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Blessing Sham Shelters

Tax lawyers take ethical risks as they earn millions by helping corporations hide from the IRS. Even some of them think that needs to change. **By Sheldon D. Pollack**

THE SPOTLIGHT THAT CAUGHT ENRON CORP. AFTER ITS bankruptcy revealed that in four of the last five years, the company paid no federal income tax. In fact, though it was the seventh-largest corporation in the United States (at least on paper), Enron received \$382 million in refunds of taxes paid in earlier years in part because the company set up nearly 900 foreign subsidiaries—mostly in the Cayman Islands, where corporations pay no taxes and bank records are beyond the reach of U.S. tax authorities.

If there had been no scandal surrounding Enron's sudden financial collapse, however, this ruse might have gone unnoticed, by the Internal Revenue Service and everyone else. In recent years, it has become commonplace for large corporations to invest in tax shelters that greatly shrink their tax bills to the Treasury. When the government challenges these deductions, the law is usually on its side. But enforcement is devilishly difficult—and many tax lawyers are making things worse.

Instead of advising clients against suspect shelters, law firms that only a decade ago would have blushed now join investment bankers and accounting firms in brokering deals for their clients. Some of the most successful American law firms are accused of aiding Enron in setting up its tax shelters—firms like Chicago-based Kirkland & Ellis and the international powerhouse Skadden, Arps, Slate, Meagher & Flom.

While the specifics differ from deal to deal, tax shelters are "investments" designed to produce tax deductions, not profits. Michael J. Graetz, a Yale law professor, defines a shelter as "a deal done by very smart people that, absent tax considerations, would be very stupid." The goal is to produce a tax loss with no corresponding financial risk. The current shelters don't exploit loopholes in the tax code, because most of those have been closed. Instead, they typically apply a rule in some unforeseen, unintended way.

In 1986, Congress effectively shut down tax shelters for individuals, but not for corporations. Statistics suggest an increase in corporate shelters in the 1990s. From 1985 to 1996, tax refunds to corporations were below \$19 billion a year. In 1999 refunds set a record of more than \$31 billion—despite corporations' higher profits. While no one can say for sure what's behind the increase, tax shelters are a likely explanation. Economist Martin Sullivan estimates

that the government loses \$10.6 billion a year in revenue because of shelters, and says the number could be as high as \$30 billion.

Big accounting firms and Wall Street investment bankers peddle the shelters to corporations, which then ask lawyers to bless the deals with "opinion letters." The fee for an individual letter can run into the millions, because a letter works like a get-out-of-jail-free card. The IRS can come down hard on a corporation that it finds using a shelter to hide income. But the company may avoid a penalty if a lawyer has explained in an opinion letter why there was a "reasonable basis" to think that the shelter was legal. To write that letter, the lawyer has to conclude that the client has a better-than-even chance of beating the IRS in court. Given the complexity of the tax code, that means a lot of close calls.

Still, the IRS often wins when it discovers a shelter and goes after it in court. The government has some well-established legal principles on its side, like the one that doesn't allow tax deductions produced by sham, tax-motivated transactions. In a leading case, *ACM Partnership v. Commissioner*, a federal court of appeals rejected a tax shelter, sold by the financial services company Merrill Lynch to the consumer-goods producer Colgate-Palmolive, which generated a \$98.5 million capital loss. The government's victory in the case netted the U.S. treasury \$30 million. But the IRS loses some big cases, too. In *Compaq Computer v. Commissioner*, the IRS challenged a \$3.38 million tax savings, won before the tax court, and then lost on appeal. That could prove a major victory for other corporations that bought into similar shelters.

And even *ACM Partnership* represents the comeuppance of only one taxpayer. While the IRS's victory has encouraged quick settlements in some similar cases, Merrill Lynch sold plenty of other investments just like this one that are still in dispute, with as much as \$1 billion in taxes at stake.

