This is the Accepted Manuscript version. This version is defined in the NISO recommended practice RP-8-2008 http://www.niso.org/publications/rp/


Copyright

Items in ResearchSpace are protected by copyright, with all rights reserved, unless otherwise indicated. Previously published items are made available in accordance with the copyright policy of the publisher.

This is an Accepted Manuscript of an article published in Journal of Human Development and Capabilities on 01 Oct 2015, available online: http://www.tandfonline.com/doi/full/10.1080/19452829.2015.1091810

For more information, see General copyright, Publisher copyright, SHERPA/RoMEO.
Abusive Tax Avoidance and Responsibilities of Tax Professionals
Draft only
Final copy appears as:


1. Introduction

Edmund Burke, an eighteenth-century philosopher, once remarked that “Revenue is the chief preoccupation of the state. Nay more it is the state” (Dietz 1964, 213). Whether or not one endorses Burke’s view, taxation is undeniably very important to the state. Without sufficient tax revenue, governments are typically unable to discharge their core obligations to citizens, let alone protect human rights, develop citizens’ capabilities, and generally promote well-being. So when some taxpayers avoid paying their fair share of taxes, perhaps by using creative accounting practices to illegitimately reduce their apparent tax obligations, a central function of government is compromised. Abusive tax avoidance should thus be a serious concern for legislators, political theorists, civil advocacy groups and others with an interest in creating a more just world. In this paper we are primarily concerned with the assignment of remedial responsibilities for the deprivation caused by abusive tax avoidance. In other words, we address the normative problem of determining who is obligated to help end abusive tax avoidance and why particular parties have these remedial duties. Our focus is on tax professionals whose various and intimate connections to the tax avoidance industry are sufficient, we argue, to generate significant remedial responsibilities.

We begin by clarifying some terminology to be used throughout the paper. “Tax avoidance,” broadly defined, includes any activity, arrangement or transaction that reduces the total amount of explicit taxes paid by an individual or organization. This definition captures a wide spectrum of tax-reducing activities, from the clearly illegal to the obviously unobjectionable. A tax avoidance arrangement is abusive when it reduces explicit taxes in a manner not intended by law. Abusive tax avoidance includes “tax evasion” activities that directly violate the letter of the law, such as deliberately not declaring taxable assets on a tax return; but abusive avoidance also includes tax-reducing activities that are merely contrary to the law’s spirit or intent. Abusive tax avoidance is thus a broader category than tax evasion. An advantage of focusing on abusive avoidance is to prohibit innovative tax avoidance schemes that remain within the
letter of the law only by exploiting legislative technicalities that lawmakers have not yet anticipated. Moreover, the category of abusive tax avoidance is currently used by tax enforcement authorities in the United States (see, for example, GOA [2011, 1]). Other governments have similar policies, although the terminology used can vary.

There is an extremely blurry line between abusive and non-abusive tax avoidance. Abusive tax avoidance strategies often use creative accounting techniques to appear legal, and in practice it can be very difficult to determine whether a complex strategy is in fact contrary to the spirit of the law. For this reason, potentially abusive tax avoidance strategies, which push the boundaries of the law’s intent without obviously crossing those boundaries, are also within the scope of this paper. Furthermore, we are particularly concerned with highly sophisticated and technical abusive (or potentially abusive) tax avoidance schemes, which are sometimes called “tax shelters” (GAO 2011).

Abusive tax avoidance practices cause significant and troubling levels of deprivation in both developed and developing countries. Estimates of the degree and impact of abusive tax avoidance vary but reasonably reliable estimates are that developing countries lose approximately $160 billion each year from tax evasion and avoidance – roughly 60 billion more than the annual international aid given from all developed countries to the developing world (Christian Aid 2008, 1-2). Tax avoidance is also a serious problem for developed countries. The US Inland Revenue Service estimates that about 1 million tax returns involved abusive tax avoidance in 2004 (GAO 2011). The IRS’s most recent estimates of the “tax gap” – the difference between the total tax amount that should have been voluntarily paid and the amount that was actually paid – are $290 billion for the 2001 tax year and $385 billion for 2006 (IRS 2012). These figures are likely to significantly underestimate the amount of US tax that is lost from taxpayers exploiting technical loopholes in the tax code in ways that lawmakers never intended.

Tax avoidance on this scale has serious consequences and real victims for both developed and developing countries. Governments tax their populations in order to finance public projects such as infrastructure, healthcare and education, provide support to vulnerable groups in the form of transfer payments, and perform a range of other functions in the public interest. When large corporations and wealthy individuals engage in extensive tax sheltering, they deprive governments of revenue that is needed to fund these public projects and transfer payments. Often this means certain services must be cut back; other times it forces governments to increase taxes on labor or goods and services in order to meet their fiscal obligations, resulting in tax systems that are generally more regressive (Christensen and Kapoor 2004). Both of these outcomes tend to have the greatest negative effect on the most disadvantaged members of society, who typically have the least ability to arrange their financial affairs so as to reduce their effective tax burdens. Abusive tax avoidance thus reduces both the effectiveness and equity of fiscal institutions: governments are rendered incapable of adequately financing important components of public spending, and a greater proportion of the tax burden is put on poorer individuals. These consequences are most severe in the developing world,
where well-meaning governments cannot always meet the basic needs of their residents. According to one estimate, the lives of an additional 350,000 children under the age of five would be saved each year, without any change in the proportion of government revenues spent on healthcare, if developed countries were able to recoup the $160 billion lost to tax avoidance annually (Christian Aid 2008, 2). Recent government shut-downs in the US have highlighted the fact that the developed world is not immune from the effects of pressure on fiscal institutions.

