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Tax advisers feel heat of criminal indictments and the Supreme Court

The criminal prosecution of tax advisers, the Pasquantino case and a toughened Circular 230 have combined to force US tax advisers to change how they deliver tax advice.

Robert MacDonald and Vanessa Tollis of Gide Loyrette Nouel analyze the hazards

The year 2005 ushered in a new and troublesome—even dangerous—era for tax practice in the US. Several developments in the regulatory arena and in the courts have changed the landscape of tax practice for tax professionals and the clients they serve: the criminal indictment of a number of prominent tax professionals for their involvement in transactions that themselves have not been ruled improper by any court; a Supreme Court decision opening the door to criminal prosecutions of US tax advisers in US courts for their involvement with clients who evade foreign taxes; and the issuance by the Internal Revenue Service (IRS) of revised Circular 230 regulations under which substantial monetary penalties can be imposed on non-compliant tax advisers. In the past, only advisors with “aggressive” practices spent much time worrying about their personal risks. In the new era, the risks of even an ordinary tax practice can lead to muttering, fidgeting, and chain-smoking.

The KPMG indictments

In “the largest criminal tax case ever filed”, the US government has indicted 19 tax professionals for conspiracy to defraud the government, tax evasion, and obstruction of justice in a case arising out of questionable

tax shelters created and sold by KPMG and others to wealthy investors. All of the accused have pleaded not guilty. In addition to naming former partners of KPMG, the indictment also named a well known tax partner in a prominent law firm, accusing him of conspiring with the KPMG partners to defraud the government through the use of the tax shelter transactions and by creating false situations to support them, including preparing false documents. The shelters allegedly were marketed to individuals who needed a minimum of \$10 million to \$20 million in losses to shelter their income from US taxes. The shelters at issue, known as FLIP (foreign leveraged investment programme), OPIS (offshore portfolio investment strategy), BLIPS (bond linked issue premium structures), and SOS (short option strategies) allegedly were designed to generate tax losses with no corresponding economic losses to the taxpayers. KPMG and the law firms involved in the transactions issued opinion letters blessing them as legitimate investment ventures under the law.

At the same time that the individual indictments were announced, a federal judge approved a \$465 million settlement between KPMG and the Justice Department allowing KPMG to avoid a

criminal indictment as a firm, perhaps thus sparing it the fate of Arthur Andersen. As part of a deferred prosecution agreement that will remain in effect until December 31 2006, KPMG also agreed to admit wrongdoing, to accept an outside monitor, and to limit severely its tax practice. The agreement virtually assures that KPMG will be aligned with the government against its former partners and outside counsel.

The indictments seem to be a very public signal that the government will employ a new tactic in combating tax shelters: pursuing not just the taxpayers who use the shelters, but the advisers who create them and give them the colour of legitimacy. The agreement with KPMG also seems to signal the willingness, and perhaps a new strategy, of the government to forgo pursuit of the advisory firms at an institutional level in favour of pursuing the individuals who are personally involved in the activity. Neither signal will be welcomed by US tax advisers.

One surprising and disturbing aspect of the KPMG case is that thus far no court has ruled that the shelter transactions at the heart of the case are themselves improper. The defendants have moved for a dismissal on that ground, among others. The defendants also have claimed that the transactions at issue were fully and openly



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reviewed and approved at all levels as being in compliance with the tax laws not only by KPMG professionals but also by numerous prominent law firms who were representing the financing banks and by the investors, who themselves were sophisticated business people. It would be troubling indeed if the prosecutors obtained criminal convictions without a court ever determining whether the underlying strategies were illegal tax evasion. It would be almost as troubling if the defendants strike a plea bargain which the stakes may compel them to do—creating a potent *in terrorem* effect on practitioners, while leaving the legitimacy of the prosecution untested. Indeed, it is hard not to wonder whether the latter is not the outcome that the government expects. It is not obvious whether the context of a criminal prosecution favours the government or the taxpayer in testing the merits of the underlying tax positions.

