United States Senate

COMMITTEE ON
GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510-6250

February 25, 2004

The Honorable Gregory F. Jenner
Acting Assistant Secretary for Tax Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, N.W.
Room 3120 MT
Washington, D.C. 20220

Filed electronically at www.irs.gov/regs

Re: **Comments on Proposed Rule, CC:PA:LPD:PR (REG-122379-02), Proposing Treasury Circular 230 Standards for Tax Shelter Opinions**

Dear Mr. Jenner:

This letter is written in strong support of the U.S. Department of the Treasury's proposed rule to modify Circular 230 and establish needed standards for tax shelter opinion letters. While the Treasury is to be commended for taking this essential action to address ongoing abuses related to the preparation and use of tax opinion letters to market abusive tax shelters, the proposed standards do not take all the steps needed and should be clarified and strengthened in several respects.

Abusive Practices Related to Tax Opinion Letters

Over the past several years, the U.S. Senate Permanent Subcommittee on Investigations, on which I serve as the senior Democrat, has conducted investigations into a variety of issues related to illegal tax shelters and offshore tax havens. One key inquiry over the past year, initiated at my request, has focused on the role played by professional firms, such as accounting firms, banks, law firms and investment advisory firms, in the development, marketing, and implementation of potentially abusive and illegal tax shelters. This investigation culminated in Subcommittee hearings on November 18 and 20, 2003, and a report prepared by my staff detailing four case studies of abusive tax shelters promoted by KPMG with assistance from certain banks, law firms, and investment advisory firms.[1] During the course of this year-long investigation, the Subcommittee uncovered substantial and disturbing evidence related to the misuse of tax opinion letters to market abusive tax shelters. This evidence, set forth in hearing testimony, documentation and the staff report, provides ample support for the proposed rule.

[1] "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals" before the Permanent Subcommittee on Investigations (Nov. 18 & 20, 2003); and "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals" (Minority Staff Report, S.Prt. 108-34, Nov. 18, 2003).

The Subcommittee investigation has documented a wide range of abusive practices associated with tax shelter opinion letters, including the knowing use by some tax practitioners of dubious tax advice; inadequate review, approval and recordkeeping procedures at some accounting and law firms; reliance by some tax practitioners on unreasonable or improper factual representations in their tax opinion letters; conflict of interest problems; and the imposition by some practitioners of inappropriate fees. The Subcommittee investigation detailed these and other abuses in the course of its examination of four KPMG tax shelters known as the Bond Linked Investment Premium Structure (BLIPS), Offshore Portfolio Investment Strategy (OPIS), Foreign Leveraged Investment Program (FLIP), and S-Corporation Charitable Contribution Strategy (SC2).

One of the most disturbing discoveries made during the Subcommittee investigation was evidence indicating that, in the case of BLIPS, KPMG sent clients tax opinion letters which KPMG knew contained dubious tax advice. The investigation determined that KPMG had used an elaborate procedure to develop BLIPS and try to reach a consensus within the firm on the substance and wording of the opinion letters to be provided to BLIPS clients. The evidence showed that, during the BLIPS review and approval process, some KPMG tax experts repeatedly raised strong technical objections to BLIPS and recommended against issuing a more-likely-than-not opinion letter for the product. Senior KPMG personnel pressured these tax experts to "sign off" on the product's technical soundness, despite their concerns. One key KPMG tax expert finally capitulated, sending his superior an email stating in part: "I don't like this product and would prefer not to be associated with it. However, [with] the additional [factual] representations ... I can reluctantly live with a more-likely-than-not opinion being issued for the product." He and other KPMG tax experts remained unconvinced, however, that BLIPS could withstand IRS scrutiny and continued to recommend against issuing a favorable opinion letter. Several months later, the KPMG tax expert wrote to his superiors: "[B]efore engagement letters are signed and revenue is collected, I feel it is important to again note that I and several other [KPMG] partners remain skeptical that the tax results purportedly generated by a BLIPS transaction would actually be sustained by a court if challenged by the IRS."

