November, 2006

The How and Why of the New Public Corporation Tax Shelter Compliance Norm

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Available at: https://works.bepress.com/susanmorse/1/
INTRODUCTION

Tax fraud. Tax shelters. Aggressive tax planning. Figuring out the line between acceptable and unacceptable activity presents a challenge for every tax decision maker, and overseeing these choices involves not just substantive tax regulation, but attention to the decision-making process. This Article reviews how the Sarbanes-Oxley Act of 2002, tax and securities enforcement efforts, and tax shelter regulation have impacted corporate tax decision making. Using the example of promoted tax shelters, the Article argues that context and culture, in addition to substantive rules, determine the impact of tax regulation on organizations such as large corporations.

Practitioner comments and surveys indicate the emergence of new norms at public corporations:

- Compliance (including compliance with tax accounting standards and with Sarbanes-Oxley internal control requirements) has replaced tax planning as the number-one project of public corporation tax departments.1
Tax directors and tax advisors worry more than before about personal liability, firm liability, and/or adverse publicity resulting from tax or accounting noncompliance.

Marketing tax shelters to public corporations is no longer big business.

2006 and received 123 responses. Id. at 4. The survey showed that the top priority of Fortune 500 tax directors is avoiding a financial statement error and that the second priority is achieving financial statement benefits such as a reduced effective tax rate. Id. at 11. The survey states that its results have a margin of error of plus or minus nine percentage points at the ninety-five percent confidence level. Id. at 5.

2. Employees worry, for example, that they may be scapegoated by employers seeking to avoid criminal prosecution at the firm level. See Memorandum from Larry D. Thompson, Deputy Att’y Gen., to Heads of Dep’t Components & U.S. Att’ys (Jan. 20, 2003) [hereinafter Thompson Memo], available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm (outlining “Principles of Federal Prosecution of Business Organizations”); see also, e.g., Daniel Fisher & Peter Lattman, Ratted Out, Forbes, July 4, 2005, at 49-50 (reporting that the Justice Department’s policy of encouraging employer cooperation can result in the employer’s fingering of employees and the refusal to cooperate in the employees’ defense efforts); Letter from Current and Former KPMG Bd. Members & Wash. Nat’l Tax Partners to Wall St. J. et al. (Aug. 10, 2005) [hereinafter KPMG Anonymous Letter] (on file with the Fordham Law Review) (criticizing KPMG for deciding to save the firm by entering into a deferred prosecution agreement, for failing to take responsibility for top-level firm decisions with respect to the tax shelter business, and for firing and refusing to help KPMG partners with legal fees in connection with defense of civil or criminal litigation).

3. See, e.g., Ernst & Young Analyzes Tax Transparency Dynamics, Tax Notes Today, Apr. 1, 2006, available at LEXIS, 2006 TNT 69-10 (“Companies are now more concerned than they have ever been about the diminution of their ‘brand value’ arising from the disclosure of breakdowns in corporate governance processes, including those related to tax transactions. In an Ernst & Young LLP survey of global tax directors, 70 percent said that ‘reputational consequence,’ should a strategy become public, is a very important factor in their tax planning analysis. This has translated into a more conservative approach to all tax planning, even when tax planning is related to an entirely appropriate business purpose, as it must be.”).

Most of this Article focuses on a narrow compliance norm: public corporations’ current reluctance to participate in promoted tax shelter transactions. In Part I, the Article describes the typical tax decision-making group at a public corporation and identifies organizational behavior concepts that help explain the emergence of the existing anti-tax shelter norm. In Parts II through IV, the Article sets forth three elements that have contributed to the development of this norm.

First, as discussed in Part II, Sarbanes-Oxley expanded the tax decision-making group and increased its transparency within the corporate organization. Second, as described in Part III, this group is pulled toward a compliance norm by the members’ concerns about the liability of separate firms to which they belong. These liability concerns stem from enforcement and publicity efforts in both tax and non-tax contexts, and the concerns draw reinforcement from Sarbanes-Oxley requirements such as financial statement certification and audit committee oversight. Third, as outlined in Part IV, the government has clearly labeled certain transactions unacceptable, making it straightforward for a compliance-oriented tax decision-making group to exclude these transactions from their planning.

A typical economic analysis would explain these compliance developments by framing the tax decision maker’s choice as a comparison of (1) the cost of paying tax to (2) the difference between the benefit of avoiding the tax and the cost of the imposition of tax, interest, and penalties, with the difference adjusted for the risk that the government will successfully challenge the tax avoidance strategy and perhaps adjusted for aversion to risk and reputational loss.5

The economic analysis predicts that increased taxpayer penalties—whether existing penalties,6 larger penalties,7 or differently designed also shifts focus away from the problem of tax shelters toward more diffuse tax compliance issues. See, e.g., Linda M. Beale, Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges, 25 Va. Tax Rev. 583, 586, 636-37 (2006) (arguing that the government’s enforcement efforts must expand beyond mass-marketed tax shelters to customized, abusive tax planning). Meanwhile, the same Senate subcommittee that investigated the corporate tax shelter industry several years ago, see infra note 141, has shifted its focus to tax products targeted at individual investors, particularly those that shelter assets in offshore tax havens. See Staff of S. Permanent Subcomm. on Investigations, Comm. on Homeland Sec. & Governmental Affairs, 109th Cong., Tax Haven Abuses: The Enablers, The Tools and Secrecy 1 (Comm. Print 2006) [hereinafter Senate Subcommittee Report on Tax Havens], available at http://www.senate.gov/~levin/newsroom/supporting/2006/PSI.taxhavenabuses.080106.pdf (describing the problem of tax evasion by U.S. citizens through tax haven abuses).


penalties\textsuperscript{8}—will deter tax avoidance by directly increasing its cost. The economic approach also suggests that disclosure will lead to more compliance if disclosure produces more enforcement, both generally and specifically with respect to a disclosing taxpayer.\textsuperscript{9}

This Article’s story about tax compliance is consistent with the rational taxpayer economic model. Increased enforcement efforts and publicity increased the expected size of civil and criminal penalties for promoting tax shelters considered abusive by the Internal Revenue Service (IRS). Increased government efforts to identify and force disclosure of tax shelters also raised the chance of discovery of such transactions.

However, this Article offers analyses of the story that do not fit neatly into the rational economic taxpayer model. Part II argues that because tax decision making at large corporations is a group exercise, group dynamics impact the group’s collective views—including compliance tendencies. Part III contends that enforcement efforts wholly unrelated to tax have had a positive impact on tax compliance because they produce general liability concerns within organizations, including the corporate taxpayer itself, accounting firms, and other advisors to which members of the tax decision-making group belong. Part IV discusses how a clear line between acceptable and unacceptable behavior in the tax shelter area helps a decision-making group avoid ethical uncertainty and reach consensus.

Part V acknowledges that this observed new norm is narrow. Conservatism has not permeated every aspect of corporate taxpayer behavior: Corporations, for example, continue to use creative tax planning tools such as hybrid securities and offshore tax structures. Nevertheless, Part V argues that the government can draw on organizational behavior insights to encourage compliance beyond the promotion of tax shelters. As an example of culturally sensitive regulation, Part V discusses the existing Compliance Assurance Program (CAP) for large corporations.

Part V further posits that the observed new norm may be temporary. It considers how the government could encourage more permanent, noncyclical tax compliance norms. Finally, Part V briefly outlines the cost-benefit issues raised by the regulatory approaches described in the Article.

I. THE BEHAVIOR OF THE TAX GROUP

A. The Tax Director’s Organization

At a typical public corporation, the tax director has responsibility for making or recommending tax decisions. Such decisions relate to


compliance, tax controversies, planning (for example, determining what offshore structure optimizes the corporation’s tax position), and financial accounting (for example, calculating the tax provision, which is the figure that describes the corporation’s exposure to tax audit risk on its financial statements).10 The tax director might be a vice president (or have a similar title) and typically reports to the corporation’s chief financial officer (CFO).11

Depending on the size of the corporation, the tax director’s staff can vary from two or three individuals to twenty or more.12 The corporation’s tax department generally has responsibility for a range of taxes in addition to federal income taxes, including state income taxes, sales and use taxes, property taxes, customs and excise taxes, non-U.S. income taxes, and non-U.S. value added taxes. As a result, it is often a priority to recruit staff members with varying kinds of expertise, if only to cover routine return-filing tasks.13

With respect to the tax planning portion of the tax director’s job, he or she often engages outside accounting, law, or consulting firms as tax planning advisors.14 Such experts may serve as ongoing consultants, particularly with respect to financial accounting matters. They may also advise on a specific project in a complex and market-sensitive area, such as a corporate acquisition transaction, an offshore intellectual property (IP) structure, or a transfer pricing plan.

The tax director also receives outside advice with respect to the financial accounting portion of his or her job. For example, the tax director may consult the tax experts at the corporation’s financial accounting firm to determine whether a particular tax planning exercise will result in a tax benefit asset on the corporation’s balance sheet. As another example, each quarter the tax director typically confirms the corporation’s calculation estimating its tax audit exposure with the accounting firm.15

Historically, the financial accounting firm has also provided tax planning advice. Before Sarbanes-Oxley, particularly in the case of marketed tax shelters, such consulting advice was cross-sold by accounting firms to their audit clients under conditions involving significant conflicts of interest: The offering of both tax and audit advice by the same firm to a client

11. See id. at 16-17 (reporting tax executives’ titles and the individuals to whom the tax executives report).
12. See id. at 21 (reporting the numbers of tax department staff).
13. See id. at 26 (noting numbers of employees assigned to different taxes and showing that most filled compliance roles).
14. See id. at 27-28 (noting that thirty to fifty percent of tax departments outsourced some or all of their planning).
15. Few tax directors outsource responsibility for calculating the tax provision. See id. at 29 (reporting that only five percent of tax directors outsourced their tax provision work). However, securities law requirements result in an audit of all in-house numbers, at least for public company financial statements.
discouraged an independent and critical financial accounting review of the client’s tax planning.16 As discussed in more detail below, since Sarbanes-Oxley, tax directors often separate tax planning and financial accounting, hiring independent law firms or other tax planners to provide the former and relying on their audit firm for the latter.17

In addition, under section 404 of Sarbanes-Oxley (“Section 404”), the tax director has another advisor: the Section 404 auditor. As discussed in Part II.B.2 below, this auditor, who is often from the corporation’s financial accounting firm but who has a separate mandate under Sarbanes-Oxley, vets the process by which the tax department reaches its decisions in order to certify that the process meets applicable “internal controls” requirements. The Section 404 audit frequently involves some examination of the substantive correctness of tax positions.18

This Article accordingly examines the development of norms within a typical post-Sarbanes-Oxley public corporation tax decision-making group anchored by at least four tax or accounting specialists: the tax director, the outside law firm (or other tax planner), the financial auditor, and the Section 404 auditor. Each specialist identifies professionally with other entities. The tax director works at the public corporation; the Section 404 auditor and the financial auditor at the corporation’s accounting firm; and the tax planner at a law firm, accounting firm, or different consulting firm.

B. The Relevance of an Expanded and More Transparent Group

The typical four-member public corporation tax decision-making group, as described above, tends to be larger than the pre-Sarbanes-Oxley group for two reasons. First, the public corporation’s financial auditor is less likely to provide tax planning advice. Second, the Section 404 auditor has been added to the group.

Some organizational behavior texts consider group size and structure as these characteristics relate to appropriate work assignments. These sources suggest that groups with centralized structures are better at reaching quick, correct decisions when facing simple issues; groups with decentralized structures, where each member of the group talks to the other members, are thought to be better at reaching the right decisions in complicated cases.19 A group with a centralized “wheel” or “star” structure may have a key decision maker at the center and a number of individuals feeding

16. See, e.g., Bernard Wolfman, Letter to the Editor, The Best Way to Protect Auditor Independence, 89 Tax Notes 1779, 1779 (2000) (noting that a conflict of interest can result not only from the provision of tax consulting services to an audit client, but also from selling a tax product to a non-audit client, since “another tax product huckster” might peddle a similar product).
17. See infra Part II.B.1.
18. See infra Part II.B.2.
A decentralized or “all channel” group is diagrammed as a polygon of some kind, where each person communicates with each other person in the group.21

The basic insight of the comparison between a “star” group and an “all-channel” group is that the contribution of a number of different viewpoints is advantageous for solving complex problems. Anyone who has circulated an academic article for review or run a tricky situation by a law-practice colleague has acted on a similar instinct. In addition to capturing new ideas from a variety of sources, the process of discussion may help the participants to focus on the problem being discussed—rather than on the many other puzzles their brains constantly face.22

An all-channel group also has the potential to increase information flow if the members of the group themselves belong to different networks. A related theory about organizational behavior considers “structural holes” in organizations. In the corporate governance context, the application of this social capital and economic sociology theory suggests that gaps between social networks in a corporation create opportunities for individuals bridging the gaps to control information and, consequently, to influence a network’s behavior.23 For example, a chief executive officer (CEO) who is the sole bridge between the social network of an independent board and the social network of a corporation can benefit greatly from controlling the information the board of directors receives (such as compensation information).24

Some pre-Sarbanes-Oxley decisions to promote tax shelters were apparently made by the tax shelter promoter and the corporation, without input from other advisors.25 In contrast, after Sarbanes-Oxley, the typical tax decision-making group contains at least four tax or accounting specialists who bridge three major networks—those of the audit firm, the tax planning firm, and the corporate tax department. Each group member’s ability to control information for his or her own purposes is accordingly more limited. In addition, the increased internal transparency of tax

20. Id.
21. Id.
22. Cf Terrence Chorvat & Kevin McCabe, Neuroeconomics and Rationality, 80 Chi.-Kent L. Rev. 1235, 1248-50 (2005) (describing neurological research indicating that the brain must choose what problems to address and how carefully to consider decisions).
24. See id. at 1348-50 (suggesting that independent boards are correlated with strong CEOs).
25. See, e.g., Compaq Computer Corp. v. Comm’r, 113 T.C. 214, 216 (1999) (describing a decision made by Compaq’s Treasurer, Assistant Treasurer, and Chief Financial Officer (CFO) to enter into a foreign tax credit generation transaction after the Treasurer and Assistant Treasurer had a one-hour initial meeting with promoters from Twenty-First Securities Corporation), rev’d, 277 F.3d 778 (5th Cir. 2001).
26. Although “transparency” frequently means visibility of corporate decisions to outside groups such as regulators or shareholders, this Article generally uses it to mean
decisions at public corporations after Sarbanes-Oxley, attributable in large part to audit committee oversight, attributable in large part to audit committee oversight, further limits a tax decision maker’s ability to control information.

C. Group Norm Development

The increased size of the tax decision-making group does not automatically indicate increased compliance. Organizational behavior research has examined the phenomenon of group norms, or the “informal rules that groups adopt to regulate . . . group members’ behavior.”

Several organizational behavior concepts are relevant here. First, a group norm may take the form of a narrow legal norm or a broader social norm. These are distinguishable, though legal rule changes can prompt changes in both. A narrow legal norm might produce a monitoring and internal control system designed to effect purely rational, economic calculations regarding the cost of compliance, the likelihood of detection, and the level of penalties. A social norm constitutes a broader agreement that compliance is one of the social, or even moral, values of the organization.

Second, even though a larger group has the potential to permit increased sharing of information and more considered decisions, it also has the capacity simply to adopt and exaggerate signals sent by senior members of internal transparency, or visibility of decisions made by small groups within a large organization to the rest of the organization.

27. See infra Part II.C.


32. See, e.g., Timothy F. Malloy, Regulation, Compliance and the Firm, 76 Temp. L. Rev. 451, 473 (2003) (“[E]vidence of compliance-oriented firm policies and structures is equally consistent with the deterrence model. Even a strictly rational firm would comply with some regulations, and thus would need mechanisms to identify the ‘right’ rules with which to comply and to make sure that those obligations are met.”).

the group. Organizational behavior literature suggests that group norms within a business organization develop as a result of negotiation between the members of the group, which is heavily influenced by the views of leaders of the organization. Group norms may differ from individual norms, and in particular may amplify them. Professor Cass Sunstein has described group members’ tendency to defer to information offered by others instead of disclosing their own information, especially when the offeror of information is a peer or supervisor and adverse reputational sanctions might result from putting forth different information.

In other words, Sunstein argues, groups tend to amplify information or results supplied early in a discussion by a senior member of the group—whether the information or results are good or bad—and groups often arrive at a more extreme consensus relative to the individual view initially offered. Professor Donald Langevoort offers the example of large corporations’ tendency to develop optimism biases that lead to overcommitment and overbidding for assets.

Third, both positive and detrimental group norms can develop. Positive and production-encouraging group norms may include rules of etiquette (be prompt; don’t interrupt) and performance standards (do the work assigned by the deadline; be ready to back up conclusions with good data). They are essential to the successful performance of a group. Conversely, detrimental group norms may develop that hinder or block a group’s effectiveness.

