

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

By Susan Cleary Morse*

Abstract

This paper examines the recent shift toward an anti-tax shelter federal income tax compliance norm at public corporations, as evidenced by practitioner and government comments and survey results. The paper focuses on the organizational behavior of tax decisionmakers within public corporations as they respond to Sarbanes-Oxley, enforcement and publicity initiatives, and tax shelter regulation.

The paper identifies three elements that have contributed to the development of a stronger tax compliance norm. First, Sarbanes-Oxley has resulted in the expansion and increased transparency of public corporation tax decisionmaking groups. Organizational behavior insights suggest that this may produce more considered decisions. Second, civil and criminal enforcement and accompanying publicity have resulted in real concerns about personal and firm liability among organization leaders. This causes organization hierarchies to encourage and reward compliance. Third, the government has clearly identified objectionable tax shelter transactions and plainly labeled them unacceptable and even fraudulent. In the tax shelter area, this substantially reduces the ethical or legal uncertainty that otherwise presents an obstacle to the development of compliance norms in organizations.

The paper identifies elements of this story that do not fit neatly under the classic economic analysis of tax avoidance or evasion, including the importance of enforcement outside the tax context and the particular power of clear government rules. The paper argues that this norm development story could provide a blueprint for regulatory attacks on deviant transactions but contends that it offers different lessons for regulatory challenges in greyer areas, pointing to a more cooperative approach. It also sketches the challenges of a cost-benefit analysis of such culturally sensitive regulatory strategies.

* Teaching Fellow, Santa Clara University School of Law. Previously, Ms. Morse practiced tax law with Wilson Sonsini Goodrich & Rosati in Palo Alto and Ropes & Gray in Boston. The author gratefully acknowledges the comments of Bill Black, June Carbone, David Hasen, Stu Karlinsky, Deborah Nolan, Kandis Scott, Bernard Wolfman; participants in theconglomerate.org Junior Scholars' Workshop, particularly Mike Guttentag, Kristin Hickman, and Claire Hill; and participants in the Santa Clara University School of Law works-in-progress series, particularly Brad Joondeph and Jeff Kahn.

Table of Contents

Introduction	3
I. The Behavior of the Tax Group	6
A. The Tax Director's Organization	6
B. The Relevance of an Expanded and More Transparent Group	7
C. Group Norm Development	9
D. The Relevance of Liability and Enforcement	11
E. The Relevance of a Clear Government Message	13
II. How Sarbanes-Oxley Produced an Expanded and More Transparent Tax Decisionmaking Group	14
A. Sarbanes-Oxley Overview	14
B. Sarbanes-Oxley Provisions That Expand the Tax Decisionmaking Group	15
C. Sarbanes-Oxley Provisions That Increase the Tax Decisionmaking Group's Internal Transparency	19
D. Internal Transparency Begets External Transparency	20
E. What Causal Effect Does Sarbanes-Oxley Have on Tax Compliance?	22
III. Why Tax Decisionmakers Now Worry About Personal and Firm Liability	23
A. Criminal Prosecution and Other Enforcement Efforts Directed at Corporate Managers	23
B. Gatekeeper Liability: Criminal Enforcement, Civil Liability and Circular 230	24
C. Publicity	30
IV. A Clear Government Message	32
A. The Tax Shelter Problem	32
B. Drawing the Tax Shelter Line	34
C. New FASB Tax Benefit Accounting Standard	40
V. Norm Development and Tax Policy	41
A. How to Promote a Broader Norm	42
B. How to Address Norm Cyclicity	48
C. Is the Norm Worth the Cost?	51
Conclusion	52

Introduction

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

Practitioner comments and survey evidence indicate the emergence of a new compliance norm at public corporations:

- Compliance (including compliance with tax accounting standards and 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 about personal or firm liability² or adverse publicity³ resulting from tax or tax accounting noncompliance.

¹ See Brad L. Brown & James Wolfrom, “SOX 404: Year Two” at 21 (Nov. 7, 2005) (powerpoint presentation for San Jose State University/Tax Executives International Conference, on file with the author) (citing KPMG survey results showing financial reporting, Sarbanes-Oxley and tax return compliance as the top three priorities and effective tax rate management as the fourth); Tax Council Policy Institute Market Research Study at 11 (February 2006) (hereinafter “TCPI 2006 Survey”) (survey results prepared for Tax Council Policy Institute conference, on file with the author) (citing avoiding a financial statement error as one of the two top priorities for 83% of Fortune 500 tax director respondents and achieving financial statement benefit for 50% of respondents). The TCPI 2006 Survey solicited responses from the tax directors of the Fortune 500 from December 2005 – January 2006 and received 123 responses. *Id.* at 4. The questionnaire report states that it has a margin of error of plus or minus 9% at a 95% 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 to Heads of Department Components; United States Attorneys from Larry D. Thompson, Deputy Attorney General (Jan. 20, 2003) ([available at www.usdoj.gov](http://www.usdoj.gov)) (outlining “principles of federal prosecution of business organizations) [hereinafter “Thompson Memo”]; see, e.g., Daniel Fisher & Peter Lattman, “Ratted Out,” *Forbes*, July 4, 2005, at 49 (reporting that the Justice Department’s policy of encouraging employer cooperation can result in the fingering of employees and the refusal to cooperate in their defense efforts); Letter from Current and Former KPMG Board Members and Washington National Tax Partners to Wall Street Journal, New York Times et al. (August 10, 2005) (on file with the author) (criticizing KPMG’s decision to save the firm by entering into a deferred prosecution agreement, failing to take responsibility for top-level firm decisions with respect to the tax shelter business, and firing and refusing to help KPMG partners with legal fees or otherwise in connection with defense of civil or criminal litigation) [hereinafter “KPMG Anonymous Letter”].

³ See, e.g., “Ernst & Young Analyzes Tax Transparency Dynamics,” 2006 TNT 69-10 (Apr. 10, 2006) (“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.”)

- Marketing tax shelters to public corporations is no longer big business.⁴

Most of this Article focuses on a narrow compliance norm: public corporations' current reluctance to participate in promoted tax shelter transactions. In Part I, this Article describes the typical tax decisionmaking group at a public corporation and identifies organizational behavior concepts that help explain the emergence of the existing anti-tax shelter norm. Then, 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 decisionmaking group and increased its transparency within the corporate organization. Second, as described in Part III, this group is pulled toward a compliance norm by concerns about liability at each of the firms to which the group's members belong. These liability concerns stem from enforcement and publicity efforts in both tax and nontax contexts and draw reinforcement from Sarbanes-Oxley financial statement certification and audit committee oversight requirements. Third, as outlined in Part IV, the government has clearly labeled certain unacceptable transactions, making it straightforward for a compliance-oriented tax decisionmaking group to exclude transactions described in the tax shelter regulations, particularly listed transactions, from their planning.

The usual economic analysis would explain these compliance developments by framing the tax decisionmaker's choice as a comparison of (1) the cost of paying tax and (2) the difference between the benefit of avoiding the tax and the cost of the imposition of tax, interest, and penalties, risk-adjusted for the possibility that the government will successfully challenge the tax avoidance strategy and perhaps adjusted for risk aversion and reputational loss factors.⁵

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.”)

⁴ See Robert Goulder, “Current, Former IRS Officials See New Attitude in Corporate Tax Planning,” 2005 TNT 206-5 (October 25, 2005) (reporting observation of IRS official Deborah Butler of “a more conservative approach to strategic tax planning”); Allan Kenney, “Treasury, IRS Officials Discuss Shelter Crackdowns, Circular 230 Concerns,” 2005 TNT 125-2 (June 29, 2005) (reporting government officials' praise for progress in “stamping out abusive tax shelters” and their attribution of that progress to “stemming shelter promotion”) (citing statements of IRS Commissioner Mark Everson, IRS Chief Counsel Donald Korb, and acting Treasury deputy assistant secretary for tax policy Eric Solomon). Conversations with practitioners confirm the observations of these government officials. See also Rachel Emma Silverman, “The Search for a Safe Tax Shelter,” Wall St. J., Oct. 13, 2005 (“Big accounting and law firms are being more cautious than in the past, shying away from marketing aggressive shelters, especially those designed to generate losses.”). At least one recent academic article 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 L. Rev. 583, 586 (2006) (arguing that compliance momentum must expand beyond mass-marketed tax shelters to more tailored, but still abusive, tax planning).

⁵ See Joel Slemrod, “The Economics of Corporate Tax Selfishness,” 57 Nat'l Tax J. 877, 881-82 (2004) (describing standard model).

The economic analysis predicts that increased taxpayer penalties, whether enforcement of existing penalties⁶ or the addition of larger⁷ or differently-designed⁸ penalties, will deter tax avoidance by directly increasing its cost. The economic approach also suggests that disclosure will lead to more compliance if it produces more enforcement, both generally and specifically with respect to a disclosing taxpayer.⁹

This Article's tax compliance norm development story is consistent with the rational taxpayer economic model. Increased enforcement efforts and publicity increased the perceived likelihood of discovery and expected size of civil and criminal penalties for participation in promoted tax shelters considered abusive by the IRS. Increased government efforts to identify and force disclosure of tax shelters also raised the chance of discovery of such transactions.

However, this Article also claims the importance of several elements that do not fit neatly into the rational economic taxpayer model. Part II argues that because tax decisionmaking at large corporations is a group exercise, group dynamics amplify commonly held 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 and advising accounting firms, to which members of the tax decisionmaking group belong. Part IV emphasizes the importance of the clarity of the line drawn between acceptable and unacceptable behavior in the tax shelter area as a factor that helps a decisionmaking group avoid ethical uncertainty and reach consensus.

Part V acknowledges that this observed new norm is narrow. Some anecdotal evidence suggests more generally conservative corporate taxpayer behavior, but corporations 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 outside the promoted tax shelter area, although the appropriate approach may differ from the three elements contributing to the development of the anti-promoted tax shelter norm. As examples of such culturally-sensitive regulation, Part V points to several IRS initiatives for large corporations.

⁶ See, e.g., Michael L. Schler, "Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach," 55 Tax L. Rev. 325, 361 (2002) (noting that taxpayers believe that penalties will not be imposed).

⁷ See, e.g., Department of the Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals 109 (July 1999) (hereinafter "1999 Treasury Report") (calling for a 25% excise tax on tax benefits earned from a tax shelter).

⁸ See, e.g., Alex Raskolnikov, "Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty," 109 Colum. L. Rev. 569, 572-73 (2006) (proposing to calculate penalty as a function of related deduction or income item in order to impose a higher penalty for items that are more difficult to detect).

⁹ See Ronald A. Pearlman, "Demystifying Disclosure: First Steps," 55 Tax. L. Rev. 289, 293-94 (2002) (listing tax policy, audit and deterrence reasons for requiring disclosure).

Part V also states that the observed new norm may be temporary. It considers how the government could encourage more permanent, noncyclical tax compliance norms. Finally, Part V offers a brief consideration of 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.¹⁰ Such decisions relate to both 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). This tax director might have a vice president or similar title and typically reports to the corporation's CFO.

Depending on the size of the corporation, the tax director's staff ranges in size from two or three to twenty or more. The tax department generally has responsibility for a range of taxes in addition to federal income taxes, including state income, sales and use, property, customs and excise, non-US income and non-US value added taxes. As a result, there is often a premium on recruiting staff members with varying kinds of expertise, if only to cover routine return-filing tasks.

With respect to the tax planning portion of the tax director's job, he or she typically engages outside accounting, law, or other consulting firms as tax planning advisors. Such experts may serve as ongoing consultants, particularly with respect to financial accounting matters. Or they may advise on a specific project in a complex and market-sensitive area, such a corporate acquisition transaction, an offshore intellectual property 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 of the tax provision estimating its tax audit exposure with the accounting firm.

Historically, the financial accounting firm has often also provided tax consulting 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 provision of both tax and audit advice by the same firm to a client discouraged an independent and critical financial

¹⁰ [2004-2005 Tax Executives Institute survey data to provide backup for description of tax director organization in this Part III.A.]

accounting review of the client's tax planning.¹¹ As discussed in more detail below, after 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.¹²

In addition, after Sarbanes-Oxley, 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 also often involves some examination of the substantive correctness of tax positions.¹³

This Article accordingly examines the development of norms within a typical post-Sarbanes-Oxley public corporation tax decisionmaking 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 of the four members of the tax decisionmaking group also belong to other groups. Specifically, they hail from three different firms: the tax director from the public corporation; the Section 404 auditor and the financial auditor from the corporation's accounting firm; and the tax planner from a law firm, consulting firm, or different accounting firm.

B. The Relevance of an Expanded and More Transparent Group

As described above, the typical four-member public corporation tax decisionmaking group is 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 it relates to appropriate work assignments. They suggest that groups with centralized structures are better at reaching quick, correct, simple decisions; 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.¹⁴ A group with a centralized "wheel" or "star" structure may have a key decisionmaker at the center and a number of individuals feeding information to that decisionmaking person.¹⁵ A decentralized or "all channel" group is diagrammed as a polygon of some kind; the number of people in the

¹¹ See, e.g., Bernard Wolfman, "The Best Way to Protect Auditor Independence," 89 Tax Notes 1779 (Dec. 25, 2000) (noting that conflict of interest can result not only from 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).

¹² See *infra* Part II.B.1.

¹³ See *infra* Part II.B.2.

¹⁴ See, e.g., Laurie J. Mullins, *Management and Organisational Behavior* at 488 ff. (1999).

¹⁵ *Id.*

group determine the number of sides and points of the polygon, and each person communicates with each other person in the group.¹⁶

The basic insight of the comparison between a “star” group and an “all-channel” group is that complex problems benefit from the contribution of a number of different viewpoints. 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 better focus their mental energies on the problem being discussed – as opposed to the many other puzzles their brains constantly face.¹⁷

It is also true that an all-channel group has the potential to increase information flow if the members of the group themselves belong to different networks. A related theory 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 who bridge the gaps to control information and thus, results.¹⁸ For example, a 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 receives (such as compensation information).¹⁹

At least some pre-Sarbanes-Oxley decisions to engage in promoted tax shelters were apparently made by the tax shelter promoter and the corporation, without input from other advisors.²⁰ In contrast, after Sarbanes-Oxley, the tax decisionmaking 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 transparency²¹ of tax decisions at public corporations after Sarbanes-Oxley, attributable in large part to audit committee oversight,²² further limits tax decisionmakers’ ability to control information.

¹⁶ Id.

¹⁷ 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).

¹⁸ See Lawrence E. Mitchell, “Corporate Misbehavior by Elite Decision-Makers Symposium: Perspectives from Law and Social Psychology: Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance,” 70 Brooklyn L. Rev. 1313, 1323-26 (2005) (summarizing Ronald Burt’s theory).

¹⁹ See id. at 1348-1350 (suggesting that independent boards tend to be correlated with strong CEOs).

