Ethics, The Law and Taxes:
The Ethical and Legal Implications of a Tax Shelter

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It is accepted practice for business students to take ethics courses. These courses typically focus on case studies to illustrate ethical dilemmas that the students analyze during the course. These case studies take different forms, so any type of case involving an ethical dilemma could be presented. Tax cases are not typically used as case studies in these courses although tax case studies can effectively be used in ethics courses. This paper thus presents a tax case study that can be used by instructors.

INTRODUCTION

It is now accepted practice for business students in Colleges of Business to take an ethics course and this is the case across the majors. These ethics classes thus have marketing majors, management majors, accounting majors, etc. all taking the same ethics course.

Many of these courses focus on case studies to illustrate ethical theories and dilemmas that the students then analyze and work with during the course. These case studies may take many forms: celebrities might be involved (Martha Stewart), the case could be from decades ago (Ford Pinto) or the case could be one that is discussed in many different classes (Enron). Because these case studies take many different forms, nearly any type of case involving an ethical dilemma could be presented to students in their ethics classes.

While earnings management cases are prevalent in ethics classes, tax cases are not. This could be because tax cases are more complex, that there just are not many tax cases with an ethical dilemma involved or maybe instructors just are not as interested in discussing such cases. In this paper, we, however, present a tax case study that we believe would be interesting to students as well as helpful to instructors teaching ethics. We begin by discussing the facts of the case, we then discuss the court decision in the case and finally, we analyze the case to determine if the court decision was appropriate or not. Most citations to the case refer to the written decision of the trial judge in the case with the exception of the discussion of the appellate decision in the case.

TAX SHELTERS

The 1990's saw a dramatic increase in the use of corporate tax shelters. The Internal Revenue Service (I.R.S.) reported that just one strategy involved 1,165 taxpayers and resulted in collections of $3.2 billion dollars (Flom, 2005). It was reported that the I.R.S. record of litigating tax shelters in the 1990's was about 50-50 (Flom, 2005). The I.R.S. lost high profile cases at the trial court level involving GE Capital and Black & Decker (Flom, 2005). Although there were early wins at the trial court level, many of these taxpayer victories were reversed on appeal (*TIFD III-E Inc.,* 2006). Others on appeal gave the Treasury only partial victories (Tax Notes, 2007, p. 980).

By 1999, the Treasury Department developed a plan to crack down on corporate tax shelters as part of President Clinton's 2000 budget proposal. The AICPA tax executive chair, David A. Lifson, testified before the Senate Finance Committee that the Treasury plan provided, "virtually unbridled discretion in the imposition of penalties and other sanctions" (Rankin, 1999). The Joint Committee on Taxation stated in a report, "Although economic information concerning the cost of tax shelters is largely anecdotal, some believe that the resulting revenue loss may be in excess of $10 billion a year. This amount is equal to approximately five percent of annual corporate income tax receipts" (Joint Committee on Taxation, 1999).

In 1998, *Forbes* reported that, although hesitant at first to participate, respectable accounting firms, law offices, and public corporations succumbed to competitive pressures to join the "loophole frenzy" (Novack and Saunders, 1998, p. 198). The corporate shelters were described as based on "arcane quirks in the tax code" (Novack and Saunders, 1998, p. 198). By the turn of the century, the use of corporate tax shelters was a widespread tax planning strategy and the Treasury Department was determined to use its power to stop the practice. This is the history and background that the accounting firm Grant Thornton, LLP was aware of when they began selling a tax shelter known as Lev301 to Yung in 2000. Then, in 2013, a Kentucky state court ordered Grant Thornton to pay $100 million in compensatory and punitive damages to their client.

PARTIES IN THE CASE

The plaintiffs in the case were William and Martha Yung (*Yung*, 2013). Yung is "an experienced business man" and a "successful hotelier and entrepreneur" (*Yung,* 2013, p. 2). Yung began an S corporation, Wimar Tahoe Corporation, and through that corporation, Yung bought casinos in a number of states (*Yung*, 2013, p. 2).

More pertinent to this case, Yung "also owns hotels and casinos in the Cayman Islands through Wytec, Ltd., and Casuarina Cayman Holdings, Ltd., Cayman Island holding corporations, which are the entities used to purchase the Grant Thornton 301 Leveraged Distribution Product": the subject of the trial and thus, this paper and case (*Yung,* 2013, p. 2). Grant Thornton, a public accounting firm, was hired by the plaintiffs in the 1990's through 2007 for tax advice (*Yung,* 2013, p. 5). Grant Thornton was the defendant in this case (*Yung,* 2013, p. 1).