This Article does not contend that the recent tax shelter compliance norm is a broad social norm, as opposed to a narrow legal norm. Furthermore, the Article acknowledges that the observed norm may result from amplification of group leaders’ signals. But, in contrast to other analyses of group norms observed in corporate settings, this Article contends that the observed tax shelter compliance norm is a positive norm—or at least one that conforms to regulators’ objectives. Accordingly, the same reasons for...

34. See, e.g., James G. March & Herbert A. Simon, Organizations 99-100 (2d ed. 1993) (noting that individual members of work groups can exert pressure on norm development and that disproportionate weight may be accorded to norms to which more group members subscribe and norms held by senior group members); Lawrence E. Mitchell & Theresa A. Gabaldon, If I Only Had a Heart: Or, How Can We Identify a Corporate Morality, 76 Tul. L. Rev. 1645, 1663 (2002) (contending that “individuals are psychologically constrained by their corporate roles”); cf. Feldman, supra note 28, at 225-26 (discussing how superiors and departmental colleagues can exert great pressure on an individual).


37. See id. at 1012-13 (noting the “polarization” process and “cascades”).

38. See Langevoort, supra note 35, at 139-40 (stating that business organizations often amplify optimism bias).

39. See, e.g., id. at 155-56 (discussing how optimism, as a group norm, can both facilitate productive behavior and discourage it).
the development of aggressive or risk-taking firm norms can also support the development of compliance norms. In particular, amplification of senior group members’ views surely occurs in public corporation tax decision-making groups. But if each member of the group is inclined toward compliance as a result of the priorities of leaders at each member’s firm, increased compliance is the amplified consensus. In other words, the group dynamic can work in the regulator’s favor.

In order to unravel the development of this positive dynamic, it is useful to examine the typically cited reasons for the blurring of individual norms as group norms develop. First, some note that the de-emphasis of individual norms coincides with the decrease in personal responsibility for decisions made by a group. Second, corporations are hierarchies, and disagreement with one’s superior on ethical (or other) matters can cause adverse results ranging from exclusion from social conversations to job loss. Third, commentators have observed that managers often face uncertain dilemmas, where the ethical path is not clearly distinguishable from the unethical path.

D. The Relevance of Liability and Enforcement

The first two reasons that individual norms are blurred in a group setting—decreased personal responsibility and hierarchy—make individual ethics in corporations contingent on the ethics of the corporation. The ethics of the corporation, in turn, are often expressed through the views of superiors within the corporation. In particular, with respect to the four tax or accounting specialists considered in this Article—the tax director, tax planner, financial auditor, and Section 404 auditor—each belongs to a distinct firm that provides top-down guidance to the individual tax specialist on the appropriate priority of ethical or “compliance”

40. See, e.g., D. Don Welch, Conflicting Agendas: Personal Morality in Institutional Settings 61 (1994) (commenting that the decrease in personal responsibility diminishes the tension between individual morality and group norms); see also Langevoort, supra note 35, at 137-38 (noting that “groups are motivated to preserve cohesiveness” when the members share decision-making responsibility).

41. See Robert Jackall, Moral Mazes 45 (1988) (“For most managers, however, future chances in an organization, after the crucial break points in a career are reached, are seen to depend not on competence nor on performance as such. Instead, managers see success depending principally on meeting social criteria established by the authority and political alignments—that is, by the fealty and alliance structure—and by the ethos and style of the corporation.”); see also John M. Darley, The Dynamics of Authority Influence in Organizations and the Unintended Action Consequences, in Social Influences on Ethical Behavior in Organizations 37, 38-39 (John M. Darley, David M. Messick & Tom R. Tyler eds., 2001) (noting that authority hierarchies help to influence individuals to commit acts they otherwise would not).

42. See, e.g., Baysinger, supra note 29, at 354 (noting the uncertainty of the boundary between legal and illegal behavior, especially for less-senior employees); Kimberly D. Krawiec, Cosmetic Compliance and the Failure of Negotiated Governance, 81 Wash. U. L.Q. 487, 542-43 (2003) (arguing that inevitable gaps in compliance rules leave room for self-interested groups, including regulated corporations and their legal advisers, to push their own agendas).
considerations. This top-down guidance will largely determine whether the group defines a “better” decision as a more compliant decision.

The factors of decreased personal responsibility and hierarchy accordingly explain the importance of recent tax and securities enforcement efforts and practice-standard revisions to the development of a corporate tax shelter compliance norm. Part III further discusses these developments. To the extent that they generate real anxiety about personal and firm liability among leaders of corporations, law firms, other tax planning firms, and accounting firms, the leaders’ focus on avoiding liability should prompt subsidiary decision-making groups like the tax group to prioritize compliance.

This Article in fact observes such an emphasis on compliance, particularly with respect to avoiding promoted tax shelters. This post-Sarbanes-Oxley compliance contrasts sharply with other studies of harmful corporate group dynamics. Professor Robert Jackall, for example, describes norm development at corporations as an exercise in trading more ethical individual norms for less ethical corporate norms. His analysis includes discussion of a whistleblower who lost his job after reporting financial accounting fraud, an engineer who faced suspension after documenting procedural shortcuts in the cleanup of the Three Mile Island nuclear site, and corporate efforts to conceal both respiratory illness caused by cotton dust and ozone erosion caused by formaldehyde.

Similarly, Professor Donald Langevoort has written extensively about the “groupthink” phenomenon and other cognitive biases within corporations, in an effort to explain securities fraud and other harmful activities. He argues that corporations suffer from “optimism bias” and points out that groups give individuals a strong disincentive to “introduce stressful dissonant information into a group setting once the group has implicitly agreed to think otherwise.”

43. Some note, however, that the process by which organizations communicate a top-down desire for increased ethics or compliance is complex and imperfect, in part because of the inevitable simultaneous focus on measurable output metrics. See, e.g., Baysinger, supra note 29, at 362-63 (citing NASA’s experience with the 1986 Challenger disaster as an example of the difficulty of institutionalizing safety norms); Malloy, supra note 32, at 491 (suggesting that information flow problems interfere with compliance efforts).

44. See supra notes 1-4 and accompanying text.

45. See Jackall, supra note 41, at 105-11.

46. See id. at 112-18.

47. See id. at 156-61.

48. See id. at 177-78.

49. See Donald C. Langevoort, The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior, 63 Brook. L. Rev. 629, 639-642 (1997) (citing cognitive simplification, optimism, and commitment as reasons why corporations overlook bad news and underestimate risk); Langevoort, supra note 35, at 138-39 (noting that groups’ desire to preserve cohesiveness can explain institutional decision making that leaves out important information (citing Irving Janis, Victims of Groupthink 8 (1972))).

negative information encourages groups to make riskier, less conservative
decisions than individuals would make.\footnote{See also Baysinger, supra note 29, at 353-54 (citing optimism bias as a reason why corporations may commit crime).}

Case studies of business responses to regulation note the tension between
profit-motivated business norms, which are related to the harmful
tendencies identified by Jackall and Langevoort, and regulation-responsive
compliance norms. For example, Professors Ian Ayres and John Braithwaite conclude after examining a series of case studies that business
managers can be influenced both by internal or social compliance norms
and by profit-seeking norms, which may often point in opposite
directions.\footnote{See Ian Ayres & John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate 21-29 (1992) (noting a variety of motivations); see also Malloy, supra note 32, at 474-75 (noting evidence of compliance norm development within business firms in other regulatory response case studies).} Ayres and Braithwaite state that in light of these different incentives, both forgiveness (for well-meaning firms with strong compliance norms) and ferocity (for rationally calculating firms influenced
mainly by profit-seeking norms) are appropriate regulatory tools.\footnote{See Ayres & Braithwaite, supra note 52, at 26-27.}

The recently developed tax shelter compliance norm in public corporations, however, finds support not only in individual managers’
underlying commitment to law-abiding behavior, but also in the consensus
and conformity tendencies identified by Jackall and Langevoort as typical
factors in the creation of harmful group norms. In particular, all four tax or
accounting specialists—the tax director, tax planner, Section 404 auditor,
and financial auditor—have reason to advocate compliance as a result of
concern about personal liability for aggressive planning. Moreover, the
interaction of these individuals, each with an independent reason to fear
liability, works to overcome the tendency to discount the risk of
enforcement (optimism bias) and contributes to the development of a
compliance consensus and of an anti-tax shelter group norm.

\textbf{E. The Relevance of a Clear Government Message}

The third factor noted at the end of Part I.C as a contributing factor to the
blurring of individual norms within an organization is the uncertainty of the
legal or ethical path. In a group decision-making context, such uncertainty
can permit other goals—such as profit or self-interest—to push the ethical
interpretation exercise to its limit.\footnote{See, e.g., Baysinger, supra note 29, at 354.} In the tax area, ongoing tax shelter
controversies amply illustrate the difficulty of determining whether a
certain tax product is illegal.\footnote{See infra Part IV.B.1 (describing tax shelter litigation).}

Moreover, in the area of corporate tax compliance, the clarity of the line
between acceptable and unacceptable activities is of particular importance.
Despite some evidence that individuals believe that paying taxes is a moral
obligation, such an obligation can quickly become obscured, particularly in the corporate context, by the complexity of the rules that determine the amount of tax due and by the uncertainty about how the government will interpret and enforce the rules.

Clear rules, as opposed to broad standards, have potential disadvantages, such as extreme complexity and narrowness. Nevertheless, in the promoted tax shelter context, clear rules appear to have achieved good results. As discussed in Part IV, the unequivocal government disapproval of promoted tax shelters limits the impact of other decision factors and provides a clear course of action that the members of the tax decision-making group can agree on: Do not engage in promoted tax shelter transactions, especially those that are listed as such.

II. HOW SARBANES-OXLEY PRODUCED AND EXPANDED A MORE TRANSPARENT TAX DECISION-MAKING GROUP

A. Sarbanes-Oxley Overview

The 2002 Sarbanes-Oxley Act emerged from a highly charged political atmosphere where decision makers were motivated to take action by well-publicized scandals and a bear stock market. Some commentators have pointed out that the enactors of Sarbanes-Oxley did not pay much attention to academic empirical evidence and theoretical research relating to the

56. See Slemrod, supra note 5, at 883 (noting significant “experimental and empirical evidence” of noneconomic taxpayer motives such as civic duty and trust in the fairness of the tax system); see also Robert W. McGee, The Ethics of Tax Evasion: A Survey of International Business Academics 24-39 (Feb. 12, 2006) (unpublished manuscript), available at http://www.ssm.com/abstract=803964 (reporting survey results indicating that business professors believed tax evasion was unethical even where government engaged in objectionable or even reprehensible acts); Pew Research Ctr., A Barometer of Modern Morals: Sex, Drugs and the 1040, at 1 (Mar. 28, 2006), available at http://www.pewresearch.org/assets/social/pdf/Morality.pdf (reporting that seventy-nine percent of survey respondents believed that “not reporting all income on your taxes” was morally wrong).

57. See Slemrod, supra note 5, at 883 (noting that corporations frame the tax compliance question as a matter of tax avoidance, or “creative compliance,” not tax evasion); id. at 884 (“To be sure, creative compliance is facilitated because the tax law is exceedingly complex and open to alternative interpretations, and this undoubtedly facilitates ethical rationalizations of positions taken.”).

58. See infra notes 287-90 and accompanying text.

59. See infra Part IV.B.3.


likely success of various regulatory approaches. Others have criticized the Act’s failure to impose strict liability penalties on, or otherwise raise the stakes for, the professionals auditing and advising corporations. But the impact of Sarbanes-Oxley on the composition and internal transparency of public corporation tax decision-making groups demonstrates the potential benefits of at least some provisions enacted as part of that legislation.

Sarbanes-Oxley includes a new oversight board for the accounting profession; various disclosure, audit, and governance rules intended to encourage corporate responsibility; specific rules to promote director and auditor independence; and provisions imposing or increasing criminal penalties for actions including document destruction and fraud. With few exceptions, Sarbanes-Oxley does not attempt to distinguish substantively between appropriate and inappropriate transactions. For example, the new oversight board, the Public Company Accounting Oversight Board (PCAOB) does not have responsibility for developing substantive rules under generally accepted accounting principles (GAAP). The Financial Accounting Standards Board (FASB) continues to make GAAP rules after Sarbanes-Oxley.

62. See, e.g., Romano, supra note 61, at 1535-37 (contending that nineteen of twenty-five available empirical studies found no link between audit quality and prohibitions on auditor provision of non-audit services); id. at 1541-43 (stating that two available empirical studies of the value of officer certification of financial statements give ambiguous results); see also Larry E. Ribstein, Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. Corp. L. 1, 25, 35-45 (2002) (discussing perceived costs of increased regulation).


65. For an example of an exception, see 15 U.S.C. § 78m(k) (Supp. III 2003) (codifying Section 402(a) of Sarbanes-Oxley, which prohibits issuers from extending certain personal loans to executives).

66. See 15 U.S.C. §§ 7211-17, 7219 (codifying provisions from Title I of Sarbanes-Oxley that establish the Public Company Accounting Oversight Board).

B. Sarbanes-Oxley Provisions that Expand the Tax Decision-Making Group

Two Sarbanes-Oxley provisions in particular have impacted the tax decision-making group: limitations on non-audit services and internal control requirements.68

1. Non-Audit Services Limitations

Sarbanes-Oxley prohibits an audit firm from providing tax services to a client without prior approval from the client’s independent audit committee.69 Further, more restrictive rules promulgated by the PCAOB flatly prohibit accounting firms from providing (and cross-selling) certain kinds of tax services to their audit clients.70 Specifically, these PCAOB rules forbid the provision of advice related to the implementation of any transaction (1) listed as a shelter by the IRS,71 (2) defined as a confidential transaction by the IRS,72 (3) involving the provision of certain aggressive tax advice,73 or (4) provided under a contingent fee arrangement.74

There is evidence that the restrictions on non-audit services have had real effects in the market. In particular, even before the PCAOB finalized the rules described above, one study of public filings suggested that public corporations had significantly modified their consumption of tax services.

68. See David E. Hardesty, Sarbanes-Oxley Compliance in the Corporate Tax Department, State Tax Today, Nov. 29, 2004, available at LEXIS, 2004 STT 229-3 (analyzing non-audit services rules and Section 404 of Sarbanes-Oxley (Section 404)).

69. See 15 U.S.C. § 78j-1(h), (i) (codifying a portion of Section 201(a) and Section 202 of Sarbanes-Oxley). Prior to the passage of Sarbanes-Oxley, audit firms had divested many consulting units. See Cunningham, supra note 64, at 953-54 (commenting on Ernst & Young’s sale to Cap Gemini, PricewaterhouseCoopers’s sale to IBM, KPMG’s initial public offering/spin-off, and Deloitte & Touche’s planned split-off). These spin-offs, however, generally did not involve the separation of tax consulting services from audit operations; instead, they focused on other consulting areas such as information technology.


72. See id. R. 3522(a) (treating an auditor as not independent if it markets, plans or opines with respect to any confidential transaction as defined in Treas. Reg. § 1.6011-4(b)(3) (2006)).

73. See id. R. 3522(b) (treating an auditor as not independent if it markets, plans or opines with respect to any transaction recommended by the firm that has a significant purpose of tax avoidance and if the transaction is more likely than impermissible under relevant tax law).

74. See id. R. 3521 (treating an auditor as not independent if it has any contingent fee arrangement, including one relating to tax advice).
by seeking those services from advisors other than their auditors. 75 One 2005 survey indicated that forty-one percent of public corporations now prohibit their audit firms from providing them with any tax services. 76 Another survey indicated that audit firms are often prohibited from providing any tax work to their audit clients and, even if they do provide some tax work, are typically not the largest tax services provider. 77

Corporations have, then, often responded to the non-audit services rules by adding a tax planning advisor from a different firm to the typical public corporation tax decision-making group. The cited data sources do not carefully distinguish between routine tax services such as uncontroversial tax return preparation and more involved tax planning, such as offshore tax structuring, transfer pricing, state tax planning, or tax structuring in connection with a business transaction such as an acquisition, joint venture, or financing. But a more pronounced shift within corporations toward seeking advice in the latter, more uncertain or riskier planning categories would be consistent with the PCAOB rules, which focus on tax planning as opposed to return preparation.

2. Section 404

Sarbanes-Oxley Section 404 requires public corporations to establish, document, and have audited “internal controls” ensuring accurate financial reporting. 78 Commentators have sharply criticized the higher-than-expected costs of the internal control rule 79 and its confusing and

75. See Edward L. Maydew & Douglas A. Shackelford, The Changing Role of Auditors in Corporate Tax Planning 19-20 (Nat’l Bureau of Econ. Research, Working Paper No. 11504, 2005), available at http://www.nber.org/papers/W11504 (showing that the ratio of audit fees to tax fees provided by the same firm had increased from approximately 1:1 in 2001 to approximately 4:1 in 2004). Although an increase in audit fees as a result of internal control and other compliance also influences this data, Professors Maydew and Shackelford record the same trend for 2003, before companies began to incur Sarbanes-Oxley compliance costs. See id. The authors also present evidence that tax fees remain strong, although they tend to be earned from clients other than audit clients. See id. at 21-24; see also Tax Executives Inst., Inc., supra note 10, at A-41 (reporting results showing that forty-six percent of surveyed companies subject to Sarbanes-Oxley reduced their use of external audit firms for tax work after Sarbanes-Oxley, and fourteen percent of such companies reported that they would no longer use an audit firm for tax services).


