Tax Shelter Information and How the Confidentiality Rule Protects Clients: The Relevance of Recent Changes to ABA Model Rule of Professional Conduct 1.6

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I. INTRODUCTION

The underlying foundation of federal income taxation, namely a tax on individual or corporate income, motivates taxpayers to reduce taxable income and therefore reduce taxes. The progressive nature of the rate structure further aggravates this motivation because taxpayers strive for income

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income classifications in lower tax brackets.\(^2\) Taxpayers regularly make transactional decisions that are motivated, either in whole or in part, by the amount of tax savings achieved. Many of these activities are performed in a legitimate means of tax reduction, tax avoidance, or tax shelter schemes.\(^3\) From an Internal Revenue Service ("IRS") perspective, problems arise when these schemes are so significant that they effectuate an abuse on the system of taxation. Federal securities laws, IRS regulations, and American Bar Association ("ABA") rules have responded to these abusive tax shelter schemes by requiring certain disclosures, registrations, and listings. These reforms have also led to a variety of guidelines to determine which shelters are defined as abusive.\(^4\) The main parties subject to reforms are corporate or individual taxpayers, accountants, and attorneys. Tax lawyers involved in tax shelter schemes are in a peculiar position that arguably creates conflicts between some of these regulations and their duties to clients.

This article analyzes the conflict between the manner in which regulations impose an implicit duty upon lawyers to protect the integrity of the federal income tax system while the profession imposes duties upon lawyers to protect client interests and information.\(^5\) Conflicts arise when client interests are not aligned with the interests of the tax system, which is perhaps the norm rather than the exception. The legal profession operates in a self-regulated fashion by adopting Model Rules or Model Codes that outline the boundaries of lawyering.\(^6\)

Tax lawyers have historically argued that tax shelter information is protected under Rule 1.6 of the Model Rules of Professional Conduct,\(^7\) entitled "Confidentiality of Information." Nevertheless, the ABA House of Delegates debated the possibility of amending Rule 1.6 to include permissive disclosures for fraud that creates financial injury. During their Annual Meeting in August 2003, the House of Delegates decided to pass amendments to Rule 1.6 to broaden the scope of permissive disclosure for fraud.\(^8\) Arguably these changes were adopted to hold attorneys more accountable to

\(^2\) "A progressive income tax is one with rates that rise as income rises." WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAX 13 (13th ed. 2003).
\(^3\) See id. at 532.
\(^4\) See Rosow, supra note 1.
\(^7\) Model Rules of Professional Conduct used herein are as amended in 2003 from the 2001 version. Reference to the newly amended Model Rule 1.6 is an additional change in August 2003 to the published 2003 version of Model Rules.
third parties when clients engage in crimes or frauds that are likely to financially injure those third parties. The changes to Rule 1.6 mark a drastic shift in how tax lawyers' conflicting interests (tax system versus client) are weighed. The Rule effectively places a looming shadow over the paramount duty to protect client interests, thereby giving the tax system interests more weight.

The question now becomes whether or not the changes to Rule 1.6 will, in turn, create changes in how tax lawyers approach tax shelters and tax shelter clients. In short, the answer is no. Tax lawyers who create tax shelters will continue to use principles of confidentiality regardless of the changes because the possibility of a situation fitting within the narrow confines of Rule 1.6 is rare. This article will first outline tax shelter schemes and the problems that abusive tax shelters schemes pose to the system of taxation. Next, this article will discuss the anti-abuse rules and regulations that have developed in response to abusive tax shelters. The third section explores the depths of Model Rule 1.6 and how the Rule has been changed. Finally, the article will analyze the implications of Rule 1.6 for tax attorneys and conclude with suggestions for improvement.

II. TAX SHELTERS AND THE PROBLEMS WITH ABUSE

Tax shelters are generally understood to be transactions or activities that have significant tax benefits. According to ABA Formal Opinion 346 (revised), as tax shelter is:

an investment which has a significant feature for federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.9

Tax shelters are often grouped into three categories: deferral, conversion, and tax arbitrage.10 Shelters achieve deferral if current period income can be shifted into a future period, thus delaying the time period for which taxes are due.11 Deferral schemes might also be used for losses, allowing taxpayers to

10 See KLEIN ET AL., supra note 2, at 533.
11 See id.
offset years with high income to years with losses. Conversion shelters allow taxpayers to change income from one classification to another. This leads to changes in income tax rate structures. One commonly sought conversion tries to change ordinary income into capital gain income. Tax arbitrage results from transactions that create deductible expenses, which are paired against tax-favorable income. The aforementioned schemes can be used legitimately or can be used to abuse the tax system. Common parlance of tax shelters incorrectly assumes that all tax planning is abusive and therefore an illegal shelter. The guidelines that determine which tax shelters are abusive will be further discussed when this article explores anti-abuse measures.

A. Tax Shelter Packages

Tax lawyers may be asked to develop tax shelters, evaluate shelters, or issue tax opinions on the propriety of tax shelters. The latter task is the most common out of these three activities. Frequently, tax lawyers will be instrumental in both developing a shelter transaction and issuing a tax opinion on the tax shelter. In these cases, accounting firms and law firms work together to turn tax shelter schemes into a marketable product. Accounting firms and law firms have found a lucrative niche for their tax expertise: selling tax shelter packages to large corporations. Reading the Internal Revenue Code closely, these professionals arrange a variety of complex transactions that can generate gains or losses that create a favorable impact on reportable financial statements without falling in the realm of illegal dealings. Oftentimes accounting firms will create, market, and sell these tax schemes to companies without outside assistance from lawyers. Lately, however, accounting firms have developed joint ventures with law firms to create a packaged deal that includes an attorney's legal opinion that the shelter is viable. In this context, accountants and attorneys are often grouped together and classified as promoters or organizers.