²⁰ See, e.g., Compaq Computer Corp. v. Comm’r, 113 T.C. 214, 216 (1993) (describing decision involving Compaq’s treasurer, assistant treasurer and CFO one day after a one-hour initial meeting with promoters from Twenty-First Securities Corporation to enter into a foreign tax credit generation transaction), *rev’d*, 277 F.3d 778 (5th Cir. 2001).

²¹ Although “transparency” frequently means visibility of corporate decisions to outside groups such as regulators or shareholders, this Article generally uses it to mean internal transparency, or visibility of decisions made by small groups within a large organization to the rest of the organization.

²² See infra Part II.C.

C. Group Norm Development

Even if group members effectively share information to reach more informed, better decisions, “better” may not mean “more compliant” decisions, depending on how the group defines “better.” Organizational behavior research has examined the phenomenon of group norms, or the “informal rules that groups adopt to regulate . . . group members’ behavior.”²³ Positive and production-encouraging group norms may include rules of etiquette (be prompt; don’t interrupt) and performance standards (do the work assigned on 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.²⁴

Group norms also encompass legal and ethical matters such as compliance with the law. A compliance norm may take the form of narrow legal norm or a broader social norm.²⁵ These are distinguishable,²⁶ though legal rule changes can prompt changes in both.²⁷ A narrow legal norm might produce a monitoring and internal control system designed to effect purely rational, economic calculations regarding the cost of compliance, likelihood of detection, and level of penalties.²⁸ A social norm constitutes a broader agreement that compliance is one of the social or even moral values of the organization.²⁹

Organizational behavior literature suggests that group norms develop within a business organization as a result of negotiation between the members of the group, which

²³ Daniel C. Feldman, “The Development and Enforcement of Group Norms,” in Management & Organizational Behavior Classics 217, 217 (Michael T. Matteson & John M. Ivancevich, eds., 7th ed. 1999).

²⁴ See, e.g., id. at 218 (distinguishing between group norms that facilitate productive behavior and those that discourage it); Hackman & Oldham, [], in Classic Readings in Organizational Behavior 251, 257-58 (J. Steven Ott, ed., 2d ed. 1996) (recommending encouraging groups to develop specific performance-enhancing norms).

²⁵ Cf. Barry D. Baysinger, “Organization Theory and the Criminal Liability of Organizations,” 71 B.U.L. Rev. 341, 349-50 (1991) (stating that management influences organizational norm development both through direct “indoctrination,” or “strategic controls,” and through the selection of output measurement standards for judging work, or “financial controls”);

²⁶ See Eric Talley, “Disclosure Norms,” 149 U. Pa. L. Rev. 1955, 1960-61 (2001) (distinguishing between legal compliance and extralegal norms, and arguing that the two are complementary).

²⁷ See, e.g., Eric Posner, Law and Social Norms 33 (2000) (noting that legal changes can amend both people’s behavior and their beliefs); Jeffrey J. Rachlinski, “The Limits of Social Norms,” 74 Chi.-Kent L. Rev. 1537, 1544 (2000) (noting that law can produce social norm changes).

²⁸ See, e.g., Timothy F. Malloy, “Regulation, Compliance and the Firm,” 76 Temp. L. Rev. 451, 472-73 (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.”).

²⁹ See Robert Cooter, “Expressive Law and Economics,” 27 J. Leg. Stud. 585, 607 (1998) (“Law provides an instrument for changing social norms by expressing commitments.”); Melvin A. Eisenberg, “Corporate Law and Social Norms,” 99 Colum. L. Rev. 1253, 1262-63 (1999) (describing social norms rooted in “belief systems”); Cass R. Sunstein, “Social Norms and Social Rules,” 96 Colum. L. Rev. 903, 914 (1996) (attributing “social attitudes of approval and disapproval” to social norms).

is heavily influenced by the views of leaders of the organization.³⁰ Group norms may differ from individual norms, and in particular may amplify them.³¹ Professor Cass Sunstein has described group members' tendency to defer to information offered by others instead of disclosing their own information, particularly when differing information is offered by a peer or supervisor and adverse reputational sanctions might result from offering different information.³² Under this view, groups tend to amplify information or results offered early in a discussion or by a senior member of the group – whether the information or results are good or bad – and arrive at an more extreme consensus relative to the individual view initially offered.³³ Professor Donald Langevoort offers the example of large corporations' tendency to develop optimism biases that lead to overcommitment and overbidding for assets.³⁴

The same factors cited as reasons for the development of aggressive or risk-taking firm norms can also support the development of compliance norms. The dynamic Sunstein and Langevoort identify surely exists in public corporation tax decisionmaking groups. But if each member of the group is inclined toward compliance as a result of incentives at work at each member's firm, increased compliance is the amplified consensus. In other words, the group dynamic can work in the regulator's favor.

Numerous authors have documented the phenomenon of the blurring of individual norms within an organization. Some note that this de-emphasis of individual norms goes along with the decrease in personal responsibility for a decision made by a group.³⁵ In addition, corporations are hierarchies, and disagreement with one's superior on ethical (or other) matters can cause adverse results ranging from an exclusion from social office conversation to the loss of a job.³⁶ Finally, commentators have observed that managers

³⁰ 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); Feldman, *supra* note 23, at 223 (stating that statements of superiors or other group members affect the development of group norms); Lawrence E. Mitchell & Theresa A. Gabaldon, "What Are the Ways of Achieving Corporate Social Responsibility?: 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").

³¹ See Donald C. Langevoort, "Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)," 146 *U. Pa. L. Rev.* 101, 131 (1997) (noting that corporations themselves "develop belief systems – shared ways of interpreting themselves, their environments, their pasts, and their prospects") (citing March & Simon, *supra* note 30, at 160).

³² See Cass R. Sunstein, "Group Judgments: Statistical Means, Deliberation, and Information Markets," 80 *N.Y.U. L. Rev.* 962, 966 (2005) (identifying "informational influences" and "social pressures").

³³ See *id.* at 1012-13 (noting "polarization" process and "cascades").

³⁴ See *id.* at 139-40 (stating that business organizations often amplify optimism bias).

³⁵ See, e.g., Don Welch, *Conflicting Agendas: Personal Morality in Institutional Settings* 61 (1994) (commenting that the decrease in personal responsibility decreases the tension between individual morality and group norms); see also Langevoort, *supra* note 31, at 138 (noting the particular strength of group cohesion when group members share responsibility for a decision).

³⁶ 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 organization."); John M. Darley, "The Dynamics of Authority Influence in

often face uncertain dilemmas, where the ethical path is not clearly distinguishable from the ethical path.³⁷

D. The Relevance of Liability and Enforcement

The first two factors mentioned in the preceding paragraph -- decreased personal responsibility and hierarchy -- make individual ethics in corporations contingent on the ethics of the corporation, often as expressed through the views of one's superiors. In particular, with respect to the four tax or accounting specialists considered in this Article, each member – the tax director, tax planner, financial auditor and Section 404 auditor – belongs to a firm which provides top-down guidance on the appropriate priority to be given to ethical or “compliance” 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 explain the importance of recent tax and securities enforcement efforts and practice standard revisions. 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 focus at the top on avoiding liability should prompt subsidiary decisionmaking groups like the tax group to prioritize compliance.³⁸

This Article in fact observes such an emphasis on compliance, particularly with respect to avoiding promoted tax shelters.³⁹ Such a post-Sarbanes-Oxley compliance result contrasts sharply with other studies of harmful corporate group dynamics. Professor Robert Jackall describes norm development at corporations as an exercise in trading more ethical individual norms for less ethical corporate norms. Jackall reports, for example, a whistleblower who lost his job after reporting financial accounting fraud,⁴⁰ an engineer who faced suspension after documenting procedural shortcuts in the cleanup

Organizations and the Unintended Action Consequences,” 37, 38, in Social Influences on Ethical Behavior in Organizations (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).

³⁷ See, e.g., Baysinger, supra note 25, 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).

³⁸ 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 25, at 362-363 (citing NASA's experience with the 1986 Challenger disaster as an example of the difficulty of institutionalizing safety norms); Malloy, supra note 28, at 491 (noting that information flow problems interfere with compliance efforts).

³⁹ See supra TAN 1-4.

⁴⁰ See Jackall, supra note 36, at 105-11.

of the Three Mile Island nuclear site,⁴¹ and corporate efforts to conceal respiratory illness caused by cotton dust⁴² and ozone erosion caused by formaldehyde.⁴³

In a similar vein, 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.⁴⁴ 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.”⁴⁵ The resulting conformity and dislike for negative information encourages groups to make riskier, less conservative decisions than individuals would make.⁴⁶

Case studies of other business responses to regulation note the tension between profit-oriented business norms, which are related to the harmful tendencies identified by Jackall and Langevoort, and regulation-responsive compliance norms. For example, Professors Ayres and Braithwaite conclude after examination of a series of case studies that business managers can be influenced both by legal compliance norms and profit-seeking norms.⁴⁷ They state that in light of these conflicting incentives, both forgiveness (for well-meaning firms) and ferocity (for rationally calculating firms) are appropriate regulatory tools.⁴⁸

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 – tax director, tax planner, Section 404 auditor and financial auditor – have reason to advocate compliance as a result of individual concern about personal liability for aggressive planning. More critically, 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

⁴¹ See Jackall, *supra* note 36, at 112-18.

⁴² See Jackall, *supra* note 36, at 157-5

⁴³ See Jackall, *supra* note 36, at 177-78.

⁴⁴ See Donald C. Langevoort, “The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior,” 63 Brooklyn L. Rev. 629, 639-642 (1997) (citing cognitive simplification, optimism and commitment as reasons why corporations overlook bad news and underestimate risk); see Langevoort, *supra* note 31, at 138-39 (noting that groups’ desire to preserve cohesiveness can explain institutional decisionmaking that leaves out important information) (citing Irving Janis, *Victims of Groupthink* 8 (1972)).

⁴⁵ See Donald C. Langevoort, “Taking Myths Seriously: An Essay for Lawyers,” 74 Chi.-Kent L. Rev. 1569, 1578 (2000) (placing groups’ tendency to think positively in the context of a discussion about the importance of myth in organizations).

⁴⁶ See also Baysinger, *supra* note 25, at 353-54 (citing optimism bias as a reason why corporations may commit crime).

⁴⁷ See Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* 21-29 (1992) (noting a variety of motivations); see also Malloy, *supra* note 28, at 474-75 (noting evidence of compliance norm development within business firms in other regulatory response case studies).

⁴⁸ See Ayres & Braithwaite, *supra* note 47, at 27.

contributes to the development of a compliance consensus and an anti-tax shelter group norm.

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 phenomenon of individual norm blurring within an organization is the uncertainty of the legal or ethical path. In a group decisionmaking context, such uncertainty permits other goals – such as profit or self-interest – to push the ethical interpretation to its aggressive limit.⁴⁹ In the tax area, ongoing tax shelter controversies amply illustrate the difficulty of determining whether a certain tax product is illegal.⁵⁰

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 of conviction that individuals believe that paying taxes is a moral obligation,⁵¹ 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 uncertainty about how the government will interpret and enforce them.⁵²

Clear rules, as opposed to broad standards, have potential disadvantages, such as a tradeoff between extreme complexity and failure to capture similar transactions.⁵³ But in the promoted tax shelter context clear rules appear to have achieved good results. 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 decisionmaking group can agree on: don't engage in promoted tax shelter transactions, especially those that are listed as such.⁵⁴

⁴⁹ See *supra* note 37.

⁵⁰ See *infra* Part IV.B.1 (describing tax shelter litigation).

⁵¹ See Slemrod, *supra* note 5, at 883 (noting significant “experimental and empirical evidence” that of noneconomic taxpayer motives such as civic duty and trust in the fairness of the tax system); Robert W. McGee, “The Ethics of Tax Evasion: A Survey of International Business Academics,” 25-28 (Feb. 12, 2006) (unpublished manuscript, on file with the author) ([available at www.ssrn.com/abstract=803964](http://www.ssrn.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 Center, “A Barometer of Modern Morals: Sex, Drugs and the 1040” 1 (Mar. 28, 2006) (reporting that 79% of survey respondents believed that “not reporting all income on your taxes” was morally wrong).

⁵² 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.”).

⁵³ See *infra* TAN 275-276.

⁵⁴ See *infra* Part IV.B.3.

II. How Sarbanes-Oxley Produced an Expanded and More Transparent Tax Decisionmaking Group

A. Sarbanes-Oxley Overview.

The 2002 Sarbanes-Oxley Act⁵⁵ emerged from a highly charged political atmosphere where decisionmakers were motivated to take action by well-publicized scandals and a bear stock market.⁵⁶ 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 likely success of various regulatory approaches.⁵⁷ Others have criticized its failure to impose strict liability penalties on, or otherwise raise the stakes for, the professionals auditing and advising corporations.⁵⁸ But the impact of Sarbanes-Oxley on the composition and internal transparency of public corporation tax decisionmaking 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

⁵⁵ Pub. L. No. 107-204, 2002 U.S.C.C.A.N. (116 Stat.) 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).

⁵⁶ See Robert W. Hamilton, "The Crisis in Corporate Governance: 2002 Style," 40 *Hous. L. Rev.* 1, 45-48 (2003) (explaining that Republicans hastily dropped their opposition to the already-pending Democratic bill in the face of an electorate unhappy about falling stock prices and apparent corporate governance failures); Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 114 *Yale L.J.* 1521, 1543-44 (2005) (noting lack of attention to relevant research, pressure on Congress to act on corporate fraud in an election year, and weakness of accounting and business lobbies in light of contemporaneous scandals such as Enron).

⁵⁷ See, e.g., Romano, *supra* note 56, at 1533-37 (contending that 19 of 25 available empirical studies found no link between audit quality and prohibitions on auditor provision of non-audit services); *id.* at 1540-43 (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 *Iowa J. Corp. L.* 1, 25, 35-45 (2002) (discussing perceived costs of increased regulation).