TAX PRODUCT

William J. Yung, through direct and indirect investment, owned two controlled foreign corporations (CFC's) that owned hotels and casinos in the Cayman Islands. The United States did not tax the earnings of a CFC until dividends are paid to the U.S. shareholders. Grant Thornton developed a strategy to repatriate the earnings to the United States without being subject to taxation by the United States. That strategy was referred to as 301 Leveraged Distribution Product (*Yung,* 2013, p. 2).

"Grant Thornton developed a strategy designed to make certain types of distributions of monies with a minimum of tax consequences which it then marketed to clients, including Yung" (*Yung,* 2013, p. 11). This strategy, the 301 Leveraged Distribution Product ("Lev301") was then used by Yung in a way that specifically applied to Yung and his businesses (*Yung,* 2013, p. 12). The Lev301 moved "money from the

Cayman Islands into the United States" and did so by distributing profits of the Cayman Island holding corporations to the plaintiffs and their trust (*Yung,* 2013, p. 12). This was done through "fully encumbered securities, thus in theory avoiding any tax consequences to the shareholders" (*Yung,* 2013, p. 12). Under this plan, the Cayman Island holding corporations bought $30 million worth of two-year Treasury Notes and then borrowed the same amount of money using the Treasury Notes as security (*Yung,* 2013, p. 12). Thus, the Treasury Notes would have a "zero net value on the books" and could be transferred to the Yungs and their Trust back in the United States (*Yung,* 2013, p. 12). Then, the Cayman Island holding corporations pay off the debt at a later date with cash and other securities (*Yung,* 2013, p. 12).

After meeting with Grant Thornton, Yung agreed to this plan (*Yung,* 2013, p. 12). Grant Thornton contended that case law supports the fact that a shareholder's assumption of responsibility for the debt is not required (*Owen,* 1989; *Seggerman Farms, Inc.,* 2002, p. 808: "refusing 'to fashion a case-specific exception to the clear and unambiguous provisions of subject-to-a-liability provision in a statute' ").

In late December 2000, Grant Thornton based its conclusion that no taxable income would result from a Lev301 distribution on the "subject to" language of I.R.C. §301(b)(2)(B), the constructive dividend doctrine, and the interpretation that judicial doctrines cannot take precedence over a "textualist" interpretation of a statute (*Yung,* 2013, p. 57, 58). Regarding the constructive dividend, Grant Thornton argued that no constructive dividend was due because the shareholders were not personally liable for the bank debt due to not receiving a benefit from the repayment of the debt (*Yung,* 2013, p. 58). Regarding judicial doctrines, Grant Thornton believed they could not be applied to an unambiguous statute such as I.R.C. §301 (*Yung,* 2013, p. 58).

In January 2001, the "January 4th Regulations" came out five days after the Yung distributions under Lev301 (*Yung,* 2013, p. 59). The Regulations stated that they were to be applied **retroactively** to transactions described in Notice 99-54 ("Bossy"-like transactions) (*Yung,* 2013, p. 59, 60, 61). The Regulations seem to require that a shareholder who receives a distribution of T-Notes in a situation as with the Lev301, cannot reduce the value of such by the amount of the liability (*Yung*, 2013, p. 60). Grant Thornton, as a result, quit marketing Lev301, but did not inform Yung of this fact nor the fact that the January 4th Regulations would be retroactive and would result in tax consequences (*Yung,* 2013, p. 68). Was this so that Grant Thornton would not lose their $900,000 engagement fee? Did Grant Thornton purposefully fail to disclose all information to Yung needed for him to make a fully informed decision? Is Grant Thornton's conduct gross professional negligence?

The Regulations state that the Regulations apply retroactively only where the transaction was substantially similar to the transaction described in Notice 99-59. That transaction was a Bond and Option Sales Strategy (BOSS) and Notice 99-59, known as the "BOSS Notice," and stated that the tax loss claimed in such transactions was not allowable for federal income tax purposes and penalties could be assessed (*Yung,* 2013, p. 15). In 2000, regulations were also passed in an effort to reduce and/or eliminate abusive tax shelter practices (*Yung,* 2013, p. 15. 16).

A BOSS transaction consists of:

1. An individual acquiring stock in a newly formed foreign corporation with no business activity or employee.
2. The foreign corporation borrowed from a bank to purchase securities.
3. The foreign corporation distributes securities to the individual.
4. The individual then disposes of the foreign corporation stock for zero consideration. The loss is used to offset income from legitimate business ventures. (Bond and Option Sales Strategy (BOSS) and Notice 99-59).

