

# The ethical limits of tax planning

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## Abstract

The scope of legitimate tax planning by US tax practitioners has been significantly reduced over recent decades by the continuous development of robust rules of conduct applicable to tax practitioners, as well as the ever-increasing pressure on tax professionals to meet broadening ethical standards. US tax practitioners are constrained by various sources of ethical obligations, including formally promulgated rules of conduct, as well as changing general legal doctrines. In addition, the Internal Revenue Service and Department of Justice, spurred by Congress, have vastly improved their enforcement mechanisms, and the courts are approving the use of such mechanisms with increasing frequency.

well as the ever-increasing pressure on tax professionals to meet expanding ethical standards, this article explores the scope and accompanying risks of tax planning that practitioners may engage in.

## Sources of tax and estate planners' ethical obligations

When advising taxpayers of strategies to most efficiently manage their tax liabilities, US tax practitioners are constrained by various sources of ethical obligations, including formally promulgated rules of conduct as well as general doctrines and/or trends of tax enforcement that the Internal Revenue Service (IRS) and the courts are asserting with increasing frequency.

## Introduction

One may so arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes . . . there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.<sup>1</sup>

The famous endorsement of taxpayers' broad freedom to engage in tax planning by Judge Learned Hand, though once widely accepted, is being questioned and challenged more and more frequently in recent years.

In light of the continuous development of robust rules of conduct applicable to tax practitioners, as

### Formally promulgated rules of conduct

#### Rules of professional conduct

Perhaps the most obvious and widely recognized set of rules that bind not only tax practitioners but also all lawyers in general in the realm of professional ethics are the Model Rules of Professional Conduct (MRPC). Several rules specifically and explicitly prohibit lawyers from rendering legal advice to assist taxpayers in furtherance of fraud or a crime:

- Rule 1.2(c): 'A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent . . .'
- Rule 8.4(a)-(d): A lawyer commits professional misconduct by (a) violating, or attempting to

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1. *Gregory v Helvering*, 69 F2d 809, 810 (2d Cir 1934), *aff'd*, 293 US 465 (1935).

violate, the Rules of Professional Conduct or by inducing another to engage in such violation, (b) engaging in a criminal act that demonstrates a lack of honesty, trustworthiness or fitness as a lawyer, (c) engaging in dishonest, fraudulent, or deceitful behaviour, or (d) engaging in conduct that is prejudicial to the administration of justice.

Because the MRPC is adopted and administered on a state-by-state basis, the applicable rule in a given situation may vary depending on the particular jurisdiction. Upon a breach of a provision of the rules, the state Disciplinary Board(s) with administrative authority may sanction a lawyer for the violation, including licence suspension and disbarment. A lawyer's obligation to obey and adhere to the rules of professional conduct is not limited to observing only the rules of those jurisdictions in which the lawyer is licensed, but also clearly extends to the rules of sister states and US federal laws.

For instance, the New York State Bar Association ruled in an ethics advisory opinion that a New York lawyer may not counsel a client to take action in New Jersey that would be legal under New York law but illegal under New Jersey law.<sup>2</sup> In so holding, the opinion first recognized the commonplace (and, in many instances, inevitable) practice of lawyers to advise clients regarding the laws of jurisdictions in which they are not admitted to practice. It then went on to state that:

the Code's admonition to lawyers that they refrain from counseling their clients to violate the law contemplates that the situs of the act will ordinarily determine its legality, effectively requiring lawyers to observe the laws of other states to which their advice relates.

Taking this one step further, lawyers frequently face situations in which their legal advice affects and is

intertwined with the laws of a jurisdiction outside of the USA, especially due to the increasing volume of international and cross-border legal transactions. Although there is no clear provision within the MRPC that limits a lawyer's obligation to his or her state of admission or to only US jurisdictions, there is a growing consensus among practitioners that US lawyers have a duty of enquiry as to whether their advice to a client may violate a foreign law applicable to the client or the transaction.