⁵⁸ See John C. Coffee, Jr., "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms," 84 *B.U.L. Rev.* 301, 349-353 (2004) (proposing better alignment of gatekeeper and shareholder incentives through a regulatory strict liability); Patricia A. McCoy, "Realigning Auditors' Incentives," 35 *Conn. L. Rev.* 989, 1008-1012 (2003) (reviewing the alternate approaches of mandatory audit firm rotation, statutory auditors and financial statement insurance); Frank Partnoy, "Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime," 79 *Wash. U. L. Q.* 491, 540 (2001) (recommending contractual strict liability based on portion of issuer damages). See also Lawrence A. Cunningham, "Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability," 52 *UCLA L. Rev.* 413, 427-29 (2004) (evaluating financial statement insurance alternative). Accounting firms often include liability caps and arbitration provisions in their engagement agreements. See Michael Rapoport, "Auditing 'Liability Caps' Face Fire," *Wall St. J.*, Nov. 28, 2005, at C3 (reporting that some investors object to the caps).

destruction and fraud.⁵⁹ With few exceptions⁶⁰ 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, or PCAOB,⁶¹ does not have responsibility for developing substantive rules under generally accepted accounting principles, or GAAP. The Financial Accounting Standards Board, or FASB, continues to make GAAP rules after Sarbanes-Oxley.⁶²

B. Sarbanes-Oxley Provisions That Expand the Tax Decisionmaking Group

Two Sarbanes-Oxley provisions have produced an expansion in the tax decisionmaking group: limitations on non-audit services and internal control requirements.⁶³

1. Non-Audit Services Limitations.

Sarbanes-Oxley prohibits an audit firm's provision of tax services to its client without prior approval from the client's independent audit committee.⁶⁴ 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.⁶⁵ Specifically, these PCAOB rules forbid the provision of advice related to the implementation of any transaction listed as a shelter by the IRS,⁶⁶ defined as a

⁵⁹ See Lawrence A. Cunningham, "The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)," 35 Conn. L. Rev. 915, 941-42 (summarizing Sarbanes-Oxley threads); Hamilton, *supra* note 56, at 56-67 (cataloguing Sarbanes-Oxley provisions).

⁶⁰ See, e.g., 15 U.S.C. §§ 78m(k) (codifying Section 402 of Sarbanes-Oxley Act) (prohibiting issuers from extending certain personal loans to executives).

⁶¹ See 15 U.S.C. §§ 7211-7217, 7219 (codifying PCAOB provisions from Title I of Sarbanes-Oxley Act).

⁶² See 15 U.S.C. § 7218 (codifying Section 108 of Sarbanes-Oxley Act, which permits a private group to continue to set accounting standards). FASB rule projects show the effects of recent events, however. See, e.g., *infra* Part IV.C (regarding accounting for uncertain tax positions under proposed amendments to FAS 109).

⁶³ See David E. Hardesty, "Sarbanes-Oxley Compliance in the Corporate Tax Department," 2004 STT 229-3 (Nov. 29, 2004) (analyzing non-audit services rules and Section 404).

⁶⁴ See 15 U.S.C. §§ 78j-1 (h) and (i) (codifying a portion of Section 201(a) and Section 202 of Sarbanes-Oxley Act). Prior to the passage of Sarbanes-Oxley, audit firms had divested many consulting units. See Cunningham, *supra* note 59, at 953-954 (commenting on EY's sale to Cap Gemini, PriceWaterhouseCoopers' sale to IBM, KPMG's IPO/spin-off and Deloitte'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.

⁶⁵ See PCAOB, "Board Adopts Standard on Remediation of Material Weaknesses, Rules on Auditor Independence and Tax Services," July 26, 2005 (finalizing Rules 3521-3524). See also Emily Davis, "New PCAOB Rules Target Tax Shelters," 2005 TNT 145-5, July 29, 2005.

⁶⁶ See PCAOB Rule 3522 (treating an auditor as not independent if it markets, plans or opines with respect to any listed transaction as defined in Treasury regulations).

confidential transaction by the IRS,⁶⁷ involving the provision of certain aggressive tax advice,⁶⁸ or provided under a contingent fee arrangement.⁶⁹

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 rule described above, one study of public filings suggested that the public corporations had significantly shifted their consumption of tax services to advisors other than their auditors.⁷⁰ One 2005 survey indicated that 41% of public corporations now prohibit their audit firms from providing them with any tax services.⁷¹ Another survey indicates 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.⁷²

Corporations have, then, typically responded to the non-audit services rules by adding a tax planning advisor from a different firm to the typical public corporation tax decisionmaking group. Moreover, this shift may be more pronounced with respect to more involved tax planning decisions. 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 for 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.⁷³ Commentators have sharply criticized the higher-than-expected costs of the internal

⁶⁷ See PCAOB Rule 3522(a) (treating an auditor as not independent if it markets, plans or opines with respect to any confidential transaction as defined in Treasury regulation § 1.6011-4(b)(3)).

⁶⁸ See PCAOB Rule 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 not more likely than permissible under relevant tax law).

⁶⁹ See PCAOB Rule 3521 (treating an auditor as not independent if it has any contingent fee arrangement, including one relating to tax advice).

⁷⁰ See Edward L. Maydew & Douglas A. Shackelford, “The Changing Role of Auditors in Corporate Tax Planning,” NBER Working Paper 11504, at 19-20 (June 2005) (finding that the ratio of audit fees to tax fees, provided by the same firm, had increased from about 1:1 in 2001 to about 4:1 in 2004). Although an increase in audit fees as a result of internal control and other compliance also influences this data, the authors 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.

⁷¹ See KPMG LLP, “2005 Tax Department Survey: Executive Summary” 4 (2005) (on file with the author) (reporting results of telephone survey of tax directors at 98 “major US corporations” in June and July 2005).

⁷² See TCPI 2006 Survey, *supra* note 1 at 19 (reporting that of 56% of responding tax directors used their external audit firm for some tax work but not as the primary tax services provider, while 27% did not use their external auditor for any tax work).

⁷³ 15 U.S.C. § 7262 (codifying Sarbanes-Oxley Act Section 404).

control rule⁷⁴ and its confusing and overinclusive drafting.⁷⁵ However, it appears to provide some synergies with respect to the regulation of tax planning.

The SEC rules implementing Section 404 call for a “control framework that is established by a body or group that has followed due-process requirements, including the broad distribution of the framework for public comment.”⁷⁶ In practice, companies rely on the “COSO” internal control framework, compiled by a consortium of accounting practice groups.⁷⁷ The COSO standard is process oriented and elaborate. It features a three-part process including controls (e.g. reviews and reconciliations), information capture and communication and monitoring.⁷⁸

⁷⁴ The SEC estimated the costs of internal control compliance at \$91,000 per company or \$1.24 billion total annually. See Securities and Exchange Comm’n, “Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,” 68 Fed. Reg. 36636, 36657 (June 18, 2003). But surveys demonstrate that the actual cost is significantly higher, even for years subsequent to the initial year of compliance. See, e.g., Financial Executives International Sarbanes-Oxley Survey Executive Summary 2 (Mar. 2006) (available at http://www.fe.org/membersonly/FEI_404_Survey_4_2006.pdf) (reporting internal and external costs at larger accelerated filer companies at \$3.8 million each for 2005); 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 \$860,000 according to a survey by the Big Four accounting firms).

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,” USC Center in Law, Economics and Organization Research Paper No. C06-5 and USC Legal Studies Research Paper No. 06-10, available at www.ssrn.com, at 56-57 (reporting 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,” Financial Times, Nov. 18, 2005, at 13 (reporting that Chinese companies avoid listing on New York-based stock exchanges in part to avoid the burdens of Sarbanes-Oxley compliance).

In partial response to these concerns, the SEC extended effective date of the Section 404 internal control provisions for corporations whose market capitalization is less than \$75 million, SEC, “Management’s Report on Internal Controls Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies That Are Not Accelerated Filers, Rel. No., 33-8618 (Sept. 22, 2005). An SEC advisory committee has recommended tailoring Sarbanes-Oxley to small businesses, including exempting smaller companies from internal controls requirements. See generally Final Report of the Advisory Committee on Small Public Companies to the U.S. Securities and Exchange Commission 48-57 (Apr. 23, 2006) (SEC Release 33-8666) [hereinafter “SEC Small Company Advisory Committee Report”] (providing recommendations for “scaled” application of Rule 404 to smaller corporations, including reduction or elimination of external audit requirements). The SEC is considering taking such actions. See, e.g., Rebecca Buckman & Kara Scannell, “Do U.S. Regulations Drive Away Start-Ups?,” Wall St. J., Apr. 27, 2006, at C5 (reporting SEC officials’ apparent willingness to consider tailoring internal control requirements).

⁷⁵ See Joseph A. Grundfest, Fixing 404 5 (Nov. 3, 2005) (unpublished manuscript on file with the author) (noting that the internal control statute requires the reporting of control failures that “raise a more than remote likelihood of a more than inconsequential misstatement”).

⁷⁶ 17 CFR 240.13a-15(c) (Exchange Act Rule 15d); 17 CFR 240.15d-15(c) (Exchange Act Rule 15d) (containing same language).

⁷⁷ See SEC Small Company Advisory Committee Report, *supra* note 74, at 26-27 (identifying and briefly describing COSO standard).

⁷⁸ See COSO, “Internal Control – Integrated Framework Executive Summary” (2005) (providing an overview of COSO internal control approach).

Section 404 auditors search for the tax department's ability to catch, on a quarterly⁷⁹ or more current basis, law changes; correctly record notoriously elusive intercompany transaction data; and document their decisions about reporting transactions with memos or opinions from relevant advisors.⁸⁰ Section 404 auditors describe a testing process for tax matters that involves zeroing in on the "key review person" (the besieged tax director), asking the 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, the documentation of intercompany transactions such as transfer pricing) is in fact followed.⁸¹ In a 2004 survey, a large majority of responding tax directors reported that "some additional effort" or a "major effort" would be required for tax department implementation of Section 404.⁸²

A Section 404 review may result in the identification of internal red flag "significant deficiencies"⁸³ and/or publicly reported reported "material weaknesses"⁸⁴ related to tax. One source reports that over 200 material weaknesses and 31% of adverse internal control opinions were tax-related in 2005.⁸⁵ According to the chairman of the SEC, tax issues are the second most frequent cause of material weaknesses (after revenue recognition).⁸⁶ Another source reports that up to a third of tax directors whose companies reported a tax-related material weakness left their jobs.⁸⁷ Whether or not specific issues are identified as problems, the fact that a nonprivileged conversation must occur about

⁷⁹ The focus on quarterly reporting finds reinforcement in the Sarbanes-Oxley requirement that CEOs and CFOs certify quarterly and annual financial reports. See infra Part II.C.

⁸⁰ See Hardesty, supra note 63, TAN 7-21 (outlining Section 404 internal evaluation and external audit requirements)

⁸¹ James Wolfrom, Ernst & Young, LLP, Presentation at the SJSU/TEI High Technology Tax Institute (Nov. 7, 2005) (explaining the "testing script").

⁸² Tax Council Policy Institute Market Research Study at 7 (February 2004) (hereafter "TCPI 2004 Survey") (reporting that 63% of respondents reported that "some additional effort" would be required and 26% reported that "a major effort" would be necessary). The TCPI 2004 Survey solicited responses from the tax directors of the Fortune 500 from December 2003 – January 2004 and received 125 responses. Id. at 3. The questionnaire report states that it has a margin of error of plus or minus 9% at a 95% confidence level. Id. at 5.

⁸³ Significant deficiencies are known as "minor blows" in the inevitable accounting firm parlance. Brad L. Brown, KPMG LLP, Presentation at the SJSU/TEI High Technology Tax Institute (Nov. 7, 2005).

⁸⁴ Or "major blows." Id.

⁸⁵ See Allen Shoulders, "Practical Approaches to Improving Tax Control Effectiveness," 2006 TNT 80-37 (Apr. 18, 2006) (reporting results from Ernst & Young examination of public records and from an Audit Analytics study).

⁸⁶ See Christopher Cox & Matthew McKenna, "The Corporate Tax Practice: New Challenges," TAXES 49, 49-50 (June 2006). 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 relating 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 85.

⁸⁷ Brad L. Brown, KPMG LLP & James Wolfrom, Ernst & Young, LLP, Presentation at the SJSU/TEI High Technology Tax Institute (Nov. 7, 2005).

these matters with the Section 404 auditor augments the tax decisionmaking group by one and increases the internal transparency of that group's decisions.⁸⁸

C. Other Sarbanes-Oxley Provisions That Increase the Tax Decisionmaking 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.⁸⁹ An officer who knowingly or willfully falsely certifies that a report is fair and materially complete faces criminal penalties.⁹⁰ 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.⁹¹

Another relevant Sarbanes-Oxley provision is audit committee review of financial statements.⁹² The statute requires an audit committee comprised of independent members of the corporation's Board of Directors.⁹³ This committee is required to collect and review reports from the corporation's auditor regarding "critical accounting policies and practices" and possible alternative GAAP-compliant accounting treatments.⁹⁴ The certification and 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.⁹⁵ Tax directors report that material or substantive tax items or items that arise in Section 404 audits often receive

⁸⁸ See *infra* Part II.D (describing erosion of attorney-client and other privileges).

⁸⁹ See 15 U.S.C. § 7241 (codifying Section 302 of Sarbanes-Oxley Act) (requiring quarterly certifications as to the correctness and completeness of financial reports and internal controls).

⁹⁰ See 18 U.S.C. § 1350 (codifying Section 906 of Sarbanes-Oxley Act) (providing criminal penalties including fines up to \$1,000,000 or imprisonment of up to 10 years).

⁹¹ See TCPI 2004 Survey, *supra* note 82, at 5 (reporting that 19% of tax director respondents faced subcertification requirements and that 78% experienced new information collection procedures).

⁹² See 15 U.S.C. § 78j-1(k) (codifying Section 204 of Sarbanes-Oxley Act) (requiring public corporation auditors to make reports to audit committees).

⁹³ See 15 U.S.C. § 78j1-(m) (codifying Section 301 of Sarbanes-Oxley Act) (requiring an independent audit committee and defining independence as requiring no fee relationship or affiliation between a board member and the corporation).

⁹⁴ 15 U.S.C. § 78j-1(k).

⁹⁵ 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.").

specific audit committee review.⁹⁶ 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, had the following observation about his pre-government experience in practice 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 the hell 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.”⁹⁷

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.⁹⁸ A 2004 PCAOB release further contributes to this development by requiring audit documentation that provides the “basis for the auditor’s conclusions concerning every relevant financial statement assertion.”⁹⁹ The leading accountants’ trade group, the American Institute of Certified Public Accountants, or 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.”¹⁰⁰

Disclosure of tax planning advice to auditors and audit committee examination of tax planning primarily 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

⁹⁶ See TCPI 2006 Survey, *supra* note 1, at 34 (reporting that audit committee reviewed material tax items in 82% of cases, substantive tax issues in 63% of cases, and tax elements of Section 404 reports in 59% of cases).

⁹⁷ Unofficial Transcript Is Available of Forum on Tax Shelters,” 2005 TNT 40-63 (Mar. 2, 2005) (quoting Don Korb).

⁹⁸ See Sheryl Stratton, “Lawyers Discuss Postshelter Assault on Privilege,” 2005 TNT 71-5 (Apr. 14, 2005) (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* 8, 10 (October 2004) (reporting a “tug-of-war among auditors and attorneys” as a result of auditor information and representation requests that significantly exceeded the standard requests of the past 30 or so years). In a 2004 survey, 73% of responding tax directors responded that their “level of documented support for tax contingency reserves [had] increased in the past two years.” TCPI 2004 Survey, *supra* note 82 at 10. A 2006 survey showed that 74% of responding tax directors had provided outside counsel tax opinions to auditors. TCPI 2006 Survey, *supra* note 1 at 23.