This notice describes the sale of stock and the use of losses to offset other income (Bond and Option Sales Strategy (BOSS) and Notice 99-59). In the Yung transaction, no stock was sold and no gains were offset (*Yung,* 2013, p. 12). There were no losses claimed (*Yung,* 2013, p. 12). The event was a distribution to the shareholders (*Yung,* 2013, p. 12). The fact that the I.R.S. issued new regulations would seem to support Grant Thornton's interpretation of the law as of the date of the transaction. Why were new regulations needed otherwise? Later in 2001, the CFCs repaid the Bank loans and the Bank released its security interest in the collateral (*Yung,* 2013, p. 12). Did the shareholders recognize income upon the third party repayment of debt? A literal reading of the statute and the Regulation in effect at the time of the transaction seem to support Grant Thornton's position that distribution income is determined by reference to the liabilities to which the property is subject "immediately before and immediately after the distribution" (Reg. §301(b)(2(B) former Reg. §1.301-1(g)). In June 2005, the I.R.S. found the Lev301 transactions fully taxable and assessed a 20% penalty although this was, through settlement, reduced to a penalty of 13% of the tax due (*Yung*, 2013, p. 103, 104).

Was this too aggressive? Grant Thornton believed support for the position could be found in the Seventh Circuit Court of Appeals in *Falkoff* (*Falkoff,* 1979). The Seventh Circuit stated that holding assets subject to a loan does not make the shareholder personally liable for repayment of the loan. Grant Thornton reasoned that as the shareholder was not personally liable for the loan, no dividend results to the shareholder when the CFCs repay the Bank under *Falkoff* (*Falkoff*, 1979).

JUDICIAL DOCTRINES

There are three judicial doctrines involved in this case: the Business Purpose Doctrine, the Sham Transaction Doctrine, and the Step Transaction Doctrine (*Yung,* 2013, p. 18). Grant Thornton did not think that these judicial doctrines would invalidate Lev301 (*Yung,* 2013, p. 18). Under the Business Purpose Doctrine, a transaction must have a valid business purpose and not, for instance, be merely a ploy to avoid taxes (*Yung,* 2013, p. 18). The Sham Transaction Doctrine requires transactions to have economic substance and the Step Transaction Doctrine states that tax results should be considered in light of the total transaction and not be based on separate steps involved in the process (*Yung,* 2013, p. 18).

Should the distribution of the Treasury Notes to the Yungs by the CFCs that they controlled followed by the repayment of the loans by the corporations be collapsed into one transaction? The expert witnesses disagreed on this point. Ethan Yale of the University of Virgina Law School testified that he believed such because the distribution itself was not tax motivated (whether taxable or not, the distribution to the shareholders was to be used in an acquisition of another company and therefore had a business purpose) (*Yung*, 2013, p. 138). Additionally, the repayment of the loan by the CFCs to the Bank was ten months after the distribution to the shareholder so he stated, "the steps were not in rapid-fire sequence" (*Yung,* 2013, p. 138). Michael Hamersley, however, testified that the conclusions of the opinion were inaccurate because the judicial doctrines collapse the transaction (*Yung,* 2013, p. 108).

SALE OF LEV301

Grant Thornton began "selling" Lev301 to Yung through his company treasurer in 2000. At trial it was established that Grant Thornton "believed there was a 90% chance that the IRS would disallow the tax benefits of Lev301 on audit" and yet, this was not disclosed to Yung's treasurer (*Yung,* 2013, p. 25). Based on trial testimony, if this information had been known, discussions on Lev301 would not have gone forward and there was a very real risk that Lev301 was going to be viewed by the IRS as "an unlawful BOSS-like tax shelter" (*Yung,* 2013, p. 26). Lev301 was discussed, however, as a "lawful tax strategy" to move cash from the Caymans into the United States (*Yung,* 2013, p. 28). Yung was also not properly told about the business purpose requirement, nor was he told that penalties could be assessed (*Yung,* 2013, p. 28, 29). The Treasury Department issued Notice 99-59 which required tax shelter promoters to disclose the identity of those who purchased certain shelters (listed transactions). After the I.R.S. notice, Grant Thornton decided that Lev301 purchasers would have to be disclosed on Grant Thornton's promoter list (*Yung,* 2013, p. 38). It was also the court's opinion that Grant Thornton did not disclose this information to Yung so the sale would go forward and the question becomes: does this violate the standard of care in this case? The court decided yes (*Yung,* 2013, p. 39). Grant Thornton also did not inform Yung "prior to closing of the 'list maintenance' requirements, the reporting issues, or that Grant Thornton had not reached a 'more likely than not' confidence level" regarding the Lev301. The

Court concluded this information would have caused Yung to not pursue the Lev301 (*Yung,* 2013, p. 56, 57).

