxable gains without any significant economic risk. The nation’s leading legal and accounting professionals endorsed these transactions and propped them up with legal opinions, thereby creating an air of legitimacy around them. Comforted by the trappings of lawfulness, taxpayers jumped at the opportunity to reduce their taxes, paying considerable fees in the process.

As the Internal Revenue Service (“IRS”) learned of these techniques, it categorized them as “listed transactions” and disallowed punitive losses associated with their use. Many lawyers and accountants scoffed at these IRS notices and their supposed application to the tax shelters in question. In some instances, these professionals did not immediately inform taxpayer clients of the IRS’s position. In other instances, they made disclosure but insisted that taxpayer subject to the 35% marginal tax rate yields $35 for every $100 of loss, for example, compared to $15 for a taxpayer subject to the 15% marginal tax rate. In the 1990s and 2000s, tax shelter promoters focused their energies on these high-income taxpayers. See Jacoboni v. KPMG LLP, 314 F. Supp. 2d 1172, 1174 (M.D. Fla. 2004) (finding that after lucrative deal closed resulting in significant capital gains for taxpayer, taxpayer’s investment banker referred taxpayer to KPMG for tax shelter products).

16. See id. (revealing that KPMG advised the taxpayer to enter into a certain investment strategy, which later led to the taxpayer facing $28 million in federal income tax capital gains liability).

17. See id. (recounting allegations that KPMG represented its tax shelter strategy as a “no-lose” proposition).

18. See id. (noting that the plaintiff faced $28 million in federal income tax capital gains liability after following the advice of KPMG).

19. Listed transactions are those transactions that the IRS believes warrant heightened scrutiny. Treas. Reg. § 1.6011-4(b)(2) (as amended in 2007). Once a transaction is listed, a series of procedural rules take effect: taxpayers need to disclose their participation in these listed transactions as prescribed in Treas. Reg. § 1.6011-4 (as amended in 2007), and promoters (or other people responsible for registering tax shelter transactions) need to register these transactions under Treas. Reg. § 301.6111-2 (2003). In addition, material advisers must maintain lists of investors and other information with respect to these listed transactions, pursuant to Treas. Reg. § 301.6112-1 (as amended in 2007). By way of illustration, the IRS specifically “listed” those tax shelters that tax practitioners were using to negate taxpayers’ capital gains. See I.R.S. Notice 2000-44, 2000-2 C.B. 255 (denying losses associated with partnerships designed to provide taxpayers with artificially inflated bases in their investments to produce artificial losses).

20. See Wilson v. Deutsche Bank AG, No. 05 C 3474, 2005 WL 3299366, at *1 (N.D. Ill. Nov. 30, 2005) (“Plaintiffs contend that defendants should have informed them of IRS Notices 1999-59 and 2000-44, which challenged the strategy and were issued before plaintiffs entered the Strategy.”); Heller v. Deutsche Bank AG, No. 04-CV-3571, 2005 WL 525401, at *1 (E.D. Pa. Mar. 3, 2005) (noting that despite defendants’ knowledge of two IRS notices that “informed tax professionals . . . of the illegality of strategies such as the . . . purchase of digital options on foreign currency, Defendants allegedly . . . continued to aggressively market and sell the strategy as a legitimate tax shelter”).
the nature of the purchased tax shelter was distinguishable from those shelters described in the IRS notices.\textsuperscript{21}

At this point, investor taxpayers faced a choice: they could either concede the invalidity of the transaction for which they had paid sizable fees—and pay taxes owed, interest, and penalties—or fight the IRS challenge, which would involve expensive, protracted litigation with an uncertain outcome and the prospect of higher penalties.\textsuperscript{22}

The vast majority of investor taxpayers opted to cut their losses, forgo the reported tax savings, and remit back taxes and interest. These concessions, however, did not prevent investor taxpayers from targeting the professionals who peddled the invalidated tax-planning strategies. Investor taxpayers had paid for what they had been led to believe was sound legal and accounting advice; in reality, they were duped into buying tax shelters that, from the very beginning, stood little chance of withstanding administrative or judicial scrutiny. Prepared for long and expensive legal battles, and represented by highly skilled litigators, these taxpayers, seeking retribution, commenced civil malpractice cases against their former legal, accounting, and financial advisers.\textsuperscript{23}

These cases did not involve the traditional battle lines, with taxpayers aligned on one side and the government aligned on the other. Rather, these battles involved taxpayers and the government aligning on the same side, protecting tax revenues and the integrity of the tax laws (albeit taxpayers fought this battle more as reluctant mercenaries rather than as eager soldiers). On the other side stood the tax practitioners who had created, marketed, and advised the taxpayers on tax shelter use. The convergence of interests between taxpayers and the government produced significant benefits for both: at the micro-level, taxpayers reaped huge financial rewards and the

\textsuperscript{21} See RA Invs. I, LLC v. Deutsche Bank AG, No. 3:04-CV-1565-G, 2005 WL 1356446, at *2 (N.D. Tex. June 6, 2005) (asserting that although some of the opinion letters mentioned Notice 2000-44, these letters stated that it would have “no substantive effect on the Transaction into which you entered” and “is prima facie inapplicable to your situation”).

\textsuperscript{22} If the invalidated transaction was part of an amnesty or settlement program, the taxpayer could avoid penalties or pay them at a reduced rate. See I.R.S. Announcement 2005-80, 2005-46 I.R.B. 967–71 (providing that taxpayers who settled had to pay 100\% of taxes owed, interest, and, depending on the transaction, either one-quarter or one-half of the penalty the IRS otherwise would seek). The majority of listed transactions, however, were not subject to amnesty. Thus, taxpayers wishing to concede the position to the government had to pay penalties as well as back taxes and interest.

\textsuperscript{23} See, e.g., Jacoboni v. KPMG LLP, 314 F. Supp. 2d 1172, 1174 (M.D. Fla. 2004) (detailing taxpayer’s civil suit against KPMG after taxpayer incurred approximately $28 million in tax liability as a result of following KPMG’s investment strategy advice).
psychological fulfillment of obtaining justice; at the macro-level, the government emerged with a stronger tax compliance ethos in place as many rogue practitioners and firms financially stumbled or fell (and compliant practitioners and firms took note of these misfortunes).^{24}

Part I of this Article identifies the compliance-reinforcing characteristics of the tax shelter malpractice experience. Informed by a detailed examination of every published federal and state tax shelter malpractice case involving post–1986 Act law, it demonstrates how these disputes (1) leveled the litigation playing field; (2) aligned the interests of taxpayers, compliant tax practitioners, and the government on the side of tax collection rather than tax avoidance; (3) punished tax shelter lawyers and accountants with traditional sanctions in the form of monetary penalties; (4) further punished tax shelter lawyers and accountants with alternative sanctions in the form of shame and reputational humiliation; and (5) revealed that judges, juries, and arbitrators would hold tax professionals to ethical and practice guidelines.

Based upon the tax shelter malpractice experience, Part II discusses five important “lessons” for the existing tax compliance regime. In particular, it argues that successful tax enforcement requires (1) resource and information symmetries, (2) incentives for taxpayers and tax practitioners to choose compliance over avoidance, (3) enhancement of traditional sanctions, (4) enhancement of nontraditional sanctions, and (5) elevated ethical standards that are enforced.

The final part of this Article, Part III, offers recommendations for facilitating tax shelter malpractice litigation and reinforcing the above lessons. Despite the demonstrated benefits of these cases, plaintiff taxpayers face severe procedural roadblocks that favor defendant practitioners. Thus, when prevailing in these cases, plaintiff taxpayers should be afforded larger monetary recoveries, and practitioners should be subject to significantly greater economic exposure and to bad publicity for enabling abusive tax shelter activity.

I. VIRTUES OF TAX SHELTER MALPRACTICE LITIGATION

Existing case law fails to depict the entire malpractice litigation story. This is because there is not a single reported decision

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determining whether a particular defendant committed malpractice. 25 Nevertheless, the reported cases, which include not only cases brought by individuals but also class action lawsuits, 26 encompass a variety of motions, most of which were resolved in favor of plaintiffs. The motions varied in nature. Some dealt with the claims that were allowed to proceed. 27 Others considered whether there was a federal or state cause of action. 28 And still others investigated whether a claim was ripe 29 or if the statute of limitations had lapsed. 30 Although defendant practitioners won some motions, particularly actions to compel arbitration, 31 they resoundingly lost on substantive issues, particularly with respect to the legitimacy of

25. Whether a plaintiff can successfully bring a civil malpractice case depends upon several factors. Critical is a plaintiff’s ability to prove that the defendant committed a tort or breached a contract. See RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 8.1 (6th ed. 2007) (stating that the foundations of civil malpractice cases are based upon either traditional tort or contract theories of recovery). Despite technical differences, both theories in practice require professionals to exercise reasonable competence and diligence under the circumstances or risk malpractice exposure. For a prima facie tort-based cause of action (i.e., negligence), a plaintiff must show four elements: (1) a duty owed by the professional to the plaintiff, (2) breach of the duty, (3) injuries suffered by the plaintiff, and (4) proximate cause between the injury suffered and the breach of duty. Id. § 8.13. Likewise, for a prima facie contract-based cause of action, a plaintiff must show the existence of four elements: (1) the existence of a contractual relationship, (2) performance by the plaintiff, (3) breach of the contract by the defendant, and (4) damages to the plaintiff as a result of the breach. Id. § 8.6.

26. At least three class action malpractice cases were of significance. See Denney v. BDO Seidman, L.L.P., 412 F.3d 58, 68 (2d Cir. 2005) (holding that tax shelter services were within the scope of the consulting agreement and its arbitration clause); Simon v. KPMG LLP, No. 05-CV-3189, 2006 WL 1541048, at *12 (D.N.J. June 2, 2006) (approving a settlement agreement reached by defendants and plaintiff class of taxpayers after defendants allegedly defrauded plaintiffs); Ling v. Cantley & Sedacca, L.L.P., No. 04 Civ. 4566, 2006 WL 290477, at *4 (S.D.N.Y. Feb. 8, 2006) (awarding reasonable attorney fees and expenses in class action lawsuit).

27. See Amato v. KPMG LLP, 433 F. Supp. 2d 460, 463–64 (M.D. Pa. 2006) (ordering plaintiffs to submit claims to arbitration and staying the further proceedings until the completion of arbitration).


29. See Scippel v. Jenkens & Gilchrist, P.C., 341 F. Supp. 2d 363, 371 (S.D.N.Y. 2004) (finding that because damages to plaintiffs were “immediate and definite,” plaintiffs’ claims were ripe).

30. See, e.g., Scippel v. Sidley, Austin, Brown & Wood, L.L.P., 399 F. Supp. 2d 283, 289 (S.D.N.Y. 2005) (finding that plaintiffs’ securities fraud claim was not time-barred because the Sarbanes-Oxley Act extended the statute of limitations for such claims to the earlier of either five years from the violation or two years from the time of discovery).

31. See Olson v. Jenkens & Gilchrest, 461 F. Supp. 2d 710, 730 (N.D. Ill. 2006) (granting defendants’ motion to compel arbitration after finding that plaintiffs signed retainer agreements that contained an arbitration clause).
pending malpractice claims. These losses put defendant practitioners on the defensive and set the tone for subsequent settlement discussions. They also surely impacted judges’, jurors’, and arbitrators’ decisions as they considered the fate of the parties against the backdrop of these unfavorable motion decisions for defendants. And while there is a lack of direct access to settlement, jury, and arbitration outcomes, the available evidence and repeated references to settlement amounts suggest that plaintiffs prevailed in the majority of these cases, whether in front of a judge, jury, or arbitrator.

The losses that defendants experienced did not just happen by accident. The unique exigencies placed upon defendant practitioners involved in tax shelter malpractice cases make malpractice suits powerful weapons in the fight against tax avoidance and especially against abusive tax shelters. These compliance-boosting results were made possible by the many virtues of tax shelter litigation, which include (1) leveling the litigation playing field, (2) aligning the interests of taxpayers and tax practitioners with those of tax officials, (3) punishing wayward practitioners with financial penalties, (4) offering alternative sanctions such as shaming and reputational humiliation, and (5) breathing life into ethical standards that might otherwise remain largely fallow. These virtues make tax shelter malpractice litigation a useful mechanism in the face of tax avoidance and the gross misuse of tax shelters.

32. See Williams v. Sidley Austin Brown & Wood, L.L.P., 832 N.Y.S.2d 9, 11–12 (App. Div. 2007) (finding that plaintiffs’ claims, including claims of fraud and breach of the implied covenant of good faith, were sufficiently stated); see also infra Appendix (providing a complete and comprehensive survey of the nature of the motions and their outcomes).

33. See Simon v. KPMG LLP, No. 05-CV-3189, 2006 WL 1541048, at *3 (D.N.J. June 2, 2006) (detailing a proposed settlement that provides for a total recovery for the class of $153,920,847.60, including certain administrative and related expenses of the settlement, plus an additional fund of $24,624,750.00 for any award of attorney fees and the reimbursement of the plaintiffs’ counsel’s costs and expenses, in exchange for release of the class’s claims concerning or relating to tax strategies); Ling v. Cantley & Sedacca, L.L.P., No. 04 Civ. 4566, 2006 WL 290477, at *1 (S.D.N.Y. Feb. 8, 2006) (stating that the final settlement established a settlement fund of $4,599 million to resolve the class’s damage claims); Denney v. Jenkens & Gilchrist, 230 F.R.D. 317, 323 (S.D.N.Y. 2005) (noting that the mediated settlement agreement created a $75 million fund that consisted of $63.5 million from the insurance carriers, $5.25 million from Jenkens, and $6.25 million from the individual defendants).
A. Leveling the Litigation Playing Field

On the normal litigation playing field, the IRS is at an inherent disadvantage. Not only must it process millions of returns, but it must do so without sufficient money, personnel, or expertise. What makes the government’s job even more difficult is that abusive tax shelters involve arrangements that are often opaque, complex, and difficult to detect. In those rare instances when taxpayers’ aggressive tax positions are in fact detected, the IRS faces additional difficulties in prosecuting the matter. Relative to taxpayers, the IRS must conduct its litigation efforts staffed with fewer, less experienced attorneys and limited funding allocations for each case, which results in fewer expert witnesses for the government and fewer depositions of defendant parties. Furthermore, taxpayers possess all the information that the government needs, including transaction memoranda, accounting computations, accrual work papers, and opinion letters. The IRS struggles to obtain all of this information through the discovery process while fighting against the often impenetrable attorney-client privilege and work-product doctrine.


35. See IRS OVERSIGHT BD., ANNUAL REPORT 2007, at 9 (2008), available at http://www.treas.gov/irsob/reports/2008/IRSOB_Annual-Report_2007.pdf (“[W]hen its budget is adjusted for inflation, the IRS has received fewer resources compared to FY2002 and its workforce has shrunk by almost 15,000 employees.”); see also David Cay Johnston, Corporate Risk of Tax Audit Is Still Shrinking, I.R.S. Data Show, N.Y. TIMES, Apr. 12, 2004, at C1 (stating that for companies with more than $250 million in assets, the audit rate fell from 33.7% in 2002 to 29% in 2003).


37. See GRAETZ, supra note 34, at 1046 (stating that the IRS is “supposed to issue regulations promptly implementing frequent and massive legislative changes, to ferret out and deter income-tax protesters and corporate tax shelters, to halt tax evasion, and to bring the underground economy to the surface. The IRS cannot do all of these things well. Many it cannot do at all.”); Nina E. Olson, Olson Testifies on Fairness in IRS Enforcement, 2007 TAX NOTES TODAY 44-28 (explaining that the IRS “does not have the resources to pursue a significant percentage of its accounts receivable” and that “the private debt collection initiative, a controversial program that is projected to raise only about $1.4 billion over the next 10 years, results from the IRS’s lack of resources to pursue these cases itself”).

38. See United States v. BDO Seidman, LLP, 492 F.3d 806, 815 (7th Cir. 2007) (exploring the broad scope of the attorney-client privilege). See generally Linda M. Beale, Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges, 25 VA. TAX REV. 583 (2006) (arguing that the best way to stop socially wasteful tax planning is to accelerate a paradigm shift in the area of tax compliance); Richard Lavoie, Making a List and Checking It Twice: Must a Tax Attorney Divulge Who’s Naughty and Nice?, 38 U.C. DAVIS L. REV. 141 (2004) (analyzing tax
The gaping resource and information disparities result in a tax-avoidance playing field that is heavily stacked against the IRS.

The circumstances surrounding the tax shelter malpractice cases, however, level the playing field. This level playing field involves several key features: both sides sported attorneys equal in skill and expertise, both sides possessed more than adequate financial resources, and both sides had equal access to information. Each of these key features is discussed in turn below.

The attorneys representing each side of the litigation possessed a similar skill level and expertise. Given their networking circles and economic wherewithal, tax shelter investors tapped into the nation’s best and brightest plaintiff attorneys. Consider the backgrounds of two such lawyers, David Deary and W. Ralph Canada, Jr. Though their pedigrees are impressive (with Deary graduating from the University of Texas Law School and Canada graduating from Harvard Law School), their experience with sophisticated tax shelter transactions and litigation is beyond impressive. Together, Deary and Canada handled some of the most important and high-profile tax shelter malpractice cases of the last ten years. As would be expected, defendant practitioners—themselves members of the nation’s leading law, accounting, and banking firms—brought their attorneys’ ability to protect a client’s identity from the IRS under the attorney-client privilege; Shane Jasmine Young, *Pierce the Privilege or Give ‘Em Shelter? The Applicability of Privilege in Tax Shelter Cases*, 5 Nev. L.J. 767 (2005) (arguing that both the tax practitioner privilege and the identity privilege should be abolished in tax shelter cases); Angela Ahern, Note, *Are Tax Shelter Clients’ Identities Protected by Section 7525 Privilege or Left Out in the Cold? United States v. BDO Seidman, 57 Tax Law. 779 (2004) (examining the Seventh Circuit’s application of the tax practitioner-client privilege under section 7525); Sherly Stratton, *BDO Seidman Court Breathes Life into Accountant-Client Privilege*, 2005 Tax Notes Today 64-2 (addressing the implications of a district court’s holding that the section 7525 privilege, the attorney-client privilege, and the work-product doctrine protected 266 of 267 documents from IRS scrutiny in *United States v. BDO Seidman, LLP*); Sherly Stratton, *BDO Court Rules Attorney-Client Privilege Applies in Shelter Context*, 2004 Tax Notes Today 129-1 (examining United States v. BDO Seidman, LLP and its potential damaging effect on the government’s argument that the crime-fraud exception applies in communications between accounting firms and law firms).