This paper contributes to the literature on abusive tax avoidance in a number of ways. In the next section we outline the main reasons for the persistence of abusive tax avoidance practices in developed and developing countries. However, our main project in this paper is normative. We address the following questions: Who should be responsible for addressing and remedying the deprivation caused by abusive tax avoidance? What normative grounds might be used to assign such responsibilities? We argue that tax professionals – including large, multinational professional firms – have specific and significant remedial duties in connection with abusive tax avoidance. To make a case for this normative position, we discuss three principles for assigning remedial responsibilities: causal contribution, benefit, and capacity. These principles sometimes pull in different directions, but when all three converge there are especially strong grounds for assigning remedial responsibilities to a particular set of agents. We demonstrate how this convergence approach can be applied in an argument for the duties of tax professionals to assist in fiscal reform. We also mention various ways in which professionals might be able to discharge these duties, and conclude by observing that the responsibilities we argue for are consistent with, indeed required by, widely accepted standards of professional integrity.

2. Factors contributing to abusive tax avoidance

We identify six sets of factors that majorly contribute to the high levels of abusive tax avoidance in the world today. The factors are not presented in any order of priority and there are various interconnections between them. The first five factors affect both developing and developed states, while the final set of factors exacerbate the problem of abusive tax avoidance in developing nations particularly.

(i) The existence of a natural market for tax avoidance

In the first instance, it is important to realize that there is a natural economic market for tax avoidance, including abusive avoidance. This market is governed by the laws of supply and demand, just like any other. On the demand-side of the tax avoidance market, there is a population of well-financed and well-connected corporations and high net worth individuals. Large corporations view tax as merely another cost to minimize.

The supply-side of the tax avoidance market consists mainly of tax professionals whose accountancy, legal, financial or other technical skills enable them to provide tax benefits
that others without such training cannot. As in other markets, the suppliers of these tax services are under pressure to provide greater tax savings than those offered by their competitors, with the result that many tax professionals are willing to promote tax strategies of questionable legality. These tax professionals charge high fees for their services, so it is unsurprising that their clients are almost exclusively wealthy individuals and multinational corporations. We shall have much more to say about the connections between tax professionals and abusive tax avoidance later in the paper.

(ii) Transfer mispricing and other strategies that capitalize on globalization and technological advancements

In recent decades, globalization and technological advancements have vastly increased the potential for tax abuse. It is now possible to transfer funds instantaneously between tax jurisdictions, and increasingly complex financial instruments have been developed. A wide range of tax avoidance strategies has been developed to capitalize on these new levels of interconnectedness and technological capability.

The most significant of these strategies (in terms of dollars of revenue lost) is transfer mispricing. A transfer price is the price at which a company in one jurisdiction sells a good to a related company in a different jurisdiction. To avoid abuse, transfer prices ought to be set according to the “arms length principle,” which says that intra-company sales should occur at the price one would expect the same good to be traded between unrelated companies. Transfer mispricing occurs when a multinational company does not follow the arms length principle, but instead takes unfair advantage of differences in national tax laws to construct artificially low or high transfer prices for goods and services. This practice can reduce a company’s apparent tax obligations through the mechanism of unfair price manipulation. The scale of transfer mispricing is phenomenal: the Financial Transparency Coalition estimates that, for the last ten years the practice has accounted for about 80 per cent of illicit financial flows out of developing countries, or around US$4.688 trillion of the estimated US$5.86 trillion in total illicit financial flows (Kar and Freitas 2012, vii).

(iii) The offshore impact

Tax havens or “offshore” jurisdictions offer minimal or no tax rates within their territories. More importantly, tax havens generally have strict banking secrecy laws that prohibit the disclosure of information about non-residents who make use of their tax benefits. These secrecy laws are intentionally designed to facilitate the circumvention of legislation or regulation in other jurisdictions. Their effect is to severely reduce the level of transparency in global taxation arrangements, to the point where even the US Inland Revenue Service, the most well-resourced tax institution in the world, cannot access all the information it needs to tax all of its residents effectively.

Enormous amounts of private wealth are stored in tax havens: the Tax Justice Network (2005) estimates that the use of tax havens results in a global revenue loss
of US$255 million per year. In addition, approximately 50 per cent of all international trade appears to pass through tax havens, despite the fact that very little substantive economic activity occurs in these zones (Tax Justice Network 2003). Unsurprisingly, offshore jurisdictions are implicated in a wide variety of abusive tax avoidance schemes. Transfer mispricing, for example, typically involves setting transfer prices such that the majority of a company’s income is registered in tax havens, while a low profit or even a loss is registered in the jurisdictions where economic activity actually takes place.

(iv) Lack of accountability for wealthy tax avoiders

Alongside the lack of transparency in global fiscal arrangements is a lack of accountability, particularly concerning the amounts of tax paid by multinational corporations and wealthy individuals. Many high net worth taxpayers contribute far less than a fair share of tax, given their enormous means, yet it is rare for anyone to be held to account for this. This lack of accountability persists, in part, because tax institutions cannot always afford the high cost of a protracted legal battle. Wealthy taxpayers are able to hire the very best solicitors to argue on their behalf and can continue to finance a costly legal team for many years. Consequently, tax institutions sometimes find that their budgets do not allow for a legal challenge against a wealthy taxpayer, even when there is good evidence that the tax strategies of that taxpayer are abusive.

(v) The complexity of tax law

Current tax legislation is incredibly complex. To take an extreme example, the US tax system now includes more than 10,000 pages of code and regulation (Simser 2008, 124). The complexity of tax law is an issue because the more clauses and sub-clauses there are within a tax code, the more extensive is the legal knowledge needed to determine whether a given tax strategy is legal. This exacerbates the accountability issues discussed above, since a complex tax code means a skilled tax lawyer can potentially find a technicality on which to defend a seemingly abusive tax position. Complexity also creates an incentive for tax service providers to discover previously unexploited loopholes in the tax code and sell this knowledge to clients. Globalization makes tax law even more complicated: different jurisdictions have different tax regulations, transfer pricing rules, and so on, making it exceptionally difficult to determine whether a corporate structure that spans multiple tax jurisdictions complies with the law in each jurisdiction. While there are many in favor of radically simplifying national tax systems, at present the trend is towards even greater complexity: as private sector tax specialists devise ingenious new ways of avoiding tax, governments respond by adding further clauses to the existing legislation.