The packaged tax scheme includes proposals, forecasts, and entity development by accounting firms accompanied by attorney assertion that the

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12 See id.
13 See id.
14 See id. at 546-47.
15 See Frederic G. Corneel, Guidelines to Tax Practice Third, 57 TAX LAW. 181, 183 (Fall 2003).
16 See id. at 192.
17 See KLEIN ET AL., supra note 2, at 546-47.
entire shelter has legal propriety. Tax shelters sold as a package ideally reap the highest monetary advantage for all parties involved. The corporations sculpt their financial statements into desired numbers, the accountants are paid for their expertise, and the attorneys are paid for their legal opinion. Naturally, packaged tax shelters sell at much higher premiums than simply selling a tax shelter scheme.

B. Contextual Backdrop

Before delving into the regulations on tax shelters and tax lawyers, it is helpful to set the stage with three vivid examples of current concerns. Recent events in the corporate community have spurred newsworthy stories about corporate crime and fraud. These stories have regularly been in the press because of the financial repercussions upon third parties, generally public investors. The Sarbanes-Oxley Act was largely a response to these cases in an effort to create more strict controls for the future. Two notable cases are the corporate bankruptcies of Enron and WorldCom.

Large corporations need some structure of legal guidance, advice, or counseling. Enron and WorldCom both had teams of legal professionals and accountants issuing guidance and counseling that eventually led to the corporate downfall. As such, the legal and accounting professions have responded to these debacles by instituting new rules, codes, and regulations through the American Institute of Certified Public Accountants, ABA, Securities and Exchange Commission (“SEC”), and IRS. Historically, attorneys have regulated themselves by enacting codes of conduct and ethical standards. The push for the August 2003 amendments to the ABA Model Rules is an effort to continue self-regulation before outside organizations such as the SEC start imposing more stringent regulations upon attorneys.

Although the Enron and WorldCom cases provide excellent examples of current corporate problems, the cases do little to shed light on tax shelters specifically. Therefore, the third case study unpacks the nuances of tax

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20 See Sheryl Stratton, Clients Sue E&Y and Two Law Firms over Tax Shelter, 2002 TAX NOTES TODAY 249-1 (Dec. 27, 2002).
21 For example, the Jenkens & Gilchrist tax shelter cost approximately $9-10 million. See id.
22 See id.; Eric Berger, Enron Creditor Says Lawyers Have Conflict; Milbank, Tweed Worked for Units Connected to the Firm, THE HOUSTON CHRONICLE, Mar. 21, 2002 at 4.
24 See Berger, supra note 22. See also In re WorldCom, No. 02 Civ. 3288, 2003 WL 21488087 (S.D.N.Y. June 25, 2003).
26 See RHODE & HAZARD, supra note 6, at 8-11.
shelter packages by looking at a packaging scheme used by the accounting firm Ernst & Young in conjunction with legal opinions by the law firm of Jenkens & Gilchrist. The following three cases outline the current issues debated by legislatures, the Service, and the ABA.

1. ENRON

Enron Corporation was engaged in insider trading, was heavily debt leveraged, and used risky derivative financing through special purpose entities. The vast majority of these transactions were reported "Off Balance Sheet." In other words, the transactions purportedly did not change the asset or debt levels of the parent company and allowed the financial statements to reflect large gains on the income statements and cash flow statements. The combination of these transactions led to Enron's ultimate bankruptcy and a large class action suit based on securities fraud. The law firm of Milbank, Tweed, Hadley & McCloy (hereinafter "Milbank Tweed") helped Enron structure some of these complex financial tactics that camouflaged the debt leverage and other controversial instruments since the law firm represented the large banks that were providing the financing. Milbank Tweed has met much opposition by the public due to the firm's potentially conflicting roles in the case: as a creditor, a defendant in the class action, and counsel to creditors committee.

Milbank Tweed first played the role of a creditor seeking money for legal fees from the bankruptcy estate. Milbank Tweed assisted Enron in developing these schemes prior to bankruptcy for steep legal fees. Some of these fees were paid to the law firm just before Enron made its bankruptcy filing. Under the Bankruptcy Code, money paid out to any party immediately before bankruptcy is subject to scrutiny by the bankruptcy trustee and could potentially be reverted back to bankruptcy estate if found to be preferential—preferential treatment immediately before bankruptcy can effectively eliminate money that would otherwise have gone to unsecured creditors. After hearing arguments that Milbank Tweed benefited from preferential treatment, a court ordered Milbank Tweed to repay those legal fees.

28 See id.
29 See id.
30 See Berger, supra note 22.
31 See id.
32 See id.
fees to the trustee in bankruptcy.\textsuperscript{35} This left Milbank Tweed as a general creditor subject to the limitations of the bankruptcy estate and constrained by other creditors that have priority.