⁹⁹ PCAOB Release 2004-006 A1-4 (June 9, 2004).

¹⁰⁰ AIPCA, *The Standards of Field Work* § 9326.22 (2004 ed.).

advice¹⁰¹ (although work-product protection may remain in some cases).¹⁰² There is no accountant-client privilege protecting audit workpapers from disclosure.¹⁰³ A recently added section of the tax code purports to provide a tax practitioner-client privilege that provides some protection for tax advice given by accountants.¹⁰⁴ However, recent cases in the tax shelter context have established a narrow scope for the statutory accountant-client privilege and 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 promoter capacity rather than a legal advisor capacity¹⁰⁵ or when the advisor prepares tax returns.¹⁰⁶

These developments lead many practitioners to believe that their work generally will not enjoy any privilege protection.¹⁰⁷ 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).¹⁰⁸ Such a reluctance to provide written advice might decrease, rather than increase, communication

¹⁰¹ According to the classic Wigmore formulation of the attorney-client, “[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.”¹⁰¹ See 8 Wigmore, Evidence Sec. 2294 (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 tax return filing waived privilege).

¹⁰² 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 a more general balancing test that considers the strength of the claim that the material was developed in anticipation of litigation and the importance of the material to the requesting litigant’s case. See Bernard Wolfman, James P. Holden & Kenneth L. Harris, Standards of Tax Practice § 306.4.4.2, at 304 (6th ed. 2004) (describing balancing test).

¹⁰³ 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 work product privilege could cover auditor workpapers).

¹⁰⁴ See I.R.C. § 7525 (extending “common law protections of confidentiality” in attorney-client privilege context to tax practitioners).

¹⁰⁵ See, e.g., Doe #1 v. Wachovia Corp., 268 F. Supp. 2d 627, ___ (W.D.N.C. 2003) (requiring disclosure of client identity in response to IRS summons; no privilege existed between Jenkins & 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).

¹⁰⁶ See United States v. Frederick, 182 F.3d 496, 502 (7th Cir.) (Posner, C.J.), reh’g denied (1999), cert. denied (2000) (stating in dictum that nothing in Section 7525 “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).

¹⁰⁷ See, e.g., Sheryl Stratton, Lawyers Discuss Postshelter Assault on Privilege, ___ Tax Notes Today ___ (Apr. 14, 2005) (reporting comments at an April 13 teleconference sponsored by the ABA); James M. Lynch, War of the [Tax] Worlds: Privilege versus Transparency, 82 TAXES 89, TAN 2 (2004). See also Bruce Kayle, The Tax Adviser’s Privilege in Transactional Matters: A Synopsis and a Suggestion, 54 Tax Lawyer 509 (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).

¹⁰⁸ See infra Part III.B.3 (discussing Circular 230 developments).

and internal transparency. But although the reaction of requesting less written advice has been observed, it does not clearly prevail.¹⁰⁹ Perhaps auditors' demand for documentation still mandates written advice for tax matters with material financial accounting consequences.

E. What Causal Effect Does Sarbanes-Oxley Have on Tax Compliance?

This Article argues that the larger and more visible post-Sarbanes-Oxley tax decisionmaking 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 reputations consequences, including possible loss of employment.¹¹⁰ 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 decisionmaking group. Others (such as prominent criminal cases lodged against CEOs in connection with accounting scandals) do not directly impact such group members. But they have an indirect effect because of the strong influence organization leaders (like CEOs) exert on their subordinates (like tax directors).¹¹¹

This Article does not offer rigorous empirical proof that Sarbanes-Oxley is a necessary piece of this tax shelter compliance puzzle. Nevertheless, the story of a larger and more transparent group that amplifies 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.¹¹² Prior to Sarbanes-Oxley, 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).¹¹³ 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

¹⁰⁹ A 2006 survey showed that 76% of responding tax directors had "significantly changed [their] practice regarding documenting tax reserves in the last two years" and that 74% had provided outside counsel tax opinions to auditors. TCPI 2006 Survey, *supra* note 1, at 23. It is not clear from the survey data whether they increased or decreased their demand for written advice, however. The same report noted that of the 13 tax director respondents who had experienced increased government demand for information and made a change as a result, 92% only asked for written advice when absolutely necessary; and that of the 25 tax director respondents who had experienced increased government demand for information and not made a change as a result, 72% believed that the need for written record was more important than risk of possible disclosure of privileged information. *See id.* at 29, 30.

¹¹⁰ *See supra* note 87 (noting that some tax directors left their jobs after reporting material tax weaknesses).

¹¹¹ *See supra* TAN 30 (noting the importance of leaders' ethics in forming group ethics).

¹¹² *See* Deborah M. Nolan, "LMSB's Compliance Assurance Program (CAP): One Year Later," *___ Tax Executive* 27, 27 (2006) (characterizing Sarbanes-Oxley as a window of opportunity); Interview of Mark Everson by Frontline, posted Feb. 19, 2004, available at <http://www.pbs.org/wgbh/pages/frontline/shows/tax/shelter/return.html> ("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.").

¹¹³ *See infra* note 236 and accompanying text (noting frustration with pre-2002 regulations' effectiveness).

norm does not appear in private corporations not subject to Sarbanes-Oxley.¹¹⁴ Finally, survey evidence shows that Sarbanes-Oxley compliance requires a significant share of tax directors' energy and time.¹¹⁵

III. Why Tax Decisionmakers Now Worry About Personal and Firm Liability

The expanded and more transparent tax decisionmaking 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.¹¹⁶ Moreover, as described in Part I, corporate norms often display aggressive, risk-taking tendencies due to organizational behavior phenomena such as optimism bias.¹¹⁷ 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 III explains the reasons for the liability and adverse publicity concerns of the members of the tax decisionmaking group and the people they work for, which contribute significantly to the compliance-oriented nature of the recently developed group norm.¹¹⁸

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

Numerous recent enforcement initiatives combine to make corporate executives and managers worry about possible personal and firm civil and criminal liability. Big criminal prosecutions and convictions of top corporate managers have recently grown out of accounting and securities fraud charges at Adelphia,¹¹⁹ Enron,¹²⁰ HealthSouth,¹²¹ Tyco¹²² and Worldcom,¹²³ among others. Some cases have also involved civil federal

¹¹⁴ See Interview of Larry Langdon by Frontline, posted Feb. 19, 2004, available at <http://www.pbs.org/wgbh/pages/frontline/shows/tax/shelter/return.html> (“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.”).

¹¹⁵ See *supra* notes 1 and 82 and accompanying text (summarizing survey evidence).

¹¹⁶ See *supra* Part I.D.

¹¹⁷ See *id.*

¹¹⁸ See *supra* TAN 1 (stating that corporate tax directors now articulate compliance as a higher priority than effective tax rate reduction).

¹¹⁹ See Chad Bray, “Adelphia Ex-Executive Avoids Jail for False Report,” Mar. 4, 2006, at B4 (noting conviction of John and Timothy Rigas for diverting funds from Adelphia and misleading investors, their respective prison sentences of 20 and 15 years, and pending appeals).

¹²⁰ See John R. Emshwiller, Gary McWilliams & Ann Davis, “Lay, Skilling Are Convicted of Fraud,” Wall St. J., May 26, 2006, at A1 (reporting jury conviction).

¹²¹ See Chad Terhune, “Ex-Finance Chief at HealthSouth Gets Five Years in Jail,” Wall St. J., Online, Dec. 10, 2005 (reporting sentence of former HealthSouth CFO William T. Owens with respect to \$2.7 billion accounting fraud and also noting acquittal of former HealthSouth CEO Richard Scrushy despite William Owens’ testimony against him).

¹²² See Andrew Ross Sorkin, “Ex-Chief and Aide Guilty of Looting Millions at Tyco,” N.Y. Times, June 18, 2005, at A1, C4 (reporting conviction of former CEO L. Dennis Kozlowski and former CFO Mark H.

charges and private lawsuits, generating significant monetary penalties.¹²⁴ Some directors have made settlement payments out of their own pockets.¹²⁵

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.¹²⁶ Increased IRS audit and enforcement activity¹²⁷ aimed at corporate taxpayers also directly impact the tax director. Other measures, discussed below in Part III.B, target gatekeepers such as tax planners and auditors.

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.¹²⁸ The precise definition of “gatekeeper” is sometimes elusive,¹²⁹ but in the context of the tax decisionmaking 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

Swartz on securities fraud, grand larceny, conspiracy and other charges). Both Kozlowski and Swartz are in prison during their appeals. See “Guilty, Not Guilty, Mistrial,” Wall St. J. Online, Mar. 20, 2006 (reporting sentences).

¹²³ 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 \$11 billion accounting fraud and noting guilty plea of former CFO Scott Sullivan as well as Ebbers’ appeal plans). Ebbers received a sentence of 25 years and Sullivan a sentence of five years. See “Guilty, Not Guilty, Mistrial,” Wall St. J. Online, Mar. 20, 2006 (providing a summary of conviction and sentencing results for prominent white-collar defendants).

¹²⁴ See, e.g., Kara Scannell, “Tyco to Pay \$50 Million to Settle SEC Accounting Fraud Charges,” Wall St. J., Apr. 18, 2006, at C3 (reporting settlement at SEC 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 (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).

¹²⁵ See, e.g., Daniel Akst, “Fining the Directors Misses the Mark,” N.Y. Times, Aug. 21, 2005, at Section 3, Page 6 (noting Worldcom director payments of \$20 million and Enron director payments of \$13 million).

¹²⁶ See infra TAN 30-38 (discussing top-down ethical influences in large organizations).

¹²⁷ See “Statement of Eileen J. O’Connor, Assistant Attorney General, Tax Division, Before the Committee on Finance, United States Senate Concerning Corporate and Partnership Enforcement Issues,” at 3-4 at 5-8 (June 13, 2006) available at www.senate.gov/~finance/hearings/testimony/2005test/061306testeo.pdf (attributing increased Tax Division civil and workload to increased IRS enforcement); “IRS Officials Give Report on Audit Currency Efforts,” 2006 TNT 28-4 (Feb. 10, 2006) (noting report that audit currency had increased and audit cycle time had decreased).

¹²⁸ See, e.g., Coffee, supra note 58, 84 B.U.L. Rev. at 308-11 (describing 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).

¹²⁹ See Cunningham, supra note 58, 52 U.C.L.A. L. Rev. at n. 6 (2004) (suggesting that gatekeeper label is imprecise and not very useful).

“disrupt misconduct by withholding their cooperation from wrongdoers.”¹³⁰ 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,¹³¹ Andersen imploded. The Supreme Court’s subsequent reversal of the conviction¹³² came too late to save the firm.¹³³

The Andersen case also apparently deterred the government from mounting another criminal prosecution with the power to destroy another large audit firm. In the KPMG tax shelter case, the government’s criminal enforcement efforts consist instead 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.¹³⁴ 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 IRS and cavalier dismissal of the likelihood that large penalties could be imposed on the firm.¹³⁵

The Justice Department believed that the evidence that KPMG had pushed fraudulent transactions marked by untrue representations about business purpose and the like supported criminal charges against the firm.¹³⁶ But the parties knew of the market risks of ruining KPMG with a criminal indictment; a demise of KPMG would have left

¹³⁰ Kraakman, *supra* note 128, 2 J. L. Econ. & Org. at 53 (1986).

¹³¹ See *United States v. Arthur Andersen LLP*, 374 F. 3d 281, 302 (5th Cir. 2004) (affirming guilty jury verdict), *rev’d by* 544 U.S. 696 (2005).

¹³² See *Arthur Andersen LLP v. United States*, 544 U.S. 696, 125 S. Ct. 2129, 2131-32 (2005) (overruling guilty jury verdict on grounds that jury instructions did not properly articulate the knowing intent element of the obstruction of justice charge).

¹³³ See Joseph A. Grundfest, “Over Before It Started,” N.Y. Times, June 14, 2005 (stating that “Andersen was destroyed when it was indicted”).

¹³⁴ See, e.g., Lynnley Browning, “How an Accounting Firm Went from Resistance to Resignation,” N.Y. Times, Aug. 28, 2005 (noting early settlements of Ernst & Young and PricewaterhouseCoopers).

¹³⁵ See “U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals: Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2,” Minority Staff of the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, 108th Cong., 1st Sess., S. Prt. 108-34, at 7-16 (2003) (describing KPMG’s development, marketing and concealment of tax products). See also Tanina Rostain, “Travails in Tax: KPMG and the Tax-Shelter Controversy,” ___, ___, in *Legal Ethics Stories* (Deborah L. Rhode & David Luban eds., 2006) (describing disclosures by KPMG whistleblower Michael Hamersley).

¹³⁶ See Information at 4-5, *United States v. KPMG LLP*, No. 05 Cr. ____ (S.D.N.Y. Aug. 29, 2005) (describing elements of fraud including false representations and statements in tax opinion letters).

only three US-based global accounting firms.¹³⁷ Instead, 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.¹³⁸

Under the agreement, KPMG must pay \$456 million and the Justice Department agreed not to pursue its prosecution of KPMG for criminal fraud and conspiracy charges.¹³⁹ 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.¹⁴⁰ And, importantly, it agreed to "cooperate" with the government. The cooperation agreement, following the Thompson memo model, requires waiver of attorney-client privilege and provision of any requested information, including information about current and former KPMG partners and employees, to the government.¹⁴¹

Criminal fraud and conspiracy charges were filed and are still pending against 16 former KPMG partners, one lawyer, and an investment advisor.¹⁴² One former KPMG partner has pled guilty.¹⁴³ With respect to the individual criminal charges, the correct substantive outcome is unclear, in part because no court has passed on the legality of the underlying tax shelters.¹⁴⁴ The government responds to this charge by explaining that the underlying legality does not matter in light of evidently false representations made by KPMG and drafted by KPMG for attestation by its clients.¹⁴⁵ But since 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 transaction had enough substance in the first place and that the

¹³⁷ See John R. Wilke, "KPMG Faces Criminal Case on Tax Shelters," Wall St. J., June 16, 2005, at A1 (noting Justice Department aversion to causing the collapse of another accounting firm).

¹³⁸ See Thompson Memo, *supra* note 2, at Part 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).

¹³⁹ See Letter from U.S. Attorney, Southern District of New York to Robert S. Bennett 2, 13-17 (Aug. 26, 2005) [hereinafter "KPMG Deferred Prosecution Agreement"] (stating that KPMG will pay \$456 million and that the government will delay and potentially dismiss criminal charges).

¹⁴⁰ See *id.* at 4-9 (articulating practice restrictions and standards).

¹⁴¹ See *id.* at 9-12 (detailing cooperation agreement).

¹⁴² See, e.g., Lynnley Browning, "A Single Trial for 18 Named in Tax Shelters," N.Y. Times, Apr. 5, 2006, at C3 (reporting that all 18 defendants would stand trial together in New York in the fall of 2006).