77. See TCPI 2006 Survey, supra note 1, at 19 (reporting that fifty-six percent of responding tax directors used their external audit firm for some tax work but not as the primary tax services provider, while twenty-seven percent did not use their external auditor for any tax work).


overinclusive drafting. However, it appears to provide some synergies with the regulation of tax planning.

The rules of the Securities and Exchange Commission (SEC) implementing Section 404 call for a “control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.” In practice, companies rely on the internal control framework compiled by a consortium of accounting practice groups called the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO standard is process oriented and elaborate. It features a three-part process

significantly higher, even for years subsequent to the initial year of compliance. See David Reilly, Internal-Control Help Becomes Less Costly, Wall St. J., Apr. 19, 2006, at C3 (reporting average internal and external cost for all companies as $84,000 according to a survey by the Big Four accounting firms); Fin. Executives Int’l (FEI), FEI Survey on Sarbanes-Oxley Section 404 Implementation 2 (Mar. 2006), available at http://www.fei.org/membersonly/FEI_404_Survey_4_2006.pdf (reporting that the average internal and external compliance costs in 2005 for a larger accelerated filer company were estimated to be approximately $3.8 million). The high cost of internal control compliance has apparently led to going-private transactions. See Ehud Kamar, Pinar Karaca-Mandic & Eric Talley, Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis 56-57 (Univ. of S. Cal. Ctr. in Law, Econ. and Org., Research Paper No. C06-5; Univ. of S. Cal. Legal Studies Research Paper No. 06-10, 2006), available at http://www.ssrn.com/abstract=901769 (reporting the empirical finding that the rate of acquisition of small public companies increased in the year after the passage of Sarbanes-Oxley). It may also have discouraged non-U.S. corporations from listing shares on U.S. exchanges. See, e.g., Francesco Guerrera & Andrei Postelnicu, A Not So Foreign Exchange: China Shuns the West as a Location for its Big Corporate Share Offers, Fin. Times, Nov. 18, 2005, at 17 (reporting that Chinese companies avoid listing on New York-based stock exchanges in part to avoid the burdens of Sarbanes-Oxley compliance).


81. 17 C.F.R. § 240.13a-15(c) (2006); see also 17 C.F.R. § 240.15d-15(c) (containing the same language).

82. See SEC Smaller Company Advisory Committee Report, supra note 79, at 11099 (identifying and briefly describing the Committee of Sponsoring Organizations of the Treadway Commission (COSO) standard).
including controls (e.g., reviews and reconciliations), information capture and communication and monitoring. 83

Section 404 auditors assess the tax department’s ability to catch law changes on a quarterly or more current basis, correctly record notoriously elusive intercompany transaction data, and document the tax department’s decisions about reporting transactions with memos or opinions from relevant advisors. 85 Section 404 auditors describe a testing process for tax matters that involves zeroing in on the “key review person” (the besieged tax director), asking that person how he or she makes decisions, and then inspecting records to ensure that the outlined approach (for example, the reconciliation of book and tax numbers, memos that relate to particular transactions, and the documentation of intercompany transactions such as transfer pricing) is in fact followed. 86 In a 2004 survey, a large majority of responding tax directors reported that “some additional effort” or a “major effort” would be required for their tax department to comply with Section 404. 87

A Section 404 review may result in the identification of internal red flag “significant deficiencies” and/or publicly reported “material weaknesses” related to tax. One source reports that in 2005, over 200 material weaknesses and thirty-one percent of adverse internal control opinions were tax-related. 90 According to the Chairman of the SEC, tax issues are the second most frequent cause of material weaknesses (after

84. The focus on quarterly reporting finds reinforcement in the Sarbanes-Oxley requirement that Chief Executive Officers (CEOs) and CFOs certify quarterly and annual financial reports. See infra Part II.C.
85. See Hardesty, supra note 68, nn. 7-21 and accompanying text (outlining the Section 404 internal evaluation and external audit requirements).
86. James Wolfrom, Partner, Ernst & Young, Presentation at the San Jose State University/Tax Executives Institute High Technology Tax Institute: The Latest on SOX 404 (Nov. 7, 2005) (explaining the “testing script”).
87. Tax Council Policy Inst., Emerging Tax Issues of the Fortune 500, at 7 (Feb. 2, 2004) [hereinafter TCPI 2004 Survey] (unpublished market research study, on file with the Fordham Law Review) (reporting that sixty-three percent of respondents indicated that “some additional effort” would be required to implement Section 404 in their tax department while twenty-six percent indicated that “a major effort” would be necessary). The TCPI 2004 Survey solicited responses from the tax directors of the Fortune 500 from December 2003 to January 2004 and received 125 responses. Id. at 3. The survey indicated that its results have a margin of error of plus or minus nine percentage points at the ninety-five percent confidence level. Id. at 4.
88. Significant deficiencies are known as “minor blows” in the inevitable accounting firm parlance. Brad Brown, Partner, Tax Mgmt. Solutions, KPMG, Presentation at the San Jose State University/Tax Executives Institute High Technology Tax Institute: The Latest on SOX 404 (Nov. 7, 2005).
89. Material weaknesses are also referred to as “major blows.” Id.
90. See Allen Shoulders, Practical Approaches to Improving Tax Control Effectiveness, Tax Notes Today, Apr. 26, 2006, available at LEXIS, 2006 TNT 80-37 (reporting results from an Ernst & Young examination of public records and from an Audit Analytics study).
Another source reports that up to one-third of tax directors whose companies reported a tax-related material weakness left their jobs. Whether or not specific issues are identified as problems, the fact that a conversation must occur about these matters with the Section 404 auditor makes the Section 404 auditor a member of the tax decision-making group and increases the internal transparency of that group’s decisions.

C. Sarbanes-Oxley Provisions that Increase the Tax Decision-Making Group’s Internal Transparency

Other provisions of Sarbanes-Oxley are designed to ensure review of tax director (and other manager) decisions by senior managers and the board. One such provision requires CEOs and CFOs to certify quarterly financial reports. An officer who knowingly or willfully falsely certifies that a report is fair and materially complete faces criminal penalties. This quarterly certification requirement has produced sub-certification practices at some companies, which require managers including the tax director to sign certification statements with respect to their areas of responsibility on a quarterly basis. Another relevant Sarbanes-Oxley provision is audit committee review of financial statements. The statute requires an audit committee comprised of independent members of the corporation’s board of directors. This committee must collect and review reports from the corporation’s auditor regarding “critical accounting policies and practices” and possible alternative GAAP-compliant accounting treatments.

91. See Christopher Cox, Chairman of the Sec. and Exch. Comm’n, Remarks at the Seventh Annual Tax Policy and Practice Symposium: The Corporate Tax Practice: New Challenges (Feb. 9-10, 2006), in Taxes, June 2006, at 49, 49-50. Practitioners report that the most significant tax internal control issues include problems in the process for recording the deferred tax asset position or performing book and tax reconciliation; staffing shortages, including those related to a failure to “separate the three key functions of transaction authorization, transaction recording, and handling of assets,” and errors in accounting for unusual or complex transactions or foreign operations. Shoulders, supra note 90.

92. Brad Brown, Partner, Tax Mgmt. Solutions, KPMG & James Wolfrom, Partner, Ernst & Young, Presentation at the San Jose State University/Tax Executives Institute High Technology Tax Institute: The Latest on SOX 404 (Nov. 7, 2005).

93. See infra Part II.D (describing the erosion of attorney-client and other privileges).


95. See 18 U.S.C. § 1350(c) (Supp. III 2003) (providing criminal penalties including fines up to $1,000,000 or imprisonment of up to ten years).

96. See TCPI 2004 Survey, supra note 87, at 5 (reporting that nineteen percent of tax director respondents faced sub-certification requirements and that seventy-eight percent experienced new information collection procedures).


98. See 15 U.S.C. § 78j-1(m) (requiring listed issuers to have an independent audit committee and mandating that to be independent, the members of the audit committee may not accept “any consulting, advisory, or other compensatory fee from the issuer”).

audit committee oversight reinforce the top-down tendency of norm development within corporations, which was discussed in Part I, and add a statutorily mandated compliance element to that chain of command.

Practitioner observations indicate that these provisions have in fact resulted in increased oversight from corporations’ audit committees. Tax directors report that material or substantive tax items or items that arise in Section 404 audits often receive specific audit committee review. Audit committee reactions may include asking for a second opinion or increasing the opinion standard required before approving the transaction.

Don Korb, who currently serves as IRS Chief Counsel, made the following observation about his private practice experience with a post-Sarbanes-Oxley audit committee:

Sarbanes-Oxley created the milieu, created the meeting. Those guys [on the audit committee] didn’t know anything about the rule that the IRS put out. What they understood was they better pay attention to what . . . is going on. So that’s why the meeting happened. And then the professional [Korb] shows up and explains to them that even though this [proposed transaction] might work . . . they still faced this risk . . . and they made a judgment not to do it.

D. Internal Transparency Begets External Transparency

One result of increased internal control regulation and increased audit committee oversight is that financial and Section 404 auditors demand more information about tax planning. A 2004 PCAOB release further

100. See, e.g., Ernst & Young Analyzes Tax Transparency Dynamics, supra note 3 (“Perhaps the most tangible sign of how companies have responded to the new environment is the re-emergence of strong oversight and active involvement of public company audit committees in all aspects of financial risk management, including tax risk management. Audit committees are asking more questions about tax[, including] such matter[s] as risk profile, critical accounting policies embedded in tax decisions and the status of potential tax controversies.”).

101. See TCPI 2006 Survey, supra note 1, at 34 (reporting that audit committee reviewed material tax items in eighty-two percent of cases, substantive tax issues in sixty-three percent of cases, and tax elements of Section 404 reports in fifty-nine percent of cases). The tax director may or may not meet regularly with the audit committee. See Tax Executives Inst., Inc., supra note 10, at 20 (reporting survey results that forty-three percent of respondent senior tax executives met with their companies’ audit committees at least once a year).


103. See Sheryl Stratton, Lawyers Discuss Postshelter Assault on Privilege, Tax Notes Today, Apr. 14, 2005, available at LEXIS, 2005 TNT 71-5 (reporting on comments at an ABA teleconference by former IRS Chief Counsel B. John Williams, now in practice at Shearman & Sterling, who stated that auditors demand more information to support the tax provision after Sarbanes-Oxley and that attorney efforts to resist handing over information in the interest of protecting attorney-client privilege did not always succeed); Thomas W. White, The Growing Tension Between Auditors and Lawyers, Directors Monthly, Oct. 2004, at 8, 10, available at http://www.wilmerhale.com/files/Publication/b8e1bb7b-7c5d-4c11-8b9a-5e9163c70b3/Presentation/PublicationAttachment/f3000b03-2d3d-4e4f-b37b-f814ed8ce1a3/Growing%20Tension.pdf (reporting a “tug-of-war among auditors and attorneys” as
contributes to this development by requiring audit documentation that provides the “basis for the auditor’s conclusions concerning every relevant financial statement assertion.”\textsuperscript{104} The leading trade group for accountants, the American Institute of Certified Public Accountants (AICPA) backs this broad standard by specifically anticipating auditors’ access to opinions of outside counsel “notwithstanding potential concerns regarding attorney-client or other forms of privilege.”\textsuperscript{105}

Disclosure of tax planning advice to auditors and audit committee examination of tax planning increases the transparency of tax decisions within the corporation and among its advisors. But there is a broader transparency effect as well, since such disclosure waives any attorney-client or accountant-client privilege with respect to such advice\textsuperscript{106} (although work-product protection may remain in some cases).\textsuperscript{107} There is no accountant-client privilege protecting audit workpapers from disclosure.\textsuperscript{108} A recently added section of the tax code purports to provide a tax


\footnotesize{\textsuperscript{105} Am. Inst. of Certified Pub. Accountants, Interim Auditing Standards § 9326.2.22 (2003), available at http://www.pcaobus.org/standards/interim_standards/auditing_standards/au_9326.html.}

\footnotesize{\textsuperscript{106} According to the classic Wigmore formulation of the attorney-client privilege, [w]here legal advice of any kind is sought from a professional legal adviser in his capacity as such, the communications relating to that purpose, made in confidence by the client, are at his instance permanently protected from disclosure by himself or by the legal adviser, except the protection be waived. 8 Wigmore, Evidence § 2292 (McNaughton rev. 1961). The client may waive the privilege by disclosing it to a third person outside the attorney-client relationship, such as an auditor or even the government in a tax return or other filing. See, e.g., United States v. Lawless, 709 F.2d 485, 487 (7th Cir. 1983) (holding that a tax return filing waived privilege).}

\footnotesize{\textsuperscript{107} There is no automatic waiver of the work-product privilege in the event of disclosure to a third party other than the adversary. See, e.g., United States v. Stewart, 287 F. Supp. 2d 461, 464, 468-69 (S.D.N.Y. 2003) (concluding that Martha Stewart’s disclosure to her daughter of her attorney’s communication waived the attorney-client privilege but not the work-product privilege). Instead, the availability of the work-product doctrine depends on whether the material was developed in anticipation of litigation, whether the material is essential to the preparation of the opponent’s case, and whether the opponent will suffer undue hardship without access to the materials. See Bernard Wolfman, James P. Holden & Kenneth L. Harris, Standards of Tax Practice § 306.4.4.2, at 304 (6th ed. 2004) (describing the work-product doctrine). One recent case may support more expansive work-product protection claims. See United States v. Roxworthy, 457 F.3d 590, 598-99 (6th Cir. 2006) (concluding that work-product protection could apply to a KPMG opinion issued in part to protect against understatement penalties).}

\footnotesize{\textsuperscript{108} See United States v. Arthur Young & Co., 465 U.S. 805, 817-19 (1984) (noting that prior case law confirmed that no accountant-client testimonial privilege existed and reversing the Second Circuit’s conclusion that the work-product privilege could cover auditor workpapers).}
practitioner-client privilege that gives some protection for tax advice given by accountants. However, recent cases in the tax shelter context have established a narrow scope for the statutory accountant-client privilege and have indicated that the attorney-client and tax practitioner-client privileges often do not apply to tax advice, such as when the advisor acts in a promotor capacity rather than a legal advisor capacity or when the advisor prepares tax returns.

These developments lead many practitioners to believe that their work generally will not enjoy any privilege protection. One might expect that practitioners would avoid putting legal advice in writing as a result of such privilege concerns (and also because heightened opinion standards make written advice more expensive). Such a reluctance to provide written advice might decrease, rather than increase, communication and internal transparency. But although the reaction of requesting less written advice has been observed, it does not clearly prevail. Perhaps auditors’ demands for documentation still mandate written advice for tax matters with material financial accounting consequences.


110. See, e.g., Doe #1 v. Wachovia Corp., 268 F. Supp. 2d 627, 635-36 (W.D.N.C. 2003) (requiring disclosure of client identity in response to IRS summonses; no privilege existed between Jenkens & Gilchrist or KPMG and clients because Jenkins & Gilchrist and KPMG did not provide individualized tax or legal advice but rather marketed identical tax shelter packages).

111. See United States v. Frederick, 182 F.3d 496, 502 (7th Cir. 1999) (Posner, C.J.) (stating in dictum that nothing in section 7525 of the Internal Revenue Service (Code) “suggests that these nonlawyer practitioners are entitled to privilege when they are doing other than lawyers’ work”); United States v. KPMG LLP, 237 F. Supp. 2d 35, 39 (D.D.C. 2002) (concluding that advice relating to tax return preparation provided by accountants is not privileged).

112. See, e.g., James M. Lynch, War of the [Tax] Worlds: Privilege Versus Transparency, Taxes, Mar. 2004, at 89, 89 (2004); Stratton, supra note 103 (reporting comments at an April 13 teleconference sponsored by the ABA); see also Bruce Kayle, The Tax Adviser’s Privilege in Transactional Matters: A Synopsis and a Suggestion, 54 Tax Law. 509, 531-53 (2001) (noting that a tax lawyer’s transactional advice may be unprivileged due to disclosure to other parties in the negotiation or characterization as business or accounting advice instead of legal advice).

113. See infra Part III.B.3 (discussing Circular 230 developments).

114. A 2006 survey showed that seventy-six percent of responding tax directors had “significantly changed [their] practice regarding documenting tax reserves in the last two years” and that seventy-four percent had provided outside counsel tax opinions to auditors. TCPI 2006 Survey, supra note 1, at 23. It is not clear from the survey data, however, whether they increased or decreased their demand for written advice. The same report noted that of the thirteen tax director respondents who had experienced increased government demand for information and made a change as a result, ninety-two percent only asked for written advice when absolutely necessary; and that of the twenty-five tax director respondents who had experienced increased government demand for information and not made a change as a result, seventy-two percent believed that the need for a written record was more important than the risk of possible disclosure of privileged information. See id. at 29, 30.
E. What Causal Effect Does Sarbanes-Oxley Have on Tax Compliance?