40. Both attorneys worked together in over thirty federal and state tax shelter malpractice cases, including the following two huge class action cases: *Denney v. Deutsche Bank AG*, 443 F.3d 253 (2d Cir. 2006), and *Hudson v. Deutsche Bank AG*, No. 05 C 6783, 2007 WL 1018137 (N.D. Ill. Mar. 30, 2007).
own heavy hitters to the tax shelter malpractice cases. However, unlike in their typical dealings with the government, these litigators faced equals on the playing field.

Second, each side of the dispute—plaintiff taxpayers and defendant practitioners—had access to identical resources. Plaintiffs’ attorneys recognized the apparent merit of these tax shelter malpractice cases and were willing to make a significant economic commitment to see them through to the end. In *Denney v. Jenkens & Gilchrist*, a class action case, for example, five plaintiff law firms spent close to 20,000 billable hours analyzing each element of the shelter transaction, preparing and deposing witnesses, and examining thousands of documents. Experts also had to be called, including valuation experts, forensic accountants, and tax attorneys, each of whom billed at rates anywhere from $300 to $1000 per hour. At each step along the way, plaintiffs’ counsel countered defense counsel and used whatever maneuvers, at whatever cost, to secure victory (e.g., rather than just rely on the expertise of a single tax expert to identify the flaws of a particular tax shelter transaction, plaintiffs’ counsel often called upon former attorneys at the U.S.


42. Admittedly, the highly skilled members of the private tax bar who litigated on the plaintiff taxpayers’ behalf were not necessarily drawn to the controversy by altruistic reasons of arguing on behalf of the internal revenue laws but by the prospect of multi-million dollar contingency fees. See, e.g., *Ling v. Cantley & Sedacca*, L.L.P., No. 04 Civ. 4566, 2006 WL 290477, at *4 (S.D.N.Y. Feb. 8, 2006) (awarding attorneys 17% of overall recovery, or $781,830, plus $77,782.50 for costs and expenses in a tax shelter malpractice case); *Denney v. Jenkens & Gilchrist*, 230 F.R.D. 317 (S.D.N.Y. 2005) (explaining that the total award for attorney fees and expenses was $12,610,449.84, representing approximately 15.5% of the total settlement fund).


44. 230 F.R.D. 317 (S.D.N.Y. 2005)

45. Id. at 351–52.

Department of Justice to further amplify a shelter’s egregious nature). Both sides of the controversy understood that financial stinginess at any point during the dispute was short-sighted and could possibly result in either forfeiture of massive recoveries or generation of greater future costs.

Third, and perhaps most important, neither side of the dispute suffered from information deficiencies. Unlike typical tax disputes with the taxpayer possessing all of the relevant information sought by the government, both sides of the controversy in the case of tax shelter malpractice litigation possessed access to the same information. As former clients of the defendant practitioners, plaintiff taxpayers had control over the information that their legal representatives might withhold in a dispute with the government. In particular, plaintiff taxpayers were not thwarted by claims of attorney-client privilege because they were the holders of the privilege and therefore could deliver documents or evidence pertaining to tax shelter investment materials, such as opinion letters, investment guidelines, and tax return preparation instructions. Nor were they thwarted by defendant practitioners’ efforts to seek work-product protection because the plaintiff taxpayers already possessed or could obtain all documents prepared by the defendant practitioners in the course of prior representation.

With a level litigation playing field, the merits of each case could be clearly and fairly heard. Moreover, a judge, jury, or arbitrator could render judgment with all the relevant information disclosed and in

47. Information disclosure was not universally the case. For example, according to congressional investigation of the tax shelter market, “KPMG required some potential purchasers of the tax products to sign ‘nondisclosure agreements’ and severely limited the paperwork used to explain the tax products.” MINORITY STAFF OF PERM. SUBCOMM. ON INVESTIGATIONS, U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS AND FINANCIAL PROFESSIONALS, FOUR KPMG CASE STUDIES: FLIP, OPIS, BLIPS AND SC2, S. REP. NO. 108-34, at 14 (2003).

48. By way of comparison, information asymmetries did not plague plaintiff taxpayers in the tax shelter malpractice litigation as much as such deficiencies plagued the government in its civil and criminal tax prosecutions of abusive tax shelter behavior. See United States v. BDO Seidman, LLP, 492 F.3d 806, 815–16 (7th Cir. 2007) (utilizing the attorney-client privilege successfully on behalf of tax practitioner client to preclude the government’s access to a certain critical legal memorandum); United States v. Roxworthy, 457 F.3d 590, 591 (6th Cir. 2006) (reversing a district court order requiring disclosure of two memoranda prepared by KPMG under the work-product doctrine); United States v. Liebman, 742 F.2d 807, 810 (3d Cir. 1984) (finding that the attorney-client privilege precludes the IRS from getting ready access to list of clients who invested in tax shelters); United States v. Textron, Inc., 507 F. Supp. 2d 138, 154 (D.R.I. 2007) (asserting that taxpayer’s tax accrual work papers were protected under the work-product doctrine).
the open. On a level playing field, plaintiff taxpayers prevailed against defendant practitioners in a clear majority of the cases.49

B. Aligning the Interests of Taxpayers, Tax Practitioners, and Tax Officials

Historically, taxpayers and tax practitioners have viewed the tax system as an us-versus-them proposition. Taxpayers and their tax advisers have felt that they could do just about anything within legal bounds to minimize their tax obligations. And, in fact, taxpayers do not have a legal responsibility to pay more in taxes than they owe. “Any one may so arrange his affairs that his taxes shall be as low as possible,” Judge Learned Hand wrote in 1934.50 Moreover, as the U.S. Supreme Court opined just one year later, “The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.”51 Armed with this authority, tax practitioners over the years have approached taxpaying and tax advising as a zero-sum gain in which practitioners and their clients lose whenever the government wins. In other words, tax advising and tax compliance are adversarial processes.

This Article does not address the merits or demerits of this adversarial approach, a debate that commentators have fully addressed elsewhere.52 Rather, using the tax shelter malpractice cases as illustrative, it demonstrates that this adversarial paradigm can be challenged and, ultimately, overcome. Indeed, the tax shelter malpractice experience demonstrates that with the right incentives, particularly those that are monetary in nature, taxpayers and their counsel can be induced to promote rather than undermine tax compliance.

49. The Appendix indicates that plaintiff taxpayers won the vast majority of motions. By winning these motions, it is fair to assume that plaintiff taxpayers had the upper hand in subsequent litigation, settlement, and arbitration decisions.


51. Gregory v. Helvering, 293 U.S. 465, 469 (1935) (citations omitted). See Comm’r v. Newman, 159 F.2d 848, 850–51 (2d Cir. 1947) (Hand, J., dissenting) (“Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions.”).

52. See generally Dennis J. Ventry, Jr., Cooperative Tax Regulation, 41 CONN. L. REV. (forthcoming 2008) (examining several options available to the government in regulating tax shelters and articulating an approach to tax regulation based on cooperation, information sharing, and interest convergence).
Consider the fact that investor taxpayers in recent years lost millions of dollars in failed tax shelter investments. As a result of these losses, taxpayers sought financial restitution, even if that meant putting their personal and financial information, as well as their tax shenanigans, into the public realm. Plaintiffs' counsel, for their part, perceived considerable financial gain associated with assisting plaintiff taxpayers. Both groups thus aligned their interests with those of the government; that is, both groups decided to pursue the rogue practitioners that created, marketed, and enabled abusive tax shelters.

In addition to monetary incentives, these plaintiff taxpayers possessed a motivating sense of betrayal. They had entrusted their financial affairs to the lawyers and accountants who had sold them the tax shelter investments. Furthermore, they had paid these advisers considerable fees for their services. Once the IRS challenged these tax shelter transactions, however, the investor taxpayers learned that they had been duped in ways that were

53. See, e.g., Conwill, IV v. Arthur Andersen LLP, No. 602023/05, slip op. at 7 (N.Y. Sup. Ct. June 21, 2006) (concluding that plaintiffs, as a result of entering into a settlement with the IRS, "were required to pay over $3,842,385 in taxes, $521,824.01 in interest, and $436,255 in penalties").


55. Far from being idle, the government has vigorously pursued actions against aggressive tax promoters. For example, the Justice Department has brought several criminal indictments against aggressive tax planners. See, e.g., Scott Antonides, Defendant Pleads Guilty in KPMG Case, 2007 TAX NOTES TODAY 176-3 (reporting that defendant in the tax shelter case involving KPMG pleaded guilty to conspiracy, admitting to a role in selling shelters that helped clients evade an estimated $2.5 billion in taxes); Carolyn Wright LaFon, Former KPMG Partner Indicted for Defrauding the IRS with U.S., Foreign Tax Shelter, 2008 TAX NOTES TODAY 56-6 (stating that former KPMG partner, Michael Pfaff, was indicted on "charges of arranging the participation of various entities and individuals in tax shelter transactions occurring both domestically and outside the United States that resulted in millions of dollars of fee income being concealed from the IRS and Treasury").

56. See, e.g., Swartz v. KPMG LLP, 476 F.3d 756, 758 (9th Cir. 2007) ("According to the complaint, the BLIPS transactions had been devised by KPMG and B & W as a means of charging unwarranted and excessive fees to a "select audience" of individuals who had sold large businesses or otherwise incurred large capital gains."); Ducote Jax Holdings, L.L.C. v. Bradley, No. 04-1943, 2006 WL 3513716, at *1 (E.D. La. Nov. 14, 2006) ("The Plaintiffs claim that the advice from the Defendants has proven disastrous in that they have paid a significant amount of fees to the Defendants only to receive allegedly erroneous and incompetent advice. . . ."); Jacoboni v. KPMG LLP, 314 F. Supp. 2d 1172, 1174 (M.D. Fla. 2004) (stating that defendants were paid "substantial fees" for their work).
collusive, backhanded, and even fraudulent. Thus, the investor taxpayers viewed malpractice litigation as a way to teach their former advisers a lesson, even if that lesson benefited the government’s long-standing efforts to crack down on abusive tax-avoidance activity.

Just as tax shelter malpractice cases illustrate that taxpayers can bolster tax compliance in the presence of proper incentives, tax practitioners can align on the side of tax collection given proper inducement. One such incentive involves practitioners’ desire to avoid the anxiety, anguish, and agony of being the subject of a malpractice suit. These suits are time-consuming, resource-intensive, humiliating, and potentially financially ruinous. Indeed, the very existence and looming possibility of tax shelter malpractice suits constituted one of the primary reasons that, in recent years, law and accounting firms revamped internal rules and procedures.

Reconsidering internal controls and compliance procedures involved

57. See Swartz v. KPMG LLP, 476 F.3d 756, 758–59 (9th Cir. 2007) (citing plaintiff’s allegations that defendants “were active participants in the conspiracy” and “knew that the series of BLIPS transactions were predetermined steps to generate sham losses for the purpose of obtaining tax benefits”); Jacoboni, 314 F. Supp. 2d at 1174 (finding that plaintiff “was not apprised of the significant tax risks” associated with the tax shelter strategy marketed by KPMG and that KPMG represented as “bullet proof”).

58. See LaFon, supra note 55.

59. See MALLEN & SMITH, supra note 25, § 24.27, at 675 (“Tax shelter advice and activities have resulted in significant and frequent financial exposure.”); Robert Feinschreiber & Margaret Kent, Tax Shelter Malpractice, 83 TAX NOTES 1037, 1038 (1999) (“Tax professionals may face increasing financial exposure.”). To the extent that lawyers and accountants react to malpractice suits in ways similar to that of physicians, they would avoid aggressive taxpayers as clients. See Sara C. Charles et al., Sued and Nonsued Physicians’ Self-Reported Reactions to Malpractice Litigation, 142 AM. J. PSYCHIATRY 437, 440 (1985) (stating that many sued doctors avoid seeing certain kinds of patients).

60. In the case of law firm Jenkens & Gilchrist, the financial havoc wreaked by the latest wave of malpractice cases was so damaging that it forced the firm out of business. See I.R.S. News Release IR-2007-71 (Mar. 29, 2007). Upon closure of the firm, the IRS announced thus:

While it is unfortunate that the 56-year-old national firm of Jenkens & Gilchrist is terminating its legal practice, this should be a lesson to all tax professionals that they must not aid or abet tax evasion by clients or promote potentially abusive or illegal tax shelters, or ignore their responsibilities to register or disclose tax shelters.

Id.; see Lynnley Browning, Texas Law Firm Will Close and Settle Tax Shelter Case, N.Y. TIMES, Mar. 30, 2007, at C3 (writing that Jenkens & Gilchrist, “only six years ago among the largest, highest-earning law firms in the nation, becomes the latest casualty in the government’s growing crackdown on aggressive tax shelters”).

aligning practice standards with those reflected in Treasury Department regulations and statutory penalties, which, in turn, reinforced rather than undermined the internal revenue laws.  

Aside from malpractice avoidance, some practitioners also aligned their interests with those of the government for an entirely different reason—money. Fees ordinarily attract practitioners to save tax dollars on behalf of taxpayers; in the case of abusive tax shelters, tax practitioners took this tax savings mantra to extremes, suggesting that they could miraculously produce legitimate losses that involved no economic exposure. However, the opportunity to collect fees is a carrot that knows no allegiance: just as it can lure practitioners to attempt to save taxpayers tax dollars, it can also lure other practitioners to litigate against purveyors of abusive tax shelters (thus aligning their interests with those of the government) in aspirations of collecting huge contingency fees. And this is exactly what transpired in the case of tax shelter malpractice litigation as plaintiff attorneys suspected that if they invested sufficient time and resources, they would prevail in the courtroom and be handsomely rewarded for their efforts. Plaintiff attorneys and the government thus shared a common goal: to inflict as much financial hardship as possible upon the purveyors of these abusive tax shelters.

With the right incentives, taxpayers and tax practitioners can thus be motivated to align their interests with those of the government. These incentives may take the form of sticks (e.g., the threat of malpractice suits) or carrots (e.g., rich monetary awards). Together, a mix of sticks and carrots can induce taxpayers and tax practitioners to reinforce the government’s tax compliance efforts.

C. Punishing Wayward Practitioners with Traditional Sanctions: Monetary Penalties

One of the most powerful and penetrating aspects of malpractice litigation is the monetary punishment it inflicts upon wayward practitioners. As a result of their involvement in the tax shelter market, some of the nation’s most prestigious law and accounting firms, as well as their members, endured hefty direct and indirect costs.

\[62\] See supra notes 6–7 and accompanying text.


financial costs. With respect to direct financial costs, defendant firms and their members had to devote hours of time to develop litigation strategies, give depositions, and testify in court and before arbitration boards. These were wasted hours that otherwise could have been spent on current client matters and the generation of future business. Furthermore, although in some instances—when these tax professionals and their firms lost malpractice cases in court or through arbitration—their insurance carriers were required to pick up the tab; in other instances, the tax professionals and their firms were stuck holding the bill as settlement payouts exceeded the insurance coverage.

In addition, these firms and their members experienced indirect financial costs as well. Bad publicity hounded these firms and their members, exacerbating the situation with additional financial burdens. In general, law firms and accounting firms strive to achieve pristine reputations. Indeed, the better a law or accounting firm’s reputation, the easier it is to develop business and recruit talent to its ranks. The malpractice cases cast a long shadow over firms peddling

65. From 2000 until June 20, 2008, there were sixteen reported federal and state malpractice cases in which the accounting firm of KPMG was a named defendant, eighteen such cases in which the law firm of Sidley Austin was a named defendant, and twenty-four such cases in which the financial institution of Deutsche Bank was a named defendant. See infra Appendix.


67. See, e.g., Denney v. Jenkens & Gilchrist, 230 F.R.D. 317, 324 (S.D.N.Y. 2005) (providing that in class action lawsuit, malpractice insurance carriers agreed to pay $70,057,805 in claims plus an additional $24,942,195 for defendant law firm to defend or resolve the claims of class action opt-outs).

68. See id. (noting that defendants who were individually named agreed to pay a total of $6.25 million in damages and the firm agreed to pay $5.25 million); Paul Braver, The Tax Man’s Travails, Am. Law., Apr. 2004, at 22 (reporting that Paul Daugerdas will himself have to pay $4 million to help settle a lawsuit against Jenkens & Gilchrist).

aggressive tax shelters and over their commitment to the profession, thereby severely tarnishing reputations and damaging future business prospects as well as recruitment opportunities. 70

Tax professionals and their firms were not the only parties to pay for tax shelter involvement. Malpractice insurance carriers, in fact, may have paid the steepest financial price for their insureds' misdeeds. Though they tried, 71 insurance carriers could not find exculpatory language or excuses to assert that malpractice insurance coverage did not extend to acts of providing abusive tax shelter advice. As a result, these carriers were forced to pay out millions of dollars in claims, 72 causing some of them to reconfigure the scope and protections afforded under their policies. 73

The tax shelter marketplace and subsequent malpractice litigation hurt not only perpetrators, but innocent parties as well. For example, in some instances, corporate taxpayers who never participated in abusive tax shelter arrangements suffered falling share prices due to their tax professionals' involvement in abusive shelter activity. 74 In were asked in the Referral Survey how they chose to whom to refer the case, the most important reason they gave, by far, is a lawyer's reputation, followed by a lawyer's compatibility with the client

70 See Braverman, supra note 68, at 22 ("Competing firms have tried to use the deluge of bad publicity [related to the tax shelter malpractice litigation] to poach clients . . . ."); Martin A. Sullivan, Economic Analysis: Reputation or Lower Taxes?, 2005 Tax Notes Today 168-1 ("[T]he actions of the tax department can tarnish a company’s public image.").