¹⁴³ See Lynnley Browning & Colin Moynihan, "A Surprise in Tax Case on KPMG," N.Y. Times, Mar. 28, 2006 (reporting guilty plea of David Rivkin).

¹⁴⁴ See "KPMG in Wonderland," Wall St. J., Oct. 6, 2005, at A14 ("The KPMG case attempts to short-circuit the messy business of proving that a tax shelter is illegal by using the power of the 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.")

¹⁴⁵ See Lynnley Browning, "Prosecutors Lay Out the Case Against KPMG Defendants," N.Y. Times, Apr. 24, 2006, at C2 (stating prosecutors' argument that shelter description in opinion letters was false and noting that prosecutors sidestep the question of whether the transactions would be legitimate if in fact carried out in the way described in the opinion letters).

question of whether the tax shelters themselves were legal is the only appropriate starting point.¹⁴⁶

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.¹⁴⁷ In KPMG, the firm insulated itself from prosecution by identifying employees as bad apples, withdrawing attorney fee and other support from them, and waiving attorney-client privilege. Practitioners have responded with great anxiety to the possibility of being scapegoated.¹⁴⁸ 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.¹⁴⁹ 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.¹⁵⁰

2. Monetary Penalties and Civil Litigation.

The criminal prosecution and deferred prosecution agreement described above is not the end of the matter for KPMG. It faces ongoing private party fraud and malpractice claims.¹⁵¹ Proposed settlements amount to hundreds of millions of dollars,¹⁵² on top of the approximately \$450 million that KPMG must pay in connection with its deferred prosecution agreement.¹⁵³

Several of the other Big Four accounting firms – which include Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers -- have also faced stiff

¹⁴⁶ See Robert Weisberg & David Mills, "A Very Strange Indictment," Wall St. J., Oct. 12, 2005, at A16 (criticizing validity of government's case).

¹⁴⁷ See, e.g., Fisher & Lattman, *supra* note 2, at 50 (noting danger of talking to in-house attorneys).

¹⁴⁸ See, e.g., KPMG Anonymous Letter, *supra* note 2, at 6-9 (noting "random tax partner firings" and accusing KPMG leaders of improperly shifting firmwide responsibility to a small number of unfortunate individuals).

¹⁴⁹ See *United States v. Stein*, No. S1 05 Crim 0888 (LAK), 2006 U.S. Dist. LEXIS 42915, at *87 - *94 (S.D.N.Y. June 26, 2006, as amended July 14, 2006) (concluding that Thompson memorandum presumption that payment of fees indicates unwillingness to cooperate interferes with defendants' right to fair trial); *id.* at *101, *118-19 (concluding that KPMG defendants might reasonably expect legal fee assistance from KPMG and that government interference with payment of such fees could violate right to counsel).

¹⁵⁰ See Posting of Peter J. Henning to White Collar Crime Prof Blog, http://lawprofessors.typepad.com/whitecollarcrime_blog/2006/06/kpmgs_aftermath.html#comments (June 28, 2006) (noting possibility of employers or their insurers explicitly limiting future payment of legal fees).

¹⁵¹ See Jeff Bailey and Lynnley Browning, "KPMG May Dodge One Bullet Only to Face Another," N. Y. Times, June 21, 2005 (noting pending civil litigation and potential damages of hundreds of millions of dollars).

¹⁵² See David Reilly, "KPMG Can't Shake Lawsuit, as Investors Reject Settlement," Wall St. J., Apr. 27, 2006, at C2 (reporting proposed \$195 million settlement in a class-action case against KPMG and Sidley Austin Brown & Wood, which a number of class members have rejected).

¹⁵³ See *supra* TAN 139.

finer or other sanctions such as restrictions on individuals' ability to practice in recent years. Settlements may arise from shareholder class-action lawsuits¹⁵⁴ or SEC investigations.¹⁵⁵ 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,¹⁵⁶ although firms also reached large settlements in the early 1990s with respect to the savings and loan debacle.¹⁵⁷ Accountants' apparently escalating anxiety 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 Circular 230 rules¹⁵⁸ 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.¹⁵⁹ The government has amended and updated Circular 230 several times in the last several years.¹⁶⁰ Circular 230 sets forth threshold requirements for an individual to be permitted to practice before the IRS,¹⁶¹ articulates practice standards,¹⁶² describes reasons for disciplinary action,¹⁶³ and establishes enforcement mechanisms which may lead, for example, to the sanction of prohibition of future practice before the IRS.¹⁶⁴ An

¹⁵⁴ See, e.g., Barnaby J. Feder, "KPMG Units Agree to Pay to Settle Malpractice Suits," N.Y. Times, Oct. 8, 2004 (reporting \$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 settlement with Cendant shareholders of \$335 million).

¹⁵⁵ 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 failure to detect accounting violations at Cendant Corporation, which forbids them from auditing public companies).

¹⁵⁶ See Feder, supra note 154 ("noting that a KPMG settlement "reflects a trend in the last decade in which major accounting firms have been drawn into – an paid large sums to get released from – litigation growing out of major financial scandals").

¹⁵⁷ See Alison Leigh Cowan, "Big Law and Auditing Firms to Pay Millions in S.&L. Suit," N.Y. Times, Mar. 31, 1992 (reporting significant settlements from a number of firms in connection private and government actions with respect to savings and loan fraud).

¹⁵⁸ Regulations Governing the Practice Before the Internal Revenue Service, 31 CFR Part 10 [hereinafter Circular 230].

¹⁵⁹ See Wolfman, Holden & Harris, supra note 102, at § 105.1.1, at 17-18 (defining practice before the IRS).

¹⁶⁰ See Steven R. Schneider, Steven R. Dixon & Mona L. Hymel, "Impact of the New Anti-Tax Shelter Rules on Non-Tax Lawyers and Accountants," 64 Inst. Fed. Tax'n ____, TAN (2006).

¹⁶¹ See Wolfman, Holden & Harris, supra note 102, at § 105.1.2, at 19-22 (describing categories of eligible practitioners, including attorneys and CPAs).

¹⁶² See id. at § 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").

¹⁶³ See id. at § 105.1.5.1, at 26-28 (listing reasons for disciplinary action including conviction of felony or crime involving dishonesty, knowingly providing false information to the government, knowingly or recklessly rendering a false tax opinion, or willfully violating any provision of Circular 230).

¹⁶⁴ See Circular 230 § 10.50. See also Wolfman, Holden & Harris, supra note 102, at § 105.1.5, at 26 (describing enforcement measures).

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.¹⁶⁵

At least two recent developments in Circular 230 have received significant practitioner attention.¹⁶⁶ The first relates to tax opinions, and provides standards that “covered opinions” must meet in order to provide a taxpayer with “reasonable cause” protection against penalties.¹⁶⁷ 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.”¹⁶⁸ However, an opinion that includes a disclaimer stating that it may not be used for penalty protection purposes does not count as a covered reliance opinion.¹⁶⁹

A practitioner delivering a valid covered opinion must not rely on any factual assumptions or representations that he or she should know are unreasonable¹⁷⁰ and must provide a conclusion as to each significant federal tax issue unless explicit agreement regarding a “limited scope opinion” is made with the client.¹⁷¹ These requirements of broad investigation of facts and broad analysis of law make covered opinions elaborate and expensive exercises. And the broad definition of reliance opinions has persuaded some practitioners that every email communication might be a reliance communication, giving rise to a ubiquitous practice of placing Circular 230 disclaimers stating that advice may not be used for penalty protection purposes at the bottom of every law firm email, in an effort to take the communication out of the “covered opinion” definition.¹⁷²

The goal of the ubiquitous disclaimer is to avoid the possibility of Circular 230 sanctions as a result of a covered opinion that failed 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 other sanctions. Related penalties such as inability to partner with another, unsanctioned practitioner, loss of state-issued professional licenses, or

¹⁶⁵ See *id.*

¹⁶⁶ See generally Bernard Wolfman, James P. Holden & Kenneth L. Harris, *Standards of Tax Practice* at 2-21 (Supp. 2006) (providing an overview of Circular 230 amendments)

¹⁶⁷ See Circular 230, § 10.35 (describing “covered opinion” requirements). Under Section 6664, certain penalties applicable to underpayments do not apply if the taxpayer demonstrates that its acted in good faith and that there was reasonable cause for its return position. See IRC §§ 6664(c), (d). A tax opinion is one common way of demonstrating reasonable cause.

¹⁶⁸ Circular 230, § 10.35(4)(i).

¹⁶⁹ See Circular 230, § 10.35(4)(ii) (providing no-penalty-protection carveout from reliance opinion definition).

¹⁷⁰ See Circular 230 § 10.35(c)(1) (detailing Circular 230 requirements regarding factual matters).

¹⁷¹ See Circular 230 § 10.35(c)(3) (detailing requirements regarding evaluation of tax issues).

¹⁷² See Letter from New York State Bar Association to IRS Commissioner Mark W. Everson, IRS Chief Counsel Donald L. Korb, and Acting Deputy Assistant Treasury (Tax Policy) Eric Solomon 2 (May 1, 2006) (noting “nearly universal” practice of legending all written communications with a no-penalty-protection warning). The same letter notes that the no-penalty-protection warning may be inaccurate, since no regulations under § 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.* at 3.

reputational harm can follow from IRS sanctions. Prior to the current Circular 230 amendments, general professional ethics rules governed non-tax shelter tax opinions¹⁷³ and tax shelter opinions were narrowly defined,¹⁷⁴ so that the sanction of losing the privilege of practicing before the IRS did directly not 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.¹⁷⁵

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, or OPR, and its staff doubled in size.¹⁷⁶ 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.¹⁷⁷ OPR has also taken the controversial step of proposing public, not private, disciplinary proceedings when a case reaches the administrative law judge stage.¹⁷⁸ The proposal has drawn significant practitioner criticism because of the perceived in terrorem effect of publicity.¹⁷⁹

Circular 230 is one important reason why one member of the tax decisionmaking group – the tax planner – feels an increased incentive to behave in compliance 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 more about the possibility of enforcement. Moreover, the provision that establishes supervisory responsibility for tax practice heads 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.

C. Publicity

The media spotlight has shone on scandal in recent years, and this, too, makes tax decisionmakers 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.

¹⁷³ See Wolfman, Holden & Harris, *supra* note 102, at § 503.2.1, at 418 (outlining professional rules).

¹⁷⁴ See Wolfman, Holden & Harris, *supra* note 102, at § 503.4.2.1, at 426 (providing definition of tax shelter under prior rules).

¹⁷⁵ See Circular 230 § 10.36(a) (imposing responsibilities on tax practice leader).

¹⁷⁶ See Schneider, Dixon & Hymel, *supra* note 160, at TAN 98 – 99 (describing new OPR).

¹⁷⁷ See Dennis B. Drapkin, “ABA Tax Section Submits Comments on Disciplinary Procedures of IRS Office of Professional Responsibility,” 2005 TNT 236-18, at TAN 7-10 (Dec. 9, 2005) (reporting OPR intention to shift its enforcement focus).

¹⁷⁸ See Proposed Circular 230 § 10.72 (proposing open proceedings).

¹⁷⁹ See, e.g., Sheryl Stratton, “Transparency at the IRS Office of Professional Responsibility: A Two-Way Street?,” 110 Tax Notes 579, ___ (Feb. 6, 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).

A tax planner is always wary of the intrepid Lee Sheppard, of Tax Notes, and her colleagues. But major newspaper reporters of late have been known to undertake detailed public record examination in search of a tax shelter story.¹⁸⁰ 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' proposed inversion transaction.¹⁸¹ A recent PBS "Frontline" report on tax shelters also raised the issue's profile.¹⁸²

The government plays more than a standby role in this media saga. They issue press releases about their pursuit of tax cheats, sometimes based settlement deals with taxpayers that include the taxpayer's waiver of certain confidentiality rights.¹⁸³ They publicize settlement offers about tax strategies whose legality has not yet been adjudicated – and then publicize the billions of dollars of revenue that result from the settlement offers.¹⁸⁴ They publicize 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.¹⁸⁵ Ernst & Young describes successive trends in tax planning, from cost-cutting in the 1980s to lowering effective tax rates in the 1990s to protecting corporate reputation today.¹⁸⁶ And conference participants buzz anxiously about the possibility of landing on the front page of the Wall Street Journal.¹⁸⁷

¹⁸⁰ See, e.g., Jonathan Weil, "KPMG Used Its Own Tax Shelter," Wall St. J., Oct. 14, 2005, at C1 (naming KPMG and six other companies as purchasers of a particular product marketed by KPMG).

¹⁸¹ See David Cay Johnston, *Perfectly Legal*, 231-252 (2003).

¹⁸² "Frontline: Tax Me If You Can" (PBS television broadcast [Feb. 19, 2003]) (presenting corporate tax shelter expose).

¹⁸³ See Statement of Eileen J. O'Connor, *supra* note 127, at 21 (noting that Justice Department Tax Division has begun issuing press releases with respect to civil and criminal cases during her tenure as its head); see, e.g., Press Release, IRS Accepts Settlement Offer on Contingent Liability Tax Shelter (Dec. 16, 2004) available at <http://www.irs.gov/newsroom/article/0,,id=132350,00.html> ("Hercules [taxpayer] has further agreed to a limited waiver of the taxpayer privacy and anti-disclosure rules in connection with this press release."). The Hercules settlement followed two prominent government court setbacks in contingent liability cases. See TaxProf Blog, http://taxprof.typepad.com/taxprof_blog/2004/12/irs_settles_her.html (Dec. 16, 2004) (noting IRS losses in *Black & Decker* and *Coltec*).

¹⁸⁴ See *infra* TAN 201-202 (describing IRS announcements regarding tax shelter settlement offers).

¹⁸⁵ Martin A. Sullivan, "Economic Analysis – Reputation or Lower Taxes," Tax Notes, Aug. 29, 2005, at 981 (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).

¹⁸⁶ Ernst & Young study – "Taxes in the Boardroom – A Discussion Paper."

¹⁸⁷ E.g. John Brennan presentation at SJSU/TEI High Technology Tax Institute, Nov. 8, 2005. See also "Ernst & Young Analyzes Tax Transparency Dynamics," 2006 TNT 69-10 (Apr. 10, 2006) ("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.").

