Title
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Tax Shelter Opinions Threatened
The Tax System in the 1970s

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In early 1980 the IRS reported that tax shelter activity was threatening the tax system. The tax shelter industry was bilking the government out of billions of dollars in revenue, overloading the court system, and undermining the voluntary nature of the U.S. federal income tax. IRS Commissioner Jerome Kurtz told the Institute on Federal Taxation at the University of Southern California in January 1980 that abusive tax shelters amounted to a tax administration problem “of major proportions.” Nearly 200,000 individual returns representing 18,000 shelter schemes were clogging the examination and appeals process. Those returns, Kurtz said, involved almost $5 billion “in questionable deductions.” IRS emissaries process. Those returns, Kurtz said, involved almost $5 billion “in questionable deductions.”

Tax lawyers were complicit in the proliferation of tax shelters. Their written tax opinions legitimized questionable schemes, protected investors from fraud penalties, and encouraged taxpayers to participate in transactions that were likely to be disallowed if challenged. “At a minimum,” Mundheim explained, “the tax opinion is viewed as fraud insurance” whereby “the investor is protected against loss” with respect to statutory fraud penalties. Kurtz believed that the penalties themselves needed to be strengthened and that that was a job for

2 Id. By September 1980 Treasury had identified another 7,000 shelter schemes, and the total lost revenue from abusive tax shelters had exceeded $5 billion. See Proposed Amendments, Tax Shelters; Practice Before the Internal Revenue Service, 45 Fed. Reg. 58,594 (Sept. 4, 1980) at supplementary information.

Court docket. “The great abuse we are finding in this area,” Kurtz warned, “could result in a serious decline in taxpayers’ perception of the fairness and evenhandedness of our administration of the tax system and consequently in the level of voluntary compliance.” Mundheim shared similar fears, saying that the “widespread nature” of tax shelters “undermines the public’s confidence in the fairness of the tax system” and ultimately “may affect the level of voluntary compliance.”

In September 1982, 15,105 tax shelter cases were included on a docket of 50,968 cases. New York State Bar Association (NYSBA) Tax Section, “Managing the Tax Court Docket,” 85 TNT 146-93 (July 24, 1985).


Mundheim, supra note 3, at 213. Commentators saw a similar relationship between tax shelter activity and reductions in voluntary compliance writ large. See James B. Lewis, “The Treasury’s Latest Attack on Tax Shelters,” Tax Notes, Oct. 13, 1980, p. 723 (tax shelters produce “impairment to the fairness of the income tax, the perception of unfairness by the rest of the taxpaying public, and the feared adverse impact on the level and temper of voluntary compliance”). But see John André LeDuc, “The Legislative Response of the 97th Congress to Tax Shelters, the Audit Lottery, and Other Forms of Intentional or Reckless Noncompliance,” Tax Notes, Jan. 31, 1983, p. 363 at 366 (questioning the theory that the perceived inequity of tax shelters leads to an across-the-board decline in voluntary compliance rates). Some commentators challenged the very notion of the U.S. federal income tax as a voluntary tax. “There is a myth,” Henry Sellin wrote, “nurtured by a long series of Commissioners of Internal Revenue, that ours is a self-assessing system.” Sellin, “Professional Responsibility of the Tax Practitioner,” 52 Taxes 584 (October 1974). Judge Learned Hand called taxes “enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.” Commissioner v. Newman, 159 F.2d 848, 851 (2d Cir. 1947).

deferred his tax payment at a favorable rate of interest."  

11 If the taxpayer claimed questionable deductions and avoided an audit, "he has won."  

10 In the event of an audit, "he may still have won because he has deferred his tax payment at a favorable rate of interest."  

314,15 explained that while there was a reasonable basis

12 The marketed product was not the transaction itself but the lawyer’s opinion providing the "free ticket to the audit lottery."  

13 Kurtz, supra note 8, at 262.  

14 The taxpayers owed "a particular responsibility to the Treasury" because their legal opinions propped up the tax shelter industry.  

15 The transaction was represented fairly by the promoter. The benefits of the shelter, as long as the facts of the shelter

16 Treasury undertook to remind tax lawyers of their responsibilities, both to their clients and to their government.  

17 Treasury Hints at Its Antishelter Strategy  

Treasury’s strategy for raising the professional bar regarding legal opinions for tax shelter transactions began to emerge in the late 1970s. The Tax Reform Act of 1976  

18 much like securities lawyers in the sale of letter stock," Mundheim analogized, "tax attorneys through their opinions control access to the market place."  