Perhaps the biggest problem for the government in enforcing the law is that the IRS doesn't know about many of the tax shelters out there. The IRS audits most of the 1,000 largest corporations annually, but smaller companies often escape scrutiny for years. Even with an audit, shelters are so thoroughly camouflaged that they often remain undercover, according to Lindy Paull, Chief of Staff of the Joint Committee on Taxation, which advises Congress on tax issues. This is because Congress has left

the IRS so short of auditors (for some lawmakers, the first step in a full-scale assault on the income tax itself). When the agency does uncover a shelter, the IRS may not have the lawyer-power to take the case to court. So the IRS often agrees to settle the case without penalizing the taxpayer for claiming the deduction—further encouraging taxpayers to play the audit lottery.

THE REALITY IS THAT PROMOTERS OF SHELTERS ARE ALWAYS a step ahead of the government. Professional tax journals report on fresh and intricate schemes almost every week. Occasionally, a story about an especially ingenious gimmick lands on the front page of *The New York Times* or *The Wall Street Journal*. The story is the kiss of death for that scheme, but it doesn't matter to the promoters, who know that each of their deals has a limited shelf life.

When the IRS steps in, promoters move on to new schemes that much more quickly. The irony, then, is that government vigilance has a perverse fertilizing effect. As Martin Sullivan points out, "By legislating the obsolescence of existing tax shelters, Congress creates a market for new shelters."

Is massive corporate tax evasion simply a costly (and infuriating) fact of life? Perhaps, in part due to Congress. In 1997, the Senate Finance Committee held televised hearings on alleged tax abuses—but of taxpayers by the IRS. In dramatic testimony, disgruntled taxpayers (some wearing hoods to conceal their identities) complained about the agency's collection practices. To the delight of the Republicans who ran them, the hearings made headlines around the country—unlike later reports discrediting the allegations. Morale at the IRS plummeted, and enforcement proceedings against tax cheats dried up for a time.

In any case, it's impossible to draft tax laws without unintended results. And if shelters save corporations money, it's not surprising that they go for them—a point that some politicians make in defense of corporations. "The business of a corporation is . . . to maximize its earnings for its shareholders," says House Majority Leader Dick Arme, who holds a Ph.D. in economics. "Since tax is a very large part of their costs, anything they can do to minimize that share of their costs would be a legitimate thing. Obviously, they need to do what is legal, and we presume they are doing that."

Arme's last sentence—the emphasis is added—is an indictment, however unintended, of corporate tax lawyers. Congress can presume that corporations are following the tax laws only if their lawyers counsel them to stay safely within the bounds of the law. But they don't always do that.

Why are prominent lawyers in firms that once spurned such legal work now shielding sham shelters? It's the link between the economics and the ethics of lawyering that best explains the suspect shelters. Huge fees are an obvious motive. Just as important, lawyers don't like to say no to clients for fear of losing business to the eager firm down the street. When so many lawyers rake in huge fees and so many corporations get away with shady deductions, there's a strong temptation to accept tax shelters as business as usual. If everyone else is doing it and nobody is getting caught, why shouldn't you? But the problem is that the pressure on lawyers puts them at risk of violating basic ethical norms of their profession—the ones that say you can't misrepresent the law or file a false or misleading tax return.

Is there any way to stop the race to the bottom? Clinton officials tried threatening lawyers who promote tax shelters with fines and professional sanctions. The idea was to scare lawyers, or shame them. But so far, no one has been fined or sanctioned, so there's not much to be scared of.

A better hope may lie with an unlikely group: tax lawyers themselves. In 1999, the New York State Bar Association's tax committee urged the Treasury Department to stop waiving fines for shelters because lawyers write opinion letters blessing them. The idea is that if companies could no longer hide behind the letters, they'd be more interested in hearing their lawyers debate the real merits of a shelter's legality. The Clinton Treasury Department dropped the plan, but in March the Bush Administration revived it. The New York bar association lawyers "think of themselves as a pretty radical bunch," says Tanina Rostain, an ethics professor at New York Law School. "They're taking positions that their clients would not be happy with." ■

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