IV. A Clear Government Message

In Part II, this Article described the emergence of an expanded and more transparent public corporation tax decisionmaking group that amplified its members' compliance tendencies. In Part III, this Article explained that recent criminal enforcement, civil liability, professional standard, and publicity efforts cause members of this decisionmaking group to worry more about personal and firm liability. This Part IV provides the final piece to the organizational behavior puzzle of the recent creation of a tax compliance norm at public corporations: the clear government identification of acceptable, and unacceptable, activities, particularly in the tax shelter area. It also explores the reaction of public corporation tax decisionmaking groups 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 Code or regulation provisions¹⁸⁸ 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.¹⁸⁹ In 1999, Treasury released a report on shelters¹⁹⁰ that catalogued the available substantive provisions,¹⁹¹ disclosure and penalty requirements,¹⁹² and case law doctrines limiting or regulating tax shelters,¹⁹³ 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 1997-2000, 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

¹⁸⁸ See Wolfman, Holden & Harris, *supra* note 102, at 139 (contrasting recent trend with individual tax shelters of the 1970s and 1980s, which made use of tax preferences contemplated by the Code or regulations).

¹⁸⁹ See, e.g., Janet Novack & Laura Saunders, “The Hustling of X-Rated Shelters,” *Forbes*, Dec. 14, 1998, at 198, ___ (describing practice of aggressively marketing questionable tax products).

¹⁹⁰ See 1999 Treasury Report, *supra* note 7.

¹⁹¹ *Id.* at 35-36 (giving examples of general anti-abuse provisions, specific statutory responses to specific tax shelter problems, and statutory grants of broad regulatory authority).

¹⁹² *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).

¹⁹³ *Id.* at 46-58 (outlining substance-over-form, step transaction, business purpose and economic substance doctrines).

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, based on 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.¹⁹⁴

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.¹⁹⁵ 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.¹⁹⁶

At its peak in the late 1990s tax product work may have represented as much as 10% of some accounting firms' global revenues and as much as 25% of US revenues.¹⁹⁷ It also resulted in significant losses to the U.S. fisc. Tax shelter revenue loss measures are notoriously difficult to estimate,¹⁹⁸ but most attempts indicate at least \$10 billion annually during the late 1990s.¹⁹⁹ IRS estimated tax losses at up to \$85 billion from listed and nonlisted transactions as of September 30, 2003.²⁰⁰ 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.²⁰¹ A settlement offer covering numerous other

¹⁹⁴ See Notice 2000-44, 2000 CB 255; Joseph Bankman, "The Tax Shelter Problem," 57 N'tl Tax J. 925, 926-27 (2004) (describing son-of-BOSS shelter).

¹⁹⁵ See S. Rep. No. 109-54, at 34, 39-40 (describing KPMG telemarketing center and its use in marketing SC2 shelter).

¹⁹⁶ See *id.* at 36-38 (describing cooperation between tax product and audit teams in designing and marketing products).

¹⁹⁷ See *id.* at 11-12 (reporting KPMG worldwide revenue of \$10.7 billion and KPMG US revenue of \$4 billion in 2002 and peak annual tax shelter revenue of \$1.2 billion).

¹⁹⁸ The difference between book and tax income is frequently used as an accessible but imperfect measure of corporate tax shelter activity. See, e.g., Desai. However, one recent study was unable to confirm the existence or growth of tax sheltering activity based on an examination of book and tax income. See Gil B. Manzon, Jr. & George A. Plesko, "The Relation Between Financial and Tax Reporting Measures of Income," 55 Tax L. Rev. 175, 177 (2002).

¹⁹⁹ See Slemrod, *supra* note 5, at 880 & n. 9 (citing IRS contractor estimate of \$14.8 – 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," 2005 TNT 60-5 (Mar. 29, 2005) (noting that National Research Program study indicated a tax gap of \$312 to \$353 billion in 2001 and that most of the tax gap derives from underreporting by self-employed individuals and small businesses).

²⁰⁰ See U.S. General Accounting Office, Challenges Remain in Combating Abusive Tax Shelters 11 (2003) [hereinafter GAO 2003 Report] (providing data and noting that potential tax loss amounts do not consider reductions that might result during examination and appeal).

²⁰¹ See "IRS Announces Success of Taxpayer Settlement Initiatives," 2005 TNT 132-7 (July 12, 2005).

shelters, which closed in January 2005, attracted an estimated 2000 taxpayers and generated an estimated \$2 billion.²⁰²

Costs other than direct revenue loss also result from tax shelter activity.²⁰³ They include wasted time and money in the form of uneconomic tax planning and resulting enforcement efforts,²⁰⁴ increased complexity as a result of statutory response to perceived abuse,²⁰⁵ and the degeneration of the voluntary compliance that underlies the U.S. income tax system (aside from wage withholding) in the first place. With respect to the last point, sociologists have noted the phenomenon of taxpayers drawing on and copying each others' normative decisions, commenting that the "right" decision from a taxpayer's perspective depends on context, as evidenced by empirical data suggesting that compliant taxpayers believe that other taxpayers also comply, while noncompliant taxpayers believe that other taxpayers also engage in fraud.²⁰⁶

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 1999 white paper emerged, 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.²⁰⁷ 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.

²⁰² See "Global Settlement Offer May Net 2000 Taxpayers, \$2 Billion, Everson Says," 2006 TNT 59-1 (Mar. 27, 2006) (reporting on results of settlement offered in Announcement 2006-80, 2005-46 I.R.B. 967).

²⁰³ See 1999 Treasury Report, *supra* note 190, at iv.

²⁰⁴ 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, 222-225 (2002) (asserting that tax planning is a negative externality although acknowledging that planning to avoid taxpayer-adverse mistakes in the law may have value).

²⁰⁵ See James S. Eustice, "Abusive Corporate Tax Shelters: Old "Brine" in New Bottles," 55 Tax L. Rev. 135, 161-62 (2002) (arguing that legislation often generates more problems than it solves).

²⁰⁶ See, e.g., John S. Carroll, "How Taxpayers Think About Their Taxes: Frames and Values," in *Why People Pay Taxes: Tax Compliance and Enforcement* 43, 47 (Joel Slemrod, ed., 1992).

²⁰⁷ See I.R.C. § 6111(d) (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 102, at 137-40 (describing the history of tax shelters, including the episode of aggressively marketed individual tax products in the 1970s and 1980s); *id.* at 149-59 (outlining 1994 law change that raised the opinion standard for corporate tax shelters for purposes of the substantial understatement penalty in Section 6664(c) and the 1997 change requiring registration of certain confidential transactions in Section 6111(d)).

The government has generally challenged alleged tax shelter transactions with substance-over-form arguments. That is, the government claims that such transactions' form should not be respected because they lack economic substance or business purpose.²⁰⁸ A full survey of recent corporate tax shelter cases is beyond the scope of this Article. However, the section 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, 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.²⁰⁹ The ACM court focused in 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.²¹⁰ The Third Circuit affirmed.²¹¹

Since ACM, the government has scored several trial and appellate victories. The Eleventh Circuit agreed with the Tax Court in Winn-Dixie 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, agreeing that the program lacked economic substance where the paid interest and fees exceeded the policies' expected return and also finding no business purpose.²¹² The Second Circuit upheld an unusual 40% 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.²¹³ The Fourth Circuit reversed a district court's grant of summary judgment for the taxpayer in Black & Decker, concluding that court had to hear expert witnesses and consider more carefully the IRS argument that the taxpayer lacked an objective profit motive.²¹⁴ And in Coltec, the Federal Circuit, reversing the Court of Claims, concluded

²⁰⁸ See Rice's Toyota World v. Comm'r, 81 T.C. 184, 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, 752 F.2d 891 (4th Cir. 1985). See also Wolfman, Holden & Harris, supra note 102, at 169-171 (noting subjective business purpose element and objective profit motive elements of economic substance inquiry).

²⁰⁹ See ACM P'ship v. Comm'r, 73 T.C.M (CCH) 2189 (1997), aff'd in part and rev'd in part, 157 F.3d 231 (3d Cir. 1988).

²¹⁰ See Wolfman, Holden & Harris, supra note 102, at 177-78 (analyzing ACM).

²¹¹ See ACM P'ship v. Comm'r, 157 F.3d 231, 263 (affirming disallowance of noneconomic losses) (3d Cir. 1998), aff'g in part and rev'g in part 73 T.C.M. (CCH) 2189 (1997).

²¹² See Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316-17 (11th Cir. 2001) (noting unchallenged finding that program could not generate a pre-tax profit and that program lacked any real business motive), aff'g 113 T.C. 254 (1999).

²¹³ See Long-Term Capital Holdings, LP v. United States, 2005 U.S. App. LEXIS 20988 (2d Cir. Sept. 27, 2005) (per curiam), aff'g 330 F. Supp. 2d 122 (D. Conn. 2004).

²¹⁴ See Black & Decker Corp. v. United States, 436 F.3d 431, 440-43 (2006) (noting that Black & Decker had stipulated for purposes of summary judgment that the transaction was tax-motivated and criticizing the district court's failure to thoroughly consider IRS evidence tending to show lack of an objective profit motive), aff'g in part and rev'g in part 340 F. Supp. 2d 621 (D. Md. 2004). But see Karen C. Burke,

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.²¹⁵

However, some of the government's trial court victories have been 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 and IES, the purchase of non-U.S. corporate stock (in the form of American Depositary Receipts, or ADRs) 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.²¹⁶ The lower courts concluded, after treating the foreign tax as an expense, that there was not economic profit.²¹⁷ 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.²¹⁸ Another case reveals courts' reluctance to disregard transactions with unrelated third parties. In UPS, the Eleventh Circuit reversed the Tax Court in respecting the taxpayer's transfer of its excess value insurance business to a related Bermuda corporation through a reinsurance agreement with an unrelated firm.²¹⁹

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.²²⁰ Legislation clarifying the economic substance standard is sometimes proposed.²²¹ But prominent commentators

"Black & Decker in the Fourth Circuit: Tax Shelters and Textualism," 111 Tax Notes 315, Pt. IV (Apr. 17, 2006) (noting that, despite pro-government economic substance decision, Fourth Circuit's textualist approach to statutory interpretation of Section 357 ignored secondary sources and might encourage rigid technical readings of statutes by tax shelter designers).

²¹⁵ See Coltec Indus., Inc. v. United States, No. 05-5111, 2006 U.S. App. LEXIS 17351 (Fed. Cir. July 12, 2006), at *45-*54, vacating and remanding 62 Fed. Cl. 716 (2004) (discussing economic substance issue).

²¹⁶ See Wolfman, Holden & Harris, supra note 102, at 183 (describing transaction).

²¹⁷ See Compaq Computer Corp., supra note 20, 113 T.C. at 223-25 (concluding that transaction lacked economic substance or business purpose); IES Industries, Inc. v. United States, 2001-2 U.S.T.C. (CCH) ¶ 50,470, 1999 U.S. Dist. LEXIS 22610 (N.D. Iowa 1999) (finding a sham transaction because of the lack of any change in the taxpayer's economic position), rev'd by 253 F.2d 250 (8th Cir. 2001).

²¹⁸ See Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 784-87 (5th Cir. 2001) (eliminating foreign tax expense from profit calculation and using resulting pre-tax profit as evidence of economic substance and business purpose), rev'g 113 T.C. 214 (1999); IES Industries, Inc. v. United States, 253 F.3d 350, 354-56 (8th Cir. 2001) (reaching similar result), rev'g 2001-2 U.S.T.C. (CCH) ¶ 50,470, 1999 U.S. Dist. LEXIS 22610 (N.D. Iowa 1999).

²¹⁹ See United Parcel Serv. of Am. v. Comm'r, 254 F.3d 1014, 1018-20 (emphasizing participation of unrelated firm and comparing UPS transaction to form-of-entity or debt-versus-equity tax-influenced business decisions) (11th Cir. 2001), rev'g 78 T.C.M. (CCH) 262 (1999).

²²⁰ See Wolfman, Holden & Harris, supra note 102, at 180 (noting that "courts continue to struggle with whether a transaction needs to possess both a bona fide non-tax business purpose and a 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).

²²¹ See, e.g. H.R. 4297, ___ Cong. ___ Sess., at §§ 411-13 ("clarifying" economic substance and providing penalties for transactions without it) (passed by the Senate Feb. 2, 2006). See also Lee Sheppard, "News

criticize this approach, arguing that the limits of statutory drafting would result in an inferior doctrine.²²² The government also no longer advocates economic substance codification.²²³ Treasury and the IRS have concentrated their regulatory energies instead on articulating, enforcing, and using information from a tax shelter “web of disclosure.”²²⁴

2. Defining Tax Shelters: The Academic Debate

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

Some commentators contend that a tax shelter definition should diligently avoid encompassing transactions that have any business element.²²⁵ 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.²²⁶ Some commentators focus on legislative intent, rather than business or tax motive,²²⁷ others would simply err on the side of overinclusiveness.²²⁸

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

Analysis: Economic Substance Update,” 110 Tax Notes 1137 (Mar. 13, 2006) (noting that the provision, scored as a \$15 million revenue raiser, was expected to be deleted in conference).

²²² See, e.g., Eustice, *supra* note 205, at 164-65 (stating that the economic substance doctrine is better left to the courts); Bernard Wolfman, “Why Economic Substance is Better Left Uncodified,” 104 Tax Notes 445 (July 26, 2004) (“There is no shortcut.”). See also Marvin A. Chirelstein & Lawrence A. Zelenak, 105 Colum. L. Rev. 1939, 1952-53 (2005) (arguing for disallowance of loss in excess of measurable net worth decrease but not for codification of the economic substance doctrine).

²²³ See, e.g., “Senators Scrutinize ‘Peddlers’ of Abusive Tax Shelters,” 2003 TNT 204-1 (Oct. 22, 2003) (noting administration’s opposition to codification of economic substance because of increased uncertainty and burdens on IRS rulemaking process) (reporting comments of Pamela Olson, assistant secretary for tax policy, at hearing before Senate Finance Committee).

²²⁴ See “Treasury Official Discusses Reportable Transactions, Disclosure Requirements, 2003 TNT 215-5 (Nov. 5, 2003) (noting comments of Eric Solomon describing a tax shelter policy based on a “web of disclosure”).

²²⁵ 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 a transaction that “would not have been entered into at all but for the desire to claim tax benefits”).

²²⁶ See Eustice, *supra* note 205, at 155-56 (describing engineered Cottage Savings swap transaction as legitimate because the accelerated loss was a real economic loss).

²²⁷ See Schler, *supra* note 6, 55 Tax L. Rev. at 331 (outlining definition).

²²⁸ See Pearlman, *supra* note 9, 55 Tax. L. Rev. 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”).

bringing them down to a more practical level. Professor 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 pushback); and the presence of a flaw in the tax system that mismatches economic and tax income (a factor relating to legislative intent).²²⁹ Professor Eustice proposes a similar list, adding the absence of economic profit prospects or business purpose.²³⁰

Bankman and Eustice also include factors relating to the marketing or promotion of tax shelters in their lists of characteristics, suggesting that "prepackaged" transactions²³¹ and transactions suitable for use by more than one taxpayer²³² 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: "the shelter is likely to be shut down by legislative or administrative change soon after it is detected."²³³ 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 2000.²³⁴ Its initial attempt featured a broad definition of tax shelter transactions and (due to a lack of Congressional action)²³⁵ no penalties for nondisclosure. The regulations were not as effective as the government had hoped.²³⁶ After several rounds of amendment, drafters arrived at a clearer and more specific approach. The government also established the dedicated Office of Tax Shelter Analysis to identify and shut down tax shelter transactions.