71 See Braverman, supra note 68, at 22 ("The firm’s primary insurer, Executive Risk Indemnity Inc., had previously disclaimed coverage for the litigation, arguing that Jenkens had already drawn on its policy to settle an earlier tax shelter case, and that the policy doesn’t cover reimbursement of clients for fines imposed by the IRS.").

72 See Denney, 230 F.R.D. at 324 (detailing the amounts Jenkens & Gilchrist’s insurance provider had to pay).

73 See James M. Fischer, External Control over the American Bar, 19 Geo. J. Legal Ethics 59, 66 (2006) ("[T]he precise limitations attached to coverage have a more penetrating and a more directing impact on the actual practice of law by lawyers than the professional codes. Increasingly the manner and method by which lawyers practice law is determined by insurers’ requirements rather than professional guidance."). See generally George M. Cohen, Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions, 4 Conn. Ins. L.J. 305 (1997) (surveying how the changes in the regulatory environment governing lawyering has caused insurance companies to alter their policies).

74 Taxpayers who unwittingly retained legal and accounting professionals who had helped orchestrate abusive tax shelters had to deal with the fallout from these malpractice cases. Empirical studies indicate that the fair market value of stock declines in value when the reputations of the professionals that the issuing firm retains face ethical scrutiny. See generally William R. Baber, Krishna R. Kumar & Thomas Verghese, Client Security Price Reactions to Laventhol and Horwath Bankruptcy, 33 J. Acct. Res. 385 (1995) (providing statistical analysis of the negative impact of Levathol & Horwath’s bankruptcy on its clients stock returns); Paul K. Chancy & Kirk L. Philipich, Shredded Reputation: The Cost of Audit Failure, 40 J. Acct. Res. 40 (2002) (analyzing the impact of the Enron audit failure on the reputation of Arthur
other instances, innocent tax professionals paid the price as malpractice insurance carriers were forced to reconsider the scope of attorney and accountant coverage as well as the structuring of the premium base, a reconsideration that has led to steep rises in premium costs and even curtailment of coverage.

In sum, malpractice litigation can inflict a broad range of financial hardships upon both rogue and compliant tax professionals and their firms. In addition to the traditional third-party penalties found in the Internal Revenue Code (“Code”), designed to punish rogue practitioners who peddle overly aggressive tax advice, practitioners are subject to the financial consequences of lawsuits by plaintiff taxpayers seeking retribution from the responsible tax professionals.

What practitioners have learned is that erstwhile clients who have met with defeat at the hands of the IRS will likely turn around and sue Andersen, Enron’s auditor, and the resulting negative impact on the stock prices of Andersen’s clients; William A. Hillison & Carl Pacini, Auditor Reputation and the Insurance Hypothesis: The Information Content of Disclosures of Financial Distress of a Major Accounting Firm, 16 J. MANAGERIAL ISSUES 65 (2004) (studying the impact on share price of litigation-bankruptcy related rumors of the client’s auditor); Krishnagopal Menon & David D. Williams, The Insurance Hypothesis and Market Prices, 69 ACCCT. REV. 327 (1994) (suggesting that the disclosure of the bankruptcy of the accounting firm Leventhol & Horwath had an adverse effect on the market prices of the firm’s clients); see also Julia L. Higgs et al., Taxing Audit Markets and Reputation: An Examination of the Tax Shelter Controversy (Mar. 5, 2008) (unpublished manuscript), available at http://ssrn.com/abstract=956053 (“We find evidence consistent with past research that the market values the reputation of the auditor, and when the auditor’s reputation is in question, investors downgrade both the quality of the firm’s audits and the value of the insurance provided by the CPA firm with a decline in the stock price.”).

Appropriate protections to be included can, for instance, include larger self-insured retentions, modification of the policy’s definition of Loss to protect against fines and penalties that the IRS may assess against clients, which fines and penalties the clients will turn to insureds for. To the extent the Insuring Clause utilizes the term “Professional Services,” the definition of that term can likewise be modified to exclude acts as an organizer or seller within the scope of 26 CFR § 301.6112-1, or a material adviser, as defined in 26 U.S.C. § 6111 or 26 CFR § 301.6112-1. Finally, exclusionary language can be specifically crafted to eliminate coverage for such abusive tax shelters.

Andersen, supra note 43, at 3.

76. See, e.g., Anthony Lin, Law Firm Malpractice Premiums on the Rise, N.Y. L.J., Mar. 18, 2003 (predicting much higher insurance premiums attributable, in part, to legal malpractice cases); Richard Perez-Pena, When Lawyers Go After Their Peers: The Boom in Malpractice Cases, N.Y. TIMES, Aug. 5, 1994, at A23 (“In 1970, lawyers were paying less for malpractice insurance than for car insurance, and a lot of insurers were just throwing it in for free on other policies . . . . Today, premiums of $10,000 to $15,000 a year for one lawyer are common.” (internal quotation marks omitted)).

77. See generally Jay A. Soled, Third-Party Civil Tax Penalties and Professional Standards, 2004 WIS. L. REV. 1611 (discussing the third-party civil tax penalties applied in three major categories: (1) tax shelter promoters and abettors, (2) income tax return preparers, and (3) information return preparers).

78. See sources cited supra note 1.
them. What practitioners do not know, however, is what their ultimate financial exposure may be. The fear of being sued but not knowing the downside risk can have a transformative effect on practitioners and how they practice, causing them to be more cautious and to eschew overly aggressive tax planning.

D. Punishing Wayward Practitioners with Nontraditional Sanctions: Shaming and Reputational Harm

In addition to financial costs, there are nonfinancial costs pertaining to malpractice litigation, such as shame and reputational harm. Like financial costs, these nonfinancial costs (or their threat) are persuasive in extracting tax compliance from tax practitioners.

At least one well-recognized study indicates that for shaming to be a truly effective deterrent to tax noncompliance, the following four conditions must be met: “[(1)] audience awareness and participation, [(2)] a cohesive body of would-be offenders who perceive and are sensitive to the same shame, [(3)] judicial personnel and procedures that can tailor sanctions to the target audience sensitivities, and [(4)] a formal means of reintegrating shamed offenders.”

Malpractice litigation arguably fulfills the first two of these conditions: First, the public and practitioners are informed about tax shelter malpractice suits via the public media and professional journals. Second, within each state, tax practitioners are a fairly cohesive cohort commonly working and attending tax seminars together. It is a bit more difficult to prove that the third and forth conditions are satisfied. The IRS Office of Professional Responsibility, however, has made strides in tailoring the punishment to the magnitude of the transgression; likewise, the same agency has

80. See supra note 13 and accompanying text.
81. For example, the Tax Section of the American Bar Association (1) holds semiannual meetings that are usually well attended by a coterie of tax attorneys with practices throughout the country, (2) publishes quarterly news reports, and (3) cosponsors publication of the Tax Lawyer. See generally ABA: Section of Taxation, http://www.abanet.org/tax/home.html (last visited Oct. 2, 2008). For nearly a century, New York University has annually sponsored a tax institute that attracts attorneys and accountants from throughout the country. See NYU Sch. of Continuing and Prof’l Studies, 67th Inst. on Fed. Taxation, http://www.scps.nyu.edu/splash/ift.html (last visited Oct. 2, 2008) (touting discussions regarding the “latest technical, legislative, and planning developments”); cf. Leslie C. Levin, The Emperor’s Clothes and Other Tales About the Standards for Imposing Lawyer Discipline Sanctions, 48 Am. U. L. Rev. 1, 75 (1998) (asserting that lawyers “usually value their reputations within the larger community and may be more likely to respond to shaming sanctions”).
attempted to reintegrate shamed offenders. Thus, shaming has the potential to be effective in the sphere of tax practice because tax practitioners, like other professionals, fear “banishment from the community.”

Consider that during the heyday of the most recent tax shelter bonanza, tax practitioners who orchestrated these abusive tax shelters were viewed with tremendous esteem, gaining semi-star status at their firms. After all, once in place, these abusive tax shelters proved to be a cash cow because they could easily be replicated for very little cost and with tremendous revenue generation. One associate described Paul Daugerdas, the chief engineer of many of the 1990s most abusive tax shelters, as the “focal point” in the Chicago office of Jenkens & Gilchrist.

When the IRS challenged the bona fides of these abusive tax shelters, the initial reaction was that not all was lost. After all, tax professionals involved in formulating these abusive tax shelters could assuage themselves and their consciences by rationalizing that IRS challenges were a typical cost of doing business and providing tax advice. In fact, these IRS challenges could be viewed as a positive development insofar as additional fees could potentially be generated by offering taxpayers defense counsel.

But as the IRS’s successes began to mount and as former clients began to commence malpractice actions, these practitioners experienced a plunging fall from grace. Professional malpractice claims usually come as an explosive shock to the system:

82. See, e.g., I.R.S. News Release IR-2007-197 (Dec. 9, 2007), available at http://www.irs.gov/newsroom/article/0,,id=176212,00.html (noting that in a settlement with the Office of Professional Responsibility, attorneys who had engaged in questionable practices agreed on a going-forward basis “to comply fully with practices and procedures implemented by their current firm in its public finance group, including but not limited to (i) submitting new matters to a review and approval process, (ii) completing questionnaires and checklists to document the due diligence activities undertaken in the matter, and (iii) following practices and procedures established by the firm’s opinion committee for municipal bond opinions”).

83. Massaro, supra note 79, at 1903.


85. Braverman, supra note 12.

86. See supra note 55 (detailing how several practitioners who peddled abusive tax shelters found themselves the subject of a criminal indictment).
professionals are used to directing clients, not having clients direct them. Moreover, practitioners are used to scrutinizing clients’ actions, not having clients scrutinize their actions.

There is one further speculative dimension to consider, namely, the effect that these malpractice suits had on the interpersonal relationships of these tax professionals. How strange it must have been for these tax professionals to have to share with their family, friends, and neighbors the emotional trauma associated with being confronted with a malpractice suit and, no less, to read about themselves on the front page in the popular press and practitioner journals regarding the averred shortcomings in their abilities. As a result of these malpractice claims, tax professionals who had met with financial and professional success their entire careers had to come face-to-face with intense shame and reputational harm in their homes, at the office, and around their communities. Tax practitioners were publicly disgraced for failing to fulfill their professional duties.

Although such public embarrassment contains no positive attributes for those thrust infamously into the public limelight, shame and reputational harm are, in fact, virtues of the tax shelter malpractice litigation because they will lead to tax compliance in the future. Not only will such tactics deter defendant practitioners from similar shenanigans, they will deter other, compliant, practitioners who have seen from the sidelines the effect of such consequences upon their colleagues.

E. Raising the Ethical Bar

A final virtue of the tax shelter malpractice litigation is a renewed interest in and push for the ethical behavior that one should ideally expect from tax practitioners.

By way of background, the guidelines for regulating attorney behavior are authored by the American Bar Association (“ABA”) and are compiled in several sources, including the ABA Model Code, the ABA Model Rules, and the formal opinions promulgated by the ABA Committee on Professional Ethics that interpret the Model Code and

87. These stories of malpractice litigation spanned the media spectrum, from newspapers (e.g., Rick Rothacker, *Ruling Puts Tax-Shelter Lawsuit Nearer Trial*, CHARLOTTE OBSERVER, June 25, 2007, at 8A) to professional journals (e.g., Heather Cole, *IRS Looked into St. Louis’s Lewis Rice & Fingersh Tax Advice*, MO. LAW. WKLY., Aug. 27, 2007).

88. See supra note 13 (giving examples of national media coverage of the tax shelter fallout for tax practitioners).
the Model Rules.89 All such guidelines are administered by state bar disciplinary boards.90

The rules governing tax return positions are found in three ABA ethical opinions.91 When an attorney advises a client with respect to a tax-controversy representation and negotiation and settlement proceedings, the attorney must satisfy a confidence level of "reasonable basis," or a 10 percent to 20 percent likelihood of success on the merits.92 When an attorney advises on tax-reporting positions, a slightly higher level of confidence, a "realistic possibility of success,"93 is required, which allows the lawyer to advise a position as long as she believes in good faith that the advice possesses a 33 percent likelihood of success.94 And, finally, when an attorney provides a tax shelter opinion that she knows or should know will be relied upon by third parties, the lawyer "functions more as an advisor than as an advocate" and must render a "more likely than not" opinion that the transaction in question would succeed if it were challenged by the IRS.95

The American Institute of Certified Public Accountants ("AICPA") is the professional organization that promulgates the ethical responsibilities of accountants. These ethical standards are found in eight so-called "Statements on Standards for Tax Services." Statement on Standards for Tax Services Number 1 specifically provides that members only advocate tax return positions that meet a "realistic possibility" of success standard (which is very similar in nature to the ABA "realistic possibility of success" return position standard).96

89. See generally WOLFMAN ET AL., supra note 10.
90. Id. § 103.2.
91. See Richard A. Shaw, Ethics and the Internal Revenue Service, in PARTNERSHIPS, LLCs, AND LLPs: UNIFORM ACTS, TAXATION, DRAFTING, SECURITIES, AND BANKRUPTCY 1009, 1041–42 (ALI-ABA 2008) (listing three ABA Formal Opinions as significant).
94. See Treas. Reg. § 1.6694-2(b)(1) (2008) (defining realistic possibility of being sustained on its merits (realistic possibility standard) as a position where "a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits").
95. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982). When lawyers represent individual clients, however, Opinion 346 indicates that the lawyer’s relationship with the IRS is adversarial. Id.
96. The professional rules governing accountants’ ethical responsibilities when providing tax services are found in two sources: the AICPA Code of Professional Conduct ("AICPA Code") and the AICPA Statements on Standards for Tax Services ("Statements"). The AICPA Code consists of two parts. The first part is aspirational in nature, asking practicing accountants to exercise integrity, objectivity, and due care. CODE OF PROF’L CONDUCT § 51.2 (Am. Inst. of Certified Pub. Accountants
Aside from the standards set by the ABA and the AICPA, Congress, under guidelines commonly referred to as Circular 230, has authorized the Treasury Department to issue guidelines to keep practitioners (and, by extension, taxpayers) in check. In particular, under Circular 230, practitioners must fulfill various regulatory requirements when issuing an opinion letter pertaining to tax shelters: they must exercise due diligence as to all relevant facts; relate the law to the facts; and, where possible, provide an opinion whether it is more likely than not that a taxpayer will prevail on the merits with respect to each material tax issue.

These standards and guidelines nevertheless fell short in curbing aggressive tax planning. Why? In rendering tax opinions pertaining to tax shelters, practitioners routinely determined that the transactions in question were more likely than not to be sustained.
They reached their conclusions on the theory that every element of the transaction meticulously met the requirements of the Code and the promulgated regulations or was sanctioned under existing case law.101

Furthermore, practitioners’ opinion letters attempted to tackle the application of judicial doctrines (such as the economic substance doctrine) that disallow noneconomic losses, distinguishing them on the basis that the transactions in question were purportedly fused with economic substance.102 The economic substance of most of the failed tax shelters hinged on an infinitesimally small potential economic upside that would richly reward taxpayers if certain conditions were met;103 however, in the thousands of tax shelters that were peddled, not once were such conditions ever met. For courts to have sustained the practitioners’ analysis, the courts would have had to ignore the long line of cases that disallowed noneconomic losses,104 even if there was a scintilla of economic substance. Instead, IRS challenges met with overwhelming success in the courtroom105 and in

letters, issued to purchasers of the strategies, further assured the buyers that the tax strategies would ‘more likely than not’ pass IRS scrutiny.”; Swartz v. KPMG L.L.P., 476 F.3d 756, 762 (9th Cir. 2007) (“While the engagement letter acknowledges the possibility of an audit, it also contains assurances that the plan would more likely than not be upheld over an IRS challenge.”).

101. See, e.g., ACM P’ship v. Comm’r, 157 F.3d 231, 245 (3d Cir. 1998) (detailing taxpayer’s contention “that, because the transactions on their face satisfied each requirement of the contingent installment sale provisions and regulations thereunder, it properly deducted the losses arising from its ‘straightforward application’ of these provisions”).

102. See, e.g., United States v. Stein, 429 F. Supp. 2d 633, 637 (S.D.N.Y. 2006) (contending that the option letter drafted “regarding the economic substance of the BLIPS template transaction was objectively reasonable”).

103. See, e.g., Paul Braverman, Still in the Shadows, AM. L. W., Oct. 1, 2003, available at http://www.law.com/jsp/article.jsp?id=1063212108768 (detailing the internal e-mail sent by the then No. 2 man at KPMG, Jeff Stein, where he argued that a FLIP tax shelter had to be replaced with the OPIS shelter as the FLIPs were a “tax disaster,” i.e., they lacked economic substance “[b]ecause a shelter user had to buy a stock warrant in a Cayman Islands company that ‘was really illusory and stood out more like a sore thumb, since no one in his right mind would pay such an exorbitant price for such a warrant’”).

104. The economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed, exclusive of tax benefits. See, e.g., Coltec Indus., Inc. v. United States, 434 F.3d 1340, 1356 (Fed. Cir. 2006); Black & Decker Corp. v. United States, 436 F.3d 431, 441–42 (4th Cir. 2006); IES Indus. v. United States, 253 F.3d 350, 353 (8th Cir. 2001); Lerman v. Comm’r, 939 F.2d 44, 49 (3d Cir. 1991); Gilman v. Comm’r, 933 F.2d 143, 146 (3d Cir. 1991); Rice’s Toyota World, Inc. v. Comm’r, 752 F.2d 89, 91 (4th Cir. 1985). Many of the most recently formulated tax shelters were deemed to lack economic substance. See, e.g., Stable Creek Investments, LLC v. United States, 82 Fed. Cl. 636 (2008) (transactions lacked economic substance beyond securing a tax advantage).