During this prolonged dispute within the firm, a senior KPMG tax professional sent an email to eight colleagues urging the firm's tax leadership to approve a tax opinion letter concluding that it was more likely than not that BLIPS would be sustained by a court. This senior KPMG tax professional frankly acknowledged the technical problems and reputational risks associated with BLIPS, but recommended going ahead and selling the product to clients. He characterized the key "business decisions" as follows:

> "(1) Have we drafted the opinion with the appropriate limiting bells and whistles . . . and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? ... My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit."

KPMG subsequently sold BLIPS and issued tax opinion letters to 186 clients, obtaining more than $53 million in fees in return. One year later, in 2000, the IRS designated BLIPS an illegal tax shelter and took enforcement action against taxpayers who used it. Several of these taxpayers have, in turn, sued KPMG for malpractice in recommending they use BLIPS.

A second disturbing discovery of the Subcommittee investigation was that, while KPMG used an elaborate procedure to draft and approve the content of its tax shelter opinion letters, other firms appeared to allow their tax practitioners to issue opinion letters in the name of the firm without adequate procedures for reviewing and approving the legal positions taken. Sidley Austin Brown & Wood, for example, through its predecessor firm, Brown & Wood, issued over 300 tax opinion letters from about 1997 to 2001, supporting three of the KPMG tax shelters examined by the Subcommittee. Brown & Wood's former managing partner testified before the Subcommittee that all of these opinion letters had apparently been drafted by a single tax partner, R.J. Ruble. Brown & Wood was unable to produce a copy of the firm's written procedures for reviewing tax opinion letters prior to 2000, and did not, until recently, maintain a central file of the letters actually sent to clients. The managing partner indicated that opinion letters drafted by one tax partner were supposed to have been reviewed by a second tax partner, but the firm had no procedures for tracking compliance with this requirement. The managing partner also indicated that an opinion committee should have approved the firm's opinion letters before they were issued, but the extent to which this committee actually did so is unclear. The managing partner disclosed that Mr. Ruble had been instructed at one point to stop issuing the tax shelter opinion letters, but had issued several more without the firm's knowledge. In addition, he testified that the firm had been unaware of the tax partner's role in helping to design some of the tax shelters analyzed in the letters and of his ongoing, close collaboration with KPMG.

A third set of problems uncovered by the Subcommittee investigation involves inaccurate and unreasonable factual representations in the tax opinion letters issued by KPMG and Brown & Wood for the three tax shelters. Each of the tax opinion letters for BLIPS, FLIP, and OPIS include factual representations attributed to the taxpayer who requested the letter, to KPMG, to a participating investment advisory firm, and to a participating bank. Essentially the same representations appear in both the KPMG and Brown & Wood letters, and play a critical role in the legal analysis presented. The Subcommittee investigation determined that, in all three cases, KPMG had itself drafted the factual representations attributed to other parties. The evidence also showed that, before attributing factual representations to other professional firms, KPMG presented draft statements to them and negotiated the wording. But in the case of factual representations attributed to a client – the taxpayer – the evidence indicates KPMG did not consult with the client beforehand and, in at least one case, refused to allow the client to alter the KPMG-drafted representations.

Equally disturbing is that some of the key factual representations that KPMG made or attributed to its clients appear to contain false or misleading statements. For example, KPMG wrote in each BLIPS opinion letter that the client had "represented to KPMG . . . [that the client had] independently reviewed the economics underlying the [BLIPS] Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pretax profit from the transactions." The Subcommittee investigation found, however, that it was doubtful that many BLIPS clients had "independently reviewed" or understood the complicated BLIPS transactions before entering into them. In addition, the evidence showed that KPMG had known there was only a remote possibility – not a reasonable possibility – of a client's earning a pretax profit in BLIPS. In early 2000, a senior KPMG tax professional wrote:

> "[A]n issue that I am somewhat reluctant to raise but I believe is very important going forward concerns the representations that we are relying on in order to render our tax opinion in BLIPS I. In each of the 66 or more deals that were done at last year, our clients represented that they 'independently' reviewed the economics of the transaction and had a reasonable opportunity to earn a pretax profit. ... As I understand the facts, all 66 closed out by year-end and triggered the tax loss. ... [T]he issue going forward is can we continue to rely on the representations in any subsequent deals ...? ... My recommendation is that we ... close the book on BLIPS and spend our best efforts on alternative transactions."