Today, taxpayer disclosure requirements and material advisor reporting 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 fast without elaborate regulatory process; (2) transactions

²²⁹ See Joseph Bankman, "The New Market in Corporate Tax Shelters," Tax Notes, June 21, 1999, at 1775, _____ (paragraph [7]).

²³⁰ See Eustice, *supra* note 205, at 158-59.

²³¹ See Eustice, *supra* note 205, at 159.

²³² See Bankman, *supra* note 229, at ____.

²³³ Bankman, *supra* note 229, at ____.

²³⁴ See T.D. 8877, ____ Fed. Reg. ____ (Feb. 28, 2000) (proposing corporate tax shelter disclosure regulations); Announcement 2000-12, 2000-12 I.R.B. 1 (Feb. 29, 2000) (summarizing regulations).

²³⁵ Tax shelter disclosure and penalty provisions made it into a Senate Finance Committee discussion draft in 2000, see Ryan J. Donmoyer & Heidi Glenn, "Finance Antishelter 'Draft' Boosts Penalties, Standards of Conduct," 1999 TNT 233-2 (Dec. 6, 1999), but did not appear in final legislation.

²³⁶ See Larry R. Langdon, "Langdon Testimony at Finance Committee Hearing on Tax Shelters," 2002 TNT 56-20 (Mar. 22, 2002) (providing testimony of IRS official Langdon that promoters interpreted the rules narrowly and inadequate disclosure resulted).

with large tax losses; (3) confidential transactions; (4) transactions that contractually require the return of an adviser's fee if the desired tax outcome does not result; and (5) transactions with brief asset holding periods.²³⁷ Under a 2004 statute, specific penalties apply for nondisclosure.²³⁸ 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.²³⁹

The government's practice of discovering abusive transactions through a focused tax shelter office and labeling transactions tax shelters by "listing" them through immediately-effective Notices is central to its disclosure strategy under these revised regulations. Notices have identified about 30 transactions as shelters.²⁴⁰ For example, Notice practice tarred each of the tax shelters described above in Part V.B.1 despite the fact that courts are still considering the validity of some of them. Listed transactions are typically marketed and promoted products, and the government's focus on promotion as a litmus test for abusive tax shelters is public information.²⁴¹

The government's strategy of specifically labeling promoted tax shelter transactions as deviant behavior has apparently effectively translated into an anti-tax

²³⁷ See I.R.C. § 6111 (requiring material advisor reporting); Treas. Reg. §§ 1.6011-4(b)(1) (requiring taxpayer disclosure); 1.6112-1(b)(2) (requiring material advisor list maintenance). The list initially included transactions with significant book-tax differences. That category has been removed as a result of the development of a new and comprehensive Schedule M-3 describing book-tax differences on corporate tax returns, which lays out book-tax differences for corporate tax returns in more detail. See Notice 2006-6, 2006-5 I.R.B. 385.

²³⁸ See I.R.C. §§ 6707A (imposing on taxpayers nondisclosure penalties of \$200,000 (\$100,000 for individuals) for listed transactions and \$50,000 (\$10,000 for individuals) for other reportable transactions and requiring disclosure of certain penalties in SEC report); 6707 (imposing on material advisors failure-to-report penalties of \$200,000 or 50-75% of the gross income the material adviser received with respect to a listed transaction, \$50,000 for other reportable transactions); 6708 (imposing on material advisors penalties for failure to maintain or supply investor lists). See also I.R.C. §§ 6662A (imposing nonwaivable 30% penalty for an undisclosed listed transaction or reportable transaction with a significant tax avoidance purpose); 6700 (imposing a penalty on promoters of 50% 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 166, at 25-33 (summarizing penalties relating to tax shelters).

²³⁹ See 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 summons of audit workpapers. See *Arthur Young & Co.*, *supra* note 103, 465 U.S. at 816-21 (requiring auditors to produce workpapers in response to IRS summons). 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) (crossreferencing I.R.C. § 6662(d)(2)(C)(ii)).

²⁴⁰ See Notice 2004-67, 2004-41 I.R.B. 600 (providing 30 listed transactions posted as of October 12, 2004). The current list is posted on the IRS website at <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html>.

²⁴¹ See GAO 2003 Report, *supra* note 200, at 4, 7 (stating that 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 4 ("I think the key aspect of technical tax shelters is marketing.") (quoting Eric Solomon).

shelter compliance norm. Government officials say taxpayers have simply stopped engaging in the development or use of such promoted tax shelter products.²⁴² Perhaps government officials say this without adequate evidence in order to enhance others' view of their performance or increase taxpayer compliance by conveying the impression that most taxpayers comply.²⁴³ But this approach would conflict with IRS and Treasury incentives to support additional budget requests.

In addition, other available information corroborates the government officials' view. For example, former government officials agree with it.²⁴⁴ 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 not to ever 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.²⁴⁵

Organizational behavior learning identifies ethical uncertainty as a factor that causes large organization norms to veer toward aggressive behavior.²⁴⁶ This 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 very 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.

C. New FASB Tax Benefit Accounting Standard

FASB's revisions to the standard for recording tax benefits for financial accounting purposes provide another example of the responsiveness of public corporation tax decisionmaking groups to revised, stricter rules. Under the longstanding standard, such benefits were denied for financial accounting purposes only if it was probable that they would be successfully asserted by the government.²⁴⁷ Under a standard proposed in

²⁴² See *supra* note 4 (summarizing government officials' view that tax shelters are no longer widely promoted to large corporations). This view is corroborated by remarks of prior government officials now in private practice.

²⁴³ See, e.g., Interview of Carl Levin by Frontline, posted Feb. 19, 2004, available at <http://www.pbs.org/wgbh/pages/frontline/shows/tax/shelter/return.html> (reporting interview with Democratic Senator from Michigan) ("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.").

²⁴⁴ See, e.g., Interview of Pamela Olson by Frontline, posted Feb. 19, 2004, available at <http://www.pbs.org/wgbh/pages/frontline/shows/tax/shelter/return.html> ("[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.").

²⁴⁵ See KPMG Deferred Prosecution Agreement, *supra* note 139, at 5, 19, 21-22.

²⁴⁶ See *supra* Part II.E.

²⁴⁷ See FAS 109, ¶¶ 8 and 17(e) (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, such as because of expected future net operating losses); FAS 5 (requiring the recording of loss contingencies (such as the possibility of increased

July 2005, such liabilities would have been recorded unless it is probable that, assuming they are asserted by the government, the government would lose.²⁴⁸ The proposal drew significant criticism from commentators who noted that it might result in accounting inaccuracies, in particular over-reporting of liabilities or under-reporting of assets.²⁴⁹ Commentators expected some softening and extension of the effective date of the proposal.²⁵⁰ Nevertheless, the pending proposal caused some auditors to require a higher level of assurance than before for the recording of a future tax benefit – i.e. a “should” opinion rather than a “more likely than not” opinion – before it was finalized.²⁵¹

FASB has since softened the standard to permit the recording of future tax benefits if it is “more likely than not” that, assuming they are asserted by the government, the government would lose.²⁵² This standard, still tougher than the longstanding tax benefit accounting standard, also has a clear effect in public corporation tax departments. Tax director surveys show that such groups are devoting significant energy to compliance with the new standard.²⁵³

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 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.

taxes on audit) if it is “probable” that the liability exists). See also James R. Browne, “Financial Reporting for Uncertain Tax Positions,” 109 Tax Notes 77, TAN 7-33 (Oct. 3, 2005) (explaining current standards).

²⁴⁸ See FASB Exposure Draft No. 1215-001, “Accounting for Uncertain Tax Positions – an Interpretation of FASB Statement No. 109 (July 14, 2005); Browne, supra note 247, at TAN 34-38 (explaining proposed standard).

²⁴⁹ See, e.g., Browne, supra note 247, TAN 57-59 (stating that longstanding standard more accurately reports tax assets and liabilities).

²⁵⁰ See “FASB to Delay Implementation of Uncertain Tax Position Guidance Until 2006, Says SEC Official,” 2005 TNT 214-2 (Nov. 4, 2005) (reporting comments of Brian Bullard that FASB planned to relax proposed standard and postpone its implementation). The original effective date of the last quarter of 2005 was eventually pushed back a year to the first year beginning after December 15, 2006. See Sirena J. Scales, “FASB Agrees on New Effective Date for Guidance on Uncertain Tax Positions,” 2006 TNT 8-2 (Jan. 12, 2006). At least some tax directors expected the pushback. See id.

²⁵¹ See, e.g., Ken Gee & Rob Terpening, Presentation at San Jose State University/Tax Executives Institute High Technology Tax Institute, in Palo Alto, CA (Nov. 8, 2005) (commenting that different auditors have different standards and that some have tightened their standard as a result of the proposed changes to FAS 109). See also KPMG Deferred Prosecution Agreement, supra note 139, at 7 (accepting a heightened opinion standard). One survey also reports that financial statement disclosure relating to uncertain tax positions has increased. See TCPI 2006 Survey, supra note 1 at 18 (reporting that 63% of respondents report such disclosure has increased in the past two years).

²⁵² See FASB Interpretation No. 48 at 12 (June 2006), available at <http://www.fasb.org/pdf/fin%2048.pdf> (outlining more-likely-than-not standard).

²⁵³ See, e.g., TCPI 2006 Survey, supra note 1, at 37 (reporting that 41% of respondents cited FAS 109 compliance as the top tax group challenge).

A. How to Promote a Broader Norm.

1. The Existing Narrow Norm.

The new tax compliance norm described in this paper is narrow: the demise of 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,²⁵⁴ 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, demanding larger payments in exchange for the transfer of existing technology overseas, suggesting adjustments to transfer prices so they are slightly less favorable to the corporation, requiring completed paperwork documenting intercompany agreements and checking to ensure that those written agreements are followed more carefully in practice.

But 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.²⁵⁵ One major area of continued big-ticket tax planning shifts income to lower-tax offshore locations.²⁵⁶ Another involves the use of hybrid securities treated as interest-generating debt for tax purposes and equity for other regulatory purposes.²⁵⁷ 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.²⁵⁸ Tax decisionmakers may rely on unclear IRS guidance to reach aggressive conclusions in these areas,²⁵⁹ while top IRS officials identify them as current compliance challenges.²⁶⁰

²⁵⁴ See *infra* Part IV.C.

²⁵⁵ Cf. Kirsten A. Cook, G. Ryan Huston & Thomas C. Omer, "Earnings Management Through Effective Tax rates: The Effects of Tax Planning Investment and the Sarbanes-Oxley Act of 2002" at 2 (June 2006) (unpublished manuscript, available at www.ssrn.com) (summarizing empirical study result that effective tax rate management is still observed post-Sarbanes-Oxley, although less so for firms that do not purchase tax services from their auditors).

²⁵⁶ See Rosanne Altshuler & Harry Grubert, "Governments and Multinational Corporations in the Race to the Bottom," ___ *Tax Notes Int'l* 459, 460-62 (Feb. 6, 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) (also forthcoming in *Florida Tax Review*). See also Lee Sheppard, "Check-the-Box Rules Not Sacred, Says Hicks," 2006 *TNT* 107-8 (June 2, 2006) (noting that "the Big Four accounting firms are thought to have already complied playbooks of CFC look-through gambits" in response to Section 954(c)(6), a look-through rule which permits certain related-party income to be treated as active, non-subpart F income).

²⁵⁷ See, e.g., Ivar Simensen, "Appeal of Hybrid Bonds Has Bankers Chasing 'Holy Grail,'" *Fin. Times*, at ___ (Feb. 8, 2006) (reporting issuances of hybrid instruments).

²⁵⁸ See Staff of Joint Comm. on Tax'n, 109th Cong., "Background and Issues Relating to the Patenting of Tax Advice" 22-23 (Comm. Print. 2006) (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).

²⁵⁹ See, e.g., Preamble to Prop. Reg. 1.482-7, ___ *Fed. Reg.* ___ (Aug. 22, 2005), available at 2005 *TNT* 162-1, Part A (describing the proposed "investor model" concept for arriving at arm's length prices for

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: further expand the internal transparency and size of the tax decisionmaking 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 shouldn't it work for offshore planning and financing transactions 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 tactics. Instead, they emphasize service as well as enforcement.²⁶¹ 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 insistently on bad-faith taxpayers.²⁶² Academics such as Professor Dan Kahan have also endorsed this idea of different regulatory approaches depending on the cooperation offered by regulated parties.²⁶³

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

intangibles transfers, which would attribute greater value to IP generated by US parent corporations because it would attach value to those corporations' "external contributions"). Rev. Rul. 2003-97, 2003-34 I.R.B. 380 (permitting separate treatment of debt and equity components of certain collateralized forward contracts, resulting in an interest deduction for issuer). See also Lee Sheppard, "News Analysis: Is Apportionment the Formula for Intangible Development?," 108 Tax Notes 1093 (Sept. 5, 2005) (criticizing confusing state of existing and proposed transfer pricing regulations and recommending a formulary apportionment approach); Lee Sheppard, "News Analysis: Having it Both Ways on Feline PRIDES," 2005 TNT 25-4 (Feb. 3, 2005) (alleging that Rev. Rul. 2003-97 does not reconcile with I.R.C. Section 163(l), which prohibits an interest deduction for interest payable in equity).

²⁶⁰ See, e.g., "Written Testimony of Commissioner of Internal Revenue Mark Everson Before Senate Committee on Finance on Compliance Concerns Relative to Large and Mid-Size Businesses" at 5-8 (June 13, 2006) available at www.senate.gov/~finance/hearings/testimony/2005test/061306testme.pdf (listing intangibles transfers, cost sharing, and transfer pricing and abusive foreign tax credit, hybrid instrument or entity transactions as major global compliance concerns).

²⁶¹ See, e.g., "IRS Commissioner Mark W. Everson Statement on 2005 Enforcement and Service Results," 1005 TNT 213-10 (Nov. 3, 2005) (emphasizing goals of service, modernization and enforcement and reporting enforcement results).

²⁶² Telephone Interview with Deborah M. Nolan, Commissioner, IRS Large and Mid-Size Business Division (June 23, 2006).

²⁶³ 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 Tranter, Evasion in Taxation (1929); Braithwaite, ed., Taxing Democracy: Understanding Tax Avoidance and Evasion (2003).