A second role played by Milbank Tweed was that of a defendant to the class action against Enron by shareholders.\textsuperscript{36} Milbank Tweed arguably enabled Enron to perpetuate a scheme against its shareholders to hide heavy debt-leveraged financing.\textsuperscript{37} As a defendant in the shareholder derivative suit, Milbank Tweed was arguably \textit{materially limited} from effectively serving its multiple roles in the case.\textsuperscript{38} Milbank Tweed was further entrenched in this direct conflict since the firm also worked with the banks that enabled Enron to become so debt leveraged.\textsuperscript{39}

Thirdly, Milbank Tweed actively sought to play the role of counsel to the creditors committee.\textsuperscript{40} As counsel, Milbank Tweed possessed a fiduciary duty to the creditors to ensure each creditor received the greatest amount of return possible. Unsurprisingly, this role is the most controversial since a number of conflicts can arise from the other positions Milbank Tweed plays. After a challenge for disqualification, a judge ruled that Milbank Tweed made enough disclosures and firewalls to maintain the firm's distance from conflicts of interest.\textsuperscript{41} The test for disqualification of creditors' committee counsel is "disinterestedness" and showing a lack of conflicts of interest can rebut this test.\textsuperscript{42}

Interestingly, the amendments to Model Rule 1.6 regarding permissive disclosure were passed in response to this kind of conflict of interest situations.\textsuperscript{43} The basic idea is that the Enron bankruptcy could have been prevented if attorneys had been capable of disclosing information.\textsuperscript{44} However, there is another underlying societal interest in holding parties responsible for tragedies like Enron. Society recognizes that the Enron bankruptcy has

\textsuperscript{35} Milbank Pays Out to Enron Debtors, THE LAWYER, March 17, 2003 at 3.
\textsuperscript{38} See MODEL RULES OF PROF'L CONDUCT R. 1.7(a)(2) (2003).
\textsuperscript{39} Braverman, supra note 36.
\textsuperscript{40} See N.Y. Judge Finds Milbank Disclosed Enough To Represent Creditors Committee, 12 No. 8 ANDREWS' PROF'L LIABILITY LITIG. REP. 3 (Feb. 2003).
\textsuperscript{41} See id. (citing \textit{In re Enron Corp.}, No. 02-5638 (S.D.N.Y. Jan. 28, 2003)).
\textsuperscript{43} See ABA Task Force on Corporate Responsibility, Report 119A (March 31, 2003).
\textsuperscript{44} See id.
properly held corporate officers and company auditors responsible, but has left the attorneys virtually untouched (with the possible exception of Vincent & Elkins). Arguably, the August amendments to Model Rule 1.6 would have imposed a duty upon Milbank Tweed to disclose information about the financial schemes before they were even perpetrated—placing more responsibility on Milbank Tweed to abate similar situations.

2. **WorldCom**

Another great example of corporate fraud is WorldCom, Inc.'s stock fraud case. Since the accounting firm of Arthur Anderson, LLP was a key player in both Enron and WorldCom, analyzing the WorldCom case will help understand auditor liability and responsibilities.

Arthur Anderson audited and perhaps enabled WorldCom to hide over $3.8 billion from investors. It was Arthur Anderson’s responsibility to ensure the audit report was signed and to certify that the financial statements correctly reflected the company’s financial position. There are no mechanisms within the field of accounting that serve to protect auditors from third parties who rely upon the audit report because the purpose of the report is to make such assurances. Additionally, there is nothing to prevent investigators from searching auditor documents. Thus, auditors are in the unenvied position of being held responsible by third parties without being able to find any protection in concepts such as confidentiality or privilege.

On June 25, 2003 the Southern District of New York ruled on several motions to dismiss in the WorldCom lawsuit, including one for Arthur Anderson. All of the motions to dismiss were granted except Arthur Anderson’s motion. The court found that Arthur Anderson possessed the requisite scienter for securities fraud because the firm had unlimited access to records, and because the firm had an understanding of the financial significance of such questionable treatment of acquisitions. Therefore, much of the blame fell upon the auditor’s shoulders.

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50 See id.
51 See id.
So, why does Arthur Anderson suffer such drastic penalties while law firms such as Milbank Tweed are barely implicated? The brunt of the answer lies in the acceptance of attorney-client privilege and the concept of confidentiality. Lawyers' roles as counselors, advocates, and advisors require open communication lines between lawyers and their clients. In essence, the reliance upon attorney-client privilege is grounded upon the concept that clients will be more frank and candid with their attorneys if there is some semblance of a guarantee that the information will remain confidential.\(^{52}\) This rule is effectively embodied in Model Rule 1.6. Additionally, attorneys are shielded to a certain extent for their documents that satisfy the work-product doctrine.\(^{53}\)

The work product doctrine allows lawyers to protect documents prepared in anticipation of litigation from discovery.\(^{54}\) Accountants are traditionally not afforded the same privilege. Even an accountant's workpapers (which are quite analogous to attorney work product) are not protected under the work product doctrine.\(^{55}\) The rationale is based on the lawyer's roles to advise and advocate versus the accountant's role to protect the public.

Perhaps the determinative factor in locating blame is how we define responsibilities for accountants as opposed to attorneys. Accountants who serve as auditors are predominately responsible to the third party investors who rely upon the audit report as an assurance that the company is financially stable. Attorneys, on the other hand, are responsible to their clients, third parties, the court, and the system of justice.\(^{56}\) Hence, attorneys can shield themselves from scrutiny by invoking the attorney-client privilege if they find their responsibilities to their clients outweigh any other responsibilities they may have to third parties, the court, or the system of justice. The fact that Model Rule 1.6 allows attorneys to make this decision (rather than third parties) is controversial because attorneys might always choose nondisclosure. There are, however, cases that show permissive disclosure is based upon a reasonableness standard, and that an attorney should have disclosed.\(^{57}\)

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\(^{54}\) See Hickman v. Taylor, 329 U.S. 495 (1947) (allowing attorneys to retain a level of confidentiality for their work product).

\(^{55}\) See Arthur Young & Co., 465 U.S. at 805.

\(^{56}\) See Rhode & Hazard, supra note 6, at 41-46.