(vi) Additional factors in developing countries

Because of the five factors discussed above, abusive tax avoidance is a significant problem for developed and developing countries alike. Additional factors heighten the extent of the problem for the developing world. First, developing states often have very
weak institutions, and tax institutions are no exception to this rule. Weak tax institutions can fail to collect large proportions of owed tax revenue. Developing countries simply lack the resources and administration necessary to combat transfer mispricing and other sophisticated tax avoidance techniques. Second, developing countries tend to have large informal sectors, which can seriously restrict their ability to tax all citizens fairly. When workers are not formally employed, it is difficult to track their wages, let alone collect any taxation from that income. Third, low tax morale can hamper developing countries’ abilities to collect taxes equitably and efficiently. When citizens do not feel that they are getting value for their taxes, they will be less willing to contribute the taxes that are owed (Frey 2002; Edling and Nguyen-Thahn 2006; Bergman 2002; Bird 2008). So, for instance, when core goods fail to be provided, when there is a perception that taxes collected will be wasted, embezzled, or otherwise not spent on their legitimate purposes, citizens will be less likely to want to contribute their legally required taxes. In particularly dire cases this can lead to negative feedback loops: low tax morale means there are insufficient funds for executing core state functions effectively, further undermining tax morale.

We now end our summary of the main factors explaining the persistence of abusive tax avoidance and begin the normative part of this paper. However, it will be important to bear in mind all of the contributory factors we have canvased in this section as we present our normative argument.

3. Assigning Remedial Responsibilities

As we noted in our introduction, abusive tax avoidance contributes to distressing levels of deprivation in both developed and developing states. Abusive tax avoidance seriously undermines the effectiveness and equity of taxation systems, which in turn undermines governments’ abilities to promote the capabilities and well-being of their citizens. This situation raises some difficult questions. The first is a policy question of how to alleviate the deprivation caused by abusive tax avoidance most effectively. Related to this is a pragmatic question of which potential solutions are politically, administratively and technically feasible. In what follows we make several comments relating to these policy and pragmatic questions, but answering them is not our main focus here. Rather, we are concerned primarily with the normative questions of who ought to be responsible for taking remedial actions against abusive tax avoidance, and what grounds there are for assigning such responsibilities.

A variety of normative approaches could be employed in addressing these issues, and we are not able to survey the range of alternatives here. Instead, we will focus on a strategy that we believe is under-explored and promises to make an important contribution to proper understanding of our normative responsibilities. Roughly speaking, the strategy notes that we have especially strong obligations to remedy instances of deprivation that we have caused, benefited from, and have capacity to fix. We now explain this approach in more detail.
Our concern here is with special responsibilities of particular individuals to remedy particular sources of deprivation, as opposed to general responsibilities to, say, respect human rights or avoid causing harm. For an agent (or group of agents) to have special responsibilities of this kind, it is necessary that this agent be connected in some important way to the deprivation in question. That is, if an agent \( A \) is specially obligated to remedy a source of deprivation \( D \), this must be because some special relation obtains between \( A \) and \( D \) that need not obtain for other agents.

Three distinct types of connection stand out as producing duties of this sort. First, if someone causes or significantly contributes to an instance of wrongdoing or injustice, that person can be expected to do more than others in correcting the injustice. (A large part of the law is concerned with assigning remedial responsibilities on this causal basis.) Second, an individual who benefits from a situation or process that causes deprivation for others can have special responsibilities to alleviate the deprivation. Third, if a person possesses resources or abilities that enable her to address a problem effectively and at low cost, that person can have special responsibilities to assist. For instance, the strongest rock climber might be expected to rescue the trapped mountaineer, but only if this is also going to involve low cost to him.

We can state each of these connections more precisely as follows. Given a set of agents \( A \) and a source of deprivation \( D \), if at least one of the following connections obtains then that can be enough to generate special responsibilities for \( A \) to help in remedying \( D \).

- **Causal contribution**: \( A \) causes or significantly contributes to \( D \).
- **Benefit**: \( A \) benefits from the situation or process that leads to \( D \).
- **Capacity**: \( A \) is capable of remedying \( D \) effectively and at relatively low cost to \( A \).

For present purposes we can assume that these principles capture all the types of connection that can produce special responsibilities to alleviate deprivation. Note that all three principles admit of degrees: one can contribute, benefit, or be capable of assisting to varying extents. Differences between the degrees to which agents satisfy these connective criteria provide an approximate basis for comparing the strengths of agents’ responsibilities.

It is tempting to treat *causal contribution*, *benefit* and *capacity* as individually sufficient conditions for the existence of special duties. In many cases, the presence of just one of the relevant connections can indeed be enough to generate such responsibilities. However, each of the principles may face some difficult counterexamples. As just one example, consider this problem for *benefit*: If medical knowledge was improved by the heinous experiments conducted on Jews in Nazi prison camps, does this mean that the beneficiaries of that medical knowledge have special responsibilities to make amends for the Holocaust? A different issue is that *causal contribution*, *benefit* and *capacity* can pull in different directions for the same case. If, for instance, someone contributes
significantly to a case of deprivation but has almost no capacity to alleviate it, *causal contribution* may not be enough to establish a special responsibility in this case.

An attempt to refine the above principles in light of these problems is beyond the scope of this paper. Instead, we adopt a strategy that, in the cases which concern us, allows us to circumvent most of these difficulties. When all three of our connective criteria *converge*, we can say that there are very strong and not easily defeasible grounds for establishing remedial responsibilities. That is, when a particular set of agents A relates to deprivation D by way of causal contribution, benefit, and capacity to assist, then we can confidently establish that A has special and significant obligations to remedy D.