In the *Matter of Scallen*,<sup>3</sup> a Minnesota-licensed lawyer was found guilty of committing a securities fraud and theft under the Canadian criminal code. The Minnesota Board of Professional Responsibility filed a petition for discipline to disbar the lawyer. The judge, in determining that an indefinite suspension of the lawyer's licence was the appropriate sanction, emphasized that:

[n]othing in [the language of the Minnesota Code of Professional Responsibility] or elsewhere indicates that its effectiveness is restricted by political or geographical boundaries. It regulates the conduct of a Minnesota lawyer anywhere in the world.<sup>4</sup>

Accordingly, the ethical obligations 'follow an attorney wherever he or she may travel and govern the attorney's every activity'.<sup>5</sup>

In addition, the court found that '[t]he emphasis of an ethical code is on its spirit rather than its letter'.<sup>6</sup> Thus, the fact that the state ethics code does not specifically enumerate foreign crime as within the scope of illegal conduct prohibited by the code is not a defence against disciplinary action pursuant to the code.

More recently, in *Pasquantino v United States*,<sup>7</sup> the US Supreme Court held that a scheme to defraud the Canadian government of tax revenue violated the US federal wire fraud statute. The court rejected the

2. NYSBA Opinion 455 (30 December 1976).

3. *Matter of Scallen*, 269 NW 2d 834 (Minn 1978).

4. *ibid* 839.

5. *ibid* 840.

6. *ibid*.

7. *Pasquantino v United States*, 544 US 349 (2005).

defendant's argument that the common law 'revenue rule'—which prohibits courts from enforcing the tax laws of foreign sovereigns—prevents prosecution of their scheme to evade Canadian importation taxes by (i) finding a general lack of jurisprudence clearly applying the revenue rule to preclude the USA from prosecuting an illegal foreign tax evasion scheme, and (ii) distinguishing the case as one involving a domestic sovereign enforcing its own penal law.<sup>8</sup> Although the decision did not directly result in collection of the Canadian excise taxes, the case could be viewed as the start of a trend against the common law revenue rule, and a warning from the judiciary that foreign law violations will be taken into consideration in determining US legal issues.

In view of these precedents, and particularly the *Pasquantino* decision, tax professionals who provide legal advice that has effect both within and without the USA should take caution not to cross the boundaries of legality set by a relevant foreign jurisdiction.

### *Treasury Department Circular 230: Rules of Tax Practice*

Another well-established rule of professional conduct is Circular 230 issued by the US Treasury Department. These rules set forth the special and particularized duties and obligations of tax professionals who practice before the IRS. Some notable provisions include the following:

- Section 10.22(a): A practitioner must exercise due diligence—
  - in preparing, approving and filing documents, affidavits and other papers;
  - in determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and
  - in determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS.
- Section 10.51(a)(4): A practitioner may be sanctioned for (among others) knowingly giving false or misleading information—including facts or other matters in testimony, Federal tax returns, financial statements, affidavits, declarations, and any other document or written or oral statement—to the IRS or to any court handling a tax case, in connection with any matter pending or likely to be pending before them.

Circular 230 is administered by the Office of Professional Responsibility (OPR) within the IRS. OPR is authorized to negotiate the appropriate level of discipline with practitioners and may also initiate administrative proceedings to censure, suspend (up to 60 months), disbar, or disqualify a practitioner (or his *firm*) from further practice before the IRS. It also possesses the authority to impose monetary penalties on any practitioner who engages in sanctionable conduct. OPR bears the burden of proving by 'clear and convincing evidence' that the practitioner engaged in willful—ie voluntary, intentional—violation of one or more provision of Circular 230. Importantly, any IRS employee may refer suspected practitioner misconduct to OPR.