The evidence showed KPMG was well aware that BLIPS uniformly produced substantial paper losses for BLIPS "investors" who used them to offset and shelter other income from taxation. Nevertheless, since the existence of a reasonable opportunity to earn a reasonable profit was central to BLIPS' having economic substance and complying with federal tax law, KPMG included the questionable client representations in its opinion letters. Given KPMG's knowledge of the facts, however, its reliance on such factual representations was neither reasonable nor appropriate.

A fourth set of issues examined by the Subcommittee involves conflict of interest concerns stemming from the fact that KPMG and Brown & Wood had financial interests in the tax products being analyzed in their opinion letters and were allowing these letters to be used as marketing tools to increase sales. KPMG routinely issued favorable tax opinion letters for three of the tax products, BLIPS, OPIS and FLIP and directed its clients to obtain a second, concurring opinion letter from Brown & Wood. The evidence shows that KPMG cited the availability of both opinion letters when marketing the tax products to clients, claiming that a more-likely-than-not opinion from KPMG, combined with a supporting legal opinion letter from Brown & Wood, would protect clients from the imposition of IRS penalties. It is unclear whether KPMG also routinely disclosed to its clients that the IRS might discount the value of one or both letters due to the financial interests held by the firms in the tax shelters being analyzed. Some clients may, thus, have been misinformed with respect to the legal protections provided by the opinion letters.

The extent of collaboration between KPMG and Brown & Wood also raises serious questions about the independence of the tax advice provided by the law firm. The evidence indicates, for example, that the law firm's leading tax partner had contributed to the design of the BLIPS, OPIS and FLIP tax products and that KPMG had collaborated with him ahead of time to ensure his law firm would supply a favorable opinion letter for each product. In the case of

BLIPS, KPMG and Brown & Wood actually exchanged copies of their drafts, eventually issuing two, allegedly independent opinion letters that contained numerous, virtually identical paragraphs. In addition, the evidence indicates that, in many cases, KPMG obtained a client's second opinion letter directly from the law firm and delivered it to the client, apparently without the client's ever speaking to a lawyer at the firm. By routinely advertising and supplying its clients with a Brown & Wood opinion letter, KPMG produced a steady stream of income for the law firm, further undermining the law firm's independent status and giving it a financial stake in the tax shelters being sold by KPMG.

Finally, the Subcommittee investigation disclosed a host of abusive practices related to the fees charged by accounting and law firms for the tax shelter opinion letters they issued. Accounting firms traditionally charged flat fees or hourly fees for their tax services. In the 1990s, however, they began charging "value added" fees based on, in the words of a KPMG manual, "the value of the services provided, as opposed to the time required to perform the services." In addition, some firms began charging "contingent fees" that were based on a client's obtaining specified results from the services offered, such as projected tax savings. In response, many states began prohibiting accounting firms from charging contingent fees for tax work to avoid creating incentives for these firms to devise ways to shelter substantial sums. The Securities and Exchange Commission (SEC) and American Institute of Certified Public Accountants (AICPA) also have rules restricting contingent fees, allowing them in only limited circumstances.