\(^{57}\) See McClure v. Thompson, 323 F.3d 1233 (9th Cir. 2003).
3. JENKENS & GILCRIST

At the end of 2002, four individuals who used a tax shelter package created by Ernst & Young sued the accounting firm and two other law firms that marketed the shelter.\(^{58}\) The law firms engaged in the transaction were Jenkens & Gilchrist and Sidley Austin Brown & Wood ("Sidley Austin").\(^{59}\) Basically, the four individuals founded a computer distributorship company that had a taxable capital gain of $70 million in 1999.\(^{60}\) The accounting firm Ernst & Young, in conjunction with law firms Jenkens & Gilchrist and Sidley Austin, developed a tax shelter designed to create a large, reportable financial loss to offset the capital gain. The strategy is called a Currency Options Bring Reward Alternatives ("COBRA") scheme.\(^{61}\) The COBRA, under these particularized facts, allowed the main company’s individual owners to set up a series of six pass-through entities that used the variable changes in selling short options on the foreign currency market to generate a large loss that was then converted back to the main company to increase its basis.\(^{62}\) The tax shelter here was a typical packaged deal whereby the accounting firm devised the plan and both of the law firms affirmed its propriety. The attorneys asserted that the COBRA scheme fell outside of the general definition of a tax shelter for reporting purposes and thus was properly not registered.\(^{63}\)

To get a sense of the value of tax packages, the accounting and legal fees paid by these four individuals are worth noting. First, before being told about the mechanics behind their COBRA scheme, the individuals were required to pay $1,056,000 (nonrefundable) to Ernst & Young and sign a nondisclosure agreement.\(^{64}\) Once using the COBRA scheme, the individuals paid another $315,000 to the accountants and lawyers based on a percentage of the COBRA benefit.\(^{65}\) Additionally, Sidley Austin charged separate fees of $75,000 for two legal opinion letters.\(^{66}\) So far, the total of nearly $1.5 million is essentially only for the tax shelter. In addition to this $1.5 million, the individuals each paid Jenkens & Gilchrist $2,012,000 for

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\(^{58}\) See Stratton, supra note 20.

\(^{59}\) See id.

\(^{60}\) See id.

\(^{61}\) See id.

\(^{62}\) See id.

\(^{63}\) See id.

\(^{64}\) See id.

\(^{65}\) See id.

\(^{66}\) See id.
legal opinions that verify the propriety of the tax shelter. The total expenditure was approximately $9.5 million.

After following the tax shelter package as directed, the four individuals later found themselves the subject of an audit. Internal Revenue Notice 99-59 disallows tax shelters that are exclusively used to generate losses. The plaintiffs contended that the COBRA used was precisely what the 1999 notice disallowed, and that the accountants and lawyers had knowledge of this fact. Arguably, this 1999 notice was too general and vague to be directly related to the complex COBRA scheme. The greater part of the tax shelter scheming was accomplished before the end of April 2000. In September 2000, the IRS issued another notice (2000-44), which more closely resembled the COBRA scheme, and disallowed it. Once this new notice was published, however, the law firms did nothing to change their opinions or modify the tax shelter.

John Doe Summonses had been issued upon Ernst & Young, Jenkens & Gilchrist, and Sidley Austin. Of particular interest are the summons issued to the law firms since the accounting firms have already agreed to comply and have historically been compelled to comply. The John Doe Summonses issued to Jenkens & Gilchrist sought a full listing of clients who had been advised to use the COBRA scheme. The law firm asserted the attorney-client privilege and presented it as "one of the most respected and important principles in our nation's legal system." The theory suggests that the names of clients constitute legal information that is confidential.

Although this article explores the arguments regarding confidentiality in the context of John Doe Summonses, a constitutional law question bears mentioning. In the last few months the Supreme Court of the United States has decided to hear Hiibel v. 6th Judicial District Court of Nevada. The main issue is whether, within the Fourth Amendment right of privacy, an individual has a right to refuse identification of himself or herself. Since John Doe Summonses essentially request identification of individuals, the outcome of Hiibel may weigh heavily on how courts will treat John Doe Summonses in the future.

67 See id.  
68 See id.  
69 See id.  
70 See id.  
72 59 P.3d 1201 (Nev. 2002).
III. ANTI-ABUSE MEASURES

The tax lawyers’ rules of practice generally fall under three broad categories; namely, federal securities laws, IRS regulations, and ABA standards. A fourth category not addressed in this article is court decisions. Tax shelter abuse problems have led to varying degrees of anti-abuse legislation and regulation throughout the last thirty years. The pivotal Tax Reform Act of 1976 started a generation of abuse-conscious reforms. This approach continued through the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1986. While scholars debate whether the Tax Reform Act of 1986 marked the end of the era for individual tax shelters, the act was indisputably a high-water-mark for intolerance of abuses.

A. Federal Securities Laws

In 2002 Congress passed the Sarbanes-Oxley Act ("Act") in response to securities violations that were largely unmonitored or unenforced. The Act focuses upon responsibilities of corporate executives, accountants or auditors, and attorneys to report securities fraud and enhance disclosures in financial reports. In addition, the Act imposes stricter sanctions upon companies and their accountants.

Corporate officers, accountants, and attorneys of publicly traded companies have a variety of heightened requirements under the Act. Corporate officers are held fully responsible for the information on the financial statements. This includes assertions that the officers have reviewed the reports and implemented effective internal controls. The financial statements must also accurately reflect the corporate officers’ actual knowledge of the company’s financial condition. Financial statements are required to be prepared according to generally accepted accounting principles and must include full and proper disclosures of all material information. The auditors must comply with strict adherence to independence, both actual and

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75 See id.
76 See KLEIN ET AL., supra note 2, at 5-6.
78 Id.
79 See id. at §§ 401-403.
implied. If auditors wish to engage in other services to the company, such as tax or bookkeeping, the accounting firm must first register and acquire pre-approval for such services. In the event of corporate oversight, fraud, crime, or white-collar crime, the officers and auditors face risks of criminal penalties and securities violations.