We are now in a position to see how this convergence strategy can be applied to abusive tax avoidance. A number of different stakeholders are implicated in the deprivation caused by tax avoidance, including governments, corporations, high net worth individuals, and tax professionals. Of these stakeholders, it is not obvious who should be considered specially responsible for remedying the deprivation. As we saw in the previous section, abusive tax avoidance is associated with an interconnected array of political, legal, economic and technological factors. When global justice issues are complex in this way, views on who ought to be responsible for remedying the issue can reasonably differ. The convergence strategy we have described provides a tractable way to proceed in our normative inquiry. If it turns out that a particular group of agents contributes to, benefits from, and has the capacity to reduce the deprivation caused by abusive tax avoidance, then we can say with confidence that this group of agents does in fact have a significant and specific duty to assist in solutions to the problem.

Ideally, the convergence test would be applied to each of the relevant stakeholders in abusive tax avoidance, and some effort would be put into assessing the relative strengths of responsibilities in the manner suggested above. Because of space constraints, in the remainder of the paper we focus solely on tax professionals – especially accountants, lawyers and financial advisors. Tax professionals are, it will be shown, closely connected to tax avoidance on all three of our criteria; hence, tax professionals have strong remedial responsibilities with respect to abusive tax avoidance. Our discussion of tax professionals in the next sections can serve as an example of how this normative inquiry can proceed for other relevant sets of agents (as well as for issues other than abusive tax avoidance).

4. Causal contribution: How tax professionals facilitate abusive tax avoidance

The overwhelming majority of abusive tax avoidance arrangements would simply not be possible without the deliberate assistance of a wide variety of tax professionals. Professionals, including accountants, lawyers, financial experts, estate managers, and offshore specialists have an indispensable role in enabling high net worth individuals and
large corporations to reduce their tax payments in ways that directly violate or otherwise subvert the requirements of tax law.

We begin by summarizing the tax avoidance activities of Sam and Charles Wyly, as their case is especially illustrative of the role of professionals in designing and managing tax shelters. In 2005 the Wyly brothers became the subject of a US Senate investigation for allegedly evading tax on hundreds of millions of dollars that was earned and traded in the US (PSI 2006, 113). The Wylys had set up an intricate network of 58 trusts and shell corporations in offshore tax havens such as the Cayman Islands and the Isle of Man. The Wylys moved approximately $190 million into these entities by way of a “stock option-annuity swap”: Wyly-owned stock options, an asset that is taxable only once exercised, were “sold” to Wyly-related offshore corporations in exchange for annuity promises that would not register as taxable income until many years later (163-168). The stock options were exercised offshore (and hence untaxed) and used as base funds for generating hundreds of millions through a variety of complex securities transactions in US markets. These trades were conducted by accounts opened by Wyly-related offshore entities in major US securities firms, but no US tax was paid on any of the trading gains because these profits allegedly belonged to independent offshore trusts (201-210). Over $500 million in profits from these trades was subsequently invested in Wyly-related business ventures, real estate, artwork, and jewelry (249-250, 283, 307).

An armada of tax professionals aided the Wyly brothers in all aspects of their tax sheltering schemes. The use of a stock option-annuity swap to shift assets offshore while maintaining the appearance of a legal business transaction required expert knowledge of the intricacies of US tax law; a number of US and offshore law firms were willing to provide the Wylys with that expertise (PSI 2006, 388-394). US-based legal counsel also corresponded with offshore service providers on the Wylys’ behalves and provided routine advice on how to operate the offshore entities without appearing to break US law (123-125). Offshore financial institutions assisted the Wylys by opening accounts and transferring funds across international lines, and offshore law firms provided legal advice to the Wylys and other facilitators of the network (128-130). Furthermore, major US financial institutions, including Lehman Brothers and Bank of America, held domestic accounts for the Wylys’ offshore trusts that were used to trade securities in US markets, invest in US assets, and send multi-million-dollar wire transfers. These financial institutions knew that the Wylys were associated with the offshore trusts that owned these domestic accounts, but turned a blind eye, never requiring the trusts to reveal their beneficial owners or document the nature of the Wyly connection (316).

Professionals also helped the Wylys to appear technically independent from their offshore network for taxation purposes. The Wylys did not establish or manage any of their offshore entities directly; instead they enlisted specialist offshore service providers to establish the offshore trusts and corporations, serve as their trustees and directors, and handle all related paperwork (PSI 2006, 127). The Wylys and their representatives were careful to make only “recommendations” to the registered trustees and directors
regarding the operations of their offshore entities. In reality, these “recommendations”

served as detailed instructions that were invariably carried out, but by phrasing their
correspondences as mere suggestions the Wylys could claim to be technically unrelated
to the offshore network (135-136). On paper and throughout the Senate investigations,
the Wylys have maintained a position of total independence, for taxation purposes, from
the offshore entities that acted in their interests.

As the Wyly case illustrates, effective tax avoidance strategies tend to require the
cooperation of a range of professionals with different areas of expertise. At this point it is
valuable to detail the specific contributions of three major groups of tax professionals:
accountants, lawyers, and financial experts. We are particularly concerned with cases
involving large, multi-national professional firms, as these companies have enormous
financial and human capital at their disposal and hence the potential to facilitate tax
avoidance on a huge scale.

(i) Accountants

There are currently four dominant multi-national accountancy firms: Deloitte,
PricewaterhouseCoopers (PwC), Ernst & Young (E & Y), and KPMG. Collectively, these
firms are known as the “Big Four.” Tax services are a significant component of the Big
Four’s operations; in 2012, the Big Four’s combined annual revenues from tax services
was approximately US$25 billion, or roughly one fifth of their total global revenues
(Public Accounts Committee 2013, 7-8). Of this $25 billion, the majority comes from tax
advice, and much of that advice is aimed at helping wealthy individuals and corporations
minimize the tax they pay (7-8).