Applying the complex web of US tax rules is a challenging endeavour requiring interpretive judgement calls. Legal positions in the tax world generally are not evidently either righteous or Satanic, and few taxpayers are anxious to pay more tax than the law requires. Thus, one might be concerned that the KPMG defendants may find themselves in jail effectively because they made the wrong analytical assessment, even though they never harboured the state of mind normally thought of as criminal intent. (The authors, of course, do not pretend to have any knowledge of the defendants' state of mind or any other facts of the case.) It is hard to imagine that this will not lead to higher levels, and unwarranted levels, of caution on the part of tax advisers. Indeed, it is easy to imagine that advisers in some cases simply will refuse to advise their clients on certain transactions rather than risk being caught up in a criminal prosecution, leaving the clients without legal advice.

Pasquantino v United States

The Supreme Court recently gave tax advisers another cause for anxiety with *Pasquantino v United States*, in which the

US federal wire fraud statute was applied to a scheme to defraud a foreign government of tax revenue. In *Pasquantino*, several US citizens smuggled liquor into Canada, thereby avoiding heavy Canadian excise taxes. The Court upheld a federal court's conviction of the defendants under the US federal wire fraud statute, which forbids schemes using the US wires or mails to obtain money or property illicitly. The Court first found that Canada's right to excise taxes constitutes a "property" interest for purposes of the wire fraud statute. The Court next dismissed petitioners' argument that the wire fraud statute was given "extra-territorial effect" on the basis that the object of the scheme was foreign property (that is, Canadian tax revenue). According to the Court, the wire fraud statute "punishes the scheme, not its success" and, thus, the convictions were based on the petitioners' use of domestic interstate wires, regardless of the foreign nature of the property right that had been compromised by the scheme.

In a surprising turn, however, the Court further held in its five-to-four majority opinion that prosecution under the wire fraud statute did not violate the "revenue rule", a long-standing common law principle generally thought of as prohibiting domestic courts from assisting in the collection of foreign tax liabilities. Resolving a split of authority in the lower courts, the Court found no violation of the revenue rule even though the end result of *Pasquantino* was that the US government would recover the Canadian excise taxes due and remit them to Canada, thus effectively enforcing the collection of a foreign tax obligation. The Court concluded that the revenue rule is not implicated when the government seeks to enforce a domestic law to punish domestic criminal conduct, which sounds like an unchallengeable proposition until one notes, as did Justice Ginsburg in dissent, that in this case it was only the violation of foreign revenue laws that made the conduct criminal.

When *Pasquantino* nightmares awaken

US tax advisers in wee hours, there is more involved than their deep concern for their clients' wellbeing. Their own hides are at risk. After *Pasquantino*, even routine international practice raises the spectre of US criminal prosecutions of US advisers.

It seems fair to say that most US tax advisers traditionally have taken the view (fortified by the revenue rule) that, while they will not support the evasion of US taxes, it was simply not their concern whether foreign governments were receiving the revenues to which those governments deemed themselves entitled. *Pasquantino* surely requires a re-examination of that view.

Parties to an international transaction in which a foreign tax is evaded apparently can be found guilty under the federal wire fraud statute if the parties intended the tax avoidance, US wires or mail were used in the scheme, and a misstatement or omission was part of the scheme. Foreign tax planning almost invariably involves using the wires or mail, and the misstatement or omission element could easily be fulfilled by the misrepresentation of, or failure to report, the tax owed. Thus, all that may protect a US advisor (aside from the admittedly low practical likelihood of federal (if not state) prosecution), is the element of intent.

While we shall leave to the criminal law experts the analysis of criminal intent in this context, a few points present themselves immediately.

- Does an adviser lack criminal intent if he simply follows the traditional "don't ask, don't tell" policy? Imagine that a foreign client instructs his advisers to structure an investment in such a way that no record of it will end up in the hands of his home country government unless the client voluntarily reports it on his tax home country return. The client is silent as to whether he does so, and ultimately he does not. Did the advisers have a criminal intent to defraud? Note that although *Pasquantino* involved excise taxes, nothing in the decision limits the Court's holding to such taxes. Thus, a



foreign income tax avoidance scheme could be prosecuted under the US federal wire fraud statute.

- Imagine a transaction that produces a tax shelter under the foreign law. The advisors in the transaction, even the non-tax lawyers, obviously intend for the transaction to take place. Do they have the requisite intent to defraud if they know only that the transaction is a "tax shelter" transaction?
- Does it matter whether the failure to satisfy the foreign government's revenue entitlement is actually a crime under the foreign law? Although one may presume from the *Pasquantino* opinion that in fact a crime had been committed under Canadian law, the Court's opinion does not depend on that. Under the Court's logic, the Canadian government's right to its customs revenue was a property right, of which the *Pasquantino* gang had deprived it by fraud, thus satisfying the requirements of the wire fraud statute without inquiry into whether a crime had been committed in Canada. Thus, *Pasquantino* apparently could lead to the rather peculiar result that a US tax adviser could be convicted of a crime in the US even though no crime was committed under the foreign law.