Tax shelter fees are typically substantial, and KPMG has admitted obtaining more than $124 million in fees from just the four tax products examined by the Subcommittee. In the case of SC2, KPMG charged $2 million for a single tax opinion letter that did not even address all of the material issues related to that tax shelter. Documents show that, in three of the cases, KPMG often set its fees as a percentage of the paper loss to be generated by the transaction. In the case of BLIPS, for example, fees were typically set at 7% of the generated "tax loss" that clients could use to shelter other taxable income. While one key senior KPMG tax professional took the position that these fees qualified as contingent fees and were prohibited in certain circumstances, other KPMG tax professionals disagreed and insisted on using this fee structure. In addition, evidence indicates that, in at least some instances, KPMG was willing to deliberately manipulate the way it handled certain tax products to circumvent the contingent fee prohibitions. A KPMG document related to OPIS, for example, identifies the states that prohibit contingent fees. Then, rather than prohibit OPIS transactions in those states or require an alternative fee structure, the memorandum directs KPMG tax professionals to make sure the OPIS engagement letter is signed, the engagement is managed, and the bulk of services is performed "in a jurisdiction that does not prohibit contingency fees."

Brown & Wood obtained more than $23 million from issuing concurring opinion letters for BLIPS, OPIS and FLIP, charging an average of $74,000 per letter and, on one occasion, billing a fee of $900,000. Brown & Wood has estimated that the key tax partner recorded a total of about 2500 hours working on the 300 tax opinion letters, which means that his overall hourly rate exceeded $9,000 per hour. American Bar Association (ABA) Model Rule 1.5 states that "[a] lawyer shall not make an agreement for, charge, or collect an unreasonable fee," and cites as the factors to consider when setting a fee amount "the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly." Brown & Wood charged substantial fees for each legal opinion it issued to a FLIP, OPIS, or BLIPS client, even when those opinions were virtually identical to a template that had been developed earlier, contained no new facts or legal analysis, and did not require client consultation or individualized legal or tax advice. In the case of BLIPS, documents indicate that KPMG had promised to pay Brown & Wood a fee in any BLIPS sale where a prospective buyer was told that the law firm would provide a favorable tax opinion letter if asked, regardless of whether the opinion was actually requested or provided. Such fees bear little if any relation to Brown & Wood's time, labor, or tax expertise.

The abusive practices identified by the Subcommittee investigation in connection with tax shelter opinion letters, including knowing use of questionable tax advice, inadequate firm procedures for issuing tax opinion letters, unreasonable or improper factual representations, conflicts of interest, and inappropriate fees, are not confined to the actions of a single accounting firm or a single law firm. To the contrary, evidence presented elsewhere, such as in recent hearings before the U.S. Senate Committee on Finance,[2] television documentaries,[3] and written analyses,[4] demonstrate that abusive practices involving tax opinion letters affect other tax practitioners as well. Accordingly, the staff report released at the Subcommittee hearings in November made this specific recommendation: "The U.S. Treasury Department should clarify and strengthen professional standards of conduct and opinion letter requirements in Circular 230 and explicitly address tax shelter issues."

Analysis and Recommendations

The public has traditionally relied on tax opinion letters to obtain informed and trustworthy advice about whether a tax-motivated transaction meets the requirements of the law. The Subcommittee's tax shelter investigation has shown that, in too many cases, tax opinion letters no longer contain disinterested and reliable tax advice, even when issued by supposedly reputable accounting or law firms. Instead, too many tax opinion letters have become marketing tools used by tax shelter promoters and their allies to sell clients on their latest tax products. In too many of these cases, financial interests were concealed, unreasonable factual assumptions were used to justify dubious legal conclusions, and taxpayers were misled about the risks that the proposed transaction would later be designated an illegal tax shelter. Reforms are essential to address these abuses and restore the integrity of tax opinion letters issued by reputable firms.

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[2]See, for example, "Tax Shelters: Who's Buying, Who's Selling and What's the Government Doing About It?" Senate Committee on Finance (Oct. 21, 2003).

[3]See, for example, "Tax Me If You Can," Frontline (Feb. 19, 2004).

[4]See, for example, "Helter Shelter," The American Lawyer (Dec. 2003).

