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From the Editor:

Daugerdas Conviction Spells End of an Era

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In the late 1990s and early 2000s, Jenkens & Gilchrist was one of the most influential and prominent tax firms in the country. By the end of 2007, the firm had collapsed under the weight of an IRS investigation and a series of lawsuits by clients involved in tax shelters. The destruction of Jenkens & Gilchrist was one of the IRS's more remarkable victories during the war on tax shelters — a war that the government has decisively won.

On May 24 Paul Daugerdas, a former partner at the firm, and three others were found guilty of engaging in a decade-long tax fraud and evasion conspiracy. Daugerdas was accused of creating numerous tax shelter transactions and using them to hide client and personal income. Among the various schemes in which the defendants were engaged were short sales, short options strategy swaps, and HOMER transactions. Other lawyers at Jenkens & Gilchrist were implicated, with several pleading guilty. The government alleged that the firm had cost the United States more than $7 billion in lost tax revenue. In a lightning-fast series of moves in 2006 and 2007, the Dallas-based firm admitted that it had engaged in the marketing of tax shelters, signed a deferred prosecution agreement, stopped providing legal services, paid a $76 million promoter penalty, and settled a class action suit brought by former clients for $85 million. One of the primary culprits in the tax shelter craze was brought down. (For coverage, see p. 891.)

Daugerdas's attorney told Bloomberg that he intends to appeal the conviction, and sentencing will not occur until October 14, but the guilty verdict feels like a suitable bookend for the IRS's battle against tax firms and practitioners that marketed complicated transactions designed solely to minimize or eliminate tax liability. With the focus of IRS enforcement efforts shifting to offshore accounts and international tax issues, it feels very much like the end of an era.

Penalty Reform

After the enactment of the 1954 code, there were 14 penalty provisions. More than 150 exist today, as Congress has created several new penalties in the last few years to combat tax shelter transactions and provide revenue offsets for legislation. According to Jeremiah Coder, these actions have hopelessly complicated civil tax penalties and created administrative and due process problems for taxpayers and the IRS. Coder writes that the IRS needs to take the lead on penalty reform and attempt to head off potential penalty issues when legislation is being drafted by Congress. He also criticizes the increasing use of strict liability penalties and argues that the code's penalty system should remain focused on encouraging compliance and not on punishing taxpayers or raising revenue. (For Coder's analysis, see p. 887.)

Commentary

President Obama's ambitious international tax reform agenda, which he laid out in early 2009, has not resulted in much final legislation. In fact, much of it was ignored by the Democratic Congress and is now anathema to the Republican House. However, the president successfully pushed through significant changes and limitations to foreign tax credits. Section 901(m), which became effective January 1, limited the foreign tax credit benefit that formerly accompanied a section 338(g) election after the purchase of a foreign corporation. Despite the new limitation, section 338(g) elections will remain advantageous to buyers, according to Lowell Yoder and Robert Clary (p. 965). The election can still provide the purchaser with enhanced foreign tax credit results and additional post-acquisition U.S. tax benefits, the authors write. One of the major advantages of the 338 election is flexibility in post-acquisition restructurings, Yoder and Clary conclude.

Last week a special report by Daniel Shaviro argued that 1986-style tax reform might not be the best model for current efforts in Washington to reform the code and deal with the deficit. Taking a slightly different viewpoint, Robert Leonard and Kenneth Kies (who both served as tax counsels to congressional committees) write that the success of the 1986 reform effort can still provide valuable lessons to modern tax reformers (p. 973). While praising the achievements of the 1986 act, Kies and Leonard point out that presidential leadership, congressional commitment, and the engagement of the American public were key reasons for the successful passage of tax reform. They argue that tax reform is a big issue, requiring policymakers to

think and act big. Successful tax reform could restore the public's confidence in both the tax code and the leadership institutions in the United States, the authors argue.

Pamela Olson recently delivered the Laurence Neal Woodworth Memorial Lecture (p. 993) and addressed the topic of tax reform. She outlined lessons from the 1986 tax reform process and how lawmakers should approach reform in 2011. She encouraged Congress to look beyond the next election and act in the nation's long-term best interest, even though tax reform is unlikely to be popular with voters.

The codification of the economic substance doctrine has raised practitioner ire, particularly because of the strict liability nature of the penalty. But failing to provide a business purpose for a transaction, and flunking the tests of the doctrine, may carry even greater consequences than a tax penalty. Jasper Cummings, Jr. writes that the Second Circuit and the Justice Department are directing juries to convict lawyers of tax evasion if the lawyer knew that a transaction had no business purpose or profit potential (p. 977). Cummings is critical of the jury instructions given in the matter of R.J. Ruble, a lawyer from KPMG who was convicted of tax evasion in the wake of the *Stein* saga. He argues that the economic substance doctrine is too vague to support a criminal conviction if it cannot even be defined with specificity by the government or courts. In conclusion, Cummings writes that if the Supreme Court does not agree with this move by the Second Circuit, it should take up Ruble's case and, possibly, announce that it has never created any economic substance doctrine.

Although oil subsidies have received a great deal of attention on Capitol Hill, strong support from Republicans and oil-state Democrats likely means that no trimming of these tax benefits is in the offing. However, ethanol subsidies might not fare as well. Those provisions are the target of environmentalists, Tea Party-leaning lawmakers, and deficit hawks. Diana Furchtgott-Roth writes that with gasoline prices surging to more than $4 a gallon, it is time for ethanol to compete on its own (p. 991). She lists all the benefits that accrue to ethanol under current law, including a mandate and numerous tax credits. Several bills in Congress would simply reformulate the credits, rather than eliminate them entirely, according to Furchtgott-Roth. She concludes that it might be time to eliminate all energy-specific subsidies and let the chips fall where they may.

In 1948 Congress created the joint filing status to create tax equality between married couples in community and non-community-property states. Favored treatment for community property taxpayers was a result of the *Seaborn* decision by the Supreme Court. However, joint filing has created major administrative problems, including the marriage penalty and innocent spouse issues, according to Katherine Black, Mary Black, and Julie Black (p. 943). In their special report, they argue that same-sex marriages would only add to the confusion because almost any taxpayer would be eligible for joint filing status. They break down the tax benefits intended for families with children that frequently go to families without children because of filing status and income phase outs. They conclude that Congress should require all taxpayers to file an individual tax return.

The differences between independent contractors and employees can create a tax mess. Lawyers advising in the area of employee classification frequently commit surprisingly fundamental mistakes, writes Robert Wood (p. 987). He provides a list of the top 10 mistakes made with independent contractors and argues that fixing those errors would make independent contractor classifications much more defensible. ■

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