The Act focuses on corporate officers and auditors much more than attorneys. Attorneys are required to report SEC violations to the highest corporate officer in the company. This standard is consistent with the Model Rules of Professional Conduct, which require attorneys to report up the ladder within the company. If the attorney or corporate officer determines that the problem is persisting, the attorney may report to the audit committee or board of directors.

B. Internal Revenue Service Regulations

IRS Treasury Circular 230 § 10.33 controls the scope of factual inquiries and identification of material issues that attorneys must explore regarding tax shelters. In general, the attorney must fairly recognize any areas that would be challenged by the IRS and make basic conclusions on how the tax shelter will withstand the challenge.

Many tax shelters must be registered once the accounting firms or law firms begin marketing the shelters according to Section 6111(d) of the Internal Revenue Code ("I.R.C.") (as enacted by the Taxpayer Relief Act of 1997). These registration requirements apply to tax shelters that produce large amounts of deductions or credits. The main prong in determining whether a tax shelter should be registered is whether the shelter has a significant tax avoidance purpose. Additionally, tax shelters may be subject to disclosure if they are of a certain type or create certain tax effects.

80 See id. at § 201(a).
81 See id. at § 201.
82 See id. at §§ 802-803, 903-904.
83 See id. at § 307.
84 See generally MODEL RULES OF PROF'L CONDUCT R. 1.13(b)-(c) (Aug. 2003) (directing attorneys to first find higher authority within an organization before revealing information).
87 See id.
89 See id.
90 See id. at 441.
91 See id. at 470-77.
tion includes a complete description of the tax shelter and its effects as well as a list of participants. 92 Those transactions that do not fall within the requirements for registration may still be subject to investor list regulations. Investor lists identify clients that have been sold tax shelters that could be potentially abusive even though these shelters are not required to be registered. 93 Generally, the IRS can request these lists without a summons unless the attorney can prove an attorney-client privilege exists or that confidential information cannot be disclosed. 94

C. American Bar Association Reforms

The ABA regulates tax lawyers by promulgating formal opinions and by adopting Model Rules or Model Codes that establish ethical behaviors. ABA Formal Opinion No. 352 (1985) discusses when tax lawyers can take a position on the “realistic possibility of success if the matter is litigated” for tax issues. 95 Formal Opinion 85-352 also requires tax lawyers to make these decisions in good faith. Since Formal Opinion 85-352 does not specify the authorities lawyers are permitted to rely upon, the 1987 ABA Tax Section Comments, I.R.C. § 6661, the Revenue Reconciliation Act of 1989, and later I.R.C. § 6662 developed the types of authorities permitted. 96

Another important ABA Formal Opinion (346) was issued and then revised in 1982, which is entitled “Tax Law Opinions in Tax Shelter Investment Offerings.” 97 This Formal Opinion speaks directly to the most common tax lawyer duty in the context of tax shelters: legal opinion letters. Once an attorney is sought to issue an opinion on the tax shelter, ABA Formal Opinion 346 (Revised) controls the level of diligence the attorney must meet. 98 As a general matter, attorneys who draft opinion letters for tax matters must have a clear understanding of all of the relevant tax information with few assumptions. 99 Formal Opinion 346 (Revised) outlines the tax lawyers’ responsibilities such as full disclosures with clients, technical inquiries of relevant facts, taking reasonable steps in assuring material

92 See id. at 456-57.
93 See id. at 459.
96 See Salch, supra note 74.
information is considered, and separating the differing material tax issues if differing outcomes result for each.\textsuperscript{100}

The ABA has also begun reformation efforts on the Model Rules or Model Code of Professional Conduct. That is the focus of this article and the Model Rules are described more thoroughly in the next sections.

\section*{IV. AMERICAN BAR ASSOCIATION MODEL RULE 1.6}

The ABA's Model Rules of Professional Conduct must first pass through the House of Delegates before being recommended to the states for adoption.\textsuperscript{101} As such, many states have Model Rules that vary slightly from each other because each state may choose the extent it desires to follow the rules passed by the House. Additionally, states may choose to adopt the Rules with significant amendments. Historically, lawyers are self-regulated by individual states rather than by some overarching federal authority or numerous local authorities.\textsuperscript{102}

\subsection*{A. Historical Background}

In 1887 the first formal code of ethics was adopted in Alabama.\textsuperscript{103} The profession saw a need to regulate itself to maintain integrity and uphold the moral tone of the times. The ABA adopted the Canons of Professional Ethics in 1908, and many states followed the trend.\textsuperscript{104} The Canons were concise statements that provided ethical guidelines for lawyers to follow. There were 47 Canons by the 1930s.\textsuperscript{105} The Canons remained dominant in the states until the early 1970s when criticisms regarding vagueness overwhelmed the industry and reforms were sought.

The ABA appointed a committee in 1964 to examine the Canons and rework the language towards more specificity.\textsuperscript{106} The result was the Model Code of Professional Responsibility, which was adopted by the ABA in 1969.\textsuperscript{107} Into the 1970s, the Model Code became the law of the land and a dominant feature in legal practice regulation. The vision of a lawyer under

\begin{thebibliography}{99}
\bibitem{100} See R.J. Ruble, \textit{The Professional Responsibilities of a Tax Lawyer in the Context of Corporate Tax Shelters}, 571 P.L/I/TAX 1039, 1048-49 (2003).
\bibitem{101} See HAZARD, KONIAK & CRAMTON, \textit{supra} note 52, at 15.
\bibitem{102} See RHODE & HAZARD, \textit{supra} note 6, at 2.
\bibitem{103} See HAZARD, KONIAK & CRAMTON, \textit{supra} note 52, at 13.
\bibitem{104} See id.
\bibitem{105} See id.
\bibitem{106} See id.
\bibitem{107} See id. at 13-14.
\end{thebibliography}
the Model Code stresses courtroom advocacy, equality in the justice system, and a watchful judge. These notions became outdated quickly because attorneys regarded the practice of law as many other things outside the courtroom.