This Article argues that the larger and more visible post-Sarbanes-Oxley tax decision-making group amplifies the compliance tendencies of each of its members. These compliance tendencies depend in part on the possibility of tax-related significant deficiencies or material weaknesses under Section 404, which carry adverse reputational consequences, including possible loss of employment for the tax director. They also depend on the enforcement measures and professional standards described in Part III. Some of the enforcement elements described in Part III (such as Circular 230 enforcement standards) directly impact members of the tax decision-making group. Others (such as prominent criminal cases against CEOs in connection with accounting scandals) do not directly impact such group members. Nevertheless, the enforcement efforts have an indirect effect because of the strong influence that organization leaders (like CEOs) exert on their subordinates (like tax directors).

This Article does not offer rigorous empirical proof that Sarbanes-Oxley is a necessary piece of the tax shelter compliance puzzle. Nevertheless, the story of a larger and more transparent group with amplified compliance tendencies fostered by enforcement squares with the descriptions given by practitioners and government officials. Current government officials cite Sarbanes-Oxley as a factor that facilitates their efforts to increase public companies’ tax compliance. Prior to Sarbanes-Oxley, the IRS and Treasury reported frustration with their efforts to crack down on promoted tax shelters (although the relevant tax shelter rules were also changed in 2002). Larry Langdon, the former Commissioner of the IRS Large and Mid-Size Business Division (LMSB) who is now in private practice, has observed that a strong anti-tax shelter norm does not appear in private corporations not subject to Sarbanes-Oxley. Likewise, congressional

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115. See supra note 92 and accompanying text (noting that some tax directors left their jobs after reporting material tax weaknesses).
116. See supra note 34 and accompanying text (noting the importance of leaders’ ethics in forming group ethics).
117. See Deborah M. Nolan, LMSB’s Compliance Assurance Program (CAP): One Year Later, 58 Tax Executive 26, 26 (2006) (noting that CAP “is structured to leverage new corporate governance and financial reporting requirements imposed by the Sarbanes-Oxley Act”); Frontline, Tax Me If You Can: Will the Shelter Problem Return?, http://www.pbs.org/wgbh/pages/frontline/shows/tax/shelter/return.html (last visited Oct. 14, 2006) (“Congress . . . has moved forward with Sarbanes-Oxley, and boards of directors and professionals are certainly much more reticent to enter into some of these transactions.” (quoting Mark Everson, IRS Commissioner, 2003-present)).
118. See infra note 247 and accompanying text (noting frustration with pre-2002 regulations’ effectiveness).
119. See Frontline, supra note 117 (“I think, in large measure, [the tax shelter problem] has been licked for listed corporations because of Sarbanes-Oxley. I think we still have a major challenge with wealthy individuals, small companies, and private companies, because the lack of disclosure in those arenas still allows all the things we talked about with regard to promoters selling things to people and getting away with it.”) (quoting interview with Larry Langdon, IRS Commissioner, Large and Midsize Business Division, 1999-2003)).
attention has recently focused on the persistent problem of tax shelters for wealthy individuals—who have apparently not been deterred from participating in transactions that have been targeted by the IRS in the past.\footnote{See Senate Subcommittee Report on Tax Havens, supra note 4, at 17-28 (describing activities through 2005 of an internet-based promoter equity development group, which marketed off-the-shelf tax haven companies).} Finally, survey evidence shows that Sarbanes-Oxley compliance requires a significant share of tax directors’ energy and time.\footnote{See supra notes 1, 87 and accompanying text (summarizing survey evidence).}

III. WHY TAX DECISION MAKERS NOW WORRY ABOUT PERSONAL AND FIRM LIABILITY

The expanded and more transparent tax decision-making group described in Part II did not alone foster the development of a tax compliance norm. The group norm development literature discussed in Part I indicates that decreased personal responsibility and corporate hierarchy can allow corporate norms to overrule individual norms.\footnote{See supra Part I.D.} Moreover, as described in Part I, corporate norms often display aggressive, risk-taking tendencies due to organizational behavior phenomena such as optimism bias.\footnote{See id.} Parts I and II alone might suggest that groups whose work is transparent within an organization may more efficiently experience pressure to develop group norms that favor profit seeking (or effective tax rate minimization) over compliance. This Part explains the reasons for the liability and adverse publicity concerns of the members of the tax decision-making group and the people for whom they work. These concerns contribute significantly to the compliance-oriented nature of the recently developed group norm.\footnote{See supra text accompanying note 1 (noting that corporate tax directors now articulate compliance as a higher priority than effective tax rate reduction).}

A. Criminal Prosecution and Other Enforcement Efforts Directed at Corporate Managers

and Worldcom, among others. Some cases have also involved civil federal charges and private lawsuits, generating significant monetary penalties and settlements. Some directors have made settlement payments out of their own pockets.

Criminal and monetary penalties in these non-tax corporate manager cases have particular impact on the corporate hierarchy and culture within which the tax director works, because of the strong influence top executives wield over the ethics of their subordinate managers and the corporation as a whole. Increased IRS audit and enforcement activity aimed at corporate taxpayers have also directly impacted the tax director. Other measures, discussed below in Part III.B, target gatekeepers such as tax planners and auditors.

billion accounting fraud and also noting the acquittal of former HealthSouth CEO Richard Scrushy despite William Owens’s testimony against him).


129. See Almar Latour, Shawn Young & Li Yuan, Ebbers is Convicted in Massive Fraud, Wall St. J., Mar. 16, 2005, at A1 (reporting jury conviction of former Worldcom CEO Bernie Ebbers in connection with an $11 billion accounting fraud and noting the guilty plea of former CFO Scott Sullivan as well as Ebbers’s appeal plans). Ebbers received a sentence of twenty-five years and Sullivan a sentence of five years. See Guilty, Not Guilty, Misdrial, supra note 128 (providing a summary of conviction and sentencing results for prominent white-collar defendants).

130. See, e.g., Kara Scannell, Tyco to Pay $50 Million to Settle SEC Accounting Fraud Charges, Wall St. J., Apr. 18, 2006, at C2 (reporting the SEC settlement and noting that Tyco still faces active shareholder litigation including a class-action lawsuit related to accounting fraud). In some cases where offending corporations entered bankruptcy, class-action lawsuits against outside advisors have resulted in settlements. See, e.g., Gretchen Morgenson, Bank of America Settles Lawsuit over WorldCom, N.Y. Times, Mar. 4, 2005, at C1 (reporting that Citigroup had agreed to pay $2.65 billion and Bank of America would pay $460.5 million to settle a class action lawsuit brought by bondholders who alleged that the bankers failed to fulfill their duty to investigate WorldCom’s financial condition in connection with offerings of WorldCom bonds).

131. See, e.g., Daniel Akst, Fining the Directors Misses the Mark, N.Y. Times, Aug. 21, 2005, § 3, at 6 (noting Worldcom director payments of $20 million and Enron director payments of $13 million).

132. See supra notes 34-43 and accompanying text (discussing top-down ethical influences in large organizations).

B. Gatekeeper Liability: Criminal Enforcement, Civil Liability, and Circular 230

The idea of imposing liability on gatekeepers in an effort to prevent principals from engaging in misconduct has enjoyed significant academic attention. The precise definition of “gatekeeper” is sometimes elusive, but in the context of the tax decision-making group considered by this Article, three of the four members—the tax planner, the financial auditor, and the Section 404 auditor—qualify as agents who can “disrupt misconduct by withholding their cooperation from wrongdoers.” Recent enforcement efforts targeting gatekeepers increase the likelihood that they will do so.

1. Criminal Prosecution of Gatekeepers

The criminal prosecution of Arthur Andersen on charges of obstruction of justice in connection with the government’s investigation of Enron provides one example of this phenomenon. When the jury returned a guilty verdict, Andersen imploded. The U.S. Supreme Court’s subsequent reversal of the conviction came too late to save the firm. The harsh fate of Anderson apparently deterred the government from mounting another criminal prosecution against a similarly large audit firm KPMG for promoting tax shelters. Instead, the government’s criminal enforcement efforts consisted of a deferred prosecution agreement with the firm and criminal prosecution of individual employees.

KPMG was not alone in developing and marketing tax products in the 1990s, but other firms that did so made the decision to settle with the government. KPMG initially fought back. However, KPMG’s defense sagged in the face of emerging information, including a Senate minority report, about KPMG’s systematic tax product development and marketing practices, its strategies to conceal the products’ existence or details from the

134. See, e.g., Coffee, supra note 63, at 308-11 (describing the gatekeeper concept and possible pitfalls in reliance on gatekeepers); Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53 (1986).
135. See Cunningham, supra note 63, at 417 n.6 (2004) (suggesting that the gatekeeper label is imprecise and not very useful).
138. See Arthur Andersen LLP v. United States, 544 U.S. 696 (2005) (overruling a guilty jury verdict on grounds that the jury instructions did not properly articulate the knowing intent element of the obstruction of justice charge).
139. See Joseph A. Grundfest, Op-Ed., Over Before It Started, N.Y. Times, June 14, 2005, at A23 (stating that “Andersen was destroyed when it was indicted”).
IRS and its cavalier dismissal of the likelihood that large penalties could be imposed on the firm.141

The Justice Department believed that it could sustain criminal charges against the firm through evidence that KPMG had pushed fraudulent transactions marked by untrue representations about business purposes and the like.142 But both parties knew of the risk that a criminal indictment would ruin KPMG and knew that the demise of KPMG would have left only three U.S.-based global accounting firms.143 Thus, the parties entered into a deferred prosecution agreement, which drew heavily from the Justice Department’s corporate cooperation blueprint articulated in its 2003 Thompson memo.144

Under the agreement, KPMG must pay $456 million in return for the Justice Department’s promise not to pursue its prosecution of KPMG for criminal fraud and conspiracy charges.145 KPMG also agreed to limitations on its tax practice, such as heightened opinion letter standards and a prohibition on marketing any “pre-packaged tax product” or providing any confidential tax services.146 Importantly, KPMG also agreed to “cooperate” with the government. The cooperation agreement, following the Thompson memo model, requires a waiver of attorney-client privilege and the provision of any requested information, including information about current and former KPMG partners and employees, to the government.147

Criminal fraud and conspiracy charges were filed and are still pending against sixteen former KPMG partners, one lawyer, and one investment advisor.148 One former KPMG partner has pled guilty.149 With respect to

144. See Thompson Memo, supra note 2, pt. II.A.4 (listing “the corporation’s . . . willingness to cooperate in the investigation of its agents” as an element to be considered in determining whether to criminally charge a corporation).
145. See Letter from Justin S. Weddle et al., U.S. Att’y’s, S. Dist. of N.Y., to Robert S. Bennett, Att’y 2, 13-17 (Aug. 26, 2005) [hereinafter KPMG Deferred Prosecution Agreement] (on file with the Fordham Law Review) (stating that KPMG will pay $456 million and that the government will delay and potentially dismiss criminal charges).
146. See id. at 4-9 (articulating the practice restrictions and standards).
147. See id. at 9-12 (detailing the cooperation agreement).
the other individual criminal charges, the correct outcome is unclear, in part
because no court has passed on the legality of the underlying tax shelters.150
The government responds to this charge by explaining that the underlying
legality does not matter in light of evidently false representations drafted by
KPMG and made by KPMG for attestation by its clients.151 However,
because many of the false representations related to the existence of a “real”
business transaction, some commentators and the defense argue that the
representations boil down to a view about whether the underlying
transactions had enough substance in the first place and that the question of
whether the tax shelters themselves were legal is the only appropriate
starting point.152
Even if the individual defendants find vindication on substantive ground,
however, the pending criminal case against individual KPMG partners has
practitioners particularly worried because the government approach appears
to have weakened employers’ willingness to protect their employees.153 In
KPMG, the firm insulated itself from prosecution by identifying employees
as bad apples, withdrawing attorney fees and other support from them, and
waiving attorney-client privilege. Practitioners have responded with great
anxiety to the possibility of being scapegoated.154
This government approach may have lost part of its bite: The judge in
the KPMG case ruled that government pressure on KPMG to withhold legal
support from its former partners violated the partners’ constitutional rights
to substantive due process and assistance of counsel,155 and the former
KPMG partners’ lawsuit against KPMG for payment of legal fees is

149. See Lynneley Browning & Colin Moynihan, A Surprise in Tax Case on KPMG, N.Y.
Times, Mar. 28, 2006, at C1 (reporting the guilty plea of David Rivkin).
case attempts to short-circuit the messy business of proving that a tax shelter is illegal by
using the power of prosecution to target the tax advisers directly. And by cutting them off
from the support of their firm through the threat of a death-sentence indictment of KPMG
itself, the government seems intent on compelling the accused to cop a plea or settle the case,
and so deny them their day in court.”).
151. See Lynneley Browning, Prosecutors Lay Out the Case Against KPMG Defendants,
N.Y. Times, Apr. 24, 2006, at C2 (stating the prosecutors’ argument that the shelter
description in opinion letters was false and noting that the prosecutors sidestepped the
question of whether the transactions would be legitimate if in fact carried out in the way
described in the opinion letters).
Oct. 12, 2005, at A16 (criticizing the validity of the government’s case).
153. See, e.g., Fisher & Lattman, supra note 2, at 50 (noting the danger of talking to in-
house attorneys).
154. See, e.g., KPMG Anonymous Letter, supra note 2, at 6-9 (reporting “random tax
partner firings” and accusing KPMG leaders of improperly shifting firmwide responsibility
to a small number of unfortunate individuals).
(concluding that the Thompson Memo presumption that payment of fees indicates
unwillingness to cooperate interferes with defendants’ right to a fair trial); id. at 356, 362
(concluding that KPMG defendants might reasonably expect legal fee assistance from
KPMG and that government interference with payment of such fees could violate the right to
counsel).
pending. But some commentators speculate that this may simply encourage employers to make clear that they will not pay to defend criminal or civil charges brought against employees arising out of their employment.

2. Monetary Penalties and Civil Litigation

The criminal prosecution and deferred prosecution agreement described above is not the end of the matter for KPMG. The firm faces ongoing private party fraud and malpractice claims. Proposed settlements amount to hundreds of millions of dollars, on top of the approximately $450 million that KPMG must pay in connection with its deferred prosecution agreement.

Several of the Big Four accounting firms—which include Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers—have also faced stiff fines or other sanctions such as restrictions on individuals’ ability to practice in subsequent years. Settlements may arise from shareholder class-action lawsuits or SEC investigations. The charges typically relate to the audit firms’ failure to catch and stop accounting irregularities. These monetary settlements have been described as a recent trend, representing a change developing in the last decade or so, although firms also reached large settlements in the early 1990s with respect to the savings

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156. See David Reilly, KPMG Case Ordered to Trial on Legal Bills to Ex-officials, Wall St. J., Sept. 7, 2006, at C4 (reporting the court’s denial of KPMG’s motion to dismiss).


158. See Jeff Bailey & Lynneley Browning, KPMG May Dodge One Bullet, Only to Face Another, N.Y. Times, June 21, 2005, at C1 (noting pending civil litigation and potential damages of hundreds of millions of dollars).

159. See David Reilly, KPMG Can’t Shake Lawsuit, as Investors Reject Settlement, Wall St. J., Apr. 27, 2006, at C2 (reporting a proposed $195 million settlement in a class-action case against KPMG and Sidley Austin Brown & Wood LLP, which a number of class members have rejected).

160. See supra note 145 and accompanying text.

161. See, e.g., Barnaby J. Feder, KPMG Units Agree to Pay to Settle Malpractice Suits, N.Y. Times, Oct. 8, 2004, at C2 (reporting a $115 million class action settlement relating to Lernout & Hauspie alleged accounting irregularities which would apparently rank just outside the top ten settlements by major accounting firms); Joseph B. Treaster, Ernst & Young Says It Will Pay Millions to Settle a Dispute, N.Y. Times, Dec. 18, 1999, at A1 (reporting a settlement with Cendant shareholders of $335 million).

162. See Floyd Norris, Ernst Partners Accept Limits on Audits, N.Y. Times, Apr. 25, 2003, at C1 (reporting that two Ernst & Young audit partners agreed to a settlement with the SEC related to the firm’s failure to detect accounting violations at Cendant Corporation and that the settlement forbids the partners from auditing public companies).

163. See Feder, supra note 161 (noting that a KPMG settlement “reflects a trend in the last decade in which major accounting firms have been drawn into—and paid large sums to get released from—litigation growing out of major financial scandals”).
and loan debacle. The apparently escalating anxiety of accountants is captured, among other places, at a website launched in June 2000, accountingmalpractice.com, which lists emerging reasons for increased malpractice exposure and sells tools to reduce it.

3. Circular 230

The federal government’s Circular 230 rules set forth the standards with which a tax advisor must comply in order to be eligible to practice before the IRS by, for example, representing a client in an audit situation or filing documents (beyond tax returns) on behalf of a client with the IRS. The government has amended and updated Circular 230 several times in the last several years. Circular 230 sets forth threshold requirements for an individual to be permitted to practice before the IRS, articulates practice standards, describes reasons for disciplinary action, and establishes enforcement mechanisms which may lead, for example, to the sanction of prohibition of future practice before the IRS. An IRS sanction may further lead to disbarment or revocation of a CPA license to practice, and may prevent the sanctioned individual from participating in a partnership with other, unsanctioned practitioners.

