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.”

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). Kurtz, supra note 1, at 213. That was not the first time Kurtz connected tax shelter activity to tax equity and voluntary compliance. See, e.g., Kurtz, “Remarks to the American Institute of Certified Public Accountants,” 103 Daily Tax Report J-3 (May 26, 1977); “Kurtz Outlines Service Attack on Tax Shelters,” Tax Notes, Nov. 7, 1977, p. 24.

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 Court docket.4 “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.”

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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 taxpayers, 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).

of an audit, "he may still have won because he has deferred his tax payment at a favorable rate of interest." Tax lawyers owed "a particular responsibility to the Treasury" because their legal opinions propped up the tax shelter industry. The marketed product was not the transaction itself but the lawyer's opinion providing the "free ticket to the audit lottery." Treasury characterized four particularly troublesome kinds of opinions. The first was the intentionally false or incompetent opinion, which "knowingly or recklessly" misstated facts or law, or ignored or minimized substantial legal risks to the advertised tax shelter benefits. The second opprobrious opinion was the "don't bother me with the facts" opinion. Those opinions stated hypothetically that the taxpayer would obtain the tax benefits of the shelter, as long as the facts of the shelter transaction were represented fairly by the promoter. The opinion writer took no responsibility for verifying the accuracy of the facts supporting the opinion. Third, the "nonopinion" had the appearance of a legitimate legal opinion because it discussed the law applicable to tax shelters. But it never related the law to specific facts of the transaction. Those opinions were long and rambling, were bereft of analysis of critical facts, and failed to opine on the transaction's ultimate tax consequences. Treasury identified a variant of that opinion, the "hypothetical opinion," which analyzed the consequences of some facts but never offered a conclusion as to the relevance of the hypothetical to the tax shelter at issue. The last problematic opinion was the "reasonable basis but you'll probably lose" opinion. Those opinions, sanctioned by ethical guidelines in American Bar Association Formal Opinion 314, explained that while there was a reasonable basis for the claimed tax benefits under the shelter, the taxpayer would probably lose if the IRS challenged the position. Treasury objected to that kind of "negative opinion," because they gave the impression that the taxpayer's position could be sustained on audit, however unlikely. The very existence of an opinion, positive or negative, provided a cloak of legitimacy to abusive transactions and could dupe unwary or unsophisticated investors.

Attacking tax shelters meant attacking the troublesome opinions. In turn meant attacking the opinion writers. According to Mundheim, Treasury was "increasingly concerned" about the role of tax attorneys in the tax shelter industry. "Much like securities lawyers in the sale of levered stock," Mundheim analogized, "tax attorneys through their opinions control access to the market place." 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." Treasury undertook to remind tax lawyers of their responsibilities, both to their clients and to their government.

**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 curtailed many of the known tax shelters with a suite of antishelter provisions, including enactment of the at-risk rules, significant tightening of the depreciation recapture rules, revision of the partnership special allocation rules, limitations on investment interest, inclusion of the prepaid interest subsection in the rules regarding the tax year of deduction, and enactment of section 6694, the tax return preparer understatement penalty. "But no sooner were the apparent leaks in the dike plugged than new ones appeared," Kurtz observed in late 1977. 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..."
tax avoidance and entering the world of tax evasion.”

Combating tax shelters required constant vigilance and an aggressive counterattack. The IRS undertook an ambitious, multipronged strategy to combat the persistent tax shelter market. Attacking tax shelters required more stringent reporting requirements. Raising disclosure standards for tax practitioners to, say, those required of lawyers in Securities and Exchange Commission offerings, Kurtz ventured, would alert Treasury to aggressive reporting positions, encourage the use of competent and ethical counsel, and facilitate a nonadversarial relationship between the IRS and tax lawyers. Attacking tax shelters also required increasing the audit coverage of all partnership returns (from 1.5 percent to 3 percent) and auditing higher percentages of partnership returns (nearly one-quarter) with losses of $25,000 or more. Also, Kurtz announced that the IRS would seek legislation requiring disclosure of claimed deductions or credits that were contrary to that the IRS would seek legislation requiring disclosure of claimed deductions or credits that were contrary to the 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.

Id. 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”).

Jerome 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.

James Byrne, “Kurtz Sets Reform Agenda for Internal Revenue Service,” Tax Notes, June 6, 1977, p. 3.

See 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”).

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Comments of Jerome Kurtz, supra note 29, at 15.

Kurtz explained the questionable-position proposal at a meeting of the ABA Section of Taxation in 1978. Taxpayers felt too comfortable taking questionable positions — which Kurtz defined as positions inconsistent with regulations, rulings, or case law — because of low audit coverage. Even for corporate taxpayers subject to annual audits, the audit itself examined only a sampling of transactions. Thus, there was a “good chance” that the taxpayer would prevail on uncertain issues because the return would never be examined, or if it were examined, questionable positions would escape detection. Kurtz said it seemed inappropriate that under a voluntary compliance system, taxpayers “take positions gambling 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 Corneel. “The difficulty with this ‘situation ethics’ approach,” Corneel wrote before promulgation of Opinion 314 but with equal relevance to the post-Opinion 314 era, “is that it leaves
the practitioner unprepared for temptation."44 And, because “tax obscenity, as other kinds, is in the eye of the beholder,” few temptations went unrequisitioned, 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 practitioner unprepared for temptation.”44 And, because “tax obscenity, as other kinds, is in the eye of the beholder,” few temptations went unrequisitioned, Cooper wrote.45

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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.”88 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 they demand too much, legal and ethical systems fall of their own weight in practice, even though they may linger on to be invoked on ceremonial occasions.”53 Asbill elaborated, saying “I fear that the full disclosure theory of the federal tax return asking, in effect, that the taxpayer identify every item that the Government might reasonably seek to treat differently, goes beyond what can reasonably be expected.”54 Kurtz didn’t flinch. “I don’t agree with you, because I don’t agree with Bittker,” he responded.55 Ethical rules could be elevated, he believed.56 And the IRS, unlike the ABA or Congress, was prepared to do the job.

Treasury Asks 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.57 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.58 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.59 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.60 State

41Id.
42 Cooper, supra note 40, at 1584.
43 See, e.g., comments of Harry K. Mansfield, supra note 29, at 27 (commenting that “when you have to search your own mind to see whether or not you have thought about a question properly, and how you have ultimately assessed it, that kind of inquiry is simply going to help tear down the system”).
44 Cooper, supra note 40, at 1581.
45 Id. at 1588.
46 See Corneel, supra note 43, at 5 ("If a tax practitioner concludes that he wishes to adhere to what he believes to be a 'higher' ethical standard and present all information whether favorable or unfavorable, is it not clear that he owes his client the obligation of cautioning him in advance, so that the client may then choose whether that is the type of representation that he desires?"). See also Rowen, supra note 41, at 240 (adopting Corneel's analysis).
47 Rowen, supra note 41, at 262.
48 Id. at 262-263.
49 Comments of Harry K. Mansfield, supra note 29, at 27.
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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