In 1977 the Kutak Commission was created to evaluate the Model Code and update the language to include a more modern conception of the role of lawyers. The Kutak Commission decided that the Code was unworkable and set out to create a new set of guidelines altogether. The ABA adopted the Model Rules of Professional Conduct in 1983. At this time, the ABA gave a recommendation to the states that they should replace their current Model Codes with Model Rules. Currently, 41 states and the District of Columbia have adopted the Model Rules.

The Ethics 2000 Commission was created in 1998 to consider further revisions to the Model Rules in order to update the Rules. The revisions pertain directly to Model Rule 1.6 and have recently been adopted by the House of Delegates. Model Rule 1.6 is discussed in greater detail in the next sections.

B. Recent Changes

Model Rule 1.6 subpart (a) asserts that, "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent." This section, unlike the other parts of Rule 1.6, has not been changed, and is generally understood to limit the attorney's disclosure to the extent that the client permits. That is, if the client permits disclosure of certain pieces of information or disclosure to specific people, then the attorney is allowed to make those limited disclosures. This is the general rule that applies in the absence of any exception. Model Rule 1.0(e) defines informed consent as "the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct."

Model Rule 1.6 subpart (b)(1) states that "[a] lawyer may reveal information relating to the representation of a client to the extent the lawyer

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108 See id. at 14.
109 See HAZARD, KONIAK & CRAMTON, supra note 52, at 15.
110 See id.
111 Id. at 16.
112 MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2003).
113 See HAZARD, KONIAK & CRAMTON, supra note 52, at 270.
114 MODEL RULES OF PROF'L CONDUCT R. 1.0(e) (2003).
reasonably believes necessary . . . to prevent reasonably certain death or sub-
stantial bodily harm." This section is a permissive exception to the general
rule that attorneys shall not disclose information. These two sections
remain largely intact and have significant amounts of caselaw that support
their propriety in the courts.

The House of Delegates hotly debated adding subparts (2) and (3) to
Model Rule 1.6(b). The published 2003 Version of the Model Rules omits
subparts (2) and (3) because of the repeated attacks from critics saying they
would create a radical change that undermines confidentiality and candid
communication between lawyer and client.

Model Rule 1.6(b)(2) reads:

[a] lawyer may reveal information . . . to the extent the lawyer rea-
sonably believes necessary . . . to prevent the client from committing
a crime or fraud that is reasonably certain to result in substantial
injury to the financial interests or property of another and in
furtherance of which the client has used or is using the lawyer's
services.

This amendment follows the same spirit of confidentiality that most
courts have upheld in the past regarding prevention of a crime or fraud
when considering a potential future injury. This disclosure is permissive
in nature because it is based on the attorney's analysis of what is reasonably
necessary and what may cause a substantial injury. The groundbreaking
change in this rule is the inclusion of financial interests or property. Historically,
permissive disclosure has only been reserved for situations where people are
in physical danger.

Although Model Rule 1.6(b)(2), as amended, is important because the
rule includes financial interests or property rather than limiting the rule to
physical injuries, the amendments to Model Rule 1.6(b)(3) are more drastic.
Model Rule 1.6(b)(3) states as follows:

[a] lawyer may reveal information . . . to the extent the lawyer rea-
sonably believes necessary . . . to prevent, mitigate or rectify

115 Id. at R. 1.6(b)(1).
116 See HAZARD, KONIAK & CRAMTON, supra note 52, at 312.
117 See Monroe H. Freedman, Lawyer-Client Confidence: The Model Rules' Radical Assault on the
118 MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(2) (Aug. 2003).
119 See HAZARD, KONIAK & CRAMTON, supra note 52, at 288.
120 See, e.g., People v. Fentress, 425 N.Y.S.2d 485 (County Ct. 1980).
substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client’s commission of a crime or fraud in furtherance of which the client has used the lawyer’s services.\textsuperscript{121}

This amendment is a phenomenal step in two main respects: (1) the amendment includes the above-mentioned new injury for financial interests and property; and (2) the amendment is much more controversial than Model Rule 1.6(b)(2) because the amendment can apply to past crimes and past injuries (rather than future crimes). This is important because the amendments allow attorneys the ability to disclose information not only as a prevention mechanism, but also as a tool to mitigate and rectify any injuries.\textsuperscript{122}

V. CONCLUSIONS OF HOW MODEL RULE 1.6 IMPACTS ABUSIVE TAX SHELTERS

If the tax shelter does not fit within the confines of registration or within investor listing regulations, the IRS may determine that a tax shelter is in fact illegal. The IRS may then issue a John Doe Summons to expose a listing of clients who are using the tax shelter. In the past, accounting firms complied with the John Doe Summons, and as a result, there was a ripple effect through all of the clients using the tax shelter. Law firms have been opposed to the John Doe Summons because the summons calls into question the firm’s duty of confidentiality to its clients. The fear is that compliance with a John Doe Summons, whereby law firms expose client listings of all participants in a tax scheme, will undermine client confidence, integrity, and candor.\textsuperscript{123} The new amendments to Model Rule 1.6 appear to create such disclosure and openness of client information, especially for tax shelter clients.