DID GRANT THORNTON ACT ILLEGALLY?

In expert testimony, one expert stated that Lev301 would fail the judicial doctrines test and thus, Grant Thornton's opinion that the judicial doctrines "more likely than not" would not override the Lev301 strategy was not correct (*Yung,* 2013, p. 110). The expert further stated that the Grant Thornton opinion that judicial doctrines do not have to be applied to the statute (I.R.C. §301) because the statute is unambiguous is also incorrect in light of a case which interpreted the code differently from Grant Thornton—which, by its very existence, proves ambiguity due to these two existing different interpretations (*Yung,* 2013, p. 110, 111).

The expert further stated that the Lev301 transaction created a dividend and thus, the distribution was fully taxable, "a loan does not change its character because there is a distribution" (*Yung,* 2013, p. 114, 115). The expert also testified that the Lev301 transaction was similar to a BOSS transaction (*Yung,* 2013, p. 115, 116). The expert stated that the judicial doctrines must be examined to determine if a tax shelter is abusive and that Grant Thornton "willfully, inadequately, and incorrectly applied these doctrines in its Lev301 opinions to the Yungs" (*Yung,* 2013, p. 116). According to the expert, under the step transaction doctrine, this is a single step transaction (a distribution of T-Notes unencumbered) and thus, is actually a dividend distribution of T-Notes to the shareholders because the encumbrance is unnecessary and insubstantial (*Yung*, 2013, p. 116, 117). The expert further testified that the Grant Thornton analysis of the step transaction doctrine is short in length and analysis (*Yung,* 2013, p. 117).

This transaction also is found to fail the business purpose test, according to the expert, because this was a "tax motivated transaction and not a business motivated transaction" and there is no "business advantage for a stated purpose" here (*Yung,* 2013, p. 118). The expert found there was no expectation for profit here and thus, "application of the non-tax purpose test emphasizes that this transaction was undertaken only to distribute dividends to the shareholders without tax consequences and it was, therefore, a sham transaction" (*Yung,* 2013, p. 119). Finally, the expert testified that Grant Thornton failed to exercise due professional care here "because they developed a strategy, came up with facts" without "sufficient legal basis and authority" (*Yung,* 2013, p. 121). The expert also believed Grant Thornton was not "correct, prudent or reasonable in rendering their Opinion" and that a reasonable tax practitioner would have decided that the I.R.S. would see the Lev301 as an abusive tax shelter similar to a BOSS transaction and, "Grant Thornton's advice to not disclose the transaction or report the distribution was in violation of the tax code and Circular 230" (*Yung,* 2013, p. 122).

A second expert called at trial supported Grant Thornton and testified that the step transaction doctrine would not apply here because Yung was not attempting to avoid taxes and the steps involved did not happen one right after the other (*Yung,* 2013, p. 126). This expert believed that the ten months that separated the events means that the Lev301 cannot be seen as one transaction. (*Yung,* 2013, p. 126, 127). This expert also testified that the January 4th Regulations did not apply here as those Regulations would not retroactively apply to the Yung transaction because the Lev301 transaction was not "substantially similar" to a BOSS transaction (*Yung,* 2013, p. 137).

This expert also believed that there was economic substance to the transaction and that the transaction did have a valid business purpose and not just a tax-avoidance purpose (*Yung,* 2013, p. 138). The expert found four business purposes here: "having liquidity for working capital to undertake renovation and construction projects," "repatriating funds to purchase Lodgian," "using lending opportunities to form new working relationship with lenders," and "borrowing money at a floating rate to make a fixed rate investment in Treasury Notes" (*Yung,* 2013, p. 138).

Did Grant Thornton act illegally in this case? The court held that Grant Thornton acted illegally by committing fraud by misrepresentation (*Yung,* 2013, p. 166-177). The court found that Grant Thornton made false representations, that these were made to induce Yung to continue with the Lev301 transaction and that Yung reasonably relied upon "its trusted tax advisor" (*Yung,* 2013, p. 166-174).

The court also held that Grant Thornton was guilty of fraud by omission. The court held that Grant Thornton failed to disclose a material fact as they were required to do in their professional accountant-client relationship with Yung (*Yung,* 2013, p. 178). Specifically, the court found that Grant Thornton should have told Yung about the list maintenance requirement and that the Lev301 transaction was similar to a BOSS transaction (*Yung,* 2013, p. 178-180). The court further found that this omission was due to Grant Thornton wanting Yung to complete the Lev301 transaction and thus, was an inducement to act (*Yung,* 2013, p. 181).