It is useful to divide the Big Four’s causal contributions to abusive tax avoidance into two
time periods: the late 1990s and early 2000s, and the years since then. The former
period witnessed a boom in mass-marketed, generic tax shelters, of which large
accountancy firms were among the most aggressive designers and promoters. The Big
Four targeted large corporations and wealthy individuals, approaching these taxpayers
with tax shelter proposals rather than waiting for their services to be solicited (Sikka and
Hampton 2005, 333). KPMG was probably the most aggressive promoter of these mass-
marketed tax products (332-335).6 KPMG set ambitious targets for the development of
avoidance strategies (the goal in 2001 was to come up with 150 new tax product
proposals) and staff teams were ranked according to the number of proposals they had
made (PSI 2003, 173). New infrastructure was introduced to support the increased focus
on tax avoidance services, including a “Tax Innovation Centre” tasked with developing
novel tax shelters. Staff were trained in making cold calls to potential clients (Sikka and
Hampton 2005, 333). In addition, KPMG was actively involved in the implementation of
its tax shelters, coordinating offshore entities and transactions, enlisting participation
from financial institutions, and preparing tax returns and transactional documents for
clients (PSI 2003, 148).

To prevent information on its tax products from reaching tax authorities, KPMG gave all
its client presentations on chalkboards or erasable whiteboards and required anyone
who attended an information session to sign a non-disclosure agreement (Sikka and Hampton 2005, 333-334). But despite these clandestine precautions, in 2003 KPMG became the subject of a US Senate Subcommittee investigation for allegedly marketing abusive tax shelters. In questioning, KPMG admitted to having as many as 500 active, non-disclosed tax products (PSI 2003, 169). The Subcommittee concluded that KPMG helped wealthy clients claim tax losses of at least $7.2 billion through “potentially abusive and illegal tax shelters that US taxpayers might otherwise have been unable, unlikely, or unwilling to employ” (PSI 2003, 147-148).7

The other Big Four firms were also heavily engaged in the development and marketing of generic tax avoidance strategies throughout the so-called “boom years” of tax avoidance. Between 1997 and 1999 PwC sold or was in the process of selling almost 200 tax products that the IRD later identified as abusive tax shelters (PSI 2005, 93). E & Y developed aggressive strategies to market generic tax products; in 2000 an internal email to E & Y tax professionals set a nationwide goal of generating $1 billion of tax losses through the sale of just one tax product, called a “Contingent Deferred Swap” (CDS) (83). Between 1999 and 2001, E & Y sold CDS to a total of 132 taxpayers, even though several professional staff had expressed concerns about the legality of the product (87).

The Big Four now admit to developing, marketing and implementing highly aggressive tax strategies during the late 1990s and early 2000s. They insist, however, that times have changed. KPMG, for instance, claims to have introduced stricter internal due diligence policies, including a requirement that tax advice be supportable in law (PAC 2013, 8-9). However, even if these changes claimed are indeed genuine, the Big Four should still be accountable for the large-scale tax avoidance that they facilitated in the boom period of mass-marketed tax shelters. Each of these enormous, professional firms directly and aggressively helped wealthy individuals and corporations generate billions in tax savings over these years, which on its own is enough to generate specific remedial responsibilities. Furthermore, some of the tax avoidance strategies that the Big Four designed and implemented in the boom period are still in use today: US industrial manufacturer Caterpillar continues to use a strategy devised by PwC in 1999, enabling Caterpillar to log the majority of its profits in Switzerland where the company pays an effective tax rate of only 4 percent (Douglas 2014).

There is also reason to doubt whether the Big Four have in fact exited the tax sheltering industry. Although the firms claim that all of their tax advice is supportable in law, the Big Four are at least sometimes willing to promote tax reduction strategies that have as little as a one-in-two chance of surviving a challenge by tax authorities (PAC 2013, 9). Such standards would be clearly unacceptable in an investment setting: one could hardly defend a dubious business venture by insisting it was “only 50 percent likely to be deemed illegal.” For firms supposedly trying to discourage abusive tax avoidance, the Big Four’s standards for the legal supportability of their tax advice are exceptionally low. Relatedly, the Big Four firms do not in any way reprimand or sanction tax staff responsible for designing or recommending a strategy that is later overturned by
revenue authorities (PAC 2013, 9). The Big Four may have nominally committed to
respecting the letter and spirit of the law, but they do not seem to provide their tax
professionals with strong incentives to adhere to those principles in practice.

(ii) Lawyers

There are three main ways in which lawyers facilitate abusive tax avoidance: (1)
assisting in the design and implementation of abusive shelters; (2) providing legal
opinions in support of abusive transactions; and (3) representing tax shelter clients. In
many cases, a single law firm – and even the same individual – assists a particular tax
avoider in two or three of these capacities.

The particular tax shelters we have discussed so far illustrate the very high level of legal
expertise involved in the tax avoidance industry. Among the legal knowledge required is
a sophisticated understanding of tax law as it applies to a wide variety of assets and
financial instruments, and specialist knowledge regarding the management of offshore
entities and transactions with those entities. Some particular cases are worth
mentioning. Maples & Calder, one of the largest law firms in the Cayman Islands, helped
to draft paperwork and provided legal advice to other actors involved in the Wyly
network (PSI 2006, 130). In 2013 Donna Guerin, a former Jenkins & Gilchrist lawyer,
was found guilty of running a ten year scheme that created $7 billion in fraudulent tax
deductions and cost the US Treasury $92 million in actual losses. Judge William Pauley
concluded that Guerin “was not a mindless automaton,” but rather played a central and
conscious role in managing her tax shelters (Hurtado 2013). Legal professionals were
also directly involved in designing, implementing and selling tax avoidance products for
the Big Four accountancy firms in the 1990s. During this period, the Big Four began
offering high salaries to attract the best tax lawyers, including experienced partners from
corporate firms (Rostain 2006, 91).

