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Larry's Tax Law

Another Tax Attorney Bites the Dust and Ends Up in Club Fed

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When tax advisors fail to follow the rules, it tarnishes our profession. The bad behavior may subject them to discipline by the body governing their practice, the Office of Professional Responsibility and/or the criminal justice system.

Discipline may come in many flavors, depending upon the severity of the misconduct. Sanctions generally consist of censureship, suspension, disbarment, financial penalties and imprisonment.

The stakes are high. Tax advisors and their firms need to know and follow the rules, and implement systems to ensure compliance by the members of their firms.

Background

Effective June 30, 2005, Treasury issued final regulations amending Circular 230 ("2005 Regulations"). The 2005 Regulations were specifically aimed at two goals:

- Deterring taxpayers from engaging in abusive transactions by limited or eliminating their ability to avoid penalties via inappropriate reliance on advice of tax advisors; and
- Preventing unscrupulous tax advisors and promoters from marketing abusive transactions and tax products to taxpayers based upon opinions that failed to adequately consider the law and the facts.

After the 2005 Regulations were issued, Treasury continued tinkering with the regulations to refine its approach, keenly keeping focus on these two goals. Accordingly, we have seen numerous refinements to Circular 230 in the past nine (9) years, including:

- Amendments to the 2005 Regulations published on May 19, 2005;
- Broadened authority granted by lawmakers to Treasury to expand standards relating to written advice on October 22, 2004, with the passage of the American Jobs Creation Act of 2004 ("AJCA"). In addition, the AJCA gave Treasury authority to impose monetary penalties against tax advisors who violate Circular 230;
- Amendments to Circular 230 published on February 6, 2006, in proposed form, adopting, among other things, monetary penalties for Circular 230 noncompliance. These regulations were finalized, effective

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September 26, 2007; and

- Amendments to the written advice provisions of Circular 230 published on October 1, 2012 in proposed form. These amendments were finalized on June 14, 2014.

Until 2005, Circular 230 was untouched for almost two decades. An enormous storm awoke Treasury from a deep sleep, causing a loud roar to permeate among lawmakers, the IRS, Treasury and the tax community. The result was the adoption of rules aimed at achieving the two goals set forth above.

The ultimate cause of the storm was the broad sweeping allegations of fraud and deception in the accounting and law professions which we saw in the early part of this millennium, including scandals involving ENRON, Global Crossing, imClone, WorldCom, Qwest, Tyco, HealthSouth and Aldelphia. Further feeding the storm were the black clouds created by the collapse of Arthur Andersen and the financial penalties assessed against and the practice limitations imposed upon KPMG. Last, but certainly not least, the investigations and lawsuits against tax advisors (and their firms) for developing and marketing abusive tax shelters, including the investigations and lawsuits leading to the demise of the large law firm of Jenkens & Gilchrist ("Jenkens"), added to these dark times.

The Demise of a Law Firm

In the early 1990s, Jenkens was a midsize law firm based out of Dallas, Texas. Like many law firms, it had grandiose expansion plans, including hiring lateral attorneys and opening offices beyond Texas. As the plans were implemented, the firm's increasing focus became raising the profits per partner.

In 1998, Jenkens successfully recruited Chicago tax attorney Paul Daugerdas ("Daugerdas"). Daugerdas was not a rookie tax attorney. He had been a partner with Arthur Andersen and later chaired the tax practice in the Chicago office of law firm Altheimer & Gray. With Daugerdas's help, the Jenkens tax department grew exponentially and the profits from his tax shelter practice soared to record heights. The firm's management appeared enthralled with its growth and new-found profit achievements, especially the huge revenues generated by Daugerdas and his practice.