Finally, the court held that Grant Thornton committed gross professional negligence. The court found that Grant Thornton committed gross professional negligence because Grant Thornton did not properly advise Yung about the Lev301, did not properly recognize the Lev301 as a step transaction (and as such, was not "legally supportable"), did not meet objectivity standards in preparing the Yung tax returns (by attempting to hide the Lev301 transaction), did not properly advise Yung to unwind the transaction, and did not tell Yung that the Lev301 was being audited (*Yung,* 2013, p. 185-190).

The court found these as misrepresentations:

- The representation that no penalties would be assessed based on the "more likely than not" standard (*Yung,* 2013, p. 168).
- The representation that G.E. and P&G had utilized the strategy (*Yung,* 2013, p. 168).
- The more likely than not standard had not been determined at the time the product was sold (*Yung,* 2013, p. 168).
- When a letter expressing a more likely than not opinion was issued, the court found Grant Thornton partners knew that the business purpose doctrine was not met (*Yung,* 2013, p. 170).
- The Grant Thornton partners' opinion that the January 4th representation did not effect this transaction and such representation led to the Yungs not rescinding the transaction (*Yung,* 2013, p. 171).

In determining the measure of damages, "The court finds that, had Yung not decided to utilize the Lev301 strategy, he would not have authorized the companies to make $30,000.000 in distributions in 2000. The taxes, penalties and interest paid to the IRS are directly attributable to the misrepresentations made by Grant Thornton and relied upon by Yung in entering into the Lev301 transactions" (*Yung,* 2013, p. 175). In prior administrative hearings before the I.R.S., attorneys representing the Yungs[1] represented to the I.R.S. that the Yungs were pursuing the acquisition of a publicly-traded company, Lodgian, Inc. Lodgian owned and operated 114 hotels worldwide (*Yung,* 2013, p. 59). Mr. Yung and his companies already owned 14.9% of the stock of Lodgian and were seeking to acquire 100% ownership (*Yung,* 2013, p. 59). They further represented "He [Yung] expected to finance the investment by drawing on the equity and credit of all his companies and trusts, including Columbia Sussex, CCH, Wytec, the GRATs, and the Family Trust. The planned acquisition required liquidity in the United States as well in the Caribbean" (Protest, 2006, p. 4).

Additionally, they stated that the previous cash distributions from the CCH and Wytec had been taxable (Protest, 2006, p. 5). If there was a need for liquidity in the United States, and in light of the fact that the CFCs had made previous taxable distributions, is it clear the only reason taxes were incurred was the Lev301 strategy?

UNWIND STRATEGY

The court stated, "The evidence also shows that the Lev301 distributions could have been unwound for up to two years after they were made and that potentially no taxes would have been owed had this been done" (*Yung,* 2013, p. 175). Lee Sheppard, who the court noted is a "well-known and respected commentator on federal income tax issues (*Yung,* 2013, p. 16), considered the case of *Penn v. Robertson* (1940). Ms. Sheppard noted that the court ruled that the shareholder in *Penn* was held to be in constructive receipt of a dividend in the year received. In that case, the court respected the "cardinal principle of federal income taxation requires annual returns and accounting" (Sheppard, 2010, p. 915).

The rescission doctrine, sometimes called the "unwind doctrine," is understood to provide that a transaction may be disregarded for federal income tax purposes if the parties return to the status quo in the same tax year (Prebble and Huang, 2011, p. 721). If the rescission doctrine requires the transaction to be unwound in the same year, it appears it would be of little benefit to unwind the dividend. There was constructive receipt of the dividend on December 29, 2000, and it seems doubtful the I.R.S. would have respected the rescission. The court may have been incorrect here, however.

DID GRANT THORNTON ACT UNETHICALLY?

How should Grant Thornton's professional conduct be viewed? Professional Conduct is covered by several bodies. The American Institute of Certified Public Accountants (AICPA) rules are contained in the Statement on Standards for Tax Services. The Kentucky State Board of Accountancy governs conduct through Administrative Regulations which essentially adopt the AICPA standards (The American Institute of Certified Public Accountants (AICPA) Rules, Statement on Standards for Tax Services). The Internal Revenue Service regulates practice before the I.R.S. through Circular 230 (Circular 230 §10.34(4)(i)). How do the actions of Grant Thornton look through the lenses of each? These questions will be revisited and discussed below and answers based on case law, professional regulations, and expert testimony in the case will be presented.