At least two recent developments in Circular 230 have received significant practitioner attention. The first relates to tax opinions, and provides standards that “covered opinions” must meet in order to provide a

164. See Alison Leigh Cowan, Big Law and Auditing Firms to Pay Millions in S.& L. Suit, N.Y. Times, Mar. 31, 1992, at A1 (reporting significant settlement agreements from a number of firms in connection with private and government actions for savings and loan frauds).


166. See Wolfman, Holden & Harris, supra note 107, § 105.1.1, at 17-18 (describing Circular 230’s definition of “practice before the IRS”).


168. See Wolfman, Holden & Harris, supra note 107, § 105.1.2, at 19-22 (describing categories of practitioners eligible to practice before the IRS, including attorneys and certified public accountants).

169. See id. § 105.1.4, at 24-26 (listing practice requirements including due diligence, avoidance of conflict of interest absent informed consent, and prohibition against signing a return that contains a position that lacks a “realistic possibility of being sustained on the merits unless the position is not frivolous and the position is adequately disclosed to the Service”).

170. See id. § 105.1.5.1, at 26-28 (listing reasons for disciplinary action including a conviction of a felony or crime involving dishonesty, knowingly providing false information to the IRS, knowingly or recklessly rendering a false tax opinion, or willfully violating any provision of Circular 230).

171. See Circular 230, 31 C.F.R. § 10.50 (2005); see also Wolfman, Holden & Harris, supra note 107, § 105.1.5, at 26 (describing enforcement measures).

172. See Wolfman, Holden & Harris, supra note 107, § 105.1.5, at 26.

taxpayer with “reasonable cause” protection against penalties.174 One category of covered opinions is particularly broad: reliance opinions, which constitute written advice that “concludes at a confidence level of at least more likely than not . . . that one or more significant Federal tax issues would be resolved in the taxpayer’s favor.”175 However, an opinion that includes a disclaimer stating that the opinion may not be used to protect against certain penalties176 does not count as a covered reliance opinion.177

A practitioner delivering a valid covered opinion must not rely on any factual assumptions or representations that he or she should know are unreasonable,178 and the practitioner must provide a conclusion as to each significant federal tax issue unless the client has agreed explicitly to receiving a “limited scope opinion.”179 These requirements of broad investigation of facts and broad analysis of law make covered opinions elaborate and expensive exercises. Furthermore, the broad definition of reliance opinions has persuaded some practitioners that every e-mail communication might be a reliance communication, giving rise to a ubiquitous practice of placing Circular 230 disclaimers at the bottom of every law firm e-mail. In an effort to take the communication out of the “covered opinion” definition, these disclaimers state that advice therein may not be used for penalty protection purposes.180

The goal of the ubiquitous disclaimer is to avoid the possibility of Circular 230 sanctions as a result of a covered opinion failing to meet the applicable standards. As mentioned above, violations of Circular 230 can lead to loss of the privilege of practicing before the IRS or to other sanctions. Related penalties such as a prohibition against partnering with another unsanctioned practitioner, loss of state-issued professional licenses, or reputational harm can follow from IRS sanctions. Prior to the current

174. See Circular 230, 31 C.F.R. § 10.35 (describing “covered opinion” requirements). Under section 6664 of the Code, certain penalties applicable to underpayments do not apply if the taxpayer demonstrates that it has acted in good faith and that there was reasonable cause for its return position. See I.R.C. § 6664(c), (d) (West Supp. 2005). A tax opinion is one common way of demonstrating reasonable cause.


176. See, e.g., I.R.C. § 6664(c) (providing that a taxpayer may avoid penalties under sections 6662 and 6663 of the Code with “reasonable cause” and “good faith”).

177. See Circular 230, 31 C.F.R. § 10.35(4)(ii) (providing a no-penalty-protection carveout from the reliance opinion definition).

178. See id. § 10.35(c)(1) (detailing Circular 230 requirements regarding factual matters).

179. See id. § 10.35(c)(3) (detailing requirements regarding the evaluation of tax issues).

180. See Letter from Kimberly S. Blanchard, Chair, N.Y. State Bar Ass’n Tax Section, to Mark W. Everson, IRS Comm’r, et al. (May 1, 2006), in NYSBA Tax Section Members Submit Revised Version of Proposed Circular 230 Regs, Tax Notes Today, May 1, 2006, available at LEXIS, 2006 TNT 85-19 (noting the “nearly universal” practice of tax practitioners to legend all written communications with a no-penalty-protection warning since the promulgation of the present version of Circular 230). The same letter notes that the no-penalty-protection warning may be inaccurate because no regulations under I.R.C. § 6664 have been issued to confirm that the requirements of Circular 230 will be followed for purposes of imposing penalties on taxpayers (as opposed to enforcing practice standards for tax advisors). See id.
Circular 230 amendments, general professional ethics rules governed non-tax shelter tax opinions\textsuperscript{181} and tax shelter opinions were narrowly defined,\textsuperscript{182} so that the sanction of losing the privilege of practicing before the IRS did not directly tie to opinion standards. Moreover, another revised Circular 230 provision charges the persons responsible for tax practice within a firm to ensure that others in the firm comply with Circular 230 rules.\textsuperscript{183}

The second element of the Circular 230 overhaul that has attracted significant attention is the development of a more aggressive and more public enforcement office. The former Office of Practice was renamed the Office of Professional Responsibility (OPR), and its staff doubled in size.\textsuperscript{184} OPR reportedly wants to increase the impact of disciplinary procedures, in part by pursuing prominent cases that it hopes can more broadly influence practitioner behavior.\textsuperscript{185} OPR has also taken the controversial step of proposing public, not private, disciplinary proceedings when a case reaches the administrative law judge stage.\textsuperscript{186} The proposal has drawn significant practitioner criticism because of the perceived in terrorem effect of publicity.\textsuperscript{187}

Circular 230 is an important reason why one member of the tax decision-making group—the tax planner—feels an increased incentive to comply with the law. The perceived broadening of responsibility for investigating a client’s facts and relevant law (at least for purposes of penalty protection opinions) and the tougher and more public approach of OPR makes practitioners worry about the possibility of enforcement. Moreover, the provision establishing supervisory responsibility for tax practice leaders plants this worry within the context of the firm hierarchy, making it more likely that the Circular 230 concerns of a junior associate at a law firm, for example, will be reinforced by interactions with the partner who leads the firm’s tax department.

\textsuperscript{181} Cf. Wolfman, Holden & Harris, supra note 107, § 503.2.1, at 418-19 (outlining professional ethics rules).
\textsuperscript{182} See id. § 503.4.2.1, at 426-27 (providing the definition of tax shelter under the prior rules).
\textsuperscript{183} See Circular 230, 31 C.F.R. § 10.36(a) (imposing responsibilities on tax practice leaders).
\textsuperscript{184} See Schneider, Dixon & Hymel, supra note 167, at 41-42 (describing the new Office of Professional Responsibility (OPR)).
\textsuperscript{185} See Dennis B. Drapkin, ABA Tax Section Submits Comments on Disciplinary Procedures of IRS Office of Professional Responsibility, Tax Notes Today, Dec. 8, 2005, available at LEXIS, 2005 TNT 236-18 (reporting OPR’s intention to shift its enforcement focus).
\textsuperscript{186} See Regulations Governing Practice Before the Internal Revenue Service, 71 Fed. Reg. 6421, 6433 (proposed Feb. 8, 2006) (proposing Circular 230 § 10.72, which would provide for open proceedings in general).
\textsuperscript{187} See, e.g., Sheryl Stratton, Transparency at the OPR: A Two-Way Street?, 110 Tax Notes 580, 581-82 (2006) (describing comments of prominent practitioners that open proceedings will permit the IRS to ruin a practitioner’s reputation without regard to the validity of the charge).
C. Publicity

The media spotlight has shone on corporate scandals in recent years, and this, too, makes tax decision makers anxious. Many of the authorities cited in the immediately preceding sections are newspaper articles. Scandal is big news, both general corporate scandal and tax-specific scandal.

A tax planner is always wary of Lee Sheppard, the intrepid reporter for Tax Notes, and of her colleagues. But major newspaper reporters of late also have been known to undertake detailed public record examinations in search of a tax shelter story. A recent bestseller by New York Times reporter David Cay Johnston showcases investigative tax journalism with chapters lambasting individual and company tax strategies such as Stanley Works’s proposed inversion transaction. A 2003 PBS Frontline report on tax shelters also raised the issue’s profile.

The government plays more than a standby role in this media saga. The government issues press releases about its pursuit of tax cheats, sometimes based on settlement deals with taxpayers that include the taxpayer’s waiver of certain confidentiality rights. It publicizes settlement offers about tax strategies whose legality has not yet been adjudicated—and then announces the billions of dollars of revenue that result from the settlement offers. It publicized the KPMG case, and the details of that firm’s deferred prosecution deal.

The perceived increased possibility of adverse media attention has led practitioners—including the Big Four accounting firms—to formally note the adverse impact that tax planning can have on corporate reputation.

192. See infra notes 209-12 and accompanying text (describing tax shelter settlement offers as announced by the IRS).
193. Martin A. Sullivan, Reputation or Lower Taxes?, 108 Tax Notes 981, 981 (2005) (reporting on reports put out by each of the Big Four accounting firms and noting that the focus of media and government attention is on “aggressive” or “socially irresponsible” but not necessarily tax evasive behavior).
Accounting firm papers describe successive trends in tax planning, from costcutting in the 1980s to lowering effective tax rates in the 1990s to protecting corporate reputation today. And conference participants buzz anxiously about the possibility of landing on the front page of The Wall Street Journal.

IV. A CLEAR GOVERNMENT MESSAGE

In Part II, this Article described the emergence of an expanded and more transparent public corporation tax decision-making group that amplified its members’ compliance tendencies. In Part III, this Article explained that recent criminal enforcement, civil liability, professional standards, and publicity efforts cause members of this decision-making group to worry more about personal and firm liability. Part IV provides the final piece to the organizational behavior puzzle regarding the recent tax compliance norm at public corporations: the clear government identification of acceptable, and unacceptable, activities, particularly in the tax shelter area. Part IV also explores the reactions of tax decision-making groups within public corporations to a new financial accounting standard for uncertain tax positions.

A. The Tax Shelter Problem

In the 1990s, major accounting and other tax advisory firms engaged in significant tax shelter development and marketing efforts. The tax shelter products typically involved hypertechnical readings of the Internal Revenue Code or regulation provisions and possessed a “cookie-cutter” quality: Promoters could market them to many taxpayers. In the late 1990s, media reports described heavily marketed strategies undertaken for tax reasons alone, with no real business purpose. In 1999, Treasury released a report on shelters that catalogued the available substantive provisions.


195. See, e.g., John Brennan, Vice President, U.S. Income Tax, Hewlett Packard, Presentation at the San Jose State University/Tax Executives Institute High Technology Tax Institute: Good Tax Planning Gone Bad (Nov. 8, 2005); see also Ernst & Young Analyzes Tax Transparency Dynamics, supra note 3 (“Senior management and board members sometimes refer to . . . ‘The Wall Street Journal’ factor. This is the fear of being the subject of media coverage arising from a transaction, including a tax planning transaction, that might raise the concerns of stakeholders . . . and inflict damage to corporate reputations and stock prices.”).

196. See Wolfman, Holden & Harris, supra note 107, § 208.1, at 139 (contrasting “present day corporate tax shelter[s]” with individual tax shelters of the 1970s and 1980s, which made use of tax preferences contemplated by the Code or regulations).


disclosure and penalty requirements, and case law doctrines limiting or regulating tax shelters, as well as describing several types of transactions that made the government hopping mad.

The “son-of-BOSS” loss generation transaction provides an example. Each of the Big Four accounting firms marketed this or a similar transaction between 1997 and 2000, often targeting taxpayers who had just sold corporate stock at a gain. One variation featured the contribution of offsetting positions (purchased for the purpose of engaging in the tax shelter transaction) consisting of one position with built-in gain and one position with built-in loss to a corporation or partnership. The net economic value of the two positions taken together was close to zero; a taxpayer purchased them for the purpose of engaging in the transaction at nominal cost. The loss side of the position typically involved a contingent liability or an interest component, which the taxpayer argued should not reduce the basis of the corporate stock or partnership interest. The taxpayer took the position that the basis of the stock or partnership interest increased by the high basis of the built-in gain position, but did not decrease by the full amount of the loss position. This position was rooted in a technical reading of section 752 (in the case of a partnership interest) or section 358 (in the case of corporate stock). Then the taxpayer sold the stock or partnership interest, with its high basis, for its true, lower economic value, and claimed a loss.

Promoters aggressively marketed tax shelter products. In one instance, a shelter appropriate for S corporation shareholders was marketed through a telemarketing firm that cold-called owners of S corporations throughout the country. Another marketing technique, appropriate for public corporation tax directors, involved the cross-selling of tax product services by audit partners who arranged meetings between the tax directors at their audit clients and the tax consultants at the audit firm. The tax consultants could propose products precisely tailored to the needs of the corporate client, since those needs were well-known by the audit team.

At its peak in the late 1990s, tax product work may have represented as much as ten percent of some accounting firms’ global revenues and as much

199. Id. at 35-38 (giving examples of general anti-abuse provisions, specific statutory responses to specific tax shelter problems, and statutory grants of broad regulatory authority).

200. Id. at 58-76 (reviewing tax shelter registration and other requirements from the 1980s effort against personal tax shelters and a 1997 law strengthening penalties applicable to corporate tax shelters).

201. Id. at 46-58 (outlining substance-over-form, step transaction, business purpose, and economic substance doctrines).


204. See id. at 36-38 (describing the cooperation between tax product and audit teams in designing and marketing products).
as twenty-five percent of firms’ revenues in the United States.\textsuperscript{205} It also resulted in significant losses to the U.S. fisc. Tax shelter revenue loss measures are notoriously difficult to estimate,\textsuperscript{206} but most attempts indicate at least $10 billion annually during the late 1990s.\textsuperscript{207} The IRS estimated tax losses at up to $85 billion from listed and non-listed transactions as of September 30, 2003.\textsuperscript{208} The results of tax shelter settlement offers made by the IRS also give some idea of the magnitude of the losses. The son-of-BOSS 2004 settlement offer attracted 1200 taxpayers and generated $3.7 billion in taxes, interest, and penalties.\textsuperscript{209} A settlement offer covering numerous other shelters, which closed in January 2005, attracted an estimated 2000 taxpayers and generated an estimated $2 billion.\textsuperscript{210}

Costs other than direct revenue loss also result from tax shelter activity.\textsuperscript{211} They include wasted time and money from uneconomic tax planning and from resulting enforcement efforts,\textsuperscript{212} increased complexity as a result of statutory response to perceived abuse,\textsuperscript{213} and the degeneration of the voluntary compliance that underlies the U.S. income tax system (aside

\textsuperscript{205} See id. at 11-12 (reporting KPMG’s worldwide revenue of $10.7 billion and KPMG’s U.S. revenue of $4 billion in 2002 and peak annual tax shelter revenue of $1.2 billion).


\textsuperscript{207} See Slemrod, supra note 5, at 880 & n.9 (citing an IRS contractor estimate of $14.5 to $18.4 billion in 1999 and Professor Bankman’s 1999 estimate of $10 billion for abusive shelters targeted at corporations and wealthy individuals). This amount is material, though not overwhelming, in the context of the estimated $350 billion annual tax gap. See IRS Announces Results of Study on Tax Gap, Tax Notes Today, Mar. 29, 2005, available at LEXIS, 2005 TNT 60-5 (reporting that a three-year study called the National Research Program found a tax gap of $312 to $353 billion in 2001 and that most of the tax gap derives from underreporting noncompliance).


\textsuperscript{211} See 1999 Treasury Report, supra note 7, at iv.

\textsuperscript{212} Some go so far as to assert that nearly all tax planning is worthless. See, e.g., David A. Weisbach, Ten Truths About Tax Shelters, 55 Tax L. Rev. 215, 222-25 (2002) (asserting that tax planning is a negative externality although acknowledging that planning to avoid taxpayer-adverse mistakes in the law may have value).

from wage withholding) in the first place. With respect to the last point, sociologists have noted the phenomenon of taxpayers drawing on and copying one another's normative decisions, commenting that the “right” decision from a taxpayer’s perspective depends on context. This phenomenon is evidenced by empirical data suggesting that compliant taxpayers believe that other taxpayers also comply, while noncompliant taxpayers believe that other taxpayers engage in fraud.214

B. Drawing the Tax Shelter Line

Having identified corporate tax shelters as a problem, the government faced the task of how to attack them. When Treasury’s report on The Problem of Corporate Tax Shelters emerged in 1999,215 regulations such as the requirement to register certain confidential corporate transactions with “a significant purpose” of tax avoidance already existed, though they (evidently) did not stem the corporate tax shelter tide.216 More recently, and contemporaneously with the Sarbanes-Oxley and enforcement developments described in Parts III and IV, the government has used two principal tools to define the line between acceptable business tax planning and tax shelters. The first tool is litigation. The second tool is disclosure regulations.