If *Pasquantino* is extended to more subtle cases, inevitably domestic courts will be faced with interpreting foreign law, a task problematic by its nature, and especially so for the tax law, which can be complex in foreign jurisdictions as well as in the US. US courts could find themselves in the position of deciding points of foreign tax law, which hardly seems like a sound policy. (In *Pasquantino*, the Court relied on a Canadian customs official to estimate the amount of Canadian taxes allegedly due on the smuggled liquor. While the fact and nature of the wrong to the Canadian fisc was not in doubt, the case demonstrates a somewhat unsatisfying approach to ascertaining foreign law.) If US courts are to be deciding issues of foreign tax law, US tax advisers will have to understand foreign tax law and how

domestic courts might interpret it.

While it is too early to say how *Pasquantino* will change the practices of US tax advisers, it seems likely that US tax advisers will take more advice from foreign tax counsel. They also may start seeking assurances from their clients that the clients will fully and accurately report their tax obligations in all relevant taxing jurisdictions. Whatever the course, stress levels will be rising.

Threat of criminal sanction

The daily practice of tax professionals in the US has at best become more complicated and, at worst, has now become fraught with the risk of criminal prosecution. While tax advisers don't fear the former, the latter is a different story. The KPMG indictments indicate that the government will make aggressive use of criminal prosecutions to chill aggressive tax planning, perhaps sending a few prominent tax advisers to free government housing in the process. The *Pasquantino* case has the potential to turn routine foreign tax planning advice into the basis for criminal prosecution, which will undoubtedly lead to more expensive tax planning as advisers must spend time on protecting themselves as well as their clients. The primary effect of Circular 230 on the typical tax practice has been to raise the cost of tax advice, but its threat of direct and meaningful sanctions against non-compliant practitioners adds to the stronger threat of the KPMG indictments and *Pasquantino* to make the world of US tax advisers markedly more stressful.

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Revised Circular 230

Circular 230 (Treasury Regulation section 10), which regulates the practice of tax professionals before the IRS, has been undergoing revisions since May 2000, driven by the combined efforts of Congress, the Department of Treasury and the IRS to thwart abusive tax shelters. The final result is a set of regulations that, while certainly addressing abusive tax shelters, in many cases will steeply increase the cost of tax advice to non-abusive taxpayers. In revised Circular 230, the Treasury promulgated detailed regulations about the form and content of the written advice that tax advisers provide their clients. These regulations divide written communications into five categories:

- "covered opinions" that meet Circular 230 standards;
- "covered opinions" that fail to meet such standards;
- "excluded advice";
- "other written advice"; and
- communications not concerning a federal tax issue.

For a US taxpayer to rely on an opinion from a US tax adviser and claim penalty relief due to such reliance, Circular 230 now requires the opinion to be a formal "covered opinion" meeting specified standards. Qualifying "covered opinions" are inherently time consuming and costly because Circular

230 generally requires the tax adviser preparing the opinion to make a factual investigation, write a fully "reasoned" analysis (as opposed to a conclusive opinion), and address all significant federal income tax issues arising from the transaction. Tax advisers are subject to censure, suspension, or disbarment should they provide written advice to a client that is not in compliance with Circular 230. US tax professionals seeking to avoid these new requirements - and to avoid passing the inherent costs on to their clients - are permitted under Circular 230 in some situations to include a disclaimer with their written advice, effectively preventing the taxpayer to whom the advice is addressed from claiming relief from tax penalties on the ground that he or she relied on the advice.

Unlike the KPMG indictments and the *Proskauer* decision, which stimulate reactions from frissons to shudders and which can leave tax advisers in a quandary about how to conduct their practices, Circular 230 has proven to be simply a drag, both psychologically and economically. The disclaimers have become ubiquitous in written communications from tax advisers, most noticeably in e-mail. Most clients ignore them in the same way they ignore all boilerplate, until their counsel tell that they should be getting a "covered opinion" - and how much they will have to pay for it.