As mentioned above, the court held that Grant Thornton committed gross professional negligence and the court further stated that many of the Grant Thornton partners "could have had their law and/or accounting licenses suspended for the fraudulent acts against their clients" (*Yung,* 2013, p. 209). Did Grant Thornton comply with professional standards in advising the Yungs? The AICPA's Statements on Responsibilities in Tax Practice (Tax Executive Committee of the American Institute of Certified Public Accountants, 1991) contain provisions which governed Grant Thornton's advice and tax return preparation. Statement on Responsibilities in Tax Practice No. 1, issued August 1998, was the standard in place at the time of the advice. That authority provided that, "A CPA should not recommend to a client that a position be taken with respect to the tax treatment of any time on a return unless the CPA has a good faith belief that the position has a **realistic possibility** of being sustained administratively or judicially on its merits if challenged" (Emphasis added).

The second applicable standard is the realistic possibility standard (Tax Executive Committee of the American Institute of Certified Public Accountants, 1990) which was in effect at the time of the engagement. That authority states in part:

> The realistic possibility standard cannot be expressed in terms of percentage odds. **The realistic possibility standard is less stringent than** the "substantial authority" and the **"more likely than not"** standards that apply under the Internal Revenue Code to substantial understatements of liability by taxpayers. It is more strict that the "reasonable basis" standard under regulation issued prior to the Revenue Reconciliation Act of 1989 (Tax Executive Committee of the American Institute of Certified Public Accountants, 1990, paragraph .06). (Emphasis added).

Grant Thornton's opinion was made under the "more likely than not" standard. The AICPA Code of Conduct does not express "realistic possibility" in terms of a percentage. However, in Circular 230, the Internal Revenue Service does express "realistic possibility" in terms of a one-in-three chance based upon its merits (Standards with respect to tax returns and documents, affidavits and other papers, 2011). The "more likely than not" used by Grant Thornton under Treas. Reg. § 1.6662-4 uses a measure requiring a greater than fifty percent chance of being sustained (Reg. §1.662-4(g)(4)(i)(B)).

The AICPA provides guidance for the process to be done by a CPA to research and conclude that a "realistic possibility" exists. Interpretation No. 1-1 states:

In determining whether a realistic possibility exists, the CPA should do all of the following:

a. Establish relevant background facts.
b. Distill the appropriate questions from the facts.
c. Search for authoritative answers to the questions.
d. Resolve the question by weighing the authorities uncovered by that search.
e. Arrive at a conclusion supported by the authorities (1990, paragraph .08).

The Grant Thornton opinion followed the appropriate format to make a determination under the "realistic possibility" standard as is explained above.

Finally, an analysis of the Statements on Responsibilities in Tax Practice considered in light of Grant Thornton's engagement with the Yungs must consider the Form and Content of Advice to Clients (Tax Executive Committee of the American Institute of Certified Public Accountants, 1988). The authority on Form and Content of Advice requires that, "the CPA should follow the standards in SRTP No. 1" (Tax Executive Committee of the American Institute of Certified Public Accountants, 1988, paragraph .03). While discussing the requirements concerning Advice to Clients, the following language of the regulations is noteworthy:

> While developments such as legislative or administrative changes or further judicial interpretations may affect the advice previously provided, the CPA cannot be expected to communicate later developments that affect such advice unless the CPA undertakes this obligation by specific agreement with the client. Thus, the communication of significant developments affecting previous advice should be considered an additional service rather than an implied obligation in the normal CPA-client relationship (Tax Executive Committee of the American Institute of Certified Public Accountants, 1988, paragraph .09).

It is important to note that commentators have observed that the CPA has a different role as a tax advisor as compared to an auditor. In *Federal Tax Research*, Professor Raabe (2005) observed:

> Prior to the most recent revision of Rule 102, a CPA in tax practice could resolve doubt in favor of the client. This phrase was omitted in the revised language because resolving doubt in favor of a client in an advocacy engagement is not considered as impairing integrity or objectivity and thus need not be specifically "allowed" (Raabe, et. al. p. 15).

Grant Thornton's practice before the Internal Revenue Service is governed by Circular 230. At the time of the engagement, expressing an opinion with regard to the consequences for the distribution, the effective circular was dated July 1, 1994. Circular 230 §10.34 is titled "Standards for advising with respect to tax return positions and for preparing or signing returns." That provision states in part:

> A practitioner may not sign a return as a preparer if the practitioner determines that the return contains a position that does not have a realistic possibility of being sustained on its merit [the realistic possibility standard] unless the position is not frivolous and is adequately disclosed to the service…

A "realistic possibility" considers that a reasonable and well-informed analysis by a person knowledgeable in tax law would lead to a conclusion that the position has approximately a one-in-three chance of being sustained (Circular 230 §10.34(4)(i)). The professional must evaluate the tax position using substantial authority which includes applicable provisions of the Internal Revenue Code, Regulations, Revenue Rulings, court cases and Congressional intent (Substantial understatement of income tax, 2003).