1. Litigation

The government has generally challenged alleged tax shelter transactions with substance-over-form arguments. That is, the government claims that the form of such transactions should not be respected because it lacks economic substance or business purpose.217 A full survey of recent corporate tax shelter cases is beyond the scope of this Article. However,

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216. See I.R.C. § 6111(d) (Supp. IV 1998) (requiring registration of a transaction with a significant purpose of avoidance or evasion of federal income tax by a corporation, where the transaction is offered under conditions of confidentiality and the promoter may receive a fee that exceeds $100,000); see also Wolfman, Holden & Harris, supra note 107, § 208.1, at 137-40 (describing the history of tax shelters, including the episode of aggressively marketed individual tax products in the 1970s and 1980s); id. §§ 208.3.1-208.3.2.2, at 148-59 (outlining a 1994 law change that raised the opinion standard for corporate tax shelters for purposes of the substantial understatement penalty in section 6664(c) of the Code and outlining the 1997 change requiring registration of certain confidential transactions in section 6111(d) of the Code).

217. See Rice’s Toyota World Inc. v. Comm’r, 81 T.C. 184, 203 & n.17, 209 (1983) (indicating that a transaction should be respected as valid if it either has business purpose or “possesses some modicum of economic substance”), aff’d in part and rev’d in part, 752 F.2d 89 (4th Cir. 1985); see also Wolfman, Holden & Harris, supra note 107, §§ 208.4, 208.4.1, at 169-71 (noting the subjective business purpose element and objective profit motive elements of economic substance inquiry).
the discussion below outlines several of the more prominent cases and attempts to give the mixed-results flavor of the litigation.

The government scored an early win in *ACM Partnership v. Commissioner*, in which the Tax Court disallowed partnership losses disproportionately allocated to Colgate Palmolive under a scheme involving a product marketed by Merrill Lynch, a tax-indifferent partner, and a technical interpretation of the contingent payment installment sale rules.218 The *ACM Partnership* court focused on the lack of an economic profit that exceeded transaction costs in reaching its conclusion that the transaction lacked economic substance, but failed to provide much detail regarding that standard, including how much profit would be enough or whether the economic substance and business purpose tests were independent.219 The U.S. Court of Appeals for the Third Circuit affirmed.220

Since *ACM Partnership*, the government has scored several trial and appellate victories. The Eleventh Circuit agreed with the Tax Court in *Winn-Dixie Stores, Inc. v. Commissioner* that the taxpayer could not deduct interest derived from the corporation’s borrowing against life insurance policies it owned on the lives of its employees. The court found that the program lacked economic substance where the paid interest and fees exceeded the policies’ expected return, and the court also found no business purpose.221 In *Long-Term Capital Holdings v. United States*, the Second Circuit upheld an unusual forty percent gross valuation misstatement penalty assessed against Long-Term Capital Management (LTCM) with respect to a loss-generation partnership transaction that was based in part on the false representation of LTCM that it had a valid business purpose for the transaction.222

Recently, the government has trumpeted several other wins—or, at least, not losses—in tax shelter litigation.223 The Fourth Circuit reversed a district court’s grant of summary judgment for the taxpayer in *Black & Decker Corp. v. United States*, concluding that the court had to hear expert

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219. See Wolfman, Holden & Harris, supra note 107, § 208.4.2, at 177-78 (analyzing *ACM Partnership*).
220. See *ACM P’ship*, 157 F.3d at 263 (affirming the disallowance of noneconomic losses).
221. See Winn-Dixie Stores, Inc. v. Comm’r, 254 F.3d 1313, 1316-17 (11th Cir. 2001) (accepting the tax court’s finding that the program could not generate a pretax profit and that program lacked any real business motive), aff’g 113 T.C. 254 (1999).
witnesses and consider more carefully the IRS argument that the taxpayer lacked an objective profit motive. In Coltec Industries v. United States, the Federal Circuit, reversing the Court of Claims, concluded that a contingent liability transaction lacked economic substance, rejecting the taxpayer’s claim that assigning contingent asbestos liabilities to a different subsidiary had business purpose. In TIFD III-E, Inc. v. United States (Castle Harbour), the Second Circuit concluded that interests held in a partnership by Dutch banks were debt interests, not equity interests—which meant that the underlying tax shelter would not work as intended.

However, some of the government’s earlier trial court victories were reversed by appellate courts. Two cases involving a taxpayer’s participation in a marketed and prepackaged foreign tax credit product demonstrate the difficulty of deciding on a metric to use in computing pre-tax profit. In Compaq Computer Corp. v. Commissioner and IES Industries v. United States, the purchase of non-U.S. corporate stock (in the form of American Depositary Receipts) immediately before the dividend record date and the sale of the same stock immediately after the dividend record date generated offsetting dividend income and capital loss and a bonus foreign tax credit. The lower courts concluded, after treating the foreign tax as an expense, that there was not economic profit. The Fifth and Eighth Circuits concluded that a measure of pre-tax profit should not treat foreign tax as an expense, and reversed the Tax Court. Another case reveals courts’ reluctance to disregard transactions with unrelated third parties. In United Parcel Service of America v. Commissioner, the Eleventh Circuit reversed the Tax Court in respecting the taxpayer’s transfer of its

224. See Black & Decker Corp., 436 F.3d at 440-43 (noting that Black & Decker had stipulated for purposes of summary judgment that the transaction was solely tax-motivated and criticizing the district court’s failure to thoroughly consider IRS evidence tending to show the lack of an objective profit motive). But see Karen C. Burke, Black & Decker in the Fourth Circuit: Tax Shelters and Textualism, 111 Tax Notes 315, 325-26 (2006) (noting that, despite its pro-government economic substance decision, the Fourth Circuit’s textualist approach to statutory interpretation of section 357 of the Code ignored secondary sources and might encourage rigid technical readings of statutes by tax shelter designers).

225. See Coltec Indus., 454 F.3d at 1352-54 (discussing the economic substance issue).

226. See TIFD III-E, Inc., 459 F.3d at 241 (holding that Dutch banks held debt, not equity).

227. See Wolfman, Holden & Harris, supra note 107, § 208.4.3, at 182-83 (describing the transactions at issue in Compaq Computer Corp. v. Commissioner and IES Industries v. United States).


229. See Compaq Computer Corp., 277 F.3d at 784-87 (eliminating the foreign tax expense from profit calculation and using resulting pretax profit as evidence of economic substance and business purpose); IES Indus., 253 F.3d, at 354-56 (reaching a similar result).
excess value insurance business to a related Bermuda corporation through a reinsurance agreement with an unrelated firm.\footnote{230}

Despite some recent elucidation in the government’s favor, this mixed case law does not draw a clear line between acceptable and unacceptable transactions. Indeed, courts appear to disagree on the appropriate legal standard: The cases fail to explain whether a transaction must possess both business purpose and an objective profit motive in order to be sustained.\footnote{231} Legislation clarifying the economic substance standard is sometimes proposed.\footnote{232} Prominent commentators, however, criticize this approach, arguing that the limits of statutory drafting would result in an inferior doctrine.\footnote{233} The government also no longer advocates economic substance codification.\footnote{234} The IRS and Treasury have concentrated their regulatory energies instead on articulating, enforcing, and using information from a tax shelter “web of disclosure.”\footnote{235}

2. Defining Tax Shelters: The Academic Debate

In parallel with its litigation efforts, the IRS and Treasury embarked in 2000 on a regulatory assault on tax shelters that ultimately attempted to clearly identify unacceptable tax shelters and to prevent taxpayers from

\footnote{230. See United Parcel Serv. of Am. v. Comm’r, 254 F.3d 1014, 1018-20 (11th Cir. 2001) (emphasizing the participation of an unrelated firm and comparing the UPS transaction to the form-of-entity or debt-versus-equity tax-influenced business decisions), rev’g 78 T.C.M. (CCH) 262 (1999).}

\footnote{231. See Wolfman, Holden & Harris, supra note 107, § 208.4.3, at 180 (noting that “courts continue to struggle with whether a transaction needs to possess both a bona fide non-tax business purpose and reasonable expectation of pre-tax profit to be sustained”); see also Joseph Bankman, The Economic Substance Doctrine, 74 S. Cal. L. Rev. 5, 29 (2000) (noting the complexity and uncertainty of the economic substance doctrine).}

\footnote{232. See, e.g., H.R. 4297, 109th Cong. §§ 411-13 (2006) (“clarifying” economic substance and providing penalties for transactions without it); see also Lee A. Sheppard, Economic Substance Update, 106 Tax Notes 1137, 1142 (2005) (noting that the Senate included a draft of economic substance codification in its version of the budget reconciliation bill, that the draft was “scored to bring in $15 billion over ten years,” and that the provision was expected to be deleted in reconciliation conference negotiations).}

\footnote{233. See, e.g., Eustice, supra note 213, at 164-65 (stating that the economic substance doctrine is better left to the courts); Bernard Wolfman, Letter to the Editor, Why Economic Substance Is Better Left Uncodified, 104 Tax Notes 445, 445 (2004) (“There is no shortcut.”); see also Marvin A. Chirelstein & Lawrence A. Zelenak, Tax Shelters and the Search for a Silver Bullet, 105 Colum. L. Rev. 1939, 1952-53 (2005) (arguing for the disallowance of loss in excess of measurable net worth decrease but not for the codification of the economic substance doctrine).}

\footnote{234. See, e.g., Patti Mohr, Senators Scrutinize “Peddlers” of Abusive Tax Shelters, Tax Notes Today, Oct. 22, 2003, available at LEXIS 2003 TNT 204-1 (noting the opposition of the George W. Bush Administration to codification of economic substance because of increased uncertainty and burdens on the IRS rulemaking process, and noting the comments of Pamela Olson, Assistant Secretary for Tax Policy, at a hearing before the Senate Finance Committee).}

engaging in them. The effort to define tax shelters reveals the complex schizophrenia of U.S. federal income tax law, under which some provisions of law are nicely consistent with the theory of a realization-based income tax and others are unabashed tax expenditures. Even if one can say that the tax shelter rules aim at taxpayers who take wacky positions under rules grounded (or which the government believes are grounded) in sensible income tax policy, it is often hard to tell to which group a rule belongs.

Some commentators contend that a tax shelter definition should diligently avoid encompassing transactions that have any business element.236 Another description focuses on the objective economic substance of a transaction and considers transactions illegitimate if economic losses (or gains) do not accompany tax losses (or gains) of similar magnitude.237 Some commentators focus on legislative intent, rather than business or tax motive;238 others would simply err on the side of over-inclusiveness.239

Another approach is to list the common features of tax shelters. This method borrows from the tax motivated, economic substance, and legislative intent concepts while bringing them down to a more practical level. Professor Joseph Bankman’s 1999 list included items such as providing a tax loss with little risk of economic loss (an economic substance concept); the presence of a tax-indifferent party (which suggests that the tax-concerned party will be able to fulfill its tax-motivated strategy without push back); and the presence of a flaw in the tax system that mismatches economic and tax income (a factor relating to legislative intent).240 Professor James Eustice proposes a similar list, adding the absence of economic profit prospects or business purpose.241

Bankman and Eustice also include factors relating to the marketing or promotion of tax shelters in their lists of characteristics, suggesting that “prepackaged” transactions242 and transactions suitable for use by more than one taxpayer243 are more likely to be tax shelters. These factors follow from the insight that tax strategies that develop independently of a taxpayer’s particular business situation more likely lack business purpose or economic substance. Bankman also lists the following factor: “[T]he

236. See, e.g., David P. Hariton, Commentary, Response to “Old ‘Brine’ in New Bottles” (New Brine in Old Bottles), 55 Tax L. Rev. 397, 400 (2002) (proposing a narrow definition of a tax shelter as a transaction that “would not have been entered into at all but for the desire to claim tax benefits”).

237. See Eustice, supra note 213, at 155-56 (describing mortgage pool swaps engineered by Cottage Savings as legitimate because the accelerated loss was a real economic loss).

238. See Schler, supra note 6, at 331 (outlining a definition of a tax shelter).

239. See Pearlman, supra note 9, at 290 (proposing a definition for purposes of disclosure of a transaction “if there is any possibility that the action does not comply with current law”).


242. See id. at 159.

243. See Bankman, supra note 240, at 1777.
shelter is likely to be shut down by legislative or administrative change soon after it is detected.\textsuperscript{244} The government acted definitively on this most pragmatic factor through its disclosure regulations, discussed below. And, particularly with respect to listed transactions, tax regulators gave great weight to promotion and marketing as a business purpose proxy.

3. The Web of Disclosure

The government first proposed tax shelter regulations in response to the recent wave of corporate tax shelter activity in February 2000.\textsuperscript{245} Its initial attempt featured a broad definition of tax shelter transactions and (due to a lack of congressional action)\textsuperscript{246} no penalties for nondisclosure. The regulations were not as effective as the government had hoped.\textsuperscript{247} After several rounds of amendment, drafters arrived at a clearer and more specific approach. The government also established the Office of Tax Shelter Analysis dedicated to identifying and shutting down tax shelter transactions.

Today, taxpayer disclosure requirements, material advisor reporting obligations, and list maintenance obligations target five categories of transactions: (1) listed transactions, which are specific transactions described by the IRS in quick-and-dirty notices designed to shut down the transaction quickly without elaborate regulatory process; (2) confidential transactions; (3) transactions that contractually require the return of an adviser’s fee if the desired tax outcome does not result; (4) loss transactions; and (5) transactions with brief asset holding periods.\textsuperscript{248} Under a 2004 statute, specific penalties apply for nondisclosure.\textsuperscript{249} In addition,
the government has established a policy of requesting all audit workpapers from any taxpayer who has engaged in an undisclosed listed transaction, echoing the Thompson memo’s emphasis on cooperation to remedy misbehavior.250

The government’s practices of discovering abusive transactions through a focused tax shelter office and of labeling transactions as tax shelters by “listing” them through immediately effective notices are central to its disclosure strategy under these revised regulations. Notices have identified about thirty transactions as shelters,251 including shelters whose validity is still being litigated. Listed transactions are typically marketed and promoted products, and the government’s tendency to consider “promotion” as a litmus test for abusive tax shelters is public knowledge.252

The government’s strategy of specifically labeling promoted tax shelter transactions as deviant behavior has apparently effectively translated into an anti-tax shelter compliance norm. Government officials say taxpayers have simply stopped engaging in the development or the use of such promoted tax shelter products.253 It is conceivable that government officials might make such claims without adequate evidence, perhaps in order to enhance others’ views of their performance or in order to increase taxpayer compliance by conveying the impression that most taxpayers comply.254

penalties for failure to maintain or supply investor lists); see also id. § 6662(a) (imposing a twenty percent penalty for certain underpayments); id. § 6700 (imposing a penalty on promoters of fifty percent of the gross income derived by the promoter from certain transactions). Other sanctions also follow from nondisclosure of reportable transactions. See generally Wolfman, Holden & Harris, supra note 107, at 25-33 (Supp. 2006) (summarizing penalties relating to tax shelters).

250. See I.R.S. Announcement 2002-63, 2002-27 I.R.B. 72 (announcing that IRS would request all workpapers if a taxpayer engaged in a listed transaction and failed to disclose it and would request workpapers relating to any disclosed listed transaction). This changed a historically restrained IRS policy. See id. However, it has long been clear that the IRS can enforce summonses of audit workpapers. See United States v. Arthur Young & Co., 465 U.S. 805, 816-21 (1984) (requiring auditors to produce workpapers in response to IRS summonses); see also I.R.C. § 7525(b) (providing that communications relating to transactions with a significant purpose of federal income tax avoidance or evasion do not enjoy the tax practitioner-client statutory privilege and cross-referencing I.R.C. § 6662(d)(2)(C)(ii)).


252. See GAO 2003 Report, supra note 208, at 4, 7 (stating that the IRS uses promoter investigations to identify shelters and uses investor information to identify promoters); see also Unofficial Transcript Is Available of Forum on Tax Shelters, supra note 102 (“I think the key aspect of technical tax shelters is marketing.”) (quoting Eric Solomon, Treasury Deputy Assistant Secretary for Regulatory Affairs and Acting Deputy Assistant Secretary for Tax Policy)).

253. See supra note 4 (summarizing government officials’ view that tax shelters are no longer widely promoted to large corporations).