Unfortunately, it was too late when the firm finally decided to put an end to the tax shelter business. According to the government, it ran a 10-year scheme that created $8 billion in tax deductions and over $1 billion in losses, all of which it alleged were improper. After being audited by the IRS and losing the significant deductions, clients eventually sued the firm, claiming the tax shelters were fraudulent. At that time, the government began significant investigations into the firm and its practices. Unable to withstand the stress and financial strain from the client claims and the government's investigation which resulted in a penalty assessment exceeding $75 million, the firm eventually closed its doors.

On June 9, 2009, at least seven (7) individuals were indicted on criminal charges, including Daugerdas, some of his former colleagues from Jenkens and BDO Seidman's former CEO. The indictment is a detailed 78-page chronology of the alleged events. The Jenkens firm, itself, avoided prosecution when it, in 2007,

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entered into a nonprosecution agreement. It likely paid a good portion of the $76 million penalty assessment.

The Long and Tumultuous Saga of Paul Daugerdas

In the case against Daugerdas, the government asserted, among other things, that he participated in a scheme to defraud the IRS by designing, marketing, implementing and defending fraudulent tax shelters. Through a variety of strategies, his firm issued written opinions to clients, concluding losses and deductions generated from the tax shelters would more likely than not survive IRS challenge. In addition, Daugerdas and five (5) other defendants personally used the tax shelters to evade income taxes on substantial income. John A. DiCicco, then-acting Assistant Attorney General for the Tax Division of the Department of Justice, said at the time of the indictments: "Dishonest and fraudulent tax professionals, including accountants, attorneys, and bankers, should stand up and take note of today's indictment. Professionals who sell and promote fraudulent tax shelters that help wealthy clients illegally evade taxes face serious felony charges and substantial prison time."

The case proceeded to trial. Before trial commenced, however, two (2) of the defendants pleaded guilty and agreed to cooperate with the government. Daugerdas and four (4) other defendants continued the case, eventually seeing the eyes of a judge and a jury in a Manhattan courtroom. On May 24, 2011, Daugerdas, along with three (3) others, were found guilty of charges, including conspiracy and tax evasion. One (1) of the defendants was found not guilty.

Following the initial trial, Judge William H. Pauley III, U.S. District Court for the Southern District of New York, dismissed the convictions of three (3) of the defendants found guilty when he discovered a juror had lied about her background in an effort to enhance her chances of being selected for jury duty. It turns out the juror was a suspended attorney with a substance abuse problem. One (1) of the defendants agreed to a plea after the verdict and before Judge Pauley overturned the convictions. That defendant was not eligible for a new trial.

The case proceeded to a second trial. Just before the second trial began, one (1) of the three (3) remaining defendants pleaded guilty. She was sentenced to eight years in prison and ordered to pay $190 million in restitution. This left Daugerdas and one (1) other defendant, Denis Field, the former CEO of BDO Seidman, to battle it out for a second time.

On November 4, 2013, the jury in the second trial found Mr. Field not guilty. Daugerdas, however, did not attain such a positive outcome. The jury found him guilty on seven (7) charges, including conspiracy and tax evasion. On June 25, 2014, Judge Pauley finally sentenced Daugerdas to 15 years in prison.

Daugerdas and tax advisors like him are primarily responsible for causing Treasury to create the 2005 Regulations, especially the written advice provisions. Fortunately for the tax community, as mentioned in my June 24, 2014 blog post, Treasury finally amended Circular 230, eliminating the crazy practitioner written advice disclaimers and easing up the written advice requirements. Still, because of cases like the

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Daugerdas case, practitioners need to be cautious. The government will not allow the creation, implementation and marketing of abusive tax shelters. Daugerdas's journey and the demise of Jenkens should be a lesson to the entire tax community. Daugerdas's journey was long and tumultuous, but in the end it should serve as a warning to tax advisors. The stringent and complex Circular 230 written advice rules may have recently been relaxed, but tax advisors are still subject to a high standard of conduct. A good working knowledge of Circular 230 is required of all tax advisors. Compliance is paramount.

Posted in Business Taxes, Circular 230, Individual Income Tax, Tax Laws

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