When considering Grant Thornton's obligations under Circular 230, Grant Thornton established the relevant background facts, distilled the appropriate questions from the facts and searched the appropriate authorities. These authorities are: The Internal Revenue Code, judicial authority supporting the use of the clear language of the Internal Revenue Code, regulatory authority in effect at the time of the transactions and effective after the date of the transaction, judicial authority on distributions of property subject to a liability to shareholders, judicial authority supporting the taxpayers' position in the event the Internal Revenue Service asserted that shareholders would recognize income upon payment of the liability associated with the property distributed, judicial authority that conflicts with cases favorable to a taxpayer's position, judicial doctrines which the Internal Revenue Service attempts to use to override the Internal Revenue Code, and, finally, regulations of favorable judicial authority. Based on this, Grant Thornton thus arrived at a conclusion that it believed was supported by the authorities. Grant Thornton evaluated the authorities and expressed an opinion based upon the "more likely than not" standard which exceeds the "realistic possibility standard."

The Tax Opinion Letter to the Yungs stated, "Our conclusions are summarized in Section I of the Opinion. It is our Opinion that it is more likely than not that if such issues are presented to a court, the court would arrive at the same conclusions" (Grant Thornton Opinion letter, 2001, p. 73).

Grant Thornton's Opinion Letter was designed to meet the standard set forth in Treas. Reg. §1.662-4. That regulation requires that the tax advisor must conclude that there is a greater than 50% likelihood that the tax treatment will be upheld if challenged by the Internal Revenue Service (Treas. Reg. §1.662-4(g)(4)(i)(B)). The weight of the authority will depend on its relevance and persuasiveness (Treas. Reg. §1.662-4(d)(3)(ii)). The tax profession must rely on substantial authority which includes, for example, the Internal Revenue Code, regulations, rulings, and court cases (Treas. Reg. §1.662-4(d)(3)(iii)).

The Tax Opinion Letter provided by Grant Thornton was a comprehensive evaluation of the facts, and the applicable law and regulations involving the distribution. The Opinion Letter considered the facts of the underlying transaction and these facts were described in pages 3, 4, 5 and 6. Further representations as to the form of the transaction made to Grant Thornton by the Yungs are restated in pages 6 and 7 of that letter. Grant Thornton evaluated the applicable provision of the Internal Revenue Code and concluded that the plain language of the Internal Revenue Code supported their Tax Opinion Letter in this case.

An evaluation was made regarding the position of the appellate courts, including the U.S. Supreme Court, in allowing use of the plain language of the Internal Revenue Code. Further evaluation was made again using judicial authority to evaluate the ability of the Internal Revenue Service to succeed when challenging the "plain meaning" of the Internal Revenue Code. The Tax Opinion Letter addressed judicial decisions where the statutory language is clear and the court concluded that the plain language leads to a result that may not have been intended. It was concluded, based upon that review, that judicial authority supported a literal reading of the Internal Revenue Code. Thus, Grant Thornton's Tax Opinion Letter contained advice based on a position in which Grant Thornton had knowledge of all material facts and, on the basis of those facts, concluded that the position was appropriate. Yung attorneys Mayer, Brown, Rowe & Maw LLP, independent counsel acting on behalf of the Plaintiffs before the I.R. S. in an administrative hearing, confirmed Grant Thornton's adherence to the requirements of Circular 230.

Concerning the mitigation of penalties, Mayer, Brown, Rowe & Maw LLP, as the Yungs' attorneys, wrote to the IRS, "The Grant Thornton advice meets the regulatory requirement, and the Taxpayers meet each of the requirements under the judicial three-part test…" (*Yung,* 2013, p. 31). That letter further stated, "The Grant Thornton advice was based on all pertinent facts and circumstances and the law as it related to the facts and circumstances" (*Yung,* 2013, p. 32). The letter also states, "The Grant Thornton opinion was not based on any unreasonable factual or legal assumptions and does not unreasonably rely on the representations of the Taxpayers or any other person." Thus, the statements of the independent counsel, Mayer, Brown, Rowe & Maw, support the conclusion that Grant Thornton complied with the requirement of Circular 230 and the Treasury Regulations.

