A. The Ethics of Audit Avoidance.

I deal below in more detail with the criminal law context for the Government's claims. I think it helpful first to deal with audit avoidance in the practice of tax law. I said above that audit avoidance is routine in tax practice. In this section, I document that statement.

The issue of audit avoidance in tax practice was the subject of a remarkable series of articles on in the companion publications of Tax Notes and Tax Notes Today, perhaps the most widely read tax publication.[41] These articles, published in 2001, are by David Richardson ("Richardson"), tax professor at the University of Florida, and the late Frederick Corneel ("Corneel"), a tax practitioner in Boston who, prior to his death, was recognized widely as a leading commentator on ethics for tax professionals, particularly lawyers.[42] Richardson fired the first salvo by setting up Corneel's defense of audit avoidance in a particular setting as follows:

> Frederic G. Corneel, who received the ABA Tax Section's Distinguished Service Award at the Section's May 2000 meeting, is the author of "Guidelines to Tax Practice," 31 Tax Lawyer 551 (1978), and "Guidelines to Tax Practice Second," 43 Tax Lawyer 297 (1990). In "Guidelines to Tax Practice Second," Mr. Corneel includes "audit avoidance planning" within a tax lawyer's professional responsibility.[43] He describes such planning as assisting "the client in structuring a transaction and reporting it on the return in a way least likely to be subject to audit."

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[41] David M. Richardson, Audit Avoidance via Intent Modification -- Is Fred Corneel onto Something ... or Not, 92 Tax Notes 277 (2001); Frederic G. Corneel, Audit Avoidance: A Response to David Richardson, 92 Tax Notes 681 (2001); and David M. Richardson, Further Thoughts on Audit Avoidance Techniques, 92 Tax Notes 681 (July 30, 2001); see also a related article David M. Richardson, Statement of Standards of Tax Practice: Letter to a Former Student, 87 Tax Notes 1143 (May 22, 2000). I use the first two of these articles in the ethics unit of my Tax Procedure class at the University of Houston Law School.

[42] Professor Richardson, Corneel's protagonist in this friendly discussion, called Corneel "a prominent practitioner and icon of professionalism." David M. Richardson, Statement of Standards of Tax Practice: Letter to a Former Student, 87 Tax Notes 1143 (May 22, 2000) (although the reference in the article does not name Corneel specifically, the subsequent articles makes it absolutely clear who Professor Richardson was referring to).

[43] Those guidelines state: "It is appropriate to assist the client in structuring a transaction and reporting it on the return in the way least likely to be subject to audit, provided we do not mislead the Service."

He cautions, however, that lawyers should not "participate in transactions entirely lacking in economic substance and intended solely to conceal or mislead [the Service]."

One such audit avoidance plan was described by Mr. Corneel at meetings of the Standards of Tax Practice Committee of the ABA Tax Section held in January 1996 and January 2000. His comments, both of which were made during questions from the floor and after a panel presentation, were as follows.

> [W]e know that a gift tax return is much more likely to be audited if it says 10,000 shares of family stock than if it says $50,000 cash. And so if you have family stock which has not appreciated a lot and you want to transfer it to a member of the family one of the things you can do is you can give $50,000 to the transferee and have him buy the stock and report that on Schedule D and you can report the gift as a gift of cash and in that way reduce substantially the risk of an audit. Well whether I discuss that possibility with the client or not depends very much upon my view of where the client wants to come out. And I insist that if they do not want to go the sale way to reduce the chance of audit that they better get two appraisals and that the appraisals be in the range of what's reasonable and so on. And I would never make that suggestion to somebody where I'm clear he's going to be trying to skate on thin ice. And I don't think that the line between civil fraud and negligence, and so on, is so easily drawn and so I think that if we give advice that looks in the direction of avoiding audit, maybe that doesn't quite tie in with what you are discussing but it does have to do with the likelihood of audit, then I think we have to be more sure than we would be otherwise that the client's position is sustainable.