254. See, e.g., Frontline, supra note 117 (“That’s obviously an opinion which anyone who defends the status quo is going to give—that things have changed. I don’t buy it at all.”) (quoting Sen. Carl Levin, Democrat of Michigan)).
However, this approach would conflict with IRS and Treasury incentives to support additional budget requests. Moreover, other available information corroborates the government officials’ view. For example, individuals who no longer work for the government agree that large accounting firms no longer promote corporate tax shelters.\footnote{See, e.g., id. (“‘I think that the firms are sufficiently concerned about the reputational damage of being in this tax shelter business. There is much less of an impetus for them to do it on a going forward basis.’” (quoting Pamela Olson, Treasury Assistant Secretary for Tax Policy, 2002-2004)).} Practitioners informally report that they do not currently observe the promoting and marketing of tax shelter products to public corporations. And one firm, KPMG, has explicitly agreed never to develop or market “prepackaged tax products” again and to have an internal monitor verify its compliance with this (and other) requirements for at least three years.\footnote{See KPMG Deferred Prosecution Agreement, supra note 145, at 5, 19, 21-22.}

Organizational behavior learning identifies ethical uncertainty as a factor that causes large organization norms to veer toward aggressive behavior.\footnote{See supra Part I.E.} This factor suggests that the clarity of the tax shelter rules, particularly the listed transaction rules, has contributed significantly to their success. Although numerous other factors affect a regulator’s choice between rules and standards, this example suggests a reason to consider rules seriously where the regulated party is a large organization. Perhaps the case is even stronger where, as in the tax shelter case, a relatively clear litmus test (promotion) is available and the regime is a disclosure regime, not an automatic liability regime.\footnote{See infra notes 287-93 and accompanying text.}

C. The New FASB Tax Benefit Accounting Standard

FASB’s revisions to the standard for recording tax benefits and liabilities for financial accounting purposes provide another example of the responsiveness of public corporation tax decision-making groups to revised, stricter rules. Under the long-standing standard, tax benefits were often reduced only if it was more likely than not that future tax attributes (such as net operating losses) would prevent their realization, and tax liabilities were accrued for financial accounting purposes only if it was probable that they would be successfully asserted by the government.\footnote{See James R. Browne, Financial Reporting for Uncertain Tax Positions, 109 Tax Notes 77, 78-81 (2005) (explaining previous standards); see also Accounting for Income Taxes, Statement on Auditing Standards No. 109, §§ 8, 17(e) (Fin. Accounting Standards Bd. 1992), available at http://www.fasb.org/pdf/fas109.pdf (providing that tax assets are reduced by a valuation allowance if it is more likely than not that some of the tax assets will not be realized); Accounting for Contingencies, Statement on Auditing Standards No. 5, § 8 (Fin. Accounting Standards Bd. 1975), available at http://www.fasb.org/pdf/fas5.pdf (requiring the accrual of loss contingencies (such as the possibility of increased taxes on audit) if it is “probable” that the liability exists).} A standard proposed in July 2005 would have added a presumption of government challenge and shifted the burden of proof by permitting the recording of tax benefits only
if it was probable that, assuming the benefits were challenged by the government, the government would lose. The proposal drew significant criticism from commentators who noted that the proposal might result in accounting inaccuracies, in particular overreporting of liabilities or underreporting of assets. Commentators expected some softening and extension of the effective date of the proposal. Nevertheless, the pending proposal caused some auditors to require a higher level of assurance than before for the recording of a future tax benefit—that is, a “should” opinion rather than a “more likely than not” opinion—before it was finalized.

FASB has since softened the proposed new standard to permit the recording of future tax benefits if it is “more likely than not” that, assuming they are challenged by the government, the government would lose. This standard is still tougher: It adds a presumption of government challenge and shifts the burden of proof, though “more likely than not” is less stringent than “probable.” Tax director surveys show that tax departments are devoting significant energy to compliance with the new standard.

V. NORM DEVELOPMENT AND TAX POLICY

This cultural story of the development of an anti-tax shelter norm raises several broader points. First, it provides a framework to consider whether a

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260. See Accounting for Uncertain Tax Positions—An Interpretation of FASB Statement No. 109, Exposure Draft No. 1215-001 (Fin. Accounting Standard Bd.) (2005); Browne, supra note 259, at 81-82 (explaining the proposed standard).

261. See, e.g., Browne, supra note 259, at 86 (stating that longstanding standard more accurately reports tax assets and liabilities).


263. See, e.g., Ken Gee, Audit Partner, BDO Seidman & Rob Terpening, Tax Partner, BDO Seidman, Presentation at the San Jose State University/Tax Executives Institute High Technology Tax Institute: Accounting Guidance Update (Nov. 8, 2005) (commenting that different auditors have different standards and that some have tightened their standards as a result of the proposed changes to Accounting for Income Taxes, Statement on Auditing Standards No. 109 (Fin. Accounting Standards Bd. 1992)); see also KPMG Deferred Prosecution Agreement, supra note 145, at 7 (describing the stipulation that KPMG accept a heightened opinion standard). One survey also reports that financial statement disclosure relating to uncertain tax positions had increased prior to the finalization of the new standard. See TCPI 2006 Survey, supra note 1, at 18 (reporting that sixty-three percent of respondents report such disclosure has increased in the past two years).


265. See, e.g., TCPI 2006 Survey, supra note 1, at 37 (reporting that forty-one percent of respondents cited, as the top tax group challenge, compliance with Accounting for Income Taxes, Statement on Auditing Standards No. 109 (Fin. Accounting Standards Bd. 1992)).
broader compliance norm, extending beyond promoted tax shelters, might develop. Second, it provokes the question of how either a narrow anti-tax shelter norm or a broader compliance norm could achieve permanence. Third, it raises the issue of regulatory cost-benefit analysis.

A. How to Promote a Broader Norm

1. The Existing Narrow Norm

The new tax compliance norm described in this Article is narrow: Corporate tax decision makers are avoiding promoted tax shelters. The question of whether a broader conservatism has developed remains open. Some developments, such as accounting firms’ adherence to the stricter FASB rules in advance of their finalization or effective date, point to a broader tendency to give more conservative advice. In addition, there are anecdotal reports of somewhat more conservative planning behaviors apart from the avoidance of listed transactions. For example, firms doing offshore tax planning may expect their Section 404 auditor and their financial auditor to push back at the margins by demanding larger payments in exchange for the transfer of existing technology overseas, suggesting adjustments to intercompany transfer prices so they are slightly less favorable to the corporation, and requiring completed paperwork documenting intercompany agreements and checking to ensure that those written agreements are followed more carefully in practice.

However, it goes too far to say that the tax shelter and Sarbanes-Oxley exercise has generated a broader social norm of conservative corporate taxpaying behavior. One major area of continued big-ticket tax planning shifts income to lower-tax offshore locations. Another involves the use of hybrid securities treated as interest-generating debt for tax purposes and

266. See supra Part IV.C.  
268. See Rosanne Altshuler & Harry Grubert, Governments and Multinational Corporations in the Race to the Bottom, 41 Tax Notes Int’l 459, 460-62 (2006) (noting declines in effective tax rates from 1992 to 2002 due to offshore planning and identifying tax reduction strategies including those involving hybrid securities and hybrid entities); see also Lee A. Sheppard, News Analysis: Check-the-Box Rules Not Sacred, Says Hicks, Tax Notes Today, June 5, 2006, available at LEXIS, 2006 TNT 107-8 (noting that “[t]he Big Four accounting firms are thought to have already compiled playbooks of [Controlled Foreign Corporation] look-through gambits” in anticipation of section 954(c)(6) of the Code, a look-through rule which permits certain related-party income to be treated as active, non-subpart F income).
equity for other regulatory purposes. Tax planners continue to pursue patents for some tax-reduction ideas, a pattern that suggests some of the same lack-of-business-purpose problems as tax shelter promotion. Tax decision makers may rely on unclear IRS guidance to reach aggressive conclusions in these areas. Meanwhile, the IRS keeps a list of current compliance challenges.

2. The Carrot and the Stick

So how should the government build on the success of its campaign against promoted tax shelters to increase taxpayer compliance in other areas? The direct prescription, based on the case study discussed in this Article, might read as follows: Expand the internal transparency and size of the tax decision-making group, aggressively pursue enforcement programs that affect each member of the group, and clearly label deviant transactions in non-tax shelter areas. That is what appears to have worked for tax shelters; why should it not work for hybrid financing transactions, offshore planning, and other current areas of compliance concern?

IRS and Treasury leaders have spoken out regularly and thoughtfully on issues of compliance and enforcement in recent years. They have notably not focused exclusively on hard-nosed enforcement and scarlet-letter listing.


270 See Staff of Joint Comm. on Taxation, 109th Cong., Background and Issues Relating to the Patenting of Tax Advice 22-23 (Comm. Print. 2006), available at http://www.house.gov/jct/x-31-06.pdf (noting that the patent process may encourage the development of marketable products by providing protection against duplication of a patented structure without any requirement of disclosure under the tax shelter regulations absent a contractual requirement of confidentiality).


tactics. Instead, they emphasize service in addition to enforcement.273 According to the head of LMSB, the large-corporation division of the IRS, the government’s goal is to reach out to good-faith taxpayers and build efficient working relationships marked by trust and cooperation, while cracking down on bad-faith taxpayers.274 Academics such as Professor Dan Kahan have also endorsed this idea of different regulatory approaches depending on the cooperation offered by regulated parties.275

This Article’s story about the development of a narrow tax shelter compliance norm is a story about a stick, not a carrot (with some nuance; for example, the tax shelter settlement programs offered might fit the carrot mold). It clearly offers a useful model for other situations in which the IRS wishes to clamp down on deviant transactions. In particular, the story demonstrates the power of a group to reinforce compliance norms if all members of the group have ample incentive to comply. This in turn suggests the importance of enforcement on all fronts—with respect to tax directors, their superiors within corporate organizations, and their advisors, for example. The story also shows the particular power of clear rules to promote compliance in a group norm situation.

One area where this approach may again prove effective is in the effort to stop tax protesters, who claim a constitutional right to nonpayment of income tax and currently face several well-publicized enforcement efforts. This is not a large organization issue, and some of the behavioral patterns discussed in this Article may consequently be muted. Nevertheless, individuals in society are also susceptible to the development of group norms, and the basic framework should be applicable. In the tax protestor situation, the government has established a clear rule by summarily rejecting constitutional and other blanket arguments supporting nonpayment of federal income taxes.276 It has also tried to pursue enforcement actions against both advisers and taxpayers, which may have a disproportionately

274. Telephone Interview with Deborah M. Nolan, Comm’r, IRS Large and Mid-Size Bus. Div. (June 23, 2006).
275. See Dan M. Kahan, The Logic of Reciprocity: Trust, Collective Action, and Law, 102 Mich. L. Rev. 71, 83-84 (2003) (suggesting that governments should encourage the reciprocal compliance behavior by emphasizing other taxpayers’ compliance rather than the possibility of audit, but should also punish “dedicated cheaters”); see also Ayres & Braithwaite, supra note 53, at 26-27 (noting that regulators may use different tools depending on whether regulated parties are inclined to compliance); Valerie Braithwaite, A New Approach to Tax Compliance, in Taxing Democracy 1, 2-4 (Valerie Braithwaite ed., 2003) (describing the Australian compliance model under which “more social distance between [taxpayers] and the [taxing] authority” corresponds to stricter, less flexible regulatory strategies).
276. See Statement of Eileen J. O’Connor, supra note 133, at 16 (listing such “tax fraud” schemes).
strong effect on compliance by influencing more than one element of an individual’s tax decision-making group.\textsuperscript{277}

Other current compliance issues are more gray than black-and-white. Take cost-sharing and offshore intellectual property transfers. The typical plan in this case for a U.S. parent company involves locating valuable IP in a low-tax offshore subsidiary and directing offshore profits to that IP holding company. One piece of this strategy involves structuring intercompany payments among offshore subsidiaries to avoid pitfalls in subpart F, which taxes a U.S. parent corporation on certain passive or mobile income of its non-U.S. subsidiaries.\textsuperscript{278} Another piece, a more prominent current compliance target, involves the placement of intellectual property in the IP holding company.\textsuperscript{279} The U.S. parent taxpayer benefits if it can sell its existing IP to the IP holding company at a low price and charge the IP holding company low future “cost-sharing” payments for the non-U.S. interest in future IP, because the U.S. parent will recognize less gain or income and will still wholly control the IP.\textsuperscript{280}

Recent proposed regulations attempt to address the problem of underpricing intellectual property sent offshore by introducing the “investor model” concept to force taxpayers to more fully recognize the value of the U.S. parent corporation’s contribution to the development of the IP when setting these prices.\textsuperscript{281} Recent enforcement efforts have alleged that some firms have stepped over the line with respect to their intellectual property valuations or cost-sharing methodology.\textsuperscript{282} Is the government attempting to develop a hard-nosed approach that labels aggressive IP pricing for offshore transfers deviant and bad, just as it labeled promoted tax shelters deviant and bad?

The government would be ill-advised to do so. Its stakeholders do not show signs of willingness to accept such a label of deviance. The offshore IP transfer situation is gray factually, because it depends (under current law) on a facts-and-circumstances valuation exercise. It is gray from a policy

\textsuperscript{277} See id. at 16-17 (summarizing recent cases against promoters and taxpayers).
\textsuperscript{279} See id. at 32 (noting the usual recommendation to transfer income-generating intangibles to a low-taxed foreign subsidiary using an arm’s length “buy-in” payment for existing intangibles and a cost-sharing arrangement for future intangibles).
\textsuperscript{280} See Keith Reams et al., Proposed Cost-Sharing Regulations: Are They a Realistic Alternative?, 109 Tax Notes 239, 240 (2005) (noting the IRS concern that taxpayers systematically undervalued buy-in payments and failed to enter into cost-sharing arrangements similar to the arrangements of unrelated parties).
\textsuperscript{282} See, e.g., Xilinx Inc. v. Comm’r, 125 T.C. 37, 52-53 (2005) (upholding a taxpayer’s omission of stock option costs from allocated costs under its transfer pricing agreement); Audrey Nutt, Glaxo, IRS Settle Transfer Pricing Dispute for $3.4 Billion, Tax Notes Today, Sept. 12, 2006, available at LEXIS, 2006 TNT 176-1 (noting settlement with respect to U.S. assertion that too little value was attributed to U.S. marketing intangibles and too much profit was attributed to UK parent of GlaxoSmithKline).
perspective, assuming one believes that U.S. parent corporations may invest in non-U.S. subsidiaries (and outsource to them manufacturing or other IP-dependent tasks). Enforcement efforts to tar certain aggressive taxpayers have not produced government success. In particular, the U.S. Tax Court and other nations’ tax authorities seem to think the issues are gray.

3. Lessons for Gray Areas

If the lessons of this Article’s tax shelter norm development story are relatively clear for deviant transactions, like tax protester cases, they are more subtle for gray areas, like offshore IP planning.

Consider first aggressive enforcement efforts. As Professor Kahan points out, some empirical evidence suggests that broad-based enforcement can lead taxpayers to believe that noncompliance is widespread, thus encouraging them to cheat more. Enforcement, he argues, is better aimed at determined tax cheats than at taxpayers prepared to make a good effort at compliance. This view of enforcement suggests that in gray areas, where the government believes that there are good taxpayers as well as bad taxpayers, the government should separate good from bad, and adopt different strategies for each.

Next consider the value of clear rules. The success of clear regulations aimed at promoted tax shelters is not always transferable, because many transactions are not “clearly deviant” but rather fall into a gray area. The literature on the efficiency of “rules versus standards” demonstrates that clear rules are not always an appropriate solution, due to factors such as possibly suffocating complexity and ease of avoidance.

Commentators also persuasively argue that not all regulatory situations are susceptible to rules. For example, some situations are too dependent on endlessly varying facts and circumstances, or do not permit a rule that closes off close substitutions to taxpayer planning. These problems may be somewhat muted in the case of tax shelter regulation, because its status

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283. See, e.g., Xilinx Inc., 125 T.C. at 52-53 (holding for the taxpayer).
284. See, e.g., Nutt, supra note 282 (noting that U.K. and U.S. competent authorities were unable to reach agreement in the Glaxo case).
285. See Kahan, supra note 275, at 82-83 (attributing this phenomenon to “social cueing”).
286. See id. at 84 (stating that enforcement is appropriate for “dedicated cheaters”).
287. See David A. Weisbach, Costs of Departures from Formalism: Formalism in the Tax Law, 66 U. Chi. L. Rev. 860, 867-69 (1999) (arguing that rules are systematically more complex than standards, particularly in the tax area where rules that overlook uncommon similar transactions may drive taxpayers to engage in those overlooked transactions).
288. See David M. Schizer, Frictions as a Constraint on Tax Planning, 101 Colum. L. Rev. 1312, 1323-26 (2001) (arguing that the success of a tax rule depends in large part on the nature of the “friction” a taxpayer will experience in an effort to avoid it).
289. Distinguishing between debt and equity provides a classic tax example.
290. See Schizer, supra note 288, at 1324 (noting that the difficulty of avoiding a rule must be significant and inflexible for the rule to be effective).
as a disclosure regime may mean that over-inclusiveness does not carry any direct liability for appropriate transactions.\textsuperscript{291}

The ability of clear rules to translate relatively smoothly into organizational norms constitutes a factor in favor of rules instead of standards in the large corporation context. But there remain many areas where standards, not rules, provide the right approach. In these cases, the recognition that vague standards present a challenge for the development of a large organization compliance norm should prompt the government to use different strategies to help organizations draw responsible lines.