COURT OF APPEALS DECISION

This case also resulted in an appellate decision from the Kentucky Court of Appeals in *Grant Thornton, LLP v. Yung,* NO. 2014-CA-001957-MR (Ky. Ct. App. Sep. 16, 2016).

An issue the Court of Appeals addressed was whether or not the punitive damages awarded by the trial court were excessive (*Grant Thornton,* 2016, p. 43). In the Grant Thornton case, at the trial court level, a 4:1 ratio was awarded so the question in front of the Court of Appeals was: is a 4:1 ratio constitutionally excessive? (*Grant Thornton,* 2016, p. 44). According to the Court of Appeals, Grant Thornton cited Sixth Circuit cases that held that, "the ratio of punitive to compensatory damage may not exceed 1:1" (*Grant Thornton,* 2016, p. 45). The Court of Appeals agreed with Grant Thornton's arguments and stated that punitive damages are not supposed to compensate for injury, but "serve to punish reprehensible conduct and deter its future occurrence" (Grant Thornton, 2016, p. 46).

However, the court did hold that "Grant Thornton's fraudulent conduct over an extended period of time and toward multiple customers justifies an award of significant punitive damages" (*Grant Thornton,* 2016, p. 48). The court did find, though, that the 4:1 ratio of the trial court was unreasonable (*Grant Thornton,* 2016, p. 48). The court then reduced the ratio to 1:1 by holding, "such damages would adequately punish Grant Thornton for its misconduct without exceeding the scope of constitutional due process" (*Grant Thornton,* 2016, p. 48).

The court also addressed the issue of prejudgment and postjudgment interest. The Yungs agreed that the trial court incorrectly awarded prejudgment interest: 8% per diem rather than 8% per annum (*Grant Thornton,* 2016, p. 49). The Court of Appeals remanded to correct this (Grant Thornton, 2016, p. 49). The court did keep the trial court award of postjudgment interest, however, because the amount awarded was not an abuse of discretion (*Grant Thornton,* 2016, p. 51). Thus, the Court of Appeals retained most of the trial court's judgment.

CONCLUSION

The attorneys representing the Yungs in the civil action directly contradicted the arguments made by other attorneys representing the Yungs before the I.R.S. concerning Grant Thornton's opinion letter. It certainly appears that Grant Thornton's opinion letter met the standards required by the I.R.S. to qualify for a more likely than not opinion.

Tax practitioners (CPAs and attorneys) are limited to interpreting the language of the Internal Revenue Code and Treasury Regulations. Was an attempt to apply a literal reading of the Internal Revenue Code unethical? If Grant Thornton's reading of the law was incorrect, why were new retroactive regulations necessary? As previously stated, Grant Thornton apparently met the standard set forth in Treasury Regulation §1.662-4(d)(3)(ii). Or did that opinion letter simply cut the pattern to fit the cloth? When can a tax practitioner rely on "black letter law"? One of the authors of this paper, acting as a consultant to the attorneys representing Grant Thornton, testified that he believed Grant Thornton did indeed meet the ethical standards as set forth by the accounting profession.

Did the Treasury Regulations change the legal environment or simply clarify the legal framework? Is there any ethical dilemma concerning retroactive administrative regulations?

Did this trial court rule on the merits of the Lev 301 transaction and opinion? Or did the court determine that since Grant Thornton expected the I.R.S. would disallow the tax benefits, that they were negligent in advancing the reporting position?

Grant Thornton's opinion letter stated that it was more likely than not that a court would uphold the Lev 301 transaction. Ethan Yale, Esq., expert for Grant Thornton, observed that the opinion letter did not express a "will" or a "should" opinion, but a "more likely than not" opinion, which is a lower level of assurance (*Yung,* 2013, p. 141).

It is apparent that the trial court thought that Grant Thornton did not believe its own legal analysis. Did the email trail of internal discussion and debate persuade the court that the authors of the opinion letter did not actually believe what they stated? Does this case create a new standard for tax advisors?

These questions are what make this case so interesting and such a good case for classroom use and discussion.

ENDNOTES

1. The Yungs were represented in an administrative Protest by Mayer, Brown Rowe & Maw. One of three attorneys representing the Yungs and presenting arguments to support the validity of the Lev 301 transaction was Larry R. Langdon. Mr. Langdon was the I.R.S. Commissioner, Large & Mid-Size Business Division, 1999-2003. According to PBS Frontline "Tax Me If You Can," February 19, 2004, Mr. Langdon was enlisted by the Internal Revenue Service to "combat tax shelters."

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