In 2014, Circular 230 was amended to broaden the responsibilities and obligations of tax practitioners before the IRS. One significant addition in section 10.36 is the requirement for *firm* managers to ensure that the *firm* and all members, associates and employees of the *firm* are in compliance with Circular 230. More specifically, the firm manager with such oversight responsibilities must ensure that there are adequate procedures in place to comply with Circular 230 and that such procedures are properly followed, and the firm manager must take prompt action upon learning or having reason to know of a violation.

This additional layer of professional responsibility imposed at the firm level shows the heightened scrutiny and commitment of the IRS and Treasury Department to sanction unethical behaviour of tax practitioners.

8. *ibid* 360–64.

### Other IRS weapons to police unethical practice

In addition to formally promulgated rules of professional conduct, the IRS and the courts also use general normative legal doctrines and enforcement strategies to police unethical practices of tax practitioners.

#### Conventional normative legal doctrines

Tax practitioners and the courts alike are frequently faced with the question of whether certain planning strategies to reduce the tax liability of a taxpayer is legally permissible tax ‘avoidance’ or illegal tax ‘evasion’. The conventional view of the line between the two concepts is as follows:

- Tax *avoidance* occurs when a taxpayer takes advantage of all legal opportunities to minimize its federal income, gift, or estate tax obligations through claiming permissible deductions and credits. Avoidance is considered legitimate, even if sometimes involving aggressive planning.
- Tax *evasion* occurs if the planning structure involves some form of deception, fraud, false statement or sham in fact, including concerted efforts to impair, impede and obstruct IRS tax enforcement—eg mischaracterized transactions, false book entries, false statements made during tax examinations, and under-reporting of income.

However, faced with the endless development of increasingly clever, complex and technically legal tax structures by tax practitioners, courts and the IRS have started to more frequently bring normative legal principles into the assessment of whether certain tax strategies are ethically and legally tolerable. The growing view is that tax planners should not engage in tax reduction strategies solely for that purpose, regardless of whether the structure is legally sound. This view has led to the development of two important normative legal doctrines that emphasize the

substance and purpose of a transaction to determine its legality:

- ‘*Step Transaction*’ Doctrine: Substance, rather than form, of a transaction should be given effect by ignoring for tax purposes intermediate steps of an integrated transaction, including even steps that are legally sound, if each such step lacks substantive purpose.
- ‘*Economic Substance/ Sham In Substance*’ Doctrine: The subject transaction must have an economic purpose aside from reducing the tax liability of a taxpayer in order to be considered valid.

Thus, Judge Learned Hand’s view that taxpayers have the freedom to minimize their income tax liability through the use of legal means may no longer hold true if the tax reduction strategy, completely legal from its inception to completion, has no purpose other than a reduction in the taxpayer’s tax bill.

#### The search for ‘Beneficial Owners’

Another method employed by the IRS and the Treasury Department (and other government authorities worldwide) to reinforce ethical and transparent tax planning is to identify the actual beneficial owners of offshore funds and assets. The IRS has put in obsessive effort and resources in recent years to identify ‘beneficial owners’, as evidenced by the three Offshore Voluntary Disclosure Initiatives (OVDIs) since 2009 and the roll-out of the Foreign Account Tax Compliance Act (FATCA) that was enacted in 2010, in part as a response to the conditions that gave rise to the OVDI programs.<sup>9</sup>

The focus on beneficial owners likely originated in the late 1970s as an effort to curb abusive tax treaty shopping by third country residents. This first foray by tax administrators culminated in the introduction of ‘limitation on benefits’ provisions in bilateral tax treaties, which, over time, have become increasingly complex and sophisticated.

9. FATCA was included as part of the Hiring Incentives to Restore Employment (HIRE) Act, Pub L 111–47 (18 March 2010).

The USA and other developed countries took a further step in their search for beneficial owners in 1989 by creating the Financial Action Task Force (FATF) to identify and combat money laundering activities. The FATF created greatly expanded due diligence and know-your-customer (KYC) rules, and also emphasized the concept of whether funds for financial and tax transactions have a 'legal source'. This emphasis was especially appropriate at the time when numerous countries still had legal restrictions (such as foreign exchange controls) in place that limited the free expatriation of funds outside of their borders. The use of funds that were somehow transferred outside of such countries raised the question of, and focus on, whether such funds were legally sourced. Most importantly, the FATF gave rise to more uniform and robust financial controls in Offshore Financial Centers (OFCs) that were havens for both money laundering and aggressive international tax structuring to avoid or evade taxes.