A. Analysis of Subpart (b)(2)

This section of the Rule focuses upon the point in time when a firm such as Jenkens & Gilchrist is on the verge of effectuating the tax shelter for a company because of the Rule’s introductory to prevent language.\textsuperscript{124} This subpart focuses on prevention, which indicates that it would affect Jenkens & Gilchrist during a planning stage before the shelter had actually begun. On

\textsuperscript{121} MODEL RULES OF PROF’L CONDUCT R. 1.6(b)(3) (Aug. 2003).
\textsuperscript{122} See id.
\textsuperscript{123} Cf. HAZARD, KONIAK & CRAMTON, supra note 52, at 270-71.
\textsuperscript{124} MODEL RULES OF PROF’L CONDUCT R. 1.6(b)(2) (Aug. 2003).
its face, the Rule seems to indicate that the firm should reveal information regarding the tax shelter to the extent that the firm can prevent harm to third parties—to "prevent the client from committing a crime." However, this Rule assumes that the disclosure of information by the attorney will stop the client from engaging in the crime in the first instance. This is an inherent contradiction because the attorneys are self-interested in closing the tax shelter deal, but are now constrained to prevent that very tax shelter if it is "reasonably certain to result in substantial injury to the financial interests of another."

In any case, the nature of the tax shelter sale places the attorney within the purview of the Rule because the tax shelter sale is within the "further-ance of which the client . . . is using the lawyer's services." Therefore, at first blush the new amendment to Model Rule 1.6(b)(2) would require an attorney to place third party interests above and beyond both personal and client interests. But who are the third parties with financial interests? Arguably, the third party is the IRS because the tax shelters are minimizing the amount of income the IRS will receive from that particular taxpayer. Another potential third party is any other taxpayer (be it corporate or individual) that has transactions with the company based on the tax shelter scheme. If these third parties are included, however, then there will often be harm to their financial interests because the company using the tax shelter is operating in a capital market where it hopes to maximize its own profits, not the profits of others.

Additionally, the Rule is created to prevent crimes or frauds. Therefore, the lawyer must know that the shelter will either be a crime against securities laws or other regulatory laws, or that the shelter will be a fraud. Model Rule 1.0(f) describes knowledge as "actual knowledge of the fact in question." Furthermore, Model Rule 1.0(f) states that "[a] person's knowledge may be inferred from the circumstances." This creates a difficult position for the tax lawyer because crime or fraud knowledge will likely be inferred to them in any case because of their unique expertise with tax laws. Therefore, since knowledge can be implied, the tax lawyer must be very cautious about which tax opinions are written for which tax shelters.

125 Id.
126 Id.
127 Id.
128 See id.
129 See KLEIN ET AL., supra note 2, at 548-49.
130 MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(2) (Aug. 2003).
131 MODEL RULES OF PROF'L CONDUCT R. 1.0(f) (2003).
132 Id.
Technically speaking, the amendment drastically changes the face of tax lawyer practice because a lawyer will be expected to disclose a larger variety of transactions in an effort to prevent financial injuries to other parties.133 Realistically speaking, the amendment does little to advance idealistic disclosure. Weighing of interests is still left largely to the attorney, and the all-important beginning of subpart (b) merely allows attorneys to reveal in the language that states, "[a] lawyer may reveal."134 The Rule’s permissive nature allows attorneys the opportunity to be persuaded by their own biases regarding personal interests and responsibilities to clients. Tax lawyers, however, should not feel comforted by this permissiveness. In the past, some Courts, interpreting may language through a reasonable belief standard, have required lawyers to disclose in certain instances.135

B. Analysis of Subpart (b)(3)

This amended section applies to circumstances whereby the crime or fraud by the client has already been committed as noted in the language found in Model Rule 1.6(b)(3)—"from the client’s commission of a crime or fraud."136 Historically, past crimes committed by clients are protected for attorney-client privilege reasons because of the role the attorney must play with respect to the past crime once the client decides to seek legal assistance.137 This situation is duly appreciated and remains intact according to Official Comment 8 to Model Rule 1.6 that states, “[p]aragraph (b)(3) does not apply when a person who has committed a crime or fraud thereafter employs a lawyer for representation concerning that offense.”138

Here, the amendment was driven by the potential for (or actual result of) financial or property injury. The rule assumes that an attorney’s reasonable disclosure will operate to prevent, mitigate, or rectify the harm (present or future).139 This goal of prevention or mitigation might not always be properly aligned with the remedy of disclosure. For instance, earlier this year TV Azteca’s lawyers were abiding by the disclosure requirements of the SEC and Sarbanes-Oxley in an effort to help the company and its investors. As a direct result of the disclosure, TV Azteca’s stock fell 14.9% and its B-plus

134 MODEL RULES OF PROF’L CONDUCT R. 1.6(b) (Aug. 2003) (emphasis supplied).
135 See McClure v. Thompson, 323 F.3d 1233 (9th Cir. 2003); Lucas v. State, 572 S.E.2d 274 (S.C. 2002).
137 See HAZARD, KONIAK & CRAMTON, supra note 52, at 205-9.
138 MODEL RULES OF PROF’L CONDUCT R. 1.6 (Aug. 2003), cmt. 8.
139 See id. at R. 1.6(b)(3).
credit rating fell drastically.\textsuperscript{140} Although there was an eventual rally by TV Azteca's stock, the situation is a good illustration of how disclosures can be harmful to the company and investors rather than helpful.