17 By virtue of that power and "the privileged position given the attorney by our system of law and government," the tax lawyer shouldered professional responsibilities that were "not sufficiently appreciated in the tax shelter area."  

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19 Treasury Hints at Its Antishelter Strategy  

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20 significant tightening of the depreciation recapture rules,  

21 revision of the partnership special allocation rules,  

22 limitations on investment interest,  

23 inclusion of the prepaid interest subsection in the rules regarding the tax year of deduction.  

24 and enactment of section 6694, the tax return preparer understatement penalty.  

25 "But no sooner were the apparent leaks in the dike plugged than new ones appeared," Kurtz observed in late 1977.  

26 The shelters that were emerging "indicated the tax lawyer's duty to the government" and "the privilege given the attorney by our system of law and government," the tax lawyer shouldered professional responsibilities that were "not sufficiently appreciated in the tax shelter area."  

27 Treasury undertook to remind tax lawyers of their responsibilities, both to their clients and to their government.  

28 The shelters that were emerging "indicated that some promoters are pushing harder and harder against the edges of the tax law to produce new shelter products and in some cases may be passing the bounds of..."
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on the fact that their number won’t be drawn in the audit process.” Also, Kurtz noted that the reasonable basis standard in Opinion 314 allowed taxpayers to resolve questionable positions in their favor without disclosure. Those practices prevented the IRS from closing “perceived loopholes or perceived improprieties by rulings with any great effect because a taxpayer is free under existing law, by and large, to ignore a ruling on the ground that he believes, or can make an argument, that the ruling does not accurately reflect the law.”

The reasonable basis standard authorized not only nondisclosure of questionable positions, but the assertion of any plausible position. Only a matter of conscience stopped a taxpayer from taking a position with a scintilla of a chance, commented former ABA Tax Section Chair Harry Mansfield during the Tax Section’s discussion of Kurtz’s questionable-position plan. According to Henry Sellin, even among tax lawyers, it was the adviser’s conscience that must govern. Such a reporting standard yielded the lowest common denominator, Kurtz agreed in reply: “The one with the least conscience gets the best result.”

Other commentators also considered the reasonable basis standard a bottom-feeder boon. It allowed a tax lawyer “leeway to fit his actions to his conscience except in those cases where conduct is plainly and irretrievably unlawful,” said law professor George Cooper. The line for which there is a reasonable basis (which can be taken under 314),” tax lawyer James Rowen explained, “and one which is frivolous (which cannot be taken according to ABA Model Rules) is not an easy one to draw.” Too often, former Chief Counsel Seymour Mintz said, the line was dictated by personal taste rather than a matter of ethics. “Too many believe that professional ethics is chiefly a matter of individual conscience and therefore individual choice,” lamented Frederic Cornell. “The difficulty with this ‘situation ethics’ approach,” Cornell wrote before promulgation of Opinion 314 but with equal relevance to the post-Opinion 314 era, “is that it leaves

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27Id.
28James Byrne, “Kurtz Sets Reform Agenda for Internal Revenue Service,” Tax Notes, June 6, 1977, p. 3.
29See Kurtz and panel, “Discussion on ‘Questionable Positions,’” 32 Tax Law. 13, 17 (1978-1979) (arguing that SEC requirements mandating that “every wart and pimple” be reported encouraged clients “to use more competent people because they want to make sure they get everything out because there is a penalty”).
30Id. at 26 (positing that “if there were a notion that everybody was completely open and above board with everybody else that some of the adversary nature of the system . . . might be dissipated”).
31Jerome Kurtz, “Auditing Partnerships,” Tax Notes, May 29, 1978, p. 581. Kurtz and the IRS chose not to republish proposed regulations issued in late 1976 that would have treated many limited partnerships — which the Service recognized as the basic vehicle for syndicated tax shelters — as corporations for tax purposes. The regulations were aimed at ending the typical tax shelter by preventing individual partners from claiming business deductions incurred by the operating syndicate. Byrne, supra note 28, at 4. Treasury Secretary William E. Simon withdrew the regulations as one of his last official actions. See “Simon Withdraws Partnership Regulations,” Tax Notes, Jan. 10, 1977, p. 2.
32Supra note 29.
33Comments of Jerome Kurtz, supra note 29, at 15.
34Id. at 20.
35Id. at 15.
36Id.
38Sellin, supra note 6, at 592.