In consequence of a decade of FATF ground work, it was not surprising that the OECD commenced efforts to 'level the tax playing fields' to counter aggressive national tax regimes through its release of the 1998 OECD report condemning 12 different 'harmful' tax practices.<sup>10</sup> The OECD initiative led to a substantial, if not complete, derailing and curbing of some of the most aggressive tax regimes among countries competing for greater investment.

As a result of the OECD's efforts to curtail harmful tax competition among sovereign countries, including OECD member states, the tax administrators of the world's developed and developing countries alike came to focus on tax transparency and exchange of information as the best means to identify beneficial owners. In the USA, this point of view eventually led to the enactment and implementation of the aforementioned FATCA—an information reporting and financial withholding regime requiring US taxpayers and foreign financial institutions with US account holders to provide certain information regarding foreign financial accounts and offshore assets of US

taxpayers—and, more broadly, to the Common Reporting Standard (CRS)—an information standard for the automatic exchange of information (rather than exchanges upon individual requests under treaties) adopted by all OECD countries (excluding, thus far, the USA) as well as many others.

The worldwide efforts to detect and curb abusive tax planning by promoting transparency and exchange of taxpayer information will likely continue with much force as the use of offshore assets and funds become a routine part of tax planning in the global world of today.

### *Increase in criminal prosecution against tax practitioners* **Aggressive prosecution of 'Enablers'**

Running concurrently with the increase in tax transparency and exchange of information, and perhaps spurred in part by the latter, there has also been an increased appetite of the US Department of Justice (DOJ) to more aggressively bring and pursue criminal actions against tax practitioners who structure, market, and opine on large-scale tax shelter transactions as yet another strategy of the government to keep tax practitioners' behaviour in line. In the last two decades, an unexpectedly large number of criminal actions against practitioners, labelled as 'enablers' or 'facilitators' of tax evasion, have been brought to the surprise of many practitioners. Prosecutors maintain that such practitioners willfully mischaracterized and lied about the business purpose (or lack thereof) of their tax shelters, which is now deemed a criminal act of evasion.

The Stein/KPMG indictment of 2006 is a good example of such active criminal enforcement against tax practitioners. In that case, KPMG LLP, its numerous former partners, and several high ranking bank officials were criminally indicted for designing, marketing, and implementing fraudulent tax shelters for high net worth individuals, resulting in at least \$11 billion in phony tax losses and costing the US Treasury more than \$2.5 billion in evaded taxes. More specifically, according to the indictment, the defendants created

10. See *Harmful Tax Competition: An Emerging Global Issue* (OECD 1998) 26–34.

purported loans that lacked economic substance, whose only role was to create fraudulent losses that wealthy individuals could use to offset their legitimate income. In furtherance of these tax shelters, the defendants prepared false and fraudulent US individual income tax returns for their clients who utilized the tax shelters, and also took active and deliberate measures to conceal the existence of the tax shelters from the IRS by failing to register them with the IRS as required by law. The perpetrators also issued false opinion letters that claimed that the tax shelters were legitimate investments.

After extensive investigation, KPMG admitted its criminal acts and entered into a deferred prosecution agreement with the DOJ for conspiracy to commit tax fraud, paying a total of \$456 million in fines. In addition, several of the individual defendants—ie the ‘enabling’ or ‘facilitating’ tax professionals, *rather than the taxpayers*—were convicted on various counts of tax evasion.<sup>11</sup> Several others pled guilty to charges of tax evasion and fraud.