Law firms routinely write opinions on the legality of tax avoidance strategies. For the
clients and promoters of abusive tax shelters, a positive legal opinion can serve as a
form of insurance, deterring tax authorities from challenging the legality of the shelter or,
if a challenge does occur, shielding the client or promoter from tax avoidance penalties.
In many cases of abusive avoidance, the soundness or legitimacy of these legal
opinions is highly dubious. To serve its intended function, a legal opinion needs to argue
only that the transaction in question has a greater than 50 percent chance of being
upheld if challenged by tax authorities (Rostain 2006, 93). In many cases, lawyers have
written opinions based on a limited and distorting set of facts; up until the early 2000’s it
was standard practice for opinions on tax shelters to be based solely on information
provided to the lawyer by the party seeking an opinion. Worse, in several documented
cases law firms have supplied positive opinions for shelters that the firm was itself
involved in designing or implementing. For example, Brown & Wood provided
approximately 600 opinions in support of tax shelters promoted by KPMG, despite
collaborating closely with KPMG in the design and implementation of the very same
shelters. (Indeed, Brown & Wood apparently based its “independent” opinions on templates provided by KPMG [PSI 2005, 102-105].)

Some law firms specialize in defending clients and promoters of tax shelters against the IRS and other tax authorities. For example, the US firm Sutherland Asbill & Brennan represented multiple individuals who purchased KPMG tax products and attempted to negotiate “global settlement agreements” for whole groups of these clients (PSI 2005, 107-111). This well-financed legal support creates a significant obstacle for authorities seeking to police abusive tax avoidance. Tax enforcement institutions must make decisions on how to spend limited resources, and the anticipated cost of a protracted legal battle can often be a reason for not taking legal action against an apparently abusive shelter. This is especially true given that, even if tax authorities successfully challenge an abusive tax avoidance scheme, the amount of money recouped in fines and penalties may still fall well short of the tax revenue that was lost.

(iii) Financial advisors

Financial advisors (including bankers, stock brokers, investment consultants, and so on) contribute to abusive tax avoidance arrangements by offering sophisticated financial advice about what options are available, providing multi-million dollar loans for tax avoidance purposes, facilitating wire transfers to offshore entities, and in some cases designing and implementing novel tax shelters. If major banks and securities firms were not willing to provide these services, a large number of tax shelters would be impossible to execute.

Many of the banks involved in tax avoidance are located in secrecy jurisdictions, such as the Cayman Islands and Switzerland, where banking laws strictly prohibit the disclosure of client information. These banks open undeclared accounts for US taxpayers as well as for offshore shell entities that are set up for the purpose of tax avoidance (PSI 2014, 6). Naturally, the existence of these secrecy laws is a major reason why tax avoiders choose to open accounts in Swiss and other offshore banks, as it makes it much more difficult for authorities to determine their true tax situation.

However, not all of the financial institutions involved in facilitating abusive tax avoidance are based in secrecy jurisdictions. In 2008, six Wall Street banks – Citigroup, Lehman Brothers, Morgan Stanley, Merrill Lynch, UBS, and Deutsche Bank – became the subject of a US Senate Subcommittee investigation for allegedly helping non-US persons avoid US dividend tax (PSI 2008). These banks cooperated with hedge funds in devising tax avoidance schemes that manipulated the different US tax rules for various asset types. Morgan Stanley data indicates that the bank enabled clients to escape over $300 million in US dividend taxes between 2000 and 2007; the Lehman Brothers apparently helped clients dodge $115 million in taxes in 2004 alone (PSI 2008, 8). In 2014, similar charges have been made against Barclays and Deutsche Bank; one hedge fund, Renaissance Technology Corp., allegedly dodged $6.8 billion in US taxes using schemes devised by Barclays and Deutsche Bank (McKinnon and Tracy 2014).
Where banks have not actively assisted in implementing tax shelters, they have often
turned a blind eye. Bank of America and Lehman Brothers opened accounts and
facilitated multi-million dollar transfers for the Wyly brothers' offshore entities. These
banks had good reason to suspect that the offshore entities were Wyly-controlled and
that they were being used to shelter taxable assets offshore. Indeed, internal
correspondence suggests that these banks definitely knew about the Wyly connection.
Nevertheless, the banks did not request more information about the nature of the
transactions they were facilitating, nor did they voice their suspicions to tax authorities
(PSI 2006, 316).

5. Benefit: What tax professionals gain from abusive tax
avoidance

As we noted in Section 2, the market for tax avoidance is like any other in that it consists
of consumers and suppliers. Tax professionals are the supply-side of the market, and
they are able to profit generously from the services they provide to wealthy clients.

The Big Four have earned hundreds of millions of dollars in fees for designing,
implementing and advising on abusive tax avoidance arrangements. A list of just some
of the relevant transactions is enough to illustrate this beneficiary connection. KPMG is
estimated to have netted $180 million in fees from just four of its generic tax products, as
well as between $6 million and $10 million for devising and implementing WorldCom’s
tax avoidance strategy (Sikka and Hampton 2005, 333). E & Y received about $250,000
from a typical transaction through its CDS shelter, netting a total of $27.8 million from its
132 CDS sales (PSI 2005, 84). PwC was paid more than $55 million for designing
Caterpillar’s Swiss-based shelter (Douglas 2014).

Lawyers can likewise earn substantial fees for their assistance in tax shelter
arrangements. During the “boom years” of the 1990s and early 2000s, fees for opinion
letters were sometimes as high as hundreds of thousands of dollars per shelter, and
even over one million (Rostain 2006, 94). Opinion letters are not difficult nor time
consuming to write, so these fees are incommensurate with the amount of work required
by the lawyer; instead they reflect the perceived insurance-value of these legal opinion
to tax shelter users and promoters. Law firms have also obtained sizable fees for
designing and implementing shelters; Brown & Wood earned more than $23 million from
collaborating with KPMG, and Donna Guerin allegedly earned $11.5 million in the year
2000 while running her large-scale tax avoidance scheme (Hurtado 2013). Law firms
who represent tax shelter clients in IRS challenges, or in the client’s dealings with other
institutions, can likewise be generously compensated for their services.