January 1996, New Orleans

> It strikes me [that the issue being discussed by the panel] is related to advising clients on how best to avoid an audit. My sense is there is nothing at all improper in giving advice on how to avoid an audit as long as you are satisfied that the basic position is a sound position or is at least a **reasonable basis**.[44] People may be told that if they make a gift of stock of a closely held corporation that it is

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[44] Tax Practitioners will recognize that the "reasonable basis" standard for assisting in audit avoidance with respect to the transaction is very low indeed – just some 20 to 25% likelihood of success. Burgess J.W. Raby and William L. Raby, <u>Painting the Accounting Practitioner Into a Tax Practice Corner</u>, 2005 TNT 178-4.

likely to raise an issue when it comes to an audit of the return -- may trigger an audit of the return. If, on the other hand, they were to make a sale against a note and then at some later time, the child comes into the money with which to pay the note or the note is cancelled and that is disclosed -- the audit may be avoided. I think that advice is alright if you make very sure that you have an appraisal, a sound appraisal that supports the sale. So it seems to me here that an audit is not a desirable thing and it is perfectly alright to tell people what the risk is and so on, but you must not do that in connection with a transaction that itself is improper.

January 2000, San Diego

Richardson uses Corneel's comments as a point of departure for an expanded drama whose cast includes various players in a hypothetical scenario. The following is my own adaptation of Richardson's drama:

A taxpayer desires that his daughter own 10% of his wholly-owned company. He believes the company is worth $10,000,000 because he recently received an offer in that amount from a third party willing to close the deal. He rejected the offer, but is confident that the valuation is right. He understands that the valuation could change over a short period, but at least for the time being it is a good value. So he expects to give the $1,000,000 in value in the company through the 10% stock interest. He is concerned about gift taxes because he and his wife have previously used their lifetime exemptions. So, he seeks help from his tax lawyer. The lawyer advises him first that the stock that he proposes to give is not worth $1,000,000 for gift tax purposes because a 10% stock interest is not worth 10% of the company; it might be worth 10% to a family member because of family control, but it is not worth that to a hypothetical unrelated third party in whose hands it would be a minority interest subject to the control of an unrelated party. The hypothesized unrelated third party would require a heavy discounts for minority interest and lack of marketability. The lawyer is unwilling to opine what an appropriate aggregate discount would be. The lawyer suggests that these discounts might reduce the "value" of the stock to the hypothetical buyer by as much as 40-45%. A professional opinion by a competent appraiser is advisable, but that is a likely range that the valuation might come out. (Tax lawyers recognize that this advice and planning is tax alchemy – the father can give his daughter something that is worth $1,000,000 and treat it for gift tax purposes as a gift of something significantly less.) Let's assume for a moment that the proper discounts aggregate in the 35-40% range, so the client picks the lower, 35% value, because he does not want surprises and, in all events, his family is getting a magical break with that much discount. He remembers the old saw that pigs get slaughtered. The lawyer cautions, however, that because of disclosures on a gift tax return, a gift tax return reporting a gift of closely held stock that has been highly discounted – even at a conservative high discount -- is at

a higher audit risk of audit than if just cash is given. The IRS often challenges valuation discounts and, even when such discounts are appropriate, the taxpayer may have to go to court to win and the costs and hassle of doing so may be unpleasant. The lawyer offers two alternatives – (i) give the daughter cash of $600,000 and let her buy the stock or (ii) sell the stock to the daughter for her note of $600,000 and thereafter "consider" making a gift to the daughter. The gift that need then be reported on a gift tax return is cash or a note (at the face value of the note), which will raise no audit red flags for the IRS. Practitioners will recognize that the bona fides of this planning requires that the two steps in either scenario not be interdependent,[45] but obviously from the client's perspective it achieves the goal of getting 10% of the stock to the daughter without having to lay out cash other than the gift tax at the discounted value and lowers the audit profile. This genre of tax planning is done often with, of course, the detailed facts adding substantial color to the propriety or impropriety of "separating" the steps. But, assume for a moment that, with the lawyer's guidance, the taxpayer is willing to separate the two steps for a period of time sufficient to, in the lawyer's judgment, give a reasonable shot at sustaining the result and, in all events, avoiding civil or criminal penalties.

Richardson's drama and my adaptation of it go substantially beyond Corneel's sparse setting. Richardson gives voice to the various players in the drama – lawyer, client, client wife and daughter (who happens to be a law student with a love-hate relationship with the way tax law is practiced). The client, client wife and daughter marvel at the alchemy of the large discount and the audit avoidance planning. Richardson then concludes his contrived drama by stating that there was too much connection between the two steps in either the cash gift or note gift scenario to permit the two steps to be separately recognized for return reporting purposes.[46] With that connection, the

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[45] E.g., (1) if the immediate cash gift is used, there should be some material time that elapses between the date of the gift and the purchase of the stock with there being some real risk that the value of the stock may change in the interim, or (2) if the note alternative is chosen, the daughter will have to be treated as a creditor to the father (e.g., pay interest, etc.) for at least a material amount of time before the father forgives the debt. In each case, the devil of uncertainty is in the concept of material. See the next footnote.