105. See Crystal Tandon, Senior IRS Officials Tout Tax Shelter Victories, 2006 TAX NOTES TODAY 179-1 (reporting officials’ comments on the IRS’s successful results in Black & Decker, 436 F.3d 431; Coltec Indus., 454 F.3d 1340; TIFD III-E, Inc. v. United
case settlements, and some accounting firms subsequently acknowledged that these shelters were void of economic substance. These results belied the hollowness of practitioners’ declarations that the shelters were more likely than not to be sustained; to the contrary, these shelters were mere shams that, on their merits, had virtually no chance of being sustained.

Practitioners were not the only ones who ignored the standards that they were charged with upholding. State disciplinary boards miserably failed to reprimand rogue practitioners for orchestrating abusive tax shelters. Indeed, with respect to the most recent wave of failed tax shelters, there is not a single reported case in which a state disciplinary board reprimanded or censured practitioners or instituted other forms of punishment pertaining to the promotion of abusive tax shelters and practitioners’ failure to adhere to the governing standards of practice. This abdication of responsibility is

States (Castle Harbors), 459 F.3d 220 (2d Cir. 2006); and Jade Trading, LLC v. United States, 65 Fed. Cl. 487 (2005)).

106. See Sheryl Stratton, Chief Counsel Sees Work on Guidance and Shelters Pay Off, 2003 TAX NOTES TODAY 47-2 (detailing that as a result of the settlement initiatives, the IRS has claimed that 92% of the 488 taxpayers involved in basis-shifting transactions have accepted the settlement terms); Sheryl Stratton, Inside OTSA: A Bird’s-Eye View of Shelter Central at the IRS, 2003 TAX NOTES TODAY 174-2 (touting that all but five to ten of the COLI cases had been settled).


108. See Joe M. Chambers, New Developments in the Fight Against Tax Shelters: Unethical Behavior Under Fire, 30 J. LEGAL PROF. 117, 118–19 (2006) (“Although state bar associations should be enforcing the ethical standards they set for their members, they do not appear to enforce them in the tax shelter context. The governing bodies for CPAs, the American Institute of Certified Public Accountants (A.I.C.P.A.) and individual state licensing boards, appear to have been equally inactive in enforcing their rules prohibiting accountants from engaging in unethical conduct in connection with tax shelters.”). But see In re Conduct of Cobb, 190 P.3d 1217, 1237 (Or. 2008) (reviewing the ruling of state disciplinary board that attorney who participated in tax shelter was culpable for misrepresentation, dishonesty, and conduct prejudicial to the administration of justice and ultimately holding that the bar association had not met its burden of proving the attorney culpable and thus he should be reprimanded).

109. See Chambers, supra note 108, at 118 (revealing that only a few, if any, attorneys have ever faced disciplinary action from their state bar associations for the issuance of fraudulent opinion letters). Only in extremely rare instances will state ethics boards bring disciplinary proceedings against practitioners who promote aggressive tax shelters. See, e.g., In re Hendricks, 761 P.2d 519 (Or. 1988) (supporting state licensing board’s disbarment of attorney who established fraudulent tax shelters for clients).
consistent with a long line of studies and literature revealing that legal professional standards are regularly not enforced.\textsuperscript{110}

Even though practitioners essentially ignored the standards that were designed to govern their practices and professional boards played the role of silent abettors, the tax shelter malpractice litigation did reinvigorate the ethical bar. In at least a few tax shelter malpractice cases, charges were levied against defendant practitioners that they failed to adhere to the standards of practice governing their profession and, as such, committed malpractice.\textsuperscript{111} By leveling these charges, plaintiffs imbued life into the otherwise inert ethical standards. Although case law does not reveal if judges, juries, or arbitrators found that these alleged ethical violations constituted malpractice, the fact that courts did not dismiss these charges signifies the seriousness of these allegations and the likelihood that they played an important role in coloring the final court, arbitration, or settlement decision.\textsuperscript{112}

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The latest wave of tax shelter malpractice cases has discouraged the tax shelter industry. It has leveled the tax-avoidance playing field, aligned the interests of taxpayers and their advisers with those of the government, and punished overaggressive tax advisers with financial penalties and public humiliation. In the process, the recent tax shelter malpractice episode has underscored the importance of more

\textsuperscript{110} Several commissioned reports have questioned the ability of the legal profession to police itself. \textit{E.g.}, ABA Special Comm. on Evaluation of Disciplinary Enforcement, Problems and Recommendations in Disciplinary Enforcement (1970) (the so-called Clark Report, eponymously named for the commission’s chair, retired Supreme Court Justice Tom Clark); ABA CTR. FOR PROF’L RESPONSIBILITY, LAWYER REGULATION FOR A NEW CENTURY: REPORT OF THE COMMISSION ON EVALUATION OF DISCIPLINARY ENFORCEMENT (1992) (the so-called McKay Report, eponymously named for the commission’s chair, NYU law professor Robert McKay). For accountants, the AICPA has published a report on the need to improve enforcement of ethical standards. \textit{See generally} Lisa A. Snyder, \textit{Streamlining Ethics Enforcement}, 196 J. ACCT. 51 (2003) (discussing the AICPA’s Professional Ethics Enforcement Committee’s reports on how the institute could improve its disciplinary process).

\textsuperscript{111} See, \textit{e.g.}, Seippel v. Jenkens & Gilchrist, P.C., 341 F. Supp. 2d 363, 368 (S.D.N.Y. 2004) (contending that “defendants either knew or should have known from the outset that the COBRA tax shelter would not pass muster with the IRS or Virginia tax authorities,” implicitly suggesting that the more-likely-than-not requirement posited under Circular 230 was not met). \textit{See generally} Joseph I. Portuondo, \textit{Abusive Tax Shelters, Legal Malpractice, and Revised Formal Ethics Opinion 346: Does Revised 346 Enable Third Party Investors to Recover from Tax Attorneys Who Violate Its Standards?}, 61 NOTRE DAME L. REV. 220 (1986) (analyzing how the ABA’s issuance of Revised Formal Ethics Opinion 346 impacted the ethical considerations taken by the Committee on Ethics and Professional Responsibility in tax shelter cases).

\textsuperscript{112} \textit{Supra} note 111.
rigorous practice standards and, more importantly, of holding practitioners to heightened standards. The next part of this Article extrapolates these virtues associated with the tax shelter malpractice cases into general lessons designed to foster tax compliance.

II. LESSONS FOR TAX COMPLIANCE

The current tax enforcement regime would benefit from policies emphasizing the virtues previously identified in tax shelter malpractice cases. Five important lessons (premised upon the foregoing virtues) emerge from the tax shelter malpractice experience: (1) to level the playing field, the IRS must have more resources and greater access to information; (2) practitioners and taxpayers need inducements to forge a common alliance with the government; (3) traditional sanctions must be strengthened and enforced; (4) nontraditional sanctions must be tested and, if proven effective, institutionalized; and (5) ethical standards must be enforced.

A. Addressing Resource and Information Disparities

Over the last several years the IRS has experienced relatively static funding, as adjusted for inflation.\footnote{See IRS Oversight Bd., FY2008 IRS Budget Recommendation: Special Report 25 (2007), available at http://www.treas.gov/irsob/reports/fy2008-budget-report.pdf (illustrating the relatively flat funding that the IRS has received in the past few years).} Meanwhile, over this same period of time, its responsibilities have grown tremendously. Not only must the IRS process more tax and information returns, but Congress has also charged the agency with several new tasks, including monitoring of the earned income tax credit (essentially a social welfare program) and has even suggested that the agency be used to institute emergency/disaster relief.\footnote{See generally Meredith M. Stead, Implementing Disaster Relief Through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures, 81 N.Y.U. L. REV. 2158 (2006) (discussing the Katrina Emergency Tax Relief Act of 2005 and the Earned Income Tax Credit (“EITC”), providing arguments for and against the administration of emergency relief and other social welfare programs by the IRS).} The result of this combination of static resources and augmented responsibilities is that the IRS often finds itself overburdened.\footnote{See Mary Mosquera, Boost IRS Funding to Avoid System Collapse, Oversight Board Says, GOV'T COMPUTER NEWS, Mar. 13, 2005, http://www.gcn.com/online/vol1_no1/35274-1.html (“Funding for business systems modernization at the Internal Revenue Service should be significantly higher to cut costs and delivery time and to avoid a catastrophic collapse of archaic legacy systems, the IRS Oversight Board said in a report released today.”).}
Aside from shortcomings in funding, the IRS has become a demoralized agency. In the aftermath of congressional hearings in 1997 and 1998 during which the IRS was skewered for using supposedly offensive and intrusive audit and collection tactics, the agency lost a lot of its former stature. After these hearings, Congress passed the Internal Revenue Service Restructuring and Reform Act of 1998, which added many taxpayer safeguards but also hampered the IRS’s ability to fulfill its oversight mission. As a result, many IRS senior staff left the agency, and those staff members who stayed are often unable or unwilling to vigorously fulfill their responsibilities.

The repercussions of a shoestring budget coupled with a demoralized staff are most vividly captured in the precipitous drop in the number of audits and the feeble attention given to tax collections. While national audit figures have never been robust, they have fallen to historic lows. In addition, in terms of quality, those audits that are being conducted lack the vigor of those


117. See Eric A. Lustig, IRS, Inc.—The IRS Oversight Board—Effective Reform or Just Politics? Some Early Thoughts from a Corporate Law Perspective, 42 DUQ. L. REV. 725, 736 (characterizing the portrayal of the IRS during the hearings as “an unaccountable purveyor of fear”).


119. See Ann Murphy & David Higer, The 10 Deadly Sins: A Law with Unintended Consequences, 2002 TAX NOTES TODAY 151-39 (arguing that the decreases in both the audit rate of individuals and the collection revenue were a result of IRS employees’ fear of prosecution).

120. See Amy Hamilton, Newspapers Link “10 Deadly Sins” to IRS Enforcement Figures Drop, 83 TAX NOTES 1119, 1119 (1999) (“[T]he key issue appears to be fear among the IRS employees that they will break a new law intended to protect taxpayers from overzealous collectors.”).

121. See Murphy & Higer, supra note 119 (citing the statistical declines in the percentage of taxpayers audited and the amount of tax revenue collected as evidence of the IRS’s ineffectiveness).

122. See U.S. GOV’T ACCOUNTABILITY OFFICE, HIGHLIGHTS OF GAO-05-566: INTERNAL REVENUE SERVICE: ASSESSMENT OF THE FISCAL YEAR 2006 BUDGET REQUEST 11 (2005), available at http://www.gao.gov/new.items/d05566.pdf (providing that IRS audit rates declined steeply from 1995 to 1999, but the audit rate has slowly increased since 2000); Albert B. Crenshaw, IRS Putting LIFE on Line in Bid To Improve Corporate Audits, CHI. TRIB., Jan. 6, 2003, at 10 (“Only about a third of very large businesses are audited every year, down from more than half as recently as 1995. Audit rates for businesses with assets of between $10 million and $250 million, . . . plunged to 10 percent to 15 percent in 2001 from 20 percent to 30 percent in the early 1990s.”); Stephen Joyce, Everson Letter Says IRS Will Forfeit Billions, Lack Auditors Unless FY2005 Request Is Met, 189 DAILY TAX REP. (BNA) G-8 (Sept. 30, 2004) (expressing concern that a lack of funding may result in a steep drop in the audit rate).
conducted in the past.\textsuperscript{125} Furthermore, the liens and levies that the IRS institutes to secure collection of unpaid taxes have basically stopped.\textsuperscript{126} As prescribed by Congress, for several years after these hearings, the agency has been more attuned to servicing taxpayers than monitoring compliance.\textsuperscript{127}

Some taxpayers evidently took the congressional attack on the IRS as a cue that tax noncompliance was tacitly being condoned. We know this from the growth of the tax gap, i.e., the difference between what taxpayers should have paid and what they actually paid on a timely basis. As most recently reported, the tax gap for 2001 was $345 billion, an amount equal to 16.3 percent of taxes owed and the largest dollar figure ever recorded.\textsuperscript{128} Abusive tax shelter activity reportedly accounted for a large, albeit undetermined, percentage of the tax gap’s total.\textsuperscript{129}

Not only does the IRS lack the resources necessary to ensure tax compliance, it lacks adequate access to information as well. On many occasions, the IRS’s attempt to access information has been stymied by taxpayers invoking the attorney-client privilege\textsuperscript{130} and the work-product doctrine.\textsuperscript{131} Use of these privileges has engendered an

\textsuperscript{123} See W. Edward Afield, Agency Activism as a New Way of Life: Administrative Modification of the Internal Revenue Code Through Limited Issue Focused Examinations, 7 FLA. TAX REV. 455, 457 (2006) (“In the name of increasing efficiency and better utilizing limited resources, the IRS has begun to adopt audit policies that overly favor taxpayers and greatly hinder the IRS’s ability to perform thorough audits.”).

\textsuperscript{124} See David Cay Johnston, Inquiries Find Little Abuse by Tax Agents, N.Y. TIMES, Aug. 15, 2000, at C1 (“Collection has grown so lax that some prominent tax advisers said in interviews last year that they were amazed that the I.R.S. was not trying to collect taxes owed by their clients.”).


information disparity that has given taxpayers an undue advantage in litigation and in settlement negotiations.\textsuperscript{130}

The attorney-client privilege is found in the federal rules of evidence.\textsuperscript{131} The purpose of this evidentiary rule is “to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice.”\textsuperscript{132} “[I]n order for the attorney-client privilege to attach, the communication in question must be made: (1) in confidence; (2) in connection with the provision of legal services; (3) to an attorney; and (4) in the context of an attorney-client relationship.”\textsuperscript{133} Because the attorney-client privilege curbs the court’s access to valuable information, it is generally construed narrowly.\textsuperscript{134}

A counterpart to the attorney-client privilege is the tax practitioner–client privilege. Enacted in 1998,\textsuperscript{135} this privilege protects communications made to a federally authorized tax practitioner (such as a certified public accountant (CPA) or an enrolled agent)\textsuperscript{136} pertaining to tax advice.\textsuperscript{137} This privilege, however, departs from the general attorney-client privilege insofar as communications pertaining to “tax shelters” (as defined in Code § 6662(d)(2)(C)(iii)) are not afforded any evidentiary protections.\textsuperscript{138}

Historically, the attorney-client privilege has fulfilled its purpose in allowing taxpayers to secure tax advice from their attorneys without fear that the IRS could later use these communications to assert a tax

\textsuperscript{130} See discussion infra (discussing the effects that follow from the use of these privileges).

\textsuperscript{131} Fed. R. Evid. 501; Fed. R. Civ. P. 26(b)(1). Both I.R.C. § 7453 (2000) and Tax Court Rule 143(a) require that federal evidentiary rules be employed by the Tax Court.


\textsuperscript{133} Evergreen Trading, LLC v. United States, 80 Fed. Cl. 122, 128 (2007) (internal citations omitted).

\textsuperscript{134} See United States v. Adlman, 68 F.3d 1495, 1500 (2d Cir. 1995) (disallowing an attorney-client privilege claim where inside counsel requested a tax analysis be prepared by the company’s accountant regarding an upcoming company reorganization).


\textsuperscript{136} See I.R.C. § 7525(a)(3)(A) (West 2008) (“The term ‘federally authorized tax practitioner’ means any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under section 330 of title 31, United States Code.”).

\textsuperscript{137} I.R.C. § 7525(a)(1).

\textsuperscript{138} I.R.C. § 7525(b) (Supp. 2005) (“The privilege under subsection (a) shall not apply to any written communication which is—(2) in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in section 6662(d)(2)(C)(ii)).”)}
However, this privilege does have limits. In particular, the scope of this privilege does not extend to tax return preparation, including opinion letters pertaining to tax return preparation. Furthermore, with rare exception, neither taxpayers nor their advisers can assert this privilege to protect the identities of those taxpayers who invest in tax shelters. Finally, this privilege does not apply to “communications made for the purpose of getting advice for the commission of a fraud or crime.”

Despite the foregoing attorney-client privilege limitations, this privilege remains a major impediment to the IRS in its ability to secure relevant documentation relating to abusive tax shelters. Consider the recent half-decade-long battle that the IRS has endured to obtain relevant documentation from the accounting firm BDO Seidman. This documentation was prepared by legal counsel to BDO Seidman and contained internal memoranda and notes relating to the legality of certain tax shelter products. BDO Seidman was largely successful in thwarting the IRS’s efforts to gain access to this valuable documentation. The documentation was deemed shielded by the attorney-client privilege because “the memoranda in question were prepared in order to provide legal advice to BDO, in most cases, if not every case, in direct response to a BDO inquiry for such legal advice and based on confidential facts provided by BDO to its outside

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139. See Peter A. Lowy & Juan F. Vasquez, Jr., Attorney-Client Privilege: When Does Tax Advice Qualify as “Legal Advice”? 2002 Tax Notes Today 237-50 (explaining that the privilege has proven especially important in complicated tax matters where an attorney must have a command of both facts and finances).

140. See, e.g., United States v. Lawless, 709 F.2d 485, 487 (7th Cir. 1985) (declaring outright that “[i]f the client transmitted the information so that it might be used on the tax return, such a transmission destroys any expectation of confidentiality which might have otherwise existed”).


142. See United States v. Liebman, 742 F.2d 807, 808 (3d Cir. 1984) (holding that the identities of all clients, who over a multi-year period paid legal fees in connection with a tax shelter, were protected by the attorney-client privilege against an IRS summons).