Finally, consider the expanded and more transparent tax decision-making group at public corporations. If a more cooperative, nonenforcement strategy is appropriate for good-faith taxpayers, and if some situations require standards-based regulation under which organizations must draw lines, how should the government think about the instrumental large-corporation tax decision-making group? The smart regulatory route would harness the potential strength of the group, just as the multifaceted enforcement and clear rule combination harnessed its strength and amplified the compliance tendencies of its members in the case of promoted tax shelters.

Some proposals to encourage compliance in areas beyond the marketed tax shelter arena rely on gatekeeper policing and try to increase the visibility and reputational costs of bad advice. For example, Professor Linda Beale has recently made just such a proposal to improve tax practitioners’ compliance ethic. She suggests raising the standard for a return filing position and removing attorney-client privilege protection for pre-filing advice.\textsuperscript{292}

Tax regulators have pursued some efforts to improve gatekeeper ethics, most notably the amendments to Circular 230.\textsuperscript{293} But they have also more directly tried to influence large corporations’ tax decision-making processes. Several recent initiatives rely on more, and earlier, direct communication between the government and the tax decision makers at large corporations. The programs try to select good-faith corporate taxpayers and put a government representative in direct communication with tax decision makers at the tax decision-making stage.\textsuperscript{294} The issues subject to resolution include gray areas such as the offshore IP transfer example discussed above.

\textsuperscript{291} See Pearlman, supra note 9, at 303-04 (arguing for a broad tax shelter disclosure standard).
\textsuperscript{292} See Beale, supra note 4, at 638 (summarizing her proposal).
\textsuperscript{293} See supra Part III.B.3 (discussing Circular 230).
\textsuperscript{294} See Cliff Jernigan, Corporate Tax Audit Survival: A View of the IRS Through Corporate Insider Eyes 71-78 (2005) (describing pre-filing agreements regarding factual issues, industry issue resolution agreements, and CAP, as well as measures designed to streamline the audit and appeals process).
The flagship “real time audit” initiative, called the Compliance Assurance Program (CAP), targets certain large corporations and involves an agreement executed by the government and the taxpayer, which identifies the goals of the CAP relationship. In almost all cases, top management signs off on the IRS presence. In its pilot year, seventeen large corporations accepted IRS invitations to participate in CAP. The CAP program anticipates “extensive cooperation between the Service and participating taxpayers.” Its goal is to resolve all material issues before the filing of a return, in which case the IRS pledges that it will not audit the return filed in accordance with the agreement.

The CAP early issue resolution program is a conscious government effort to take advantage of the compliance-oriented environment that currently prevails inside public corporations, including expanded and more transparent tax decision-making groups. It is consistent with an organizational behavior insight: A tax group that invites the IRS to participate in its decision making is more likely to develop and sustain strong tax compliance norms. This creative approach has achieved preliminary success and deserves continued support.

The CAP program and similar initiatives differ radically in tone and approach from the disclose-and-settle-or-we’ll-get-you tax shelter regulatory approach. CAP’s approach is a carrot. The head of LMSB describes it as a mutually beneficial trade of transparency for certainty within the context of a cooperative regulatory relationship. The tax shelter approach is a stick. Government commentators express their anger at participants in tax shelters and their determination to exact penalties.
Despite this difference, the tax shelter story and the CAP story belong in the same organizational behavior book. In the tax shelter case, the existence of a larger, more transparent tax decision-making group amplified the consistent, clear message of the tax shelter regulations and contemporaneous tax and securities enforcement efforts, such that all those involved focused on compliance, at least in the promoted tax shelter area. The CAP program more explicitly targets this decision-making group by seeking to get the IRS invited to its table, before the tax return is filed. But both approaches leverage the larger and more transparent post-Sarbanes-Oxley tax decision-making group. While the tax shelter example provides a regulatory model, in tax and other areas, for deviant transactions susceptible to rules and for deviant taxpayers responsive to enforcement, the CAP example provides a regulatory model for gray-area transactions susceptible to standards and good-faith taxpayers responsive to cooperative regulatory efforts.

B. How to Address Norm Cyclicality

1. A Permanent Anti-Tax Shelter Norm?

On the evidence we now have, there is little reason to expect a permanent uptick in corporate tax compliance, even with respect to the relatively narrow issue of tax shelters. Commentators have previously observed a historical cycle of fraud, crackdown, compliance, a shift of focus from enforcement to service, and then more fraud.306 The observed recent increase in compliance with respect to tax shelters may simply represent a reaction to the “crackdown” portion of the cycle.307 In addition, the listed transaction rules will no longer deter tax shelter participation if they fail to seek out and list new promoted transactions. Enforcement and rule currency are two important elements of maintaining the current tax shelter compliance norm.

306. See Joel Slemrod & Jon Bakija, Taxing Ourselves: A Citizen’s Guide to the Debate over Taxes 183-85 (3d ed. 2004) (noting provisions in the 1998 Internal Revenue Service Restructuring and Reform Act that imposed new requirements on the IRS in response to popular perception that the IRS often acted unfairly or unethically, and also noting an increase in IRS customer service efforts, apparently at the expense of enforcement); Bryan T. Camp, Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998, 56 Fla. L. Rev. 1, 79 (2004) (noting the debate over “pendulum” swings between service and enforcement at the IRS in the wake of the 1998 Act); see also William K. Black, The Best Way to Rob a Bank Is to Own One 247-48, 263 (2005) (noting the importance of studying and understanding fraud mechanisms, including waves of fraud, and pointing out the importance of norms as potential fraud restraints).

307. Frontline, supra note 117 (“I think this thing is going to rebound, especially as the economy improves.” (quoting Charles Rossotti, IRS Commissioner, 1997-2002)); id. (“I think what the IRS clearly has to do is to remain vigilant in this area. Because I think that if they let down their guard there is at least the risk that we will see a return to this kind of activity.”) (quoting Pamela Olson, Treasury Assistant Secretary for Tax Policy, 2002-2004)).
Part III of this Article attributes the increased interest in compliance to top executives’ and tax specialists’ fear of enforcement action. Without continued reminders of the government’s view and determination to enforce it, compliance programs that look good on paper can falter as effective regulatory tools, as regulated parties respond to a reduced economic incentive to comply, perceive that other taxpayers may not comply, and interpret uncertain areas of the law to further their own self-interest.\textsuperscript{308} The government appears to be well aware of this risk. The IRS and Treasury, together with federal prosecutors, have clearly prioritized enforcement.\textsuperscript{309} They must continue to do so.

Of course, the government cannot control the success of its enforcement program. It faces considerable litigation hazards. The use of the Thompson memo to turn employers against employees, the criminal fraud and conspiracy theory of the KPMG tax shelter case, and the alleged invalidity of various tax products may not stand up in court. The perceived violation of KPMG personnel’s constitutional rights in connection with the pending criminal case\textsuperscript{310} for example, could generate an anti-government outcry similar to the perception of unethical IRS behavior that prompted the 1998 Act. In addition, continued enforcement efforts aimed at senior corporate executives often fall outside the tax context and beyond the jurisdiction of the IRS, Treasury, or the Tax Division of the Justice Department.

With respect to rule currency, the IRS and Treasury should treat the tax shelter regulations as a living document. The Office of Tax Shelter Analysis provides a good institutional forum to filter suggestions for additional listed transactions. In addition, the government’s conscious keeping of lists of areas of compliance concern,\textsuperscript{311} its consideration of issues such as the proper treatment of patented transactions,\textsuperscript{312} and its apparently close examination of the new, more detailed Schedule M-3s showing corporate book and tax differences\textsuperscript{313} all indicate that the government devotes considerable energy to keeping these rules current.

\textsuperscript{308} See Slemrod & Bakija, supra note 306, at 185 (describing the economic incentive and the perception of wider noncompliance risks of enforcement decline following 1998 Act); Eustice, supra note 213, at 160-62 (writing that “meaningful” audits should be the government’s top priority); Bernard Wolfman, Letter to the Editor, \textit{Now Is Not the Time for IRS Enforcement to Ease Up}, 109 Tax Notes 1105, 1105 (2005) (urging continued commitment of government resources to enforcement); see also Krawiec, supra note 42, at 528-34 (arguing that legal compliance professionals and regulated business organizations interpret incomplete law to further their own self-interest).

\textsuperscript{309} See, e.g., Dustin Stamper, \textit{Everson Says IRS Could Collect up to $100 Billion More Per Year}, Tax Notes Today, Feb. 16, 2006, \textit{available at LEXIS}, 2006 TNT 32-1 (reporting the IRS Commissioner’s comment that IRS enforcement efforts have already significantly narrowed the tax gap and his request for additional enforcement funding).

\textsuperscript{310} See supra notes 153-59 and accompanying text.

\textsuperscript{311} See, e.g., Everson, supra note 272, at 5-10 (listing areas of compliance concern).

\textsuperscript{312} See supra note 270 (citing a congressional hearing on patented transactions).

Enforcement strength and rule currency feed into the tax decision-making groups to foster a tax shelter compliance norm. Without them, the current norm may falter. The dependence of the current norm on continued enforcement and rule clarity follows in part from the deviant nature of the transactions targeted. There should be no assumption, in other words, that the targets of tax shelter regulation have internalized a lasting social norm of compliance.

2. Making a Broader Tax Compliance Norm Permanent

Part V.A.3 above suggests that broadening a tax compliance norm into gray areas will benefit from a cooperative approach, like the IRS takes in its early-issue-resolution initiatives such as CAP. Such initiatives attempt to use cooperative and frank discussion, not enforcement and clear rules, to encourage compliance. They assume a population of good-faith taxpayers, not deviant tax avoiders.

The above discussion in Part V.B.1 argues that the preservation of a tax shelter compliance norm for determined tax avoiders depends on continued enforcement and rule clarity for effective policing of deviant taxpayers. What determines whether a compliance norm emerging from CAP and similar programs will survive among good-faith taxpayers?

As with the tax shelter regulations, the cooperative initiatives will continue to have effect only if their elements are maintained. These initiatives, however, use different tools than the tax shelter regulations. In addition to relying on enforcement of penalties against deviant taxpayers, as in the shelter area, they depend on the development of a responsible and responsive relationship between IRS personnel and the taxpayer. IRS personnel must do their part to build and maintain such good government relationships.

In addition, perhaps CAP has the capacity to foster a stronger tax compliance norm incorporated into the large corporation’s de facto ethical code, as well as a stronger cooperation norm for government staff. Such internalized social norms might not withstand an extended or egregious breach of trust, but they could help sustain a compliance pattern through lesser difficulties. Cliff Jernigan, a seasoned tax director and tax practitioner who served as a senior member of the LMSB IRS team when CAP was adopted, writes,

I predict that CAP will become the favored filing process by large companies. Quality taxpayers will want to tell others in their industry that they are viewed as good taxpayers by using the CAP process. Company CEOs will want their companies in the CAP program because it, like the Malcolm Baldridge Quality Award, will signify a quality company known for its honesty and fair dealing.

314. See supra notes 29-33 and accompanying text (discussing legal and social norms).
315. Jernigan, supra note 294, at 77.
Perhaps CAP participation will come to provide a clear and visible signal of honesty, encouraging others (such as prospective business partners and employees) to deal with CAP corporations.\textsuperscript{316} Perhaps such positive feedback will foster the internalization of a corporation tax compliance norm, under which individuals within a corporation feel pride in tax compliance and guilt as a result of noncompliance.\textsuperscript{317} Theories relating to the development of internalized social norms within organizations tie into individual psychology,\textsuperscript{318} as well as large-organization behavioral theory,\textsuperscript{319} and a full examination of these ideas is not attempted here. This Article simply suggests that the CAP program may open the door to the development of a tax compliance norm that is inherently stronger and more lasting than the current narrow tax shelter compliance norm. Time will tell if CAP succeeds.

C. Is the Norm Worth the Cost?

A complete cost-benefit analysis of the observed tax compliance norm is beyond the scope of this Article.\textsuperscript{320} Nevertheless, this section offers several preliminary observations and attempts to suggest the complexity of the exercise.

There are at least seven significant elements: the benefit of additional tax revenues; the benefit of deterring undesirable transactions that taxpayers declined to enter into due to concern about adverse tax outcomes; the cost of deterring valid tax planning; the cost of deterring frank attorney-client consultation as a result of the erosion of the attorney-client privilege; the cost of additional monitoring under Sarbanes-Oxley, including external Section 404 audits and independent board committees; the cost of tax and securities enforcement; and the cost of researching and drafting new rules. The CAP program and similar initiatives involve additional commitments of government resources, including significant IRS personnel time.

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\textsuperscript{318} See id. at 1661-62 (discussing moral reasoning and emotional response as avenues for the internalization of norms).
\textsuperscript{319} See supra Part I.
\textsuperscript{320} The IRS does not typically engage in the cost-benefit analysis required of some other agencies under Executive Order 12,866, typically taking the position that the rulemaking is not a “significant regulatory action,” meaning, among other things, that it will not have an annual economic effect of $100 million or more. See Executive Order 12,866, 58 Fed. Reg. 51,735, 51,738 (Oct. 4, 1993) (defining “significant regulatory action”); see, e.g., T.D. 9165, 2005-4 I.R.B. 357 (concluding that finalized Circular 230 regulations were not a significant regulatory action); cf. Edward Sherwin, The Cost-Benefit Analysis of Financial Regulation: What the SEC Ignores in the Rulemaking Process, Why It Matters, and What to Do About It, 12 Stan. J.L. Bus. & Fin. (forthcoming 2006) (manuscript at 84-92, on file with the Fordham Law Review) (arguing that the SEC should conduct cost-benefit analysis like many other U.S. agencies and like its U.K. financial regulatory counterpart).
\end{flushleft}
Each of these elements presents its own estimation challenges. For example, the payment of taxes to the government represents not an increase in economic activity, but rather a transfer that hopefully promotes a more efficient and equitable tax system.\footnote{321}{See Slemrod & Bakija, supra note 306, at 183 (noting that increased tax revenue does not represent increased economic activity).} Enforcement has the capacity to emphasize that deviant taxpayers, while unusual, are firmly dealt with (which would be expected to increase other taxpayers’ compliance) or to suggest that noncompliance is widespread (which would be expected to decrease other taxpayers’ compliance).\footnote{322}{See Kahan, supra note 275, at 83 (noting empirical evidence that widely publicized enforcement campaigns decrease compliance, but acknowledging that punishment of deviant taxpayers is necessary to shore up any social norm of compliance for others); Posner, supra note 316, at 1790-91 (positing that increasing enforcement can weaken the value of the compliance signal for those who comply with the law although it will encourage compliance for those who evaluate the compliance decision on an economic basis rather than a social norm signaling basis).} Commentators also debate the importance of “good” tax planning, differing on the key question of the extent to which such planning guides taxpayers away from traps in the law that would result in taxpayer-adverse results contrary to legislative intent.\footnote{323}{Compare Daniel N. Shaviro, Evaluating the Social Costs of Corporate Tax Shelters, 55 Tax L. Rev. 445, 450-51 (2002) (arguing that resources are over-allocated to tax planning), and Weisbach, supra note 212, at 222-25 (asserting that tax planning is a negative externality although acknowledging that planning to avoid taxpayer-adverse mistakes in the law may have value), with Hariton, supra note 236, at 400 (suggesting that the anti-tax-shelter agenda should not target “tax-motivated structuring of legitimate business transactions”), and Schler, supra note 6, at 386 (“If . . . Weisbach really means that his objection does not apply to taxpayers who take advantage of [Congressionally intended] tax incentives . . . the exceptions clearly swallow the rule.”).} Commentators further challenge the traditional assumption that erosion of the attorney-client privilege deters frank attorney-client conversations.\footnote{324}{See, e.g., Beale, supra note 4, at 663-64 (labeling the traditional argument unpersuasive).}

Measuring the cost of Sarbanes-Oxley, rule making and enforcement are daunting and inexact tasks. Moreover, only a portion of the Sarbanes-Oxley and enforcement costs should be attributed to tax compliance efforts. It is also possible that a less expensive form of, for example, Section 404 could support an equally effective expanded and transparent tax decision-making group.\footnote{325}{Cf. Grundfest, supra note 80, at 11 (offering an amended Section 404 standard that would limit the rule’s concern to more material events).} Finally, the net cost of the CAP program and similar programs is likely to be known only after it has run for a number of years, since the benefit of avoiding later tax audit-related costs will offset the initial investment in the program.

**CONCLUSION**

Regulators of large corporations and other organizations can profitably use the organizational behavior insights offered by this Article. The Article observes three factors that contribute to a currently observed anti-tax shelter...
compliance norm at large corporations: an expanded and more transparent
decision-making group, enforcement and publicity efforts directed at every
member of that group, and clear rules. These three factors provide a
blueprint for the deterrence of clearly deviant transactions.

The tax shelter story also offers the more general lesson that attention to
the behavioral dynamics of decision-making groups can strengthen
regulatory efforts. In gray areas, where regulated parties may be acting in
good faith and/or where broad regulatory standards, rather than clear rules,
are appropriate, behaviorally sensitive regulation may involve government
efforts to participate directly in such decision-making groups, as with the
IRS CAP program. The experience of these two different approaches to
influencing tax decisions within large corporations can inform and assist
regulators in non-tax areas as well.