[46] For an extreme example where the Court recognized a fleeting break in the pre-wired links in the pre-ordained events, see Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001). Lee A. Sheppard, Getting Around the Substitute Payment Withholding Rules, 2007 TNT 186-5 ((Compaq held the shares "for only a few minutes"); Michael S. Knoll, Compaq Redux: Implicit Taxes and the Question of Pre-Tax Profit, 26 Va. Tax Rev. 821, 826 (2007) ("Compaq held the shares for only about one hour"). Depending on the deal, most planners desiring to avoid the IRS collapsing the links in the chain would put significantly more time than this in the break in the links; how much more becomes the key question for planners for a deal that, even with the break(s) in the links will be completed as planned. See, e.g., the Frank Lyon case where the Supreme Court imagined that perhaps the nominal bank tenant of the building would not exercise its right to purchase after its nominated "rent" payments effectively reduced the exercise price after the nominal

transaction in his drama does not meet the minimum standard in Corneel's Guidelines. Professor Richardson also expressed a broader concern that the staple tools such as these in the tax lawyer's bag of tricks may result in client intent modification where intent is the controlling consideration. But, besides imagining that there might be some disagreement with Corneel on the imagined facts (which Corneel had never opined upon), Professor Richardson expresses no disagreement whatever as to the propriety of audit avoidance planning and reporting provided the facts support it. He only states that, in the drama he presented, the facts were not sufficiently separated to support audit avoidance. In other words, Professor Richardson would have found willfulness to support a substantive tax crime.

Corneel responded, as he should have. Corneel, of course, noted that Richardson had changed the facts to create an imagined disagreement with Corneel. But, like Richardson, Corneel did not retreat from the propriety of audit avoidance planning and reporting.

In his Third Edition, of his Guidelines for Tax Practice, edited and published posthumously in 2003,[47] Corneel's editor omitted any express reference to audit avoidance planning and reporting. It is clear that those new Guidelines do not condemn the practice and assumes that the practitioner should consider and presumably implement some level of audit avoidance. In considering reporting transactions, the Guidelines state that the lawyer should ask: "What will be the impact of the form of reporting on the likelihood and nature of the audit?" Then, in reporting the transaction, the Guidelines note that the boundaries are framed by the client's desire to reduce tax where the proper tax treatment may be uncertain and avoid interest and penalties for failing to meet statutory requirements. It is fair to conclude that, within these parameters, reporting of uncertain tax transactions truthfully but in a way to avoid red-flagging the problem for the IRS is appropriate.

I think that the discussion between these careful and thoughtful commentators in the ethical context helps frame the discussion here in the criminal context. Can it be that taking lawful and non-deceptive steps to avoid an audit without more is criminal? Turning that question back to the ethical issue, how can such steps be ethical, as these commentators certainly agreed, if they are criminal? In this regard, although noting that, under particular facts, audit avoidance planning may cross the

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landlord, related party had gotten years of benefit from the depreciation paid for by the bank. In Frank Lyon, eleven years intervened and worked; in Compaq, a few minutes to less than an hour intervened and worked. Should anywhere in between work? Cf. Charles I. Kingson, How Tax Thinks, 37 Suffolk U. L. Rev. 1031, 1035 (2004) ("Tax shelters have been blamed on shoddy promoters, but few shelters are shoddier than those approved by the Court in Lyon and Brown [Commissioner v. Brown, 380 U.S. 563 (1965) (often referred to as Clay Brown)].") One could argue that Compaq surely gives Lyon and Brown a run for their money for the shoddiness crown. For the role of tacit understandings in business transactions to take out the risk of nominal breaks in links in a chain, see Alex Raskolnikov, The Cost of Norms: Tax Effects of Tacit Understandings, 74 U. Chi. L. Rev. 601 (2007).

[47] Frederic G. Corneel, Guidelines to Tax Practice, Third, 57 Tax Lawyer 181 (2003).

that it is criminal at all unless it does cross the line.[48]

[48] The authors do not once in their articles raise the specter of criminality from audit avoidance planning.