146. See United States v. BDO Seidman, LLP, 492 F.3d 806, 809–14 (7th Cir. 2007) (detailing in painstaking fashion the myriad litigation between the IRS and BDO in the five years leading up to the 2007 decision).
The outcome of United States v. BDO Seidman is not an outlier; several other courts adjudicating abusive tax shelters have upheld defense counsel’s use of the attorney-client privilege.\textsuperscript{147} The work-product doctrine is a sibling of the attorney-client privilege. With its genesis in a U.S. Supreme Court decision,\textsuperscript{148} this doctrine grants the work product of an attorney qualified immunity from discovery. In other words, it shields the written statements, private memoranda, and personal recollections of an attorney (or other representative of a party) involved in litigation.\textsuperscript{149} The scope of the work-product doctrine is unclear. A majority of courts have construed the doctrine broadly, applying it to any legal work done because of the prospect of litigation.\textsuperscript{150} A minority of courts have construed the doctrine much more narrowly, limiting its application to work whose primary purpose was in anticipation of litigation.\textsuperscript{151}

What the tax shelter malpractice experience informs us is that tax compliance is more likely if the IRS is put on a resource and information par with taxpayers. In their quest for retribution, aggrieved taxpayers who invested in failed tax shelters were able to bring equivalent resources to the table in the form of skilled and seasoned litigators who could tap the nation’s foremost tax, accounting, and economic experts.\textsuperscript{152} In addition, these same taxpayers were able to supply their legal counsel with all of the legal memoranda and notes in their possession, so there was little or no information disparity. The combination of resource and information

\begin{itemize}
\item \textsuperscript{147} United States v. BDO Seidman, No. 02 C 4822, 2004 WL 1470034, at *2 (N.D. Ill. June 29, 2004).
\item \textsuperscript{148} See, e.g., TIFD III-E Inc. v. United States, 223 F.R.D. 47, 49 (D. Conn. 2004) (holding that the attorney-client privilege is not waived by a party even if that party places at issue the advice of counsel); Boca Investerings P’ship v. United States, No. 97-602, 1998 WL 426564, at *3–4 (D.D.C. June 9, 1998) (deciding that disclosure of the process leading up to the transaction at issue would necessarily disclose a client’s decisions to secure favorable tax treatment and therefore is protected by the attorney-client privilege).
\item \textsuperscript{149} Hickman v. Taylor, 329 U.S. 495 (1947). The work-product doctrine is now codified in Fed. R. Civ. P. 26(b)(3).
\item \textsuperscript{150} Hickman, 329 U.S. at 510.
\item \textsuperscript{151} See United States v. Adlman, 134 F.3d 1194, 1202 (2d Cir. 1998) (declaring that the “because of” formulation accords with the plain language of Rule 26(b)(3) and the purposes underlying the work-product doctrine’); Evergreen Trading, LLC v. United States, 80 Fed.Cl. 122, 131–33 (2007) (adopting explicitly the “because of” test instead of the "primary purpose" test).
\item \textsuperscript{152} See United States v. El Paso Co., 682 F.2d 530, 542 (5th Cir. 1982) (reaffirming that the work-product doctrine protects only those materials prepared in anticipation of litigation rather than those materials prepared in the ordinary course of business).
\item \textsuperscript{153} See discussion supra Part I.
\end{itemize}
parity proved lethal for peddlers of abusive tax shelters as, one by one, they were generally held accountable for their dereliction.

The tax shelter malpractice experience thus imparts a clear message: Congress must accord the IRS more funds and better access to information. The funding part of the equation is a relatively easy fix; it merely requires the realization that the voluntary self-assessment system we have is only as good as the monitoring systems we have in place to oversee compliance. More funding will undoubtedly result in greater oversight and, in cases of litigation, put the IRS on equal footing with defendant taxpayers in terms of financial resources.

Harder to address is the information disparity that currently exists between taxpayers and the government due, in large part, to the attorney-client privilege and work-product doctrine. Both the privilege and the doctrine stand at odds with IRS authorization to issue administrative summons for the production of “any books, papers, records, or other data which may be relevant or material” in “ascertaining the correctness of any return, . . . determining the liability of any person for any internal revenue tax[,] . . . or collecting any such liability.” As interpreted by the Supreme Court, this is a “broad summons authority” reflecting a “congressional policy choice in favor of disclosure of all information relevant to a legitimate IRS inquiry.”

Given this policy in favor of disclosure, the detrimental role abusive tax shelters play in widening the tax gap, and the recognition that communications pertaining to tax shelters—at least insofar as non-attorney advisers are concerned—are not worthy of protection, Congress should take the following courses of action specifically related to abusive tax shelter activity: (1) eliminate the attorney-client privilege and (2) restrict application of the work-product doctrine to those instances in which the legal work is performed with

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respect to actual litigation, as opposed to legal work that is merely anticipatory in nature. \textsuperscript{158}

There are commentators who, of course, argue that the attorney-client privilege and attorney work-product doctrine must remain a vibrant part of tax practice. \textsuperscript{159} But other commentators offer more compelling arguments for the elimination or curtailment of the

\textsuperscript{158} See Bruce Kayle, \textit{The Tax Advisor’s Privilege in Transactional Matters: A Synopsis and a Suggestion}, 54 TAX LAW. 509, 550–53 (2001) (considering whether the attorney-client privilege and the work-product privilege merit different consideration in the tax realm and concluding that one possibility would include the application of the attorney-client privilege only in criminal tax matters and the application of the work-product privilege only in actual anticipation of litigation and not when the attorney is planning or executing a transaction); see also Lee A. Sheppard, \textit{News Analysis: Confidentiality and Customer Relations}, 2005 TAX NOTES TODAY 106-3 (arguing, in the realm of tax shelter cases, that the attorney-client privilege likely provides no protection and that use of the work-product doctrine must still be founded on preparation in anticipation of litigation). In a recent piece, Professor Linda Beale argues for the elimination or curtailment of evidentiary privileges as they relate to abusive tax shelters (and, more generally, to all tax advice). Linda M. Beale, \textit{Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges}, 25 VA. TAX REV. 583 (2006). In this piece, Professor Beale first describes how the nature of our tax self-assessment system is distinguishable from other legal contexts that are properly accorded attorney-client privileges. \textit{Id.} at 646. As she posits, unlike other legal regimes, tax is a set of rules that characterize the results of taxpayer transactions for purposes of determining appropriate assessment. It is not a set of prohibitory rules that are intended to ensure that a person’s transactions stay on the legal side of a fixed line between legal and illegal conduct. \textit{Id.}

Second, she points out the common characteristics that tax return preparation and general tax advice share. Given these similarities, Professor Beale argues that there is no reason why the latter activity is afforded attorney-client privilege when the former activity is not. \textit{Id.} at 651–54. Third, she points out that recent changes in the law require disclosure pertaining to so-called reportable transactions (Treas. Reg. \textsection 1.6011-4 (2008)). In her opinion, these disclosure requirements signify a congressional recognition that, insofar as tax-oriented legal work is concerned, the attorney-client privilege should be very narrowly construed. Beale, \textit{supra}, at 654–56. Fourth, Professor Beale points out the ridiculousness of having inconsistent rules whereby the practitioner-client privilege does not apply in the case of a tax shelter (I.R.C. \textsection 7525(b) (Supp. 2005), yet it remains fully intact in the case of attorney communications. Beale, \textit{supra}, at 656–59. Fifth, Professor Beale explains why preservation of the attorney-client privilege is counterproductive as it connotes an adversarial setting, which is not what the vast majority of tax return submissions entail (unless, as she points out, taxpayers assert a very aggressive tax position that they anticipate the IRS will challenge as being abusive). \textit{Id.} at 659–63. Finally, Professor Beale argues that the purview of the work-product doctrine should be much narrower and not include pre-return advice because broader application of this doctrine “would almost invariably shield from discovery most or all materials that could shed light on the actual nature and purpose of tax-motivated transactions.” \textit{Id.} at 666. Keeping this information from disclosure does nothing to further one of the doctrine’s purposes, namely, “to prevent a litigant from taking a free ride on the research and thinking of his opponent’s lawyer.” \textit{United States v. Frederick}, 182 F.3d 496, 500 (7th Cir. 1999).

attorney-client privilege and the attorney work-product doctrine, particularly when viewed through the prism of the post–1986 Tax Act tax shelter wave that has undermined our tax system’s integrity.\footnote{160}{See discussion supra note 158.}

If the tax shelter malpractice experience teaches us anything, it is that Congress must level the resource and information disparities that put the IRS at a tremendous disadvantage relative to taxpayers. If operating on a level playing field, the IRS will enjoy greater litigation success and aggressive taxpayers will learn that their derelictions will not be met with impunity.

\subsection*{B. Inducing Taxpayers and Tax Practitioners to Choose Compliance over Avoidance}

As was evident in the sphere of tax shelter malpractice litigation, if the right set of inducements is in place, taxpayers and tax practitioners will align their interests with those of the government, and greater tax compliance will result. The opportunity to be made financially whole drove taxpayers to commence litigation against rogue practitioners, resulting in economic hardship for the practitioners and, in some instances, job loss.\footnote{161}{See, e.g., discussion supra note 6.} By the same token, the threat of malpractice litigation led many tax practitioners to advise conservatively and to stay within permissible ethical boundaries.\footnote{162}{See discussion supra notes 6–7 and accompanying text.} The tax shelter malpractice experience suggests that taxpayers’ and tax practitioners’ interests can be aligned with those of the government. The question is how to put this lesson into practice.

\textit{Taxpayers}. One way for taxpayers to forge an alliance with the government would be for Congress to better publicize its newly fashioned whistle-blower program. By way of background, for decades there has been a system in place through which taxpayers who offered information pertaining to other taxpayers’ noncompliance received a cash reward.\footnote{163}{See Treas. Reg. § 301.7623-1 (1967) (detailing the cash reward system before amendment).} The maximum reward was 15 percent of the tax dollars ultimately collected, capped at $2 million.\footnote{164}{Treas. Reg. § 301.7623-1(c) (as amended in 1998).} This reward system, however, suffered from many systematic flaws. Reward amounts were low, arbitrarily awarded, and
took years to recover. In 2006, Congress decided to overhaul the Code’s whistle-blower program and to centralize its management.

Since congressional passage of the 2006 whistle-blower reforms, the reward program has been reinvigorated. The new legislation, for example, provides a minimum reward of 15 percent and a maximum reward of 30 percent of the tax collected, with no caps limiting reward amounts. In addition, the new legislation eliminates the discretionary nature of the prior law, mandating instead that the IRS make a reward payment in all cases in which it pursues a remedy against a delinquent taxpayer based on information provided by the whistle-blower.

These enhanced monetary benefits have begun to bolster tax compliance. For example, recently there have been several important matters in which taxpayers have made claims under the revised laws that might not have been made absent these reforms. The initial successes of the revitalized whistle-blower program signify that Congress and the IRS should more aggressively promote the program to attract even more taxpayers to align their interests with those of the government.

Aside from the whistle-blower program, there are other possibilities allowing taxpayers and the IRS to build symbiotic bridges. When possible, for example, the IRS should encourage taxpayer and tax practitioner participation in the regulatory rule-making process. By encouraging such involvement (via incorporating practitioners’ comments and suggestions), final regulations stand a much better

169. I.R.C. § 7623(b).
170. See Jeremiah Coder, Law Firm Submits New Record Whistle-Blower Claim, 2008 Tax Notes Today 116-1 (relaying a law firm press release announcing the fact that the law firm would be submitting a $4.4 billion tax whistle-blower claim against a Fortune 500 company in the aftermath of congressional changes to whistle-blower laws); Tom Herman, Whistleblower Law Scores Early Success, Higher Rewards Attract Informants Submitting Tips, Wall St. J., May 16, 2007, at D3 (noting that in response to congressional changes to whistle-blower legislation, the IRS had received approximately twenty reward claims by May 2007).
171. For an extensive and exhaustive discussion of the virtues of the whistle-blower program, see Dennis J. Ventry, Jr., Whistleblowers and Qui Tam for Tax, 61 Tax Law. (forthcoming 2008).
chance of public acceptance and administrability. Furthermore, Congress should consider fast-tracking the National Taxpayer Advocate’s legislative proposals. Many of these proposals are designed to lighten taxpayers’ administrative burdens and to simplify compliance, key components in extracting taxpayer cooperation and aligning taxpayer and government interests.

Tax Practitioners. In light of our adversarial judicial system, enlisting the support of tax practitioners is inevitably difficult because most practitioners perceive their foremost duty as one to their clients rather than to the government. In a thoughtful piece about enlisting the tax bar to help instill greater taxpayer compliance, Professor David Schizer describes the difficulty of this situation and acknowledges that detaching tax practitioners from their clients is “something that is very hard to do.”

The malpractice experience teaches us, however, that many tax practitioners will toe the compliance line, if for no other reason, out of fear of subsequently being sued for malpractice. Playing on this fear is worthy of exploration because pure self-interest can cause tax practitioners to rethink their blind allegiance to their clients and realign their interests with those of the government. In particular, Congress and legal and accounting professional associations should strengthen ethical rules and bolster the enforcement of these rules. Furthermore, more tax shelter return disclosure, which greatly

172. See David Cay Johnston, I.R.S. Letting Tax Lawyers Write Rules, N.Y. TIMES, Mar. 9, 2007, at C1 (describing a pilot program in which tax attorneys are involved in the rule-making drafting process in order to take advantage of their tax expertise); I.R.S. Notice 2007-17, 2007-1 C.B. 748 (describing a pilot program in which, based upon written submissions from the public, the IRS and Treasury determine whether guidance is appropriate regarding a finite area of tax law and, if so, use that increased public participation to develop guidance, which would provide significant benefits to taxpayers, such as hastened publication of more guidance projects).


175. See Camilla E. Watson, Tax Lawyers, Ethical Obligations, and the Duty to the System, 47 U. KAN. L. REV. 847, 851 (1999) (calling into question any special duty that tax lawyers might have to the tax system). But see Randolph E. Paul, The Responsibilities of the Tax Advisor, 63 HARV. L. REV. 377, 388 (1950) (arguing that tax lawyers should embrace both a duty to clients and a duty to the tax system).


177. Id. at 367.

178. See supra note 59 and accompanying text.

179. See discussion infra Part III.
enhances the chances of detection, is essential to making practitioners leery of being too aggressive on behalf of their clients. Finally, raising and enforcing ethical standards are powerful mechanisms that could drive a wedge between tax practitioners and aggressive tax advice, causing tax practitioners to align their interests more closely with those of the government.

C. Enhancing Traditional Sanctions

What the tax shelter malpractice experience has demonstrated is that many taxpayers and tax practitioners appear willing to subscribe to aggressive tax positions if the economic benefits outweigh the risks and associated costs. Time and time again, taxpayers were told by legal and accounting counsel that the tax shelters were “bullet-proof” against IRS attack and that even if challenged, proffered tax opinions offered insulation against penalties. With little or no perceived economic risk, many taxpayers jumped on the tax shelter bandwagon. Tax practitioners, too, thought that their economic risk was low because the penalty structure applicable to practitioners who promoted abusive tax shelters was virtually nonexistent. The absence of penalties combined with the economic benefit of handsome fees led numerous practitioners and their firms to actively promote abusive tax shelters.

180. See infra text accompanying notes 195–197.
181. Cf. Robert E. Scott, The Limits of Behavioral Theories of Law and Social Norms, 86 VA. L. REV. 1603, 1613 n.22 (2000) (“Rational choice theory is premised on the assumption that individuals rationally choose among available opportunities to achieve maximum satisfaction according to their individual preferences.”). But see Jane B. Baron & Jeffrey L. Dunoff, Against Market Rationality: Moral Critiques of Economic Analysis in Legal Theory, 17 CARDOZO L. REV. 431, 432 (1996) (remarking that “we also have a range of preferences (and attributes and qualities) that markets cannot satisfy—preferences that are not self-interested, but other-regarding; preferences about our own preferences, as well as the public good”).
182. See Jacoboni v. KPMG LLP, 314 F. Supp. 2d 1172, 1174 (M.D. Fla. 2004) (noting that plaintiff alleged that “KPMG represented that [the tax shelter] was ‘bullet proof’”).
183. See MINORITY STAFF OF PERM. SUBCOMM. ON INVESTIGATIONS, U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS AND FINANCIAL PROFESSIONALS, FOUR KPMG CASE STUDIES: FLIP, OPIS, BLIPS AND SC2, S. REP. NO. 108-34, 9 (2003) (reporting that KPMG tax professionals “were instructed to tell potential buyers that opinion letters provided by KPMG and Sidley Austin Brown & Wood would protect the buyer from certain IRS penalties, if the IRS were later to invalidate the tax product”).
184. See discussion supra note 1.
185. See generally infra notes 199–203 and accompanying text.
186. See infra Appendix (illustrating that four out the six major national accounting firms were named defendants in tax shelter malpractice litigation).
In the aftermath of settlements\(^\text{187}\) and cases\(^\text{188}\) in which the IRS scored resounding victories, taxpayers learned that there were indeed economic risks associated with tax shelter participation. Likewise, in the aftermath of the recent malpractice cases,\(^\text{189}\) tax practitioners experienced first-hand the economic risks associated with tax shelter promotion.\(^\text{190}\) These economic hardships cast a dark shadow over aggressive tax planning.

In the American Jobs Creation Act of 2004 ("JOBS Act"),\(^\text{191}\) Congress took further action by instituting a whole new series of disclosure requirements and tougher penalties designed to curb aggressive tax shelters, heightening the chances of detection and simultaneously making the costs of tax shelter involvement immeasurably greater than its averred benefits.\(^\text{192}\)

For taxpayers, heightened detection starts with their participation in any so-called reportable transaction.\(^\text{193}\) Under prior law, there was no specific penalty imposed upon taxpayers who failed to disclose a reportable transaction; under the JOBS Act, the penalty for failing to disclose a reportable transaction is $50,000 for corporate taxpayers ($200,000 with respect to a listed transaction) and $10,000 in the case of individuals ($100,000 with respect to a listed transaction).\(^\text{194}\)

For tax practitioners, there is also heightened detection related to all reportable transactions. Under prior law, the penalty for failing to maintain an investor list was a measly $50 for each name required to have been on the list, subject to a maximum penalty of $100,000 per year.\(^\text{195}\) Now, any material adviser required to maintain an investor list bears a $10,000-per-day penalty for every day beyond a twenty-day window period that is triggered by an initial IRS request to see the list.\(^\text{196}\) The JOBS Act also introduced a new penalty for a material

\(^{187}\) See supra note 106.

\(^{188}\) See, e.g., Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008); Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1356 (Fed. Cir. 2006); Black & Decker Corp. v. United States, 436 F.3d 431, 441–42 (4th Cir. 2006); Jade Trading, LLC v. United States, 80 Fed. Cl. 11 (2007).