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the practitioner unprepared for temptation.”44 And, because “tax obscenity, as other kinds, is in the eye of the beholder,” few temptations went unrequited, Cooper wrote.45

Devilish enticements aside, relying on one’s conscience to divine appropriate tax positions and disclosure thresholds was too heavy a burden, both moral and administrative, for the system to bear.46 The prevailing ethical guidelines promulgated by the ABA, Cooper said, “unavoidably grapple with the tension between duty to the client and duty to something higher — the law or one’s conscience. By picking on the client-oriented side of the dilemma you can justify all manner of low conduct.”47 Indeed, there was “no enforceable obligation on the tax bar to serve as a protector of the tax environment.”48 In fact, if the individual tax lawyer wanted to act “more ethically” than Opinion 314, he probably had an obligation under existing rules to reveal his enlightened (that is, less zealous) attitude to his client.49

It was time to raise the ethical bar on tax lawyers. “Congress could change the rule of Opinion 314,” Rowen wrote, by providing that a tax adviser could recommend a reporting position only if the adviser believed the position to be correct or believed there was a reasonable basis for the position and advised the client to fully disclose the issues and facts surrounding the position.50 Congress could also impose a penalty on deficiencies attributable to some items that were not disclosed on the return.51 Others believed the IRS should lead the charge. Mansfield argued that the ABA’s reasonable basis for the position notion ought to be “knocked out completely” and that the IRS should impose a uniform standard requiring disclosure “where the taxpayer does not in good faith believe that he has the better of the argument.”52 Kurtz also believed that Treasury and the IRS should improve the ethical landscape. While discussing Kurtz’s questionable-position proposal at the ABA Tax Section meeting, former section Chair Mac Asbill Jr. warned Kurtz about getting too far ahead of the ethical curve and invoked Prof. Boris Bittker: “When you have to search your own mind and that of every lawyer in the tax shelter industry,53 Treasury asked the organized bar to help

In January 1980 Kurtz announced that Treasury had begun “an exploration . . . into the ethical and legal standards which should govern” participation by tax attorneys in the tax shelter industry.54 Treasury preferred that ethical guidance come from the bar itself, and in fact it had been discussing the issue with the organized bar for several months.55 It expressed hope that the discussion would result in the publication of a formal ABA opinion on tax shelters. Existing Opinion 314 dealt only with the preparation of individual returns and provided confusing signals regarding the participation of lawyers in the promotion of tax shelters. It was not enough for the ABA to issue an opinion, however. The organized bar also had to be willing to discipline those practitioners who failed to meet the new standards of conduct. History offered little reason to be optimistic. Enforcement of ethical rules in tax practice had “not been as vigorous or effective as those of us who believe in self-regulation would like,” Mundheim wrote.56 Treasury needed help in its tax shelter effort, particularly in restraining tax lawyers from issuing questionable tax shelter opinions. Although Treasury wanted the ABA to provide the necessary restraints, should the bar fail to respond, Treasury would be forced to act on its own.

The organized bar responded. The ABA Tax Section’s Committee on Standards of Tax Practice began drafting a suggested ethics opinion on tax shelter opinions.57 State
bar associations responded, too. The Tax Section of the New York State Bar Association established a committee in early 1980 to formulate ethical standards for tax shelter opinions.61

The response was not fast enough for Treasury. In September 1980, only eight months after soliciting the organized bar, Treasury released proposed amendments to Circular 230 setting practice standards for legal opinions used in the promotion of tax shelters and outlining harsh disciplinary rules for practitioners failing to meet the new standards.62 The 1980 amendments to Circular 230 represented Treasury’s first attempt to govern the standards of practice for tax shelter opinions. Treasury had decided, in the words of two observers, that “neither the organized Bar nor the SEC and state securities regulators could be relied upon to curb the issuance of such opinions.”63 Treasury’s preemptive move infuriated the organized bar and its member practitioners. But the inability of professional organizations to rein in the misconduct of its members participating in the tax shelter market indicated that the preemptive strike was justified.

In the next installment of Policy and Practice: “Anything You Can Articulate Without Laughing”: “Reasonable Basis” and Ethical Standards Before the 1980 Proposed Amendments to Circular 230.

63Goldfein and Weiss, supra note 7, at 340. Laurence Goldfein and Stanley Weiss were partners in the law firm of Roberts & Holland, one of the nation’s premier tax boutiques.
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