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. And the story 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 constitutional rights 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 protester situation, the government has established a clear rule by summarily rejecting constitutional and other blanket arguments supporting nonpayment of federal income taxes.²⁶⁴ It has also tried to pursue enforcement actions against both advisers and taxpayers, which may have a disproportionately strong effect on compliance by influencing more than one element of an individual's tax decisionmaking group.²⁶⁵

Other current compliance issues are more grey 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 intellectual property (or “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.²⁶⁶ The other piece, a more prominent current compliance target, involves the placement of intellectual property in the IP holding company.²⁶⁷ 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-US interest in future IP, because it will recognize less gain or income and will still wholly control the IP.²⁶⁸

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

²⁶⁴ See Statement of Eileen J. O'Connor, *supra* note 127, at 16 (listing such “tax fraud” schemes).

²⁶⁵ See *id.* at 16 – 17 (summarizing recent cases against promoters and taxpayers).

²⁶⁶ See Stephen E. Shay, “Exploring Alternatives to Subpart F,” *__ Taxes* 29, 31-33 (Mar. 2004) (providing an example of “plain-vanilla subpart F planning”).

²⁶⁷ 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).

²⁶⁸ See Keith Reams et al., “Proposed Cost-Sharing Regulations: Are They a Realistic Alternative?,” 109 *Tax Notes* 239, at TAN 6-7 (Oct. 10, 2005) (noting IRS concern that taxpayers systematically undervalued buy-in payments and failed to enter into cost-sharing arrangements like those that unrelated parties would enter into).

to the development of the IP when setting these prices.²⁶⁹ And recent enforcement efforts have alleged that some firms have stepped over the line with respect to their intellectual property valuations or cost-sharing methodology.²⁷⁰ 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 grey factually, because it depends (under current law) on a facts-and-circumstances valuation exercise. It is grey from a policy perspective, if one believes that U.S. parent corporations may invest in non-U.S. subsidiaries. And enforcement efforts to tar certain aggressive taxpayers have not produced government success. In particular, the Tax Court²⁷¹ and other nations' tax authorities,²⁷² seem to think the issues are grey.

3. Lessons for Grey Areas.

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

Consider first enforcement. 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.²⁷³ Enforcement, he argues, is better aimed at determined tax cheats than at taxpayers prepared to make a good effort at compliance.²⁷⁴ This view of enforcement suggests in grey areas, where it 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 tax shelter promoters is not always transferable, because many transactions are not "clearly deviant" but rather fall into a grey area. The literature on the efficiency of rules vs. standards demonstrates that clear rules are not always an appropriate solution, due to factors such as possibly suffocating complexity²⁷⁵ and ease of avoidance.²⁷⁶

²⁶⁹ See Preamble to Prop. Reg. 1.482-7, *supra* note 259.

²⁷⁰ See, e.g., *Xilinx Inc. v. Comm'r*, 125 T.C. 37, 52-53 (2005) (upholding that taxpayer's omission of stock option costs from allocated costs under its transfer pricing agreement); "Glaxo Sees Global Scrutiny for Transfer Pricing of Popular Drugs," BNA Daily Tax Report, at J-1 (Apr. 19, 2004) (noting 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). The Glaxo litigation is still underway.

²⁷¹ See *Xilinx*, 125 T.C. at 52-53 (holding for the taxpayer).

²⁷² See *Glaxo Sees Global Scrutiny*, *supra* note 270 (noting that UK Inland Revenue "supported Glaxo's position that no additional taxes were due to the IRS").

²⁷³ See Kahan, *supra* note 263, at 82-83 (attributing phenomenon to "social cueing").

²⁷⁴ See *id.* at 84 (stating that enforcement is appropriate for "dedicated cheaters").

²⁷⁵ 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).

Commentators also persuasively argue that not all regulatory situations are susceptible of rules. For example, some situations are too dependent on endlessly varying facts and circumstances,²⁷⁷ or do not permit a rule that closes off close substitutions to taxpayer planning.²⁷⁸ These problems may be somewhat muted in the case of tax shelter regulation, because its status as a disclosure regime may mean that overinclusiveness does not carry any direct liability for appropriate transactions.²⁷⁹

Clear rules' ability to relatively smoothly translate 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, are the right approach. In these cases, the recognition that standards' vagueness presents a challenge for the development of a large organization compliance norm should prompt the government to call in different strategies to help organizations draw responsible lines.

Finally, consider the expanded and more transparent tax decisionmaking group at public corporations. If a more cooperative, non-enforcement 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 decisionmaking group? The smart regulatory route would harness the potential strength of the group in some way, 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 to more-likely-than-not and removing attorney-client privilege protection for pre-filing advice.²⁸⁰

Tax regulators have pursued some efforts to improve gatekeeper ethics, most notably the amendments to Circular 230.²⁸¹ But they have also more directly tried to influence large corporations' tax decisionmaking process. Several recent initiatives rely on more, and earlier, direct communication between the government and the tax decisionmakers at large corporations. The programs try to select good-faith corporate taxpayers and put a government representative in direct communication with tax

²⁷⁶ 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).

²⁷⁷ Distinguishing between debt and equity provides a classic tax example.

²⁷⁸ See Schizer, *supra* note 276, at 1324 (noting that the difficulty of avoiding a rule must be significant and inflexible for the rule to be effective).

²⁷⁹ See Pearlman, *supra* note 9, at 303 (arguing for a broad tax shelter disclosure standard).

²⁸⁰ See Beale, *supra* note 4, at 638 (summarizing proposal).

²⁸¹ See *supra* Part III.B.3 (discussing Circular 230).

decisionmakers at the tax decisionmaking stage.²⁸² The issues subject to resolution include grey areas such as the offshore IP transfer example discussed above.

The flagship “real time audit”²⁸³ or “CAP” program targets certain large corporations²⁸⁴ and involves an agreement executed by the government and the taxpayer, which identifies the goals of the CAP relationship.²⁸⁵ In almost all cases, top management signs off on the IRS presence.²⁸⁶ In its pilot year, 17 large corporations accepted IRS invitations to participate in CAP.²⁸⁷ The CAP program anticipates “extensive cooperation between the Service and participating taxpayers;”²⁸⁸ 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.²⁸⁹

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 decisionmaking groups.²⁹⁰ It is consistent with an organizational behavior insight: a tax group that invites the IRS to participate in its decisionmaking is more likely to develop and sustain strong tax compliance norms. This creative approach has achieved preliminary success²⁹¹ 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.²⁹²

²⁸² 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 compliance assurance process (CAP) program as well as measures designed to streamline audit and appeals process).

²⁸³ “Korb Discusses ‘Coming Revolution’ in Large Corporate Exams,” 2006 TNT 16-23, at Pt. E.6 (Jan. 24, 2006).

²⁸⁴ See id. at 76-77 (explaining that the IRS has invited taxpayers with “a history of honest dealings” to participate and CAP and anticipating that participation in CAP will eventually be recognized as a badge of quality and integrity).

²⁸⁵ See Nolan, supra note 112, at 28 (describing Memorandum of Understanding between IRS and taxpayer).

²⁸⁶ Telephone Interview with Deborah M. Nolan, supra note 262.

²⁸⁷ See “Korb Hails Dispute Resolution, Electronic Filing as Future of IRS,” 2005 TNT 236-3 (Dec. 8, 2005) (describing IRS hopes for CAP program).

²⁸⁸ Announcement 2005-87, 2005-50 I.R.B. 1144.

²⁸⁹ See id. (stating that the IRS will accept a tax return consistent with CAP resolutions).

²⁹⁰ See Nolan, supra note 112, at 28 (noting that the IRS development of CAP emerged from an examination of “ways to leverage the increased corporate governance and SEC reporting requirements occasioned by the Sarbanes-Oxley Act).

²⁹¹ See Nolan, supra note 112, at 31 (stating that the CAP program produced 13 issue resolution agreements, 11 in-process issue resolution agreements, and one Full Acceptance Letter in its first pilot year).

²⁹² Telephone Interview With Deborah Nolan, supra note 262.

The tax shelter approach is a stick. Government commenters express their anger at participants in tax shelters and their determination to exact penalties.²⁹³

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 decisionmaking 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 tax shelter area. The CAP program more explicitly targets this decisionmaking 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 decisionmaking group. While the tax shelter example provides a regulatory model, in tax and other areas, for deviant transactions susceptible to rules and deviant taxpayers responsive to enforcement, the CAP example provides a regulatory model for grey-area transactions susceptible to standards and good-faith taxpayers responsive to cooperative regulatory efforts.

B. How to Address Norm Cyclicity.

1. A Permanent Anti-Tax Shelter Norm?

On the evidence we now have, there is little reason to expect a permanent current 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.²⁹⁴ The observed recent increase in compliance with respect to tax shelters may simply represent the “crackdown” portion of the cycle.²⁹⁵ 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.

²⁹³ See, e.g., Statement of Eileen J. O’Connor, *supra* note 127 (“The Division also prosecutes persons who promote or use fraudulent tax shelters and other schemes to evade taxes and hide assets.”).

²⁹⁴ See Joel Slemrod & Jon Bakija, *Taxing Ourselves: A Citizen’s Guide to the Debate Over Taxes* 183-85 (3d ed. 2004) (noting provisions in 1998 Internal Revenue Service Restructuring and Reform Act that imposed new requirements on IRS in response to popular perception that IRS often acted unfairly or unethically, and also noting 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 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).

²⁹⁵ Interview of former IRS Commissioner Charles Rossotti by Frontline, posted Feb. 19, 2004, available at <http://www.pbs.org/wgbh/pages/frontline/shows/tax/shelter/return.html> (“[I] think this thing is going to rebound, especially as the economy improves.”); Interview of Pamela Olson by Frontline, *supra* note 243 (“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 some risk that we will see a return to this kind of activity.”).

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.²⁹⁶ The government appears to be well aware of this risk. Treasury and the IRS, together with federal prosecutors, have clearly prioritized enforcement.²⁹⁷ 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,²⁹⁸ 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 Treasury, the IRS, or the Tax Division of the Justice Department.

With respect to rule currency, 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 attention to new regulatory strategies such as the possible listing of "yellow light" transactions,²⁹⁹ its conscious keeping of lists of areas of compliance concern,³⁰⁰ its consideration of issues such as the proper treatment of patented transactions³⁰¹ and its apparently close examination of the new, more detailed schedules M-3 showing corporate book and tax differences³⁰² all indicate that the government devotes considerable energy to keeping these rules current.

²⁹⁶ See Slemrod & Bajika, *supra* note 294, at 185 (describing economic incentive and perception of wider noncompliance risks of enforcement decline following 1998 Act); Eustice, *supra* note 205, 55 Tax L. Rev. at 160-62 (writing that "meaningful" audits should be government's top priority); Bernard Wolfman, "Now Is Not the Time for Enforcement to Ease Up," 109 Tax Notes 1105 (Nov. 21, 2005) (urging continued commitment of government resources to enforcement). See also Krawiec, *supra* note 37, at 528-34 (arguing that legal compliance professionals and regulated business organizations interpret incomplete law to further their own self-interest).

²⁹⁷ See, e.g., "Everson Says IRS Could Collect up to \$100 Billion More Per Year," 2006 TNT 32-1 (Feb. 15, 2006) (reporting IRS commissioner comment that IRS enforcement efforts have already significantly narrowed tax gap and request for additional enforcement funding).

²⁹⁸ See *supra* TAN 147 - 148.

²⁹⁹ Telephone Interview With Deborah Nolan, *supra* note 262.

³⁰⁰ See, e.g., "Written Testimony of Commissioner of Internal Revenue Mark Everson, *supra* note 260, at 5-10 (listing areas of compliance concern).

³⁰¹ See *supra* note 258 (citing Congressional hearing on patented transactions).

³⁰² See Crystal Tandon, "More Than 200 Returns Targeted on Basis of Schedule M-3 Data," 2006 TNT 133-4 (July 11, 2006) (reporting on IRS use of M-3 data).

Enforcement strength and rule currency feed into the tax decisionmaking groups to foster a tax shelter compliance norm. Without them, the current norm may be expected to 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 is 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 grey 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 argued that the continuation of a tax shelter compliance norm depended 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?

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 internalized into the large corporation's de facto ethical code, as well as a stronger cooperation norm from the government's point of view.³⁰³ 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 Baldrige Quality Award, will signify a quality company known for its honesty and fair dealing.³⁰⁴

³⁰³ See supra TAN 25-29 (discussing legal and social norms).

³⁰⁴ Jernigan, supra note 282, 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.³⁰⁵ 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.³⁰⁶ Theories relating to development of internalized social norms within organizations tie into individual psychology³⁰⁷ as well as large-organization behavioral theory³⁰⁸ and a full examination of them is beyond the scope of this Article. Here, it means simply to suggest 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 it 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.³⁰⁹ 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 other 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.

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

³⁰⁵ See Eric Posner, “Law and Social Norms: The Case of Tax Compliance,” 86 Va. L. Rev. 1781, 1794-95 (2000) (describing tax compliance norm signaling theory).

³⁰⁶ See Robert D. Cooter, “Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant,” 144 U. Pa. L. Rev. 1643, 1664 (1996) (describing characteristics of an internalized norm).

³⁰⁷ See *id.* at 1661–62 (discussing moral reasoning and emotional response as avenues for the internalization of norms).

³⁰⁸ See *supra* Part I.

³⁰⁹ The IRS does not typically engage in the cost-benefit analysis required of some other agencies under Executive Order 12886, 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 12886, 58 Fed. Reg. 51735 (Oct. 4, 1993) (defining “significant regulatory action”; see, e.g., T.D. 9165, __ Fed. Reg. __ (Dec. 8, 2004) (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,” Dec. 19, 2005 (unpublished manuscript, on file with the author) (arguing that the SEC should conduct cost-benefit analysis like many other U.S. agencies and like its UK financial regulatory counterpart).

rather a transfer that hopefully promotes a more efficient and equitable tax system.³¹⁰ 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).³¹¹ 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.³¹²

Measuring the cost of Sarbanes-Oxley, rulemaking and enforcement is a daunting and inexact task. 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 decisionmaking group. Next, some evidence challenges the traditional assumption that erosion of the attorney-client privilege deters frank attorney-client conversations.³¹³ 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 decisionmaking 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.

Less obviously, the tax shelter story offers the more general lesson that attention to of the behavioral dynamics of decisionmaking groups can strengthen regulatory

³¹⁰ See Slemrod & Bajika, *supra* note 294, at 183 (noting that increased tax revenue does not represent increased economic activity).

³¹¹ See Kahan, *supra* note 263, 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 305, 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).

³¹² Compare Daniel N. Shaviro, "Evaluating the Social Costs of Corporate Tax Shelters," 55 *Tax L. Re.* 445, 450-51 (2002) (arguing that resources are overallocated to tax planning) and Weisbach, *supra* note 204, 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 225, at 400 (suggesting that the anti-tax-shelter agenda should not target "tax-motivated structuring of legitimate business transactions) and Schler, *supra* note 6 ("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.").

³¹³ See, e.g., Beale, *supra* note 4, at 663-64 (labeling the traditional argument unpersuasive).

efforts. In grey 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 directly participate in such decisionmaking 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 nontax areas as well.