\(^{189}\) See infra Appendix (providing a list of recent malpractice cases).

\(^{190}\) See discussion supra Part I.


\(^{192}\) See, e.g., STAFF OF J. COMM. ON TAXATION, 109TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 361 (J. Comm. Print 2005), available at http://www.house.gov/jct/s-3-05.pdf ("[T]he Congress believed that legislation was needed to provide the Treasury Department with additional tools to assist its efforts to curtail abusive transactions.").


\(^{194}\) I.R.C. § 6707A (Supp. IV 2004).


adviser who fails to file an information return (or who files an incomplete information return). In this case, the penalty is equal to $50,000 with respect to a reportable transaction that is not a listed transaction; however, for a listed transaction, the penalty is the greater of (1) $200,000 or (2) 50 percent of the adviser’s gross income attributable to the aid, assistance, or advice provided with respect to the transaction (75 percent in the case of intentional disregard).\footnote{197}

Aside from elevating the punishments pertaining to detection, Congress also recognized the importance of punishing those tax practitioners who promote abusive tax shelters and those taxpayers who invest in abusive tax shelters.\footnote{198} In the JOBS Act, Congress strengthened several existing penalties and introduced several new penalties. For instance, tax practitioners who now promote abusive tax shelters based on information that they know or have reason to know is false or fraudulent as to any material matter must bear a penalty equal to 50 percent of the gross income derived from the activity for which the penalty is imposed.\footnote{199} Moreover, Congress instituted a penalty regime under new Code § 6662A applicable to all reportable transactions. Under Code § 6662A, a 30 percent penalty (rather than the normal 20 percent accuracy-related penalty applicable to nonreportable transactions) applies to any understatement attributable to a reportable transaction that a taxpayer fails to adequately disclose.\footnote{200} There are no exceptions to this penalty.\footnote{201} If adequate disclosure is made, a 20 percent accuracy-related penalty is imposed instead;\footnote{202} in limited circumstances, this latter penalty may be waived.\footnote{203}

These strengthened detection and penalty regimes are designed to change the cost-benefit analysis that tax practitioners and taxpayers undertake when promoting or contemplating investment in abusive tax shelters. Before these changes, the expected costs of abusive tax shelter involvement were low and the expected benefits were high; now, the reverse is true. Congress should continue to adhere to this strategy. In practical terms, when necessary, Congress should

\footnote{197} I.R.C. § 6707(a)–(b) (Supp IV 2004).
\footnote{199} Id. § 6700(a)(2)(B).
\footnote{200} I.R.C. § 6662A(c) (Supp. IV 2004).
\footnote{201} See I.R.S. Notice 2005-12, 2005-1 C.B. 494.
\footnote{202} I.R.C. § 6662A(a) (Supp. IV 2004).
\footnote{203} See I.R.C. § 6664(d)(2)(A) (Supp. IV 2004) (providing waivers to the penalty if the following conditions are met: (1) taxpayer makes adequate disclosure, (2) there is substantial authority for such treatment, and (3) the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment).
institute additional detection mechanisms and, if need be, introduce even harsher noncompliance penalties. The tax shelter malpractice experience has shown lawmakers that tax practitioners abhor the financial consequences associated with malpractice causes of action, and taxpayers abhor the financial consequences that flow from IRS audits of abusive tax shelters. This mutual abhorrence is what Congress should look to exploit.

D. Enhancing Nontraditional Sanctions

In addition to the financial costs of the tax shelter malpractice litigation, tax practitioners had to bear other “costs” in the form of shaming and reputational harm. Many tax practitioners involved in abusive tax shelter promotion were subsequently shunned by their firms and ostracized by the tax and accounting communities. While there is no specific evidence that suggests that the costs associated with nontraditional sanctions actually deter tax avoidance, common sense and logic dictate that they would. Indeed, a rich body of academic literature suggests that nontraditional sanctions involving shame and reputational harm can be powerful tools to induce tax compliance, causing taxpayers to take less aggressive return positions and law and accounting firms to be more cautious in the advice they render. As IRS Chief Counsel Donald Korb once succinctly said, when it comes to abusive tax shelters, “[n]o one wants to be on the front cover of the Wall Street Journal.”

There are several recent examples in which lawmakers have tried nontraditional sanctions to spur tax compliance. Some of these legislative initiatives appear quite successful while the jury is still out


205. See, e.g., Marjorie E. Kornhauser, Doing the Full Monty: Will Publicizing Tax Information Increase Compliance?, 18 CAN. J.L. & JURISPRUDENCE 1, 104–05 (2005) (“Publicity strengthens penalties because it increases the chance of getting caught (since members of the public, especially tax experts, can study returns) and it increases chances of public shaming for non-compliance.”); Stephen W. Mazza, Taxpayer Privacy and Tax Compliance, 51 U. KAN. L. REV. 1065, 1144 (2003) (“Empirical research and compliance theories also support this position, suggesting that publicity can play a positive role in discouraging noncompliant behavior and increasing the public’s commitment to the tax system.”). But see Joshua D. Blank, What’s Wrong with Shaming Corporate Tax Abuse, N.Y.U. L. REV. (forthcoming 2008) (contending that shaming corporate tax abuse may prove counterproductive).


207. Id.
on others. The use of shaming and reputational harm, for example, has proven particularly effective for state governments that have passed legislation requiring public disclosure of delinquent taxpayers.\footnote{208} The process ordinarily works as follows: if taxpayers owe tax above a certain threshold and their rights to appeal have expired, then their names are published on websites such as New Jersey’s “Largest Judgmented Taxpayer Listings”\footnote{209} and Wisconsin’s “Top 100 Delinquent Taxpayers.”\footnote{210} Most states that have institutionalized these programs have marveled at taxpayer responsiveness, simultaneously collecting millions of dollars of unanticipated revenue.\footnote{211} In the aftermath of this success, many states have sought to broaden the scope and application of their programs,\footnote{212} and several more states are now in the process of adopting similar programs.\footnote{213}

On at least three recent occasions, congressional lawmakers have experimented with the use of nontraditional sanctions to cultivate tax compliance. First, when taxpayers renounce their citizenship for tax-motivated reasons, their names are now posted in the \textit{Federal Register};\footnote{214} furthermore, such taxpayers are prohibited from returning to the United States.\footnote{215} Second, the Department of Homeland Security is prohibited from entering into contracts with domestic companies that change their place of incorporation to a foreign

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\item \footnote{208} See, e.g., Press Release, Div. of Revenue, Dep’t of Finance, State of Del., Online List of Delinquent Delaware Taxpayers Paying Off (Sept. 6, 2007) [hereinafter Delinquent Taxpayers List], \url{available at http://revenue.delaware.gov/services/press/07_release_onlinesuccess.pdf} (“Where prior collection attempts failed, the Delinquent Taxpayers list has motivated some of Delaware’s more elusive tax delinquents to finally come forward and pay up.”).
\item \footnote{209} New Jersey Division of Taxation, Largest Judgmented Taxpayer Listings, \url{http://www.state.nj.us/treasury/taxation/index.html?jdgdiscl.htm~mainFrame} (last visited Oct. 4, 2008).
\item \footnote{210} Wisconsin Department of Revenue, Top 100 Delinquent Taxpayers, \url{http://www.revenue.wi.gov/delqlist/Top100dlnq.html} (last visited Oct. 4, 2008).
\item \footnote{211} See, e.g., Delinquent Taxpayers List, \textit{supra} note 209 (remarking that the Department of Revenue was “extremely pleased [that] the results [of the list] have been so positive early on”). \textit{See generally} Kristen Wyatt, \textit{States Use Shame as Tax Collecting Tool: Web Sites Publish Names of Residents with Delinquent Tax Bills}, \textit{Wash. Post}, May 9, 2004, at A10 (claiming that states had some success in collecting money from delinquent taxpayers with public shaming websites).
\item \footnote{212} See, e.g., Wisconsin Department of Revenue, Wisconsin Delinquent Taxpayers, \url{http://www.revenue.wi.gov/html/delqlist.html} (last visited Oct. 4, 2008) (noting that Wisconsin recently lowered its posting threshold on the Internet from $25,000 to $5,000).
\item \footnote{213} Tom Herman, \textit{Deadbeats Risk Cybershame}, \textit{Wall St. J.}, June 27, 2007, at D2 (“While [shaming tax deadbeats] may strike some people as needlessly cruel, officials in the growing number of states that have launched similar campaigns over the past decade say the technique works.”).
\item \footnote{214} I.R.C. § 6039G(d) (3) (Supp. IV 2004).
\item \footnote{215} 8 U.S.C. § 1182(a)(10)(E) (2006).}


Finally, companies that pay penalties for failing to disclose to the IRS the fact that they entered into listed transactions must report the penalty payment with their annual filings to the Securities and Exchange Commission.

These congressional forays into the use of nontraditional sanctions have not been without their detractors. One commentator, for example, argues that nontraditional sanctions, such as the banishment of taxpayers who expatriate for tax-motivated reasons, can be ineffectual because they are ill-conceived and not well-coordinated with other legislative initiatives. Another commentator has detailed why shaming those individuals and firms involved with abusive corporate tax shelters may prove counterproductive.

Despite these criticisms, lawmakers should not abandon the use of nontraditional sanctions. Instead, lawmakers should address the legitimate concerns of these commentators. In other words, nontraditional sanctions should be properly conceived, well-coordinated, and used only where effective. Beyond the additional costs such sanctions impose upon noncompliant taxpayers, nontraditional sanctions serve two important secondary functions. First, nontraditional sanctions help mold social norms, sending a general signal to the community regarding appropriate behavior and the shared expectations of the community. Recalibrated social norms can be powerful forces that can change noncompliance orientations and attitudes to those of compliance. Second, these nontraditional sanctions have symbolic value, delivering

219. See Blank, supra note 205.
221. See generally Susan Cleary Morse, The How and Why of the New Public Corporation Tax Shelter Compliance Norm, 75 FORDHAM L. REV. 961 (2006) (arguing that the increase of government enforcement and disclosure of deviant transactions had strengthened compliance norms at large corporations).
222. See generally Mark Tushnet & Larry Yackle, Symbolic Statutes and Real Laws: The Pathologies of the Antiterrorism and Effective Death Penalty and the Prison Litigation Reform
reassurance to law-abiding taxpayers and tax practitioners that lawmakers are taking steps to rein in abusive tax practices. In sum, nontraditional sanctions constitute another possible arrow in the quiver of congressional tax compliance measures; it is an arrow that Congress should aim with care, for, if properly targeted, it may help curb tax noncompliance.

E. Enforcing the Ethical Bar

Over the last several decades, state bars, accounting associations, and the Treasury Department have each gradually raised ethical standards governing tax practice. Despite these higher ethical standards, abusive tax shelters flourished in the 1990s and early 2000s. Aside from the fact that prior to passage of the JOBS Act a violation of these ethical standards did not carry with it monetary penalties or censure, the fundamental problem has been one of enforcement. Regarding the lag in federal enforcement, the Director of Practice, the organization charged with enforcement of Circular 230 at the time, was not given adequate resources to do the job. Regarding the lag in state enforcement, state bars and accounting associations did not adequately fund or staff their disciplinary units. Due to these deficiencies in enforcement, rogue practitioners who routinely issued more-likely-than-not opinion letters pertaining to abusive tax shelters were, by and large, not reprimanded.

Ethical standards enforcement involves two tactics. One way to address the absence of enforcement is to devote more resources to

Act, 47 Duke L.J. 1 (1997) (suggesting that a symbolic statute, or statute that is enacted by legislators to make a point, can pose an interpretative problem).
223. See supra Part I.E.
224. See supra note 1.
226. See I.R.S. News Release IR-2003-3 (Jan. 8, 2003), available at http://www.irs.gov/newsroom/article/0,,id=105533,00.html ("With the additional resources, the Office of Professional Responsibility will thoroughly concentrate on enforcing the standards of practice for those who represent taxpayers before the IRS . . . .").
227. See id. (discussing how the Office of Professional Responsibility, which replaced the Director of Practice, would "have more than twice the staff that was available under the previous organization").
228. See supra note 110 (questioning the ability of the legal profession to police itself).
229. See Jeremiah Coder, OPR Makes Changes to Public Disclosure of Sanctions, 2008 Tax Notes Today 103-1 (reporting that the IRS Office of Professional Responsibility would begin publishing sanctions in a new format, including, for the first time, a column listing the specific section of Circular 230 that was violated).
the problem to increase the risk of detection, prosecution, and penalty imposition. Indeed, the IRS is currently utilizing this strategy to ramp up its prosecution of ethical violations; state bar and accounting associations are also trying to follow suit.

The use of malpractice suits is another way to inject life into promulgated ethical standards. Consider that in several recent tax shelter malpractice cases, plaintiff taxpayers based their claims, in part, upon practitioners' purported ethical violations. This fact signifies the importance that plaintiff taxpayers affix to ethical standards (at least as a tactical device in litigation) and suggests the usefulness of ethical standards in helping shape litigation outcomes. Admittedly, the ethical rules themselves do not set a standard for imposing civil liability (i.e., several courts have declared that ethical violations do not give rise to an independent or private cause of action because ethical rules are specially designed to help the general public and not a particular malpractice plaintiff).

230. See id. ("Allocation of greater resources specifically to ethics training and remediation likely would have more of a salutary effect than public embarrassment of the scarlet letter variety.").

231. See infra Appendix (reporting that three federal cases have been brought that included ethical violations related to tax shelters).


233. See infra Appendix (listing the types of claims on tax-shelter malpractice cases after 1986).

234. See Robert Dahlquist, The Code of Professional Responsibility and Civil Damage Actions Against Attorneys, 9 OHIO N.U. L. REV. 1, 2 (1982) ("[N]early all courts that have squarely considered the issue have held that a violation of 'the Code of Professional Responsibility is no basis for a private cause of action.'" (citation omitted)); Charles W. Wolfram, The Code of Professional Responsibility as a Measure of Attorney Liability in Civil Litigation, 30 S.C. L. REV. 281, 282–83 (1979) ("It will be seen that to date the Code has actually not served as a very important source of assistance to courts in private litigation."); see also MODEL RULES OF PROF'L CONDUCT pmbl. & scope (2008) (stating that the rules "are not designed to be a basis for civil liability").

235. See, e.g., Miami Int’l Realty Co. v. Paynter, 841 F.2d 348, 351–52 (10th Cir. 1988) (concluding that a violation of the disciplinary rules did not constitute negligence in a civil action because the code is designed to regulate lawyers and protect their clients).
Nevertheless, many courts take the position that a violation of ethical rules can be used as “rebuttable evidence” or at least “some evidence of negligence” of professional malpractice.

A compelling body of literature also propounds that malpractice litigation, rather than state bar associations, is the appropriate tool to regulate lawyers. Commentators such as Professor Manuel R. Ramos point out that state bar associations have historically done a lousy job at self-regulation and that a much more efficient mechanism to regulate lawyers and keep them in check is professional malpractice litigation. While Ramos’s views pertaining to legal malpractice causes of action are not universally shared, the success of tax shelter malpractice litigation stands as a testament to the validity of his and other commentators’ views. Thus, the next part of this Article suggests how the course of professional malpractice litigation can be improved and further invigorated.

III. FACILITATING PROFESSIONAL MALPRACTICE LITIGATION

The active promotion of abusive tax shelters appears to have ebbed: the threat of litigation brought by former clients, in combination with new statutory penalties for abusive behavior and stricter government oversight of tax practitioners, has chilled the

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237. Martinson Bros. v. Hjellum, 359 N.W.2d 865, 875 (N.D. 1985); see Lipton v. Boesky, 313 N.W.2d 163, 167 (Mich. Ct. App. 1981) (“We hold that, as with statutes, a violation of the Code [of Professional Responsibility] is rebuttable evidence of malpractice.” (citation omitted)).


240. See Ramos, supra note 239, at 2600–08.

 abusive tax shelter marketplace. It is unclear how long this détente will last, however, in the absence of additional enforcement efforts. Thus, the final part of this Article recommends that Congress and state lawmakers appreciate tax shelter malpractice litigation and its role in fostering tax compliance, and institute reforms designed to make malpractice actions an even more effective tool for tax enforcement. Specifically, this analysis advocates that lawmakers (1) address procedural roadblocks that favor defendant practitioners and prevent plaintiff taxpayers from bringing malpractice actions, (2) provide for significantly increased monetary recoveries for plaintiff taxpayers who prevail in future tax shelter malpractice actions, and (3) subject defendant practitioners to significantly greater economic hardship and bad publicity for enabling abusive tax avoidance.

A. Eliminating Procedural Roadblocks to Tax Malpractice Suits

When commencing a tax malpractice suit, taxpayers encounter numerous procedural hurdles. These hurdles include determining the applicable statute of limitations, establishing ripeness, and being forced to arbitrate their claims. To win dismissal or force favorable settlements, malpractice defense attorneys exploit these procedural obstacles.