Support for Proposed Rule. The Subcommittee's investigative work provides a solid factual foundation for many of the provisions in the proposed rule. The Subcommittee's work directly supports, for example, the proposed requirements for tax practitioners to: (1) disclose in a tax opinion letter any compensation arrangements or referral agreements between the letter writer and any person promoting, marketing, or recommending the tax shelter analyzed in the letter; (2) use reasonable efforts to identify, ascertain, and consider relevant facts and avoid reliance on unreasonable factual assumptions such as an assumption that a transaction has a business purpose or is potentially profitable apart from its tax benefits; (3) provide advice only in areas in which the letter writer is competent to do so and disclose any reliance on another person's tax expertise; (4) disclose in the opinion letter what legal protections, if any, the letter provides to the client and, if appropriate, provide a warning that the letter will not shield the client from penalties for tax violations; (5) refrain from basing an analysis on the possibility that a tax return will not be audited, an issue will not be raised on audit, or an issue will be settled; and (6) take reasonable steps to ensure the practitioner's firm has adequate procedures in place to comply with the standards for tax shelter opinion letters.

Support for Proposed Tax Shelter Definition. A number of comment letters recommend changing the proposed rule by narrowing its definition of "tax shelter" and, as a result, limiting the tax opinion letters subject to the regulation. These arguments have already been rejected once, and should be again. The Subcommittee investigation provides strong factual support for the broad tax shelter definition used in the proposed rule. For example, despite overwhelming evidence to the contrary, KPMG claimed repeatedly, throughout the Subcommittee investigation, that its tax products did not qualify as "tax shelters" under the definitions in the tax code and placed no obligation on KPMG to comply with the disclosure, reporting, or other legal requirements for tax shelters. If similar, complex definitions were included in the final rule, KPMG and others would almost certainly contend that its provisions did not apply to them or their tax opinion letters. A broad tax shelter definition is, thus, essential if this rule is to curb the abusive practices now corrupting too many tax shelter opinion letters.

Additional Clarifying and Strengthening Measures. The proposed rule presents important new standards addressing some of the key tax shelter opinion abuses examined by the Subcommittee, but the scope of some of those provisions needs to be clarified and, in some areas, the proposal fails to address important concerns. The Subcommittee's tax shelter investigation indicates the following clarifying or strengthening measures would improve the proposed rule and help reduce ongoing abusive practices related to tax shelter opinion letters.

> **Enforceable Standards.** Some comment letters urge the Treasury to change the status of all of the standards in the proposed rule and deem them "best practices" to which tax practitioners should aspire, rather than requirements to which tax practitioners could be held accountable. But the abusive practices rampant in the tax shelter industry today call for stronger measures than unenforceable guidelines. At a minimum, the proposed tax shelter provisions in Circular 230 should retain their status as enforceable standards, and additional enforceable requirements should be added.

Expansion of Best Practices. Section 10.33 in the proposed rule provides guidance on positive steps that tax practitioners should take to meet their ethical obligations, stating, for example, that tax advisors should "provide clients with the highest quality representation" and act "fairly and with integrity in practice" before the IRS. The section fails, however, to identify, address, or urge tax advisors not to engage in, the many unethical tax shelter practices that now pervade and demean the U.S. tax profession. The proposed section would be greatly strengthened if new language were added to §10.33 stating that "best practices" also mean that tax advisors: (1) should not participate in the design, promotion, or implementation of deceptive or sham transactions to reduce or eliminate a client's tax liability; (2) should not engage in aggressive marketing efforts to sell unsolicited tax shelters to existing or prospective clients, including audit clients; and (3) should not provide tax opinion letters for transactions about which there is substantial disagreement among the tax advisor's colleagues over whether the transaction complies with tax law. Given widespread tax shelter abuses, negative as well as positive precepts are essential to providing meaningful content to a list of "best practices" for tax advisors.