Due to the secrecy involved in many financial institutions, it is difficult to estimate the
extent to which financial institutions benefit from abusive tax avoidance. However, the
figures available are telling. Deutsche Bank obtained a total of $79 million in bank fees
from two KPMG tax shelters, while HVB earned $5.45 million in three months for

Aside from fees for services, professionals gain a number of other benefits by promoting and facilitating abusive tax avoidance. The value of return clients and referrals must not be overlooked: a client who solicits tax services from Deloitte and is impressed with the tax savings they secure will be much more likely to solicit Deloitte’s services in the future or recommend Deloitte to others. Note that these referral and return clients need not be solely interested in tax services; gaining a reputation for delivering tax savings could have flow on effects in terms of increasing interest in accounting services, legal advice, business consultancy or other services offered by the company in question.

6. Capacity: What tax professionals could do about abusive tax avoidance

Tax professionals have significant capacities to help deter abusive tax avoidance and remedy the deprivation caused by its persistence. Indeed, there are important respects in which private sector tax professionals are better positioned than governments to help reduce the extent of tax avoidance.

To begin with, it is important to appreciate the vast financial and other resources available to the largest professional firms. The Big Four accountancy firms, for instance, are some of the world’s largest companies and operate in almost every state. Together the Big Four dominate the accountancy industry, are large players in the financial, consultancy, legal and tax professions, and employ many of the most knowledgeable and talented individuals in these areas. Many of the financial institutions and law firms that have been implicated in tax avoidance are likewise exceptionally well financed and connected. This is important for two reasons: it means that professional companies are likely to be able to afford the costs of action against abusive tax avoidance, and it suggests that the actual costs of such action will be relatively low for these firms, given their international reach.

One of the most significant ways in which professional firms demonstrate capacity to assist is in the development of better tax legislation. Since elected officials are rarely tax experts and governments have limited resources for hiring permanent tax advisors, the technical knowledge of private-sector professionals can greatly assist in the writing of new tax law. Staff at professional firms are routinely asked to participate in advisory committees on taxation legislation, and these arrangements can enhance the quality of the legislation produced (PAC 2013, 9). Private-sector tax professionals are not only well qualified to advise on tax legislation, but can also provide reliable insights into how changes to the law will actually effect taxpayers – insights which can help ensure changes have the desired effects and do not unintentionally punish certain groups.
Many professional firms have lax internal policies relating to the regulation of tax advice, the improvement of which could greatly reduce the extent of abusive avoidance. Despite their rhetoric about respecting tax law, the Big Four firms are willing to endorse tax reduction strategies with only a one-in-two likelihood of surviving a challenge by tax officials (PAC 2013, 9). Moreover, there are currently no repercussions for Big Four employees who promote strategies that are later declared abusive. If the Big Four are indeed serious about reducing their complicity in abusive tax avoidance, they ought to introduce stricter “riskiness thresholds” (closer to an 80 or 90 percent likelihood of surviving a challenge would be appropriate) and internal sanctions such as commission cuts for individual tax professionals who advise a strategy that is ultimately deemed abusive. One fortunate implication of the domination of the accountancy industry by just a few large firms is that policy changes of this kind are relatively easy to coordinate.

There is also a notable role for professional associations in remedying abusive tax avoidance. The 2005 American Jobs Creation Act (AJCA) introduced a number of tax compliance reforms, including stricter due diligence requirements, increased penalties for abusive tax avoiders, and sanctions for lawyers who write legal opinions that are designed to provide penalty protection for tax shelter users and promoters. The Tax Sections of the American Bar Association (ABA) and New York State Bar Association (NYSBA) campaigned for these reforms prior to their introduction in the AJCA, constructively advising the US Treasury on how to minimize administrative and compliance costs (Rostain 2006, 97-104). In supporting the AJCA tax reforms, the ABA and NYSBA most likely acted on a concern that the growth of the abusive tax shelter market was eroding the professional credibility of US tax lawyers (97-104). The case demonstrates the potential for professional associations to influence government tax authorities, as well as the capacity of these associations to align the interests of tax professionals with those of tax enforcers. Unfortunately the leading representative of accountants in the US, the American Institute of Certified Public Accountants (AICPA), fought the introduction of the AJCA reforms (99, 103).

Finally, but certainly not least importantly, tax professionals have significant influence over the decisions of the clients that they serve. Many individuals and corporations will not take a tax position that is not advised by their lawyers, accountants or other relevant professionals. While there may be nothing to prevent determined taxpayers from shopping around for a team of professionals willing to administer a highly abusive tax shelter, it is within the power of credible tax professionals to decide that the acquisition of additional clients is not worth compromising their professional integrity. We say more about the implications of professional integrity in the next and final section.10

7. Conclusion: The Import of Professional Integrity

We have argued that tax professionals, and in particular accountants, lawyers and financial advisors, causally contribute to abusive tax avoidance, benefit from their contributions, and also have the capacity to significantly reduce its extent. The fact that
all three of these connections can be established between tax professionals and abusive
tax avoidance strongly indicates that professionals (and the organizations which
represent them) have special responsibilities to remedy the situation in which abusive
tax practices are so rampant.

We find this convergence argument compelling, but we are aware it may not be enough
to convince all opponents. In particular, we expect that many practicing professionals –
especially those providing tax avoidance services – will look skeptically upon the
conclusion that tax professionals have “special responsibilities” to help combat abusive
avoidance. So, as a way of wrapping up, we briefly indicate that the responsibilities at
issue are not only consistent with, but already implied by, widely accepted standards of
professional integrity.

The tax professionals reviewed are bound by a number of relevant role-related
responsibilities which should already include concern for the types of improper tax
actions that concern us. Consider as one example the American Institute of Certified
Public Accountants’ Code of Professional Conduct (AICPA, 2014). The AICPA’s code
specifically notes that professionals have duties to serve the public interest. Indeed, the
mark of a professional is said to be the acceptance of responsibility to the public. The
public interest is defined in this code as “the collective well-being of the community of
people and institutions the profession serves”. As one illustration of the advice offered to
accountants, consider item 0.300.030.03 in the AICPA code. It says:

In discharging their professional responsibilities, members may encounter
conflicting pressures from among [various] groups. In resolving those conflicts,
members should act with integrity, guided by the precept that when members
fulfill their responsibility to the public, clients’ and employers’ interests are best
served.