Background: Due to the statute of limitations, if taxpayers do not bring a timely filed suit, their cases may become time-barred. Determining the appropriate limitations period in a particular case, however, is easier said than done. In fact, courts consider at least four different possibilities for when a statute of limitations period begins to run, including when (1) the malpractice occurs; (2) the malpractice is discovered or, with reasonable diligence, is discoverable; (3) the injury is suffered; and (4) the injury is discovered or, with reasonable diligence, is discoverable. For tax shelter investors, the statute of limitations may, depending upon state


law, commence when the tax adviser renders her advice; when the investor taxpayer submits her tax return containing the claimed tax benefits; when the IRS issues a public declaration invalidating a transaction’s putative tax benefits (e.g., IRS Notice 2000-44, which invalidated the abusive tax shelter commonly known as Son of BOSS\textsuperscript{244}); when the IRS audits the taxpayer’s tax return; when the taxpayer settles with the IRS; or when the taxpayer litigates, loses, and exhausts all appeal opportunities.\textsuperscript{245}

Consider the outcome of a recent case in which a taxpayer invested in an abusive tax shelter known as the Foreign Loan Investment Program (“FLIP”) in 1997.\textsuperscript{246} Opinion letters sanctioning the transaction were issued in 1998. In 2005, the IRS informed the taxpayer that use of this tax shelter was illegal, and his losses were disallowed. The taxpayer immediately thereafter commenced a malpractice suit against the professionals who orchestrated the FLIP. On the basis of New York’s three-year statute of limitations, however, a federal district court dismissed the taxpayer’s lawsuit because the taxpayer’s cause of action was deemed to accrue when the malpractice occurred (i.e., in 1998 when the opinion letters were issued), not at the point of discovery (i.e., in 2005 when the IRS disallowed the losses).\textsuperscript{247}

While taxpayers may commence a cause of action too late, they may also commence the action too early, thereby falling prey to the ripeness doctrine.\textsuperscript{248} In defining the doctrine, the U.S. Supreme Court has said that a controversy “must be definite and concrete, touching the legal relations of parties having adverse legal interests.”\textsuperscript{249} With respect to tax shelter malpractice controversies, definiteness and concreteness typically apply only after the IRS has assessed a taxpayer for back taxes, interest, and penalties.\textsuperscript{250} Without an IRS determination, courts may dismiss tax malpractice claims on

\begin{thebibliography}{1}
\bibitem{244} I.R.S. Notice 2000-44, 2000-2 C.B. 255.
\bibitem{245} For an elaborate and comprehensive look at the issue of when the statute of limitations commences in a malpractice case involving tax issues, see Jacob L. Todres, \textit{Investment in a Bad Tax Shelter: Malpractice Recovery Is No Slam-Dunk}, 2005 \textit{TAX NOTES TODAY} 69-29.
\bibitem{247} \textit{Id.} at 235–36 (noting that the date of accrual is the date on which the malpractice occurs, not when it is discovered or when injuries are suffered).
\bibitem{248} E.g., Hirshfield v. Winer, No. 87 CIV. 8079, 1989 WL 120584, at *2 (S.D.N.Y. Oct. 3, 1989) (“The requirement that a conflict be ‘ripe’ for adjudication is one of the fundamental rules of justiciability which have their origin in the case and controversy requirement.”).
\bibitem{250} See Bowen v. First Family Fin. Serv., Inc., 233 F.3d 1331, 1339–40 (11th Cir. 2000) (holding that standing doctrine requires plaintiff to show actual injury).
\end{thebibliography}
the theory that if the plaintiff taxpayer ultimately prevails in her dispute with the IRS, the damage element in the malpractice case would disappear.\footnote{251}{See Loftin v. KPMG, No. 02-81166-CIV, 2003 WL 22225621, at *7 (S.D. Fla. Sept. 10, 2003) (dismissing the malpractice action because the taxpayer “has not established that he suffered any injury stemming from Defendants’ alleged misconduct” at the time when the plaintiff was in the process of negotiating a settlement with the IRS at the commencement of the malpractice suit); Hirshfield, 1989 WL 120584, at *1–2 (dismissing the case because the future injury of the plaintiff is entirely dependent upon the outcome of the IRS proceeding); Blumberg v. USAA Cas. Ins. Co., 790 So. 2d 1061, 1064 (Fla. 2001) (stating that the plaintiff did not incur damages); Snipes v. Jackson, 316 S.E.2d 657, 661 (N.C. Ct. App. 1984) (holding that the plaintiff did not suffer actual loss until he was assessed by the IRS and not at the time of the alleged negligent act).}

In addition to statute of limitations and ripeness concerns, the plaintiff taxpayer can be derailed by embedded arbitration clauses. Tax shelter investors typically sign a myriad of legal documents associated with their legal representation; these documents, in turn, regularly contain provisions stipulating that any future disputes between the signatories will be resolved through arbitration.\footnote{252}{In Stechler v. Diversified Group, Inc., 382 F. Supp. 2d 580 (S.D.N.Y. 2005), the taxpayers entered into several agreements, including a limited liability agreement. Contained in this agreement was the following arbitration clause: “[A]ny dispute, controversy or claim arising out of or relating to this Agreement shall be settled promptly by arbitration.” \textit{Id.} at 588. In Olson v. Jenkens & Gilchrist, 461 F. Supp. 2d 710, 726 (N.D. Ill. 2006), the taxpayers entered into a retainer agreement with their tax advisers that contained the following arbitration clause: Arbitration. While we look forward to a mutually enjoyable relationship with you, should any dispute arise between us, we mutually agree that such dispute will be subjected to binding arbitration in Oakland County, Michigan pursuant to the rules of the American Arbitration Association and that the arbitrators may award reasonable attorneys’ fees to the prevailing party in such proceedings. Note that ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 02-425 (2002), addresses the ethical propriety of having arbitration clauses in retainer agreements. In order for such clause to be valid, according to the opinion, the following conditions must be met: (1) the client has been fully appraised of the advantages and disadvantages of arbitration and has been given sufficient information to permit her to make an informed decision about whether to agree to the inclusion of the arbitration provision in the retainer agreement, and (2) the arbitration provision does not insulate the lawyer from liability. ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 02-425 (2002). Notwithstanding this opinion, some states prohibit arbitration clauses in engagement letters unless the client has independent legal representation (e.g., PA. RULES OF PROF’L CONDUCT R. 1.8 (2008); 42 PA. CONS. STAT. ANN. § 7304 (2008); OHIO PROF. COND. R. 1.8(b)(1) (2008)).}

\footnote{253}{See, e.g., Denny v. Jenkens & Gilchrist, 340 F. Supp. 2d 348, 353 n.4 (S.D.N.Y. 2004) (tax advice was rendered “pursuant to oral agreements, which of course contain no arbitration clauses”).}
covered by other parties' written agreements that did in fact contain arbitration provisions, the adviser-taxpayer relationship would also be governed by those arbitration clauses.\(^{254}\) Arbitration clauses generously sprinkled throughout governing tax shelter documents in many instances have prevented taxpayers, whose tax shelter benefits had been challenged and invalidated, from haling their former tax advisers into court.\(^{255}\)

**Proposed Reforms.** Changing the rules with respect to statutes of limitations, ripeness, and arbitration agreements will not be easy. Individual states possess legitimate and persuasive reasons for maintaining their own procedural rules. Nevertheless, given the tax compliance benefits associated with tax shelter malpractice litigation,\(^{256}\) this analysis recommends several procedural reforms to enable greater use of malpractice suits as a way to discourage abusive tax avoidance.

First, in tax shelter malpractice actions, the statute of limitations should toll until the IRS proposes an assessment against the taxpayer. This would provide a clear demarcation and date when the taxpayer is on notice that a tax-reporting position is officially being challenged. The recent tax shelter malpractice cases reveal that in many instances tax shelter investors were not aware of their adviser's misconduct until the IRS brought it to their attention.\(^{257}\) Taxpayers certainly cannot discern on their own whether their tax advisers have committed a tort or breached an implied contract, both of which constitute essential ingredients of malpractice claims.\(^{258}\) Similarly, the

\(^{254}\) See, e.g., JLM Indus. Inc. v. Stolt-Nielsen S.A., 387 F.3d 163, 176–77 (2d Cir. 2004) (broad arbitration clause may extend to a collateral issue even where the collateral issue involves no "issues of contract interpretation [or] construction, or application of any provision of the charter," if the collateral issue "touch[es] matters covered by the parties' agreements").

\(^{255}\) See infra Appendix (delineating the fact that a significant number of cases were dismissed); see also Schizer, supra note 176, at 368 (complaining about how the "proliferation of arbitration clauses" erodes the effectiveness of malpractice litigation).

\(^{256}\) See supra Part I.

\(^{257}\) Indeed, many tax advisers took several measures to shroud their misdeeds in secrecy. Consider the actions of KPMG. To hide its tax shelter involvement, it rejected “several internal recommendations by tax professionals to register a tax product as a tax shelter with the IRS”; it recommended using “improper reporting techniques on client tax returns to minimize the return information that could alert the IRS to the existence of its tax products”; and, finally, to hide information, it counseled tax professionals “not to keep certain revealing documentation in their files.” MINORITY STAFF OF PERM. SUBCOMM. ON INVESTIGATIONS, U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS AND FINANCIAL PROFESSIONALS, FOUR KPMG CASE STUDIES: FLIP, OPIS, BLIPS AND SC2, S. REP. NO. 108-34, at 13–14 (2003).

\(^{258}\) See Wolfman et al., supra note 10, § 601.1, at 459 (explaining that under tort principles a lawyer has a duty to exercise skill, care, and diligence similar to other members of the profession; while under contract theory, a tax practitioner, in
taxpayer cannot accurately quantify potential damages associated with the misconduct of its tax advisers—anther essential component of malpractice claims—until after receipt of the proposed IRS assessment.259

Several states toll their statute of limitations until damages are discovered (i.e., typically, when the IRS makes an actual assessment),260 while other states immediately commence the statute of limitations when the malpractice itself is committed (i.e., when the tax professionals render their advice).261 With respect to those states that do not toll the statute of limitations period, plaintiff taxpayers have a difficult time prosecuting their malpractice claims.262 Until lawmakers from these states alter their statutes to allow for tolling, tax shelter advisers will continue to use the statute of limitations as a defense, preventing future malpractice cases from even getting inside the courthouse doors.

The ripeness doctrine requires that a case in controversy not be subject to future contingent events.263 In tax shelter malpractice controversies, it is not entirely clear when a case becomes ripe. Some courts have ruled that a case is ripe once discovery is made (i.e., the IRS commences an audit);264 in contrast, other courts have ruled that

agreeing to represent a client, makes an implied promise of competent and diligent representation).259 See id. § 605.1, at 501 (explaining that in a professional tax malpractice cause of action, proof of damages is an essential element).

260. See, e.g., CAL. CIV. PROC. CODE § 339(1) (West 1995), interpreted by Int’l Engine Parts, Inc. v. Fedderson & Co., 888 P.2d 1279, 1280 (Cal. 1995) (declaring that the statute of limitations commences "at the time the IRS actually assesses the tax deficiency").

261. See, e.g., N.Y. C.P.L.R. 214 (McKinney 2008); Glamm v. Allen, 439 N.E.2d 390, 394 (N.Y. 1982) (“What is important is when the malpractice was committed, not when the client discovered it.”).


264. See, e.g., Seippel v. Jenkens & Gilchrist, P.C., 341 F. Supp. 2d 363, 371 (S.D.N.Y. 2004) (explaining that the case was ripe, even if the taxpayers did not owe additional taxes). The court explained thus:

The Seippels allege that they have been damaged, and continue to be damaged, as a result of defendants’ conduct. Their damages include the fees paid to defendants, losses incurred in the COBRA transactions, expenses paid to accountants and attorneys that are assisting the Seippels in
a case is not ripe until the IRS assesses a tax and the taxpayer exhausts all of her appeal rights. Thus, absent the tolling of the statute of limitations, plaintiff taxpayers face competing risks: on the one hand, if they commence a cause of action when they become aware of adviser misconduct but before the IRS has made an assessment, courts may dismiss their cases under the ripeness doctrine. On the other hand, if taxpayers wait until the IRS assesses a tax, they might meet the requirements of the ripeness doctrine but may fall victim to an expired statute of limitations. The easy solution would be to toll the statute of limitations until the controversy definitively ripens, which, in tax shelter malpractice cases, occurs only after the IRS proposes an assessment.

Finally, plaintiff taxpayers suing their former tax professionals for advising participation in an abusive tax shelter should not be compelled to arbitrate their claims. Arbitration has virtues: it is expedient, relatively inexpensive, and conducted in private. But when it comes to abusive tax shelters, arbitration is not the answer. Tax shelter malpractice cases should be painfully long, exorbitantly expensive, and open to public scrutiny. Injecting these elements into the process would weigh heavily against tax practitioners’ inclinations to participate in abusive tax shelters. As discussed above, however, tax practitioners have been afforded the opportunity to invoke arbitration agreements and thus avoid the discomfort of court proceedings. In addition, the Federal Arbitration Act ("FAA") strongly favors arbitration as a means for resolving disputes. Faced with signed arbitration agreements and the stated objectives of a

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265. See Loftin v. KPMG LLP, No. 02-81166, 2003 WL 22225621, *7 (S.D. Fla. Sept. 10, 2003) (dismissing malpractice action in which the plaintiff was in the process of negotiating a settlement with the IRS at the commencement of the malpractice suit because the taxpayer "ha[d] not established that he suffered any injury stemming from Defendants' alleged misconduct").

266. See supra notes 252–255 and accompanying text.

267. 9 U.S.C. § 1 et seq. (2006). Under the FAA, arbitration may be compelled if a party can show a written agreement to arbitrate, a dispute within the scope of the arbitration agreement, and a refusal to arbitrate by the opposing party. Zurich Am. Ins. Co. v. Watts Indus., Inc. 417 F.3d 682, 687 (7th Cir. 2005).

268. See, e.g., ACE Capital Re Overseas Ltd. v. Cent. United Life Ins. Co., 307 F.3d 24, 29 (2d Cir. 2002) (explaining that there exists "a strong federal policy favoring arbitration" and, therefore, where "the existence of an arbitration agreement is undisputed, doubts as to whether a claim falls within the scope of that agreement should be resolved in favor of arbitrability" (citations omitted)).
federal statute, courts have routinely held in favor of defense motions dismissing malpractice claims and removing the proceedings to arbitration panels.269 In light of the strong public policy against abusive tax shelters,270 however, Congress should amend the FAA to provide that all arbitration clauses pertaining to abusive tax shelters (as defined in Code § 6662(d)(2)(C)(ii))271 be considered null and void unless defendant practitioners can demonstrate that such provisions were specifically bargained for and not simply part of boilerplate provisions contained in the tax shelter investment materials.

The combination of these procedural reforms—tolling the statute of limitations in the tax shelter malpractice context and nullifying the vast majority of arbitration clauses connected with abusive tax shelter representation—will remove current roadblocks to tax shelter malpractice litigation, deterring tax professionals from participating in the tax shelter marketplace and paving the way toward tax compliance.

B. Increasing Taxpayer Recoveries

When taxpayers encounter financial hardship as a result of poor professional advice, they harbor expectations of being made financially whole if they commence a malpractice cause of action. For reasons explained below, however, rarely do tax malpractice suits secure this outcome. Furthermore, the tax professionals who orchestrated the abusive tax shelters are often left financially unscathed in the aftermath of these malpractice suits. This section envisions reforms that would reverse both of these outcomes and thereby make taxpayers (almost) financially whole and tax professionals much more financially vulnerable.

269. See, e.g., Denney v. BDO Seidman, 412 F.3d 58, 68 (2d Cir. 2005) (ruling in favor of the tax advisers’ motion to compel arbitration, holding that “in the absence of any further evidence that the contract is illegal or seriously contrary to public policy, such a factual finding does not suffice to render an entire contract void, and an arbitration agreement unenforceable”); Collins & Aikman Prods. Co. v. Bldg Sys., Inc., 58 F.3d 16, 19 (2d Cir. 1995) (noting that “[f]ederal policy requires [the court] to construe arbitration clauses as broadly as possible” and, accordingly, “will compel arbitration unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute” (citations omitted)).

270. See, e.g., supra note 19 and accompanying text.

271. I.R.C. § 6662(d)(2)(C)(ii) (Supp. 2005) (defining a tax shelter as a “partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance of federal income tax”).
Background. When taxpayers institute tax malpractice cases, they must declare the amount of damages they seek to recover. This amount, which represents all injuries proximately caused by the defendant’s negligent conduct, is ordinarily comprised of several different components: (1) transactional fees associated with the tax shelter investment, (2) interest owed on unpaid taxes related to the tax shelter investment, and (3) penalties imposed under the Code. Recovery of each of these damage components presents taxpayers with several challenges.

The first damage component is comprised of professional fees paid pre-audit to secure the tax shelter investment, and post-audit to correct the work that was performed. On its face, recovery of such damages would appear routine: a tax professional charges a hefty fee to put together a tax shelter in which the taxpayer invests, the IRS disallows losses associated with the shelter, and the taxpayer must spend additional money to remedy the tax professional’s error. Nevertheless, tax professionals do not necessarily have to concede any dereliction on their part and, thus, do not have to return any fees. Instead, tax professionals can defend their actions based upon a series of cases that protect practitioners from what is known as mere errors in judgment.

The second damage component relates to interest that the taxpayer owes resulting from the failure of the tax shelter to work as


276. *See Wolfman et al., supra* note 10, § 605.5, at 489 ("The ‘mere error in judgment’ rule reflects the belief that, because of uncertainties in the facts and law, along with constraints on the practitioner’s time, prediction of the probable outcome of litigation is often difficult, and the standard of care should reflect this difficulty."); *see e.g.*, Martinson Mfg. Co., v. Seerv, 351 N.W.2d 772, 775 (Iowa 1984) (in rendering tax advice, “[i]f an attorney acts in good faith and in an honest belief that his acts and advice are well founded and in the best interest of his client, he is not held liable for a mere error of judgment” (citation omitted)).
planned. Recovery of this damage component, too, is embroiled in controversy where courts embrace points of view that range over a broad spectrum. At one end of the spectrum, some courts hold that interest is not a recoverable component of damages. These courts point out that since taxpayers could earn a return on the uncollected tax dollars in their possession, any interest recovery would constitute a windfall to the taxpayer. On the other end of the spectrum are those courts that permit full interest recovery. These courts hold that interest payments are part of the consequential damages that taxpayers suffered as a result of making their failed tax shelter investments.

A third view has recently emerged that is directly between these polar positions. Courts embracing this middle view allow taxpayers to collect the difference between the interest the government charges and the amount of income the taxpayer was able to actually earn on the funds while held in the taxpayer’s possession.