Collaboration. As currently drafted, §10.35(d)(1) of the proposed rule requires tax shelter opinion letter writers to disclose in each letter any "compensation arrangement" or "referral agreement" between the letter writer and anyone who is promoting, marketing, or recommending the tax shelter analyzed in the letter. This disclosure requirement is essential to unearthing hidden relationships, biases, and possible conflicts of interest that may be of concern to clients or tax authorities. The provision would also benefit, however, from language making it clear that it would apply to and require disclosure of the type of collaboration between KPMG and Brown & Wood discussed earlier. This collaboration led to Brown & Wood's becoming the preferred provider of hundreds of opinion letters for three KPMG tax products, receiving in return a steady stream of lucrative fees -- all without any formal referral agreement or direct exchange of funds between the two firms. Accordingly, a new clause could be added to the end of the proposed §10.35(d)(1) requiring disclosure of "any other collaboration between the practitioner (or the practitioner's firm) and any person (other than the client for whom the opinion is prepared) with respect to the promoting, marketing or recommending of the tax shelter discussed in the opinion, resulting in additional compensation for the practitioner or the practitioner's firm."

Substantially Similar Tax Product. A related conflict of interest concern involves tax practitioners who have no direct financial interest in the tax shelter being analyzed in their opinion letters, but are promoting a substantially similar transaction. The proposed rule could be strengthened by adding a new provision to §10.35(d) requiring a tax practitioner to disclose in a more likely than not or marketed opinion letter whether the practitioner or the practitioner's firm is promoting or has a financial interest in a transaction that is substantially similar to the transaction being analyzed.

Written Review and Approval Procedures. As currently drafted, §10.36(b) in the proposed rule requires senior tax practitioners to take reasonable steps to ensure that their firm has adequate procedures to ensure compliance with the rule's tax shelter requirements. The proposed rule does not, however, provide any standards or further guidance on the nature of the required procedures for tax opinion letters issued in the name of the firm. The Subcommittee investigation found many troubling deficiencies in the ways in which firms review (or fail to review) the opinion letters issued by their tax partners, including instances in which letters were issued without prior notice to other firm members, some letters were approved through informal or ad hoc arrangements, and still others were issued over the strong objection of some firm members. To address such deficiencies, the proposed §10.36(b) could be clarified and strengthened in three ways by: (1) requiring firms to maintain "adequate **written** procedures"; (2) specifying that the procedures address not only "complying with §10.35," but also "ensuring proper review, approval, and recordkeeping for tax opinion letters issued in the name of the firm"; and (3) adding a new paragraph at the end of the section providing minimal standards or guidance on appropriate firm procedures, such as requiring establishment and use of an opinion committee to approve new opinion letters and requiring development of a procedure for resolving substantial disagreements among tax partners over the wording or content of a proposed letter.

Ban on Tax Shelter Advice to Audit Clients. The proposed rule, as currently drafted, fails to address a key conflict of interest concern that applies to accounting firms issuing tax opinion letters to a client which the firm also audits. This conflict has been repeatedly discussed in Congressional, SEC, and AICPA proceedings. The Subcommittee investigation documented numerous instances in which KPMG sold or attempted to sell tax shelters to its audit clients. Accounting firms that audit the financial statements of publicly traded companies owe a duty to the public to provide an independent, fair, and accurate audit analysis. Accounting firms that audit private businesses owe the same duty to the owners and investors in that business. An accounting firm that sells an aggressive tax shelter to an audit client will inevitably be required to audit its own work, creating a conflict of interest that undermines the actual or perceived reliability of the audit. To eliminate this conflict of interest, a new provision should be added to the proposed rule to ban accounting firms from providing a tax shelter opinion letter to an audit client for a tax product in which the accounting firm has a financial interest or is promoting a substantially similar product.

Inappropriate fees. Finally, the proposed rule fails to address any of the abusive practices related to the fees charged for tax shelter opinion letters. The proposed rule would be significantly strengthened by adding a new provision prohibiting practitioners from using inappropriate fee structures for tax shelter opinion letters in violation of federal, state, or professional regulations or ethics rules, and explicitly banning fee arrangements in which the fee amount charged by the tax practitioner is based upon a specified amount of expected tax savings or tax losses that a client could use to offset taxable income. The proposed rule could also prohibit excessive fees for boiler-plate opinion letters in which a tax practitioner provides little or no individualized legal or tax analysis or advice to the client paying the fee.

Thank you for this opportunity to comment on the proposed rule.

Sincerely,

Carl Levin

Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations

CL:ejb