Perhaps subpart (b)(3) is easier to apply than part (b)(2) because the attorneys are aware that a crime or fraud has occurred—or that the tax shelter is a crime or fraud—and therefore need to govern themselves accordingly.\textsuperscript{141} This \textit{crime} section is intellectually conflicting because the client must be using the attorney's services in furtherance of the crime, while at the same time an attorney has a duty under the Model Rules to never use legal practice to commit crimes.\textsuperscript{142}

As similarly noted for the amendment to Model Rule 1.6(b)(2), the amendment to Model Rule 1.6(b)(3) could create a requirement upon tax lawyers to disclose otherwise confidential client information. The driving question becomes: which financial interests are material enough, so that the tax lawyer must shift from his traditional duties to the client, and regard a duty to third parties as more important? Also, whether or not disclosure would actually mitigate or rectify the situation matters greatly.\textsuperscript{143} In other words, the disclosure is contingent upon the lawyers' belief that revealing the information will prevent, mitigate or rectify the damage or potential damage; therefore, disclosure that does not (or is not reasonably expected to) create any of these results will not be required.

C. \textit{Other Rules to Consider}

The added Official Comments to the amended parts of Model Rule 1.6 also correctly refer the lawyer to other Model Rules that can and do apply. The most troubling cross-referenced Rule is Model Rule 1.2(d).\textsuperscript{144} If we can assume that Model Rule 1.2(d) is working effectively, then the Rule completely eliminates both amended subparts to Model Rule 1.6. Model Rule 1.2(d) prohibits lawyers from counseling or assisting clients in crimes and frauds, which means that those lawyers who find the need to disclose under Rule 1.6 will also discover that they have violated Rule 1.2(d).\textsuperscript{145}


\textsuperscript{141} See MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(3) (Aug. 2003).

\textsuperscript{142} See MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2003).

\textsuperscript{143} See TV Azteca May Face Downgrade in Probes, supra note 140. See also \textit{The Law Firm of Laksy & Rifkind, Ltd. Announces Class Action Lawsuit Against TV Azteca S.A. de C.V.}, supra note 140.

\textsuperscript{144} MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2003) (stating that a lawyer shall not counsel or assist a client in committing a crime or fraud).

\textsuperscript{145} See id.
Therefore, lawyers who follow 1.2(d) will never find themselves subject to Model Rule 1.6(b)(2) or (3). The contradictory nature of this situation is that the recent amendments to Model Rule 1.6 inherently assume that the lawyers will be violating another Model Rule.

Another interesting cross-referenced Rule is Model Rule 1.13. Model Rule 1.13 was also amended in August of 2003 and generally provides that lawyers who have clients that are organizations must disclose circumstances that are likely to cause substantial injury to the organization. This Rule focuses on harms to the organization rather than third parties and now requires disclosure (before the amendments the disclosure was permissive) to higher authorities within the organization. The amendments also declare that disclosure is required regardless of the restrictions by Model Rule 1.6. In either case, considering many Rules together to contemplate the appropriate method and type of disclosure is important. Model Rule 1.13 is a great example because the Rule deems Model Rule 1.6 irrelevant for purposes of harm to the organization.

VI. CLOSING STATEMENTS

Tax shelter abuses are still prevalent in today’s economy and they continue to be a hard issue for tax lawyers. The reforms on abuses that create stricter registration requirements allow the IRS to get an accurate measure of the potential for abuse. The reforms on taxpayer disclosures effectively align the taxpayers’ interests with the IRS’s interests because of the risk of penalties and other sanctions. Additionally, the reforms on listing requirements imposed on tax attorneys serve as an early alert to the IRS, and provide the IRS with information to help prevent situations like those faced by the four individuals in the Jenkens & Gilchrist case (disallowance of the tax scheme used).

The federal securities laws have drastically changed the accountability of attorneys solely by enacting the Act. This regulatory response to the imbalance between liability of accountants and liability of lawyers accurately follows public perception that lawyers have historically (and arguably unfairly) been treated with more relaxed standards than accountants. The issue regarding to whom the attorneys should disclose information will continue to be debated between: groups that think noisy disclosures are proper, and groups that think disclosures should be discreet to protect the interests of the client.

146 See id. at R. 1.13.
147 See id.
148 See id. at R. 1.13(c).
The ABA Formal Opinions have set the foundation for tax lawyers operating in tax shelter situations. These Formal Opinions work in conjunction with Revenue Rulings regarding the tax shelter schemes that are not viable to give the tax lawyer a realistic idea of where the gray line on abuse stands. More importantly, the ABA Model Rules of Professional Conduct are making some pivotal changes to the conceptual role of the tax lawyer. The traditional understanding of the tax lawyer as advocate and advisor for the client, first and foremost, is giving way to a more societal-based accountability.

On balance, the new rules do not adequately change the face of these financial injuries which are preventable. John Doe Summonses are likely to remain subject to the attorney-client privilege originally protected under Model Rule 1.6. In order for the amended Model Rule 1.6 to be effective, some infrastructure of definitions should be established. Definitions for third parties, financial injury, and the level of reasonable certainly must be created. For instance, one party's material financial injury may not be material to another party. Additionally, financial injury can result from many avenues depending on whether one is an investor, shareholder, director, or the IRS. Third parties should be defined so that companies can gauge stakeholders. For instance, third parties can include the government, other companies, and individuals. Third parties might also include parent companies, subsidiary companies, or brother/sister companies. Thus, these current amendments will result in one of two outcomes: (1) a state will adopt the amendments but enforcement will be futile, or (2) a state will not adopt these amendments and try to strive for future amendments that can actually work to prevent tax shelter abuses. In any event, the current amendments will have no impact whatsoever on the policing of tax shelters today until the provisions are adequately refined with an infrastructure of definitions.