The third component of damages relates to penalties imposed upon taxpayers who invest in abusive tax shelters. In cases where courts have imposed penalties, taxpayers are likely to bring successful malpractice recovery claims for the penalties paid. In stark contrast, however, are those situations in which taxpayers settle with the IRS, including making a penalty payment, and then sue their tax shelter professionals for recovery. In these instances, tax shelter professionals argue that courts do not always impose penalties on tax shelter investors; thus, had taxpayers continued to litigate rather


278. See, e.g., Leendertsen, 916 P.2d at 451.


280. See, e.g., Talesnick, 33 F. Supp. at 352–53 (ruling that damages were based on interest owed to the IRS).

281. See, e.g., Streber v. Hunter, 221 F.3d 701, 717 (5th Cir. 2000) (taxpayers were awarded the difference “between the interest the sisters actually earned while they possessed the $1.7 million each and the interest charged by the IRS for such possession”).

282. When it comes to abusive tax shelter investments, several penalty provisions may come into play. See supra Part I.C.

283. See, e.g., Klamath Strategic Inv. Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Tex. 2007) (holding that taxpayers’ losses associated with tax shelter investment would be disallowed, but no penalties would be imposed because
than administratively settle the matter, penalties might not have been imposed. Accordingly, in malpractice litigation arising out of prior IRS settlements, tax professionals may use this argument to defeat penalty recoveries.

Proposed Reforms. Where do these observations leave taxpayers who have invested in tax shelters that the IRS has successfully challenged? Possibly in a much weaker negotiating position than they should be, given the tumult they have endured. Below, this analysis posits reforms that, if instituted, would bolster taxpayers’ negotiating and litigating positions and produce more equitable outcomes—the perfect motivation for taxpayers to engage in malpractice litigation.

Before discussing the particulars of these reforms, however, the nature of those taxpayers who invested in tax shelters warrants exploration. Concerning such taxpayers, the best that can be said is that they invested in abusive tax shelters out of benighted trust, complete ignorance, or the naïve belief that their trusted advisers had special incantations that could legitimately make these investors’ tax burdens magically disappear. Accordingly, taxpayers who did not make these or similar investments might rightfully say that these abusive tax shelter investors should shoulder responsibility and bear the financial consequences of their actions.

Even though these taxpayers were duped or purposefully engaged in reprehensible tax-avoidance actions, lawmakers need to recruit them to the side of preserving the integrity of the tax system. Think of the alternative: tax professionals promote abusive tax shelters, these shelters are uncovered, taxpayers are left holding the bag, and the responsible tax professionals walk away with immunity to concoct their next series of abusive tax shelters. From the perspective of the lesser of two evils, certainly it would be much better if lawmakers conscripted irate taxpayers to “punish” wayward tax professionals.

taxpayers purportedly had substantial authority for their position and reasonably believed their shelter was legitimate). See generally Michael Schlesinger, Avoid Tax Shelter Penalties When Transactions Are Under Attack, 73 PRAC. TAX STRATEGIES (RIA) 4 (2004).

284. As an expert witness in several tax malpractice cases, I experienced firsthand during pretrial negotiations how defense attorneys used cases in which penalties were not imposed (e.g., Klamath, 472 F. Supp. 2d 885) to secure favorable settlement terms.


286. See Paul J. Sax, Lawyer Responsibility in Tax Shelter Opinions, 34 TAX LAW. 5, 28 (1980) (speculating that the reason more malpractice suits were not brought against tax practitioners was because “of guilt at having invested in a deception, embarrassment in having been fooled, and the realization that a high-income investor caught in a tax scam holds little appeal to a civil jury”).
However, making taxpayers dollar-for-dollar whole or, alternatively, awarding taxpayers punitive or exemplary damages would create a perverse incentive for taxpayers to make tax shelter investments: if the tax shelter investment went undetected, the taxpayer would save countless tax dollars; conversely, if the tax shelter was detected, the taxpayer could sue and secure a full recovery (and possibly a bonus if punitive or exemplary damages were awarded). Either way, from a financial perspective, the taxpayer would end up either ahead or certainly no worse off. To eliminate this perverse incentive, the suggested reforms detailed below would make the taxpayer close to being financially whole, but not entirely. In particular, taxpayers would still be out-of-pocket all of their legal expenses (i.e., the so-called American rule where each side bears its own legal expenses would remain undisturbed), and, furthermore, taxpayers would not be entitled to recover punitive or exemplary damages. Taxpayers making abusive tax shelter investments (whether motivated by trust, stupidity, or guile) must face sufficient financial risks to dissuade them from making such investments in the first place.

Three suggested reforms will make taxpayers almost whole: eradicating the mere error in judgment presumption, taking the middle course for interest recovery, and allowing easier recovery of penalties. All of these reforms come at the expense of tax professionals and their insurance carriers.

First, the mere error in judgment defense should not shield abusive tax shelter promoters from malpractice. State lawmakers should embed the following rebuttable presumption in their tort laws: any time a tax practitioner promotes or advocates the use of a so-called listed transaction (i.e., those transactions that the Treasury Department has identified as tax-avoidance in nature) to save taxes and this listed transaction subsequently fails to achieve its putative tax-savings goal, the tax practitioner should be held liable for negligence.

Second, consistent with the objective of making taxpayers almost whole, courts should permit taxpayers to recover the difference between (1) the interest charge imposed on their delinquent taxes and (2) the income taxpayers earned on their unpaid tax dollars. As a practical matter, most taxpayers cannot command, on an after-tax

287. See generally W. Page Keeton et al., Prosser and Keeton on Torts § 124, at 897–98 (5th ed. 1984) (providing that absent a statutory provision or contractual agreement, litigants bear their own attorney fees and litigation costs).
288. See supra notes 275–276 and accompanying text.
basis, the interest rate charged under the Code;\textsuperscript{290} thus, disallowing taxpayers any interest recovery will often result in an economic shortfall. Conversely, awarding taxpayers the actual interest charge imposed will result in an economic windfall. The middle course—allowing taxpayers to recover the difference between the interest charge imposed and the actual interest earned (a position some courts now embrace)\textsuperscript{291}—is the most equitable recovery award.

Third, as previously indicated, when it comes to abusive tax shelters, taxpayers who settle with the IRS, pay a penalty, and subsequently sue their tax professionals for malpractice risk not recovering the penalty they have paid.\textsuperscript{292} Due to this economic deterrent of being made whole, taxpayers are apt to litigate rather than settle their differences with the IRS (because if the taxpayer then loses against the IRS and pays a penalty, the taxpayer would be much better positioned to obtain a full recovery in a malpractice cause of action). To reverse this bias against settling with the IRS, state lawmakers should institute the following rebuttable presumption: in tax shelter malpractice actions, taxpayers can recover penalties whether such penalties arose as a result of litigation or settlement. Tax professionals could rebut this presumption only in instances where they could prove that the investment in question did not constitute an abusive tax shelter (as defined under Code § 6662(d)(2)(C)(ii)).\textsuperscript{293}

Institution of these proposed reforms will motivate taxpayers to commence malpractice litigation against aggressive tax professionals who promote abusive tax shelters. For tax professionals, these reforms should prove sufficiently threatening to cause them to render less aggressive tax advice.

C. Increasing Economic Exposure and Shaming Wayward Practitioners

Undoubtedly, tax professionals who arrange abusive tax shelters do not like being sued. As a practical matter, no one likes his professional skills put under a microscope or his personal integrity questioned. However, under a pure cost-benefit analysis, if the

\textsuperscript{290} Under the Code, the interest rate on underpayments, late payments, or nonpayments of tax equals the federal short-term rate plus three percentage points. I.R.C. § 6621(a)(2) (2000). The federal short-term rate is defined in § 6621(b)(3) as the federal short-term rate determined by the Secretary of the Treasury in accordance with § 1274(d). Section 1274(d)(1)(C)(i) directs the Secretary to set the short-term rate based on the market yield of U.S. obligations with less than three years remaining before maturity.

\textsuperscript{291} \textit{See supra} note 281 and accompanying text.

\textsuperscript{292} \textit{See supra} notes 283–284 and accompanying text.

\textsuperscript{293} \textit{Supra} note 271.
financial payoff is sufficiently large, it may more than offset the inconvenience of a malpractice suit. Historically, when the tax practitioner’s legal/accounting malpractice coverage is sufficiently large, the financial downside risk of promoting abusive tax shelters has been nearly nonexistent.294

Therefore, to curb abusive tax shelters, in which billions of dollars of tax revenue are at stake,295 Congress should strip tax professionals and their firms of the financial insulation they have previously experienced. More specifically, Congress should prohibit insurance carriers from covering acts associated with the promotion of abusive tax shelters.296 Were this coverage restriction in place, tax

294. Carrie Johnson, Look Who’s Left Standing: Legal Penalties in Frauds Are Seldom Paid by Legal Advisers, WASH. POST, Aug. 31, 2006, at D-1 (discussing how financial institutions and accounting firms have paid out huge sums in connection with wrongdoings such as those committed by Enron and KPMG, but that the sanctions against law firms in connection with their conduct have been relatively small). Indeed, some commentators even assert that tax professionals’ tax shelter participation enhances their professional reputation. See, e.g., Ann Davis, Trading on Enron Mystique: Veterans Flourish, Capitalizing on Links to Innovative Giant, WALL ST. J., Nov. 16, 2006, at C1. In rare instances, however, tax shelter participation has cost tax professionals their jobs. See, e.g., Blumenstein, supra note 204. Whatever the case, given the lengthy time gap between shelter implementation, IRS discovery, and taxpayers commencing malpractice cases, tax practitioners may feel immune for a decade or more before they bear the repercussions of their derelictions. See generally Tanina Rostain, Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry, 23 YALE J. ON REG. 77 (2006).

295. At the federal level, see, for example, Brostek Hearing, supra note 127 (estimating the tax losses associated with abusive tax shelters to be in the multibillion dollar range); U.S. GEN. ACCOUNTING OFFICE, GAO STUDY 06-171, TAX SHELTERS (2005) (discovering that in the aggregate, during tax years 1998 through 2003, tax shelters cost the United States an estimated $129 billion of lost revenue); Albert B. Grenchaw, IRS Crackdown Nets $3.2 Billion, WASH. POST, Mar. 25, 2005, at E1 (“The Internal Revenue Service has collected more than $3.2 billion in back taxes, interest and penalties from participants in a single abusive tax shelter, including $100 million from one taxpayer and $20 million each from 18 others, the agency said yesterday.”); Martin A. Sullivan, One Tax Shelter at a Time!, 85 TAX NOTES 1226 (1999) (estimating that abusive tax shelters may cost $30 billion annually). At the state level, see, for example, MULTISTATE TAX COMM’N, CORPORATE TAX SHELTERING AND THE IMPACT ON STATE CORPORATE INCOME TAX REVENUE COLLECTIONS (2003), available at http://www.revenue.state.pa.us/tax_reform/lib/tax_reform/MTCtaxshelteringdocument_FINAL.pdf (estimating the annual aggregate state revenue loss from tax shelters to be in the range of $8.32 billion to $12.38 billion for fiscal 2001).

296. See Anthony E. Davis, Professional Liability Insurers as Regulators of Law Practice, 65 FORDHAM L. REV. 209, 211 (1996) (concluding that “[i]nsurers . . . are already in a position formally to regulate their insureds’); see also Kenneth A. Gary, New Opportunity for Tax Lawyers: Insuring Tax Transactions, 104 TAX NOTES 26 (July 5, 2004) (describing how transactional tax insurance is an emerging trend); Kyle D. Logue, Tax Law Uncertainty and the Role of Tax Insurance, 25 VA. TAX REV. 339 (2005). In this paper, Professor Logue questions the merits of Congress permitting “tax indemnity insurance or transactional tax risk insurance that provides coverage against the risk that the Internal Revenue Service (Service) will disallow a taxpayer-insured’s tax treatment of a particular transaction.” Id. at 339. Professor Logue concludes that the “appropriate regulatory response is probably (a) to allow the purchase of policies (and perhaps in some situations to subsidize their purchase) but (b) to compel
professionals and their firms would bear all of the financial consequences associated with their derelictions. And with this financial weight on their shoulders, tax professionals would likely be much more hesitant about promoting abusive tax shelters.

In addition, and unrelated to tax shelter malpractice litigation, Congress should require that the IRS create a website known as the “Tax Professional Wall of Shame.” Any tax professional who is penalized under Code §§ 6700, 6707, or 6708 (i.e., those penalties pertaining to failure to disclose and the promotion of abusive tax shelters) would have her name posted for a period of two years. Several states’ legislatures routinely shame delinquent taxpayers by posting their names on the Internet; thus, there is no reason why Congress should not institute this same shaming technique for delinquent tax practitioners as well. At the state level, this shaming technique has proven quite effective; at the federal level, adoption of a similar shaming technique should likewise prove effective. Succinctly put, no one likes her name besmirched before family, friends, and the community.

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One of the main purposes of the reforms suggested in Part III is to undo the seemingly inseparable bonds between tax professionals and taxpayers who participate in abusive tax shelter arrangements. Were lawmakers to institute the reforms that this analysis advocates, tax professionals would view clients in an entirely new light: general acquaintance for the moment, possible adversary down the road. As such, with respect to the professional advice they render, tax

taxpayers who purchase such policies to disclose this fact to the Service.” Id. at 339–40.


299. See generally supra note 205 and accompanying text. In other areas of the law, the technique of shaming is becoming increasingly commonplace. See, e.g., Jennifer Steinhauer, A Starring Role for Drivers Who Drink, N.Y. TIMES, Dec. 10, 2007, at A16 (describing how one county posts the name and picture on a large billboard of any driver convicted of driving under the influence).

professionals would exercise much greater caution lest their aggressive advice subsequently return to haunt them in the form of a malpractice claim. By planting the seeds of mistrust in the tax professional–taxpayer relationship insofar as abusive tax shelters are concerned, the interests of tax practitioners and taxpayers would converge with the interests of the government.

CONCLUSION

After the passage of the 1986 Act and the institution of other legislative initiatives, many lawmakers and commentators optimistically thought that abusive tax shelters had been dealt a fatal blow.\textsuperscript{301} Passive activity loss limitations, stiffer noncompliance penalties, and higher ethical standards for practitioners would presumably coax (or force) tax practitioners and taxpayers to be compliant. Yet, this overly optimistic attitude quickly gave way to a much grimmer reality: tax practitioners’ ingenuity and taxpayers’ greed resulted in the circumvention of these safeguards, resulting in an onslaught of abusive tax shelters that have cost the nation’s coffers billions of dollars in lost tax revenue.\textsuperscript{302}

From successful IRS interventions, tax shelter malpractice cases have arisen. These cases have cast a bright, revealing light on the inner workings of the seedier side of tax practice. This bright light affords invaluable lessons, pinpointing where lawmakers should direct their compliance reform efforts, particularly given the nation’s limited tax enforcement resources.

One caveat that the tax malpractice cases reveal is that there is no single silver bullet that lawmakers can discharge that will deal a fatal blow to abusive tax shelter arrangements.\textsuperscript{303} To curb abusive tax shelters, lawmakers must instead launch a multi-prong strategy. In considering various alternatives, lawmakers should recognize that tax malpractice cases have had an important chilling effect on abusive tax shelter formation. At least for the time being, anecdotal evidence indicates that most attorneys and accountants are reluctant to promote abusive tax shelters for fear of malpractice exposure. How long this fear will last remains uncertain.

Why have malpractice cases been so effective in chilling tax shelter formation? Tax practitioners know that, if sued, they must battle on a


\textsuperscript{302} See supra note 295.

\textsuperscript{303} Chirelstein & Zelenak, supra note 36.
level playing field (from a resource and information perspective), they will endure financial and emotional distress, they will be shamed and humiliated before the entire community, and they may be deemed to have violated governing ethical standards. Given all of the negatives associated with these lawsuits, practitioners would prefer to avoid them.

Lawmakers must build upon the successes brought about by these malpractice cases. In particular, lawmakers should expand opportunities for taxpayers to bring malpractice cases against professionals involved in abusive tax shelter arrangements. Consider what would happen were the reforms pertaining to malpractice causes of action, and described in this Article, instituted. Tax malpractice cases would be easier to bring, plaintiffs would be more likely to prevail with larger financial awards, and defendant tax professionals (rather than their insurance carriers) would be more susceptible to bearing the costs of their own defalcations. The downside risk of participating in abusive tax shelters would increase by several orders of magnitude. In terms of ensuring the integrity of our tax system, this would be a good thing.
APPENDIX

Post–1986 Tax Reform Act Professional Malpractice Cases Pertaining to Abusive Tax Shelters

<table>
<thead>
<tr>
<th>Case Dynamic/Feature</th>
<th>Federal</th>
<th>State</th>
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<tbody>
<tr>
<td>1. Cases/Motions in Which the Plaintiff Prevailed*</td>
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<tr>
<td>2. Cases/Motions in Which the Defendant Prevailed</td>
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<td>23</td>
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<tr>
<td>3. Cases in Which “High-Profile” Firms Were Named Defendants</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>a. Deutsche Bank</td>
<td>22</td>
<td>2</td>
<td>24</td>
</tr>
<tr>
<td>b. Sidley Austin</td>
<td>13</td>
<td>5</td>
<td>18</td>
</tr>
<tr>
<td>c. KPMG</td>
<td>13</td>
<td>3</td>
<td>16</td>
</tr>
<tr>
<td>d. Jenkens &amp; Gilchrist</td>
<td>8</td>
<td>0</td>
<td>8</td>
</tr>
<tr>
<td>e. BDO Seidman</td>
<td>7</td>
<td>1</td>
<td>8</td>
</tr>
<tr>
<td>f. PricewaterhouseCoopers</td>
<td>3</td>
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<td>3</td>
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<tr>
<td>4. Cases in Which Negligence Allegations Included Ethics Violations</td>
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<tr>
<td>a. Generally</td>
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<td>b. Circular 230</td>
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<td>a. Statute of Limitations</td>
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<td>a. COBRA</td>
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<td>b. OPIS</td>
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<tr>
<td>c. Other</td>
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<tr>
<td>d. DOS</td>
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<td>g. SOS</td>
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<td>h. CARDS</td>
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### 7. Cases/Motions Reported by Year

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* Many cases/motions in which plaintiffs prevailed included class action suits involving hundreds of plaintiffs. These class action suits make these numeric tallies somewhat misleading. *See supra* note 1.