Although civil investigations and penalties relating to the tax shelters were a foreseeable result, many observers found the vigorous pursuit of criminal charges against the tax practitioners and the actual criminal convictions of some of them surprising. This surprise was not ungrounded, as the DOJ, in 2005, abruptly increased the number of prosecution authorizations against tax crime defendants by 43 per cent in comparison to 2001. The clear message that the DOJ sent through such aggressive criminal prosecution of tax crimes is that it:

is committed to using all available law enforcement tools to recover tax revenue, punish tax offenders, and to prevent future misconduct.<sup>12</sup>

Another sign of increased enforcement efforts against tax practitioners is the focus on ‘enablers’ in

offshore cases. Through the use of a multitude of differing enforcement initiatives, including those used in the prosecutions of UBS and Credit Suisse, the DOJ–Swiss Bank Program, the several OVDIs, and the active indictments of lawyers, financial advisors and bankers, the IRS and DOJ together have been pushing hard to surface undeclared US accounts hidden through the decades-long efforts of tax professionals and foreign bank officials. This express targeting of tax practitioners rather than taxpayers is evidence of the long-standing belief of the tax enforcement community that pursuing the facilitators engenders far more ‘deterrence’ than pursuing a single taxpayer.

### Reliance

Finally, an additional source of exposure to criminal enforcement for tax practitioners is the taxpayer’s ability to claim reliance on a qualified tax expert as a defence. In many cases of taxpayer investigation, the first line of defence for the taxpayer is ‘I did what my tax professional told me to do’. The elements of such a reliance defence are that (i) the taxpayer disclosed all relevant facts to the tax advisor for him or her to make an informed decision regarding the tax matter, and (ii) the taxpayer relied in good faith on the advisor’s advice, ie had no reason to believe that the advice was incorrect. As in the tax shelter cases, the lawyers and accountants, not the taxpayers, are frequently criminally prosecuted, opening yet an additional channel of potential criminal exposure for tax practitioners.

### ‘Planning’ for ethical tax planning

The multiple layers of ethics rules and enforcement practices that have become applicable to tax practitioners over the last few decades have caused both an

11. Ironically, the DOJ may have attempted to carry its mission too far. In its zeal to prosecute the offenders, the DOJ attempted to pressure KPMG and other employers not to provide the individual defendants with indemnification of their legal costs incurred in defending against the prosecution of their employment services. As a result, a number of the successful prosecutions were thrown out by the courts. See *United States v Stein*, 541 F3d 130 (2d Cir 2008).

12. ‘Justice Department and IRS Highlight Tax Enforcement Efforts’, Department of Justice <<http://www.justice.gov/archive/tax/txdv06212.htm>> accessed 11 April 2006.

increase in risks that are entailed in tax planning and a decrease in the scope of what is considered permissible and tolerable tax planning. In light of this increasingly restrictive tax planning environment, tax practitioners and taxpayers should take caution to carefully plan the method and extent of their tax strategies so as to not overstep the narrowing boundaries of legality.

At a minimum, taxpayers should ensure that their tax planning processes are procedurally and ethically sound by seeking professional tax advice from experts, making full disclosure of all facts material and relevant to the tax plan, and making sure that the tax avoidance plan as actually implemented is in conformity with the transaction as planned. In addition, tax practitioners must also diligently monitor and review the status of their compliance with the numerous standards of legality applicable to tax

planning. Institutional practitioners such as law and accounting firms should review and enhance their firm compliance procedures to meet the level of adequacy required by the amended Circular 230.

The primary goal of most practitioners is to reduce the tax liability of their clients as much as possible through lawful, strategic planning. They must now recognize, however, that the determination of whether their strategies are 'lawful' is subject to multi-layered, constantly evolving standards of legality, influenced by considerations of morality, ethics, and government objectives. What Judge Learned Hand stated regarding the permissible scope of tax planning in his well-known 1934 decision in *Gregory v Helvering*, though still applicable in principle, has been greatly reduced by the complexities of the modern world.

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