When accountants devise tax avoidance schemes that illegitimately deny communities
much-needed revenue to sustain core functions, they fail to perform this important
professional duty.

Our submission then, is that if tax professionals take seriously the standards of integrity
and professional conduct described by the AICPA and other professional codes, they
should already be taking account of the responsibilities we have argued that they have.
At the very least, our arguments offered here provide additional support as to why such
professional duties ought to be taken more seriously than they typically are and what
taking such duties means in the case of abusive tax avoidance practices.11

References List

AICPA [American Institute of Certified Public Accountants]. 2015. AICPA Code of
Professional Conduct. Updated April 23. Available at:


---

1 Michelle Hanlon and Shane Heitzman (2010, 137) adopt a similar definition.
2 The latter category is often called “tax planning” or “tax mitigation.”
3 Note that we do not restrict our definition to explicit tax-reductions within a given tax year, as many abusive tax avoidance arrangements spread tax benefits across multiple tax years in an attempt to escape detection by authorities.
4 For similar estimates see Cobham (2005); Kar and Freitas (2012).
5 Older estimates include staggering amounts as well. See, for instance, Cobham (2005) and Oxfam GB (2000, 3).
6 For a detailed account of KPMG’s tax shelter activities, see PSI (2003).
7 KPMG eventually accepted a deferred prosecution agreement, admitting criminal wrongdoing and agreeing to pay $456 million to the U.S. Government (IRS 2005).
8 Guerin was sentenced to eight years in prison and ordered to pay $190 million (Hurdato 2013).
9 For an example, see PSI (2006, 389). We comment on the reforms introduced by the American Jobs Creation Act in Section 6.
10 An anonymous reviewer for this journal wonders whether we need to argue for a further claim for our argument to have force, namely that tax reduction practices that undermine the intent of legislation are morally unsupportable. The reviewer concedes that we do discuss the idea of fairness underlying tax law and the need to pay one’s fair share. The reviewer also notes that we present a compelling picture of the hardships faced by both developed and developing states and the unfairness of shifting the tax burden on to less well off citizens. However, the reviewer believes we should consider whether, in addition, we need to argue for the claim that those practices that undermine the intent (as opposed to the just the letter) of legislation are morally unsupportable. We thank the reviewer for this comment and for encouraging us to think through the issues. We believe that in the context of our particular argument, we do not need to take on this large and general issue. Rather, for our purposes we believe it is sufficient to argue that tax practices that undermine the intended results of legislation (results that can indeed be reasonably expected given good evidence) are morally unsupportable. Such practices undermine the effectiveness and equity of revenue collecting institutions, leading to deprivation for people whose capabilities depend on government funded initiatives. We have argued that tax professionals contribute towards, benefit from, and have the capacity to prevent these sources of deprivation. We hope that readers will be sufficiently persuaded by these connections between tax professionals and tax-related deprivation to accept that professionals have at least some obligations beyond conforming to the letter of the law.
11 There are a number of objections that could be made to the arguments we make in this paper. There is a view (with a fairly long history) that lawyers are independent from their clients and so are not morally responsible for their clients’ behavior. Lawyers can, for instance, represent criminals without being criminals themselves. In fact, the practice of offering legal representation relies on just such a distinction for the legal system’s being able to protect people’s rights robustly. Moreover, lawyers have duties to represent their clients’ interests and these fiduciary duties might well extend to advising their clients about loopholes in the law, including loopholes in tax law. Far from advice about making use of tax loopholes being morally objectionable, perhaps the conscientious lawyer ought to advise her client of just such options when they exist. Furthermore, tax shelter cheats are entitled to legal representation when they face charges and so a lawyer who takes on such a case without having designed the particular tax product is no more guilty of her client’s offenses than a lawyer who agrees to defend an accused murderer.
There are many responses to this cluster of concerns but here we highlight just a few. To take the last concern first, our primary target in this paper is those teams of tax professionals for whom three key responsibility factors converge: they are causally implicated in designing or implementing the problematic tax product; they benefit from these products; and they have excellent capacity to remedy the defective situation. These professionals often operate in highly organized teams, so they share responsibility for what they do together, even if an individual professional participates in only one highly predictable part of the process (such as legal challenges). As we saw in the Wyly case, lawyers are often core members of this team. Lawyers who only represent tax shelter cheats but have not causally contributed to the situation nor benefited from it and are not part of a team who provides such services, are not our primary target.

We would challenge several of the assumptions that underlie many of the objections. First, the actions of lawyers and those of their clients are not so easily distinguished in the cases at issue here. Rather, they work together in crucial ways when the teams of tax professionals create the products which will help clients avoid the tax in ways quite contrary to the spirit of the law (ie they fail the Canadian test discussed). Second, there are limits to the kind of partiality lawyers may show for their clients’ interests, even when they have fiduciary duties. These limits are frequently defined by courts, professional associations and other regulators. As we show in the final section, we believe plausible interpretations of the codes that govern the relevant professionals do support our case that the partiality limits were violated for the worrisome tax products. Recent court decisions and proposed regulation changes support our case. Third, in many cases the lawyers are involved not only as legal advisors but also as dealmakers who have considerable economic interest in the success of the products about which they are offering legal advice. Legal fees may well depend on successfully completing transactions, with premium billing rates applying to successful transactions and reduced fee structures for transactions that fail to close. We may therefore have reason to worry about conflicts of interest being in play. These conflicts may dispose legal advisors to violating professional norms about responsible legal judgment that gives proper consideration to public interests and other stakeholders who will be harmed by the successful operations of abusive tax products. Fourth, it may also be worth pointing out that we might well have one set of standards for practicing criminal law and the standards may differ for commercial and corporate law. Much of the force of the objections relies on what we think appropriate in criminal law, but it is a further question whether similar standards should unreflectively apply to corporate law.