October 21, 2003

Charles E. Grassley, Chairman
United States Senate
Committee On Finance
Washington, DC 20510-6200

Dear Mr. Chairman:

The text of my comments for my testimony today are reproduced below. Following those comments is a more detailed discussion of the testimony. For reference, my resume follows at the end on the discussion.

Executive Summary and Oral testimony:

My name is Robert Lally. I am honored and pleased to be before you today to talk about a subject which has been my life's work and about which I am truly passionate, tax practice. I have practiced tax in public accounting for twenty seven years. I am a CPA and an attorney.

My comments will be brief. I hope to make three observations to your committee.

First, tax law must be the same on Farmington Ave. (our address) as it is on 5th Ave. Tax law must be perceived as the same everywhere. It is a Federal system. We all read the same cases. We all read the same Revenue Procedures. An answer in Hartford should be the same answer as in San Francisco. It is a self assessment system. It will not work if clients perceive that in New York they can get a better answer, or worse yet, a magical answer. To us in the field, standards of practice must have some uniformity.

Second, I have seen standards of practice degrade over time. As a former partner in a big four accounting firm, I remember days when we had very definite notions of what was and what was not done. We did not play an audit lottery. (Although we were certainly aware of its mathematics of chance.) We did not rely on hyper technical interpretations of Code and Regs. to reach barely tenable conclusions. (Although we were very good technicians.) We did not take contingent fees. And we never, never, in my 16 years of practice with big firms, structured a transaction around side agreements, hidden buy sell arrangements, or disguised ownership. In my more detailed text which accompanies this presentation, I have outlined some further observations on this trend and its possible causes.

Finally, tax practice has changed by the introduction of the notion of "tax products". A tax product is an idea or a position or an integrated shelter which seeks to avoid tax with little or no business purpose. It is not a structuring of existing client matters to reduce or to defer tax, but a sojourn into a purely tax motivated realm. These products are typified by the following four common features:

1.) a confidentiality agreement because the idea is supposed to be proprietary;
2.) contingent fees based on the tax savings;
3.) a technical position either based on a hyper- technical reading of the tax law but which makes little common or economic sense, or in the alternative, a technical position which is based on not all of the facts being disclosed, such as hidden buy sell arrangements, etc.
4.) marketing to taxpayers outside of the existing client list.

Reforms:

1.) Regulation. The fact remains that tax practice is largely unregulated and unlicensed. One needs a license in Connecticut to cut hair but not to prepare a tax return for a fee. The signature of a CPA or a Lawyer (qualified to practice in the tax area, and not all are) should mean something about the technical quality and compliance accuracy of a return. Only by limiting practice can sanctions against unreasonable practice have meaning. Anyone with a pencil and photocopier can prepare and sign tax returns.

2.) Enforcement. The IRS audits the same issues time and again, and agents often avoid difficult technical areas (I should, perhaps, be careful what I wish for). This lack of enforcement encourages complex hyper technical positions, secure in the knowledge that no one is going to challenge them. In 27 years, I have yet to have an agent raise a LIFO issue, an accounting method issue or an intercompany pricing issue, it is always the same: lunches and cars. Only in the most arcane specialty areas, which have dedicated IRS groups, such as industry specialty groups like insurance are substantive technical issues ever raised.

As a practitioner, the recent IRS efforts at John Doe subpoena's should be applauded. (It sounds like I am giving aid to the enemy). I am actually defending thoughtful clients and practitioners. It is helpful out in the field to be able to say to clients that some law firm in New York or Washington does not have a magic answer, and that in fact, far from playing the audit lottery, you are about to play the audit certainty. Even the limited activity so far, has had a sobering effect.

3.) Fees. Contingent fees should not be permitted in tax practice. One might think that the prohibition against contingent fees in Circular 230 is sufficient to stop the practice, but it is not.

I appreciate this opportunity to come before you today.

<u>DETAILED DISCUSSION:</u>
Standards of Practice:

Circular 230 outlines basic standards of practice. For example, a tax position may be taken on a return if it is considered to have a substantial likelihood of success. A position meets this standard if it has a 1 in 3 chance of prevailing. While this wording of the standard is relatively new, it would be a fair statement to say that historically thoughtful tax practitioners used this type of guidance in their advice to clients. In my former career with Touche Ross (prior to its merger with Deloitte, Haskins and Sells), in my role as a practice unit manager, head of the Hartford office tax practice, or in my role as National Director of the firm's insurance practice or in my interactions with the National office of the firm, if a position could not stand the light of day, it was not taken. This was not an "audit lottery " standard (the position is OK because they only look at 1% of the returns). This was not a standard based on undisclosed facts or side agreements. This standard assumed that all the facts were known. The participants were honorable. The underlying books and records were accurate. The position was assumed to be examined, and we could at least explain the position in good faith and with some reasonable hope of prevailing. If lost at the audit level, one could write a thoughtful protest for appeals and have something meaningful to say.

This does not mean that before 1986 firms, my own included, did not work on tax shelter transactions. We certainly did. That was the state of the law at that time. It does not mean that we did not push the limits of creativity. One could suggest that the repeal of *General Utilities* suggested that there simply was no way to control the planning when corporations could be dissolved with one level of tax. That said, I can never recall a discussion in sixteen years where a partner said: "well they'll never find it". Or suggested that the real ownership be masked with a side deal to buy back ownership for $1.00. This simply was not done. If we could not tell the national office about it with a straight face, it did not fly. If we could not explain the strategy is ten minutes on the phone (because it was so complex and involved so many parties and steps) it probably would not pass muster. In fact, proponents of such schemes became known as gunslingers who could not get their ideas through national review and who were to be supervised with some care.

Changing Times:

At that time, partners were considered to be tenured for life. There was gray hair, or no hair, out in the firm. Partners had been around. Partnership was revered as was experience. While partners in public accounting firms did not make rock star salaries, neither did we ever find ourselves at 50 unemployed. There was a social and professional contract which was very powerful. I sense that this has changed. I went my first sixteen years in public accounting and virtually never saw a partner leave other than from death or normal retirement. After 1990, all I saw were partner transactions. Careers, to borrow a phrase, became nasty, brutish and short.

Partner pay increased dramatically in the 90's. No longer were partners in accounting firms the honored and tenured professors of our profession. We became rock stars, with aspirations of seven figure compensation. Of course, if one does not make partner until age 35 and if careers are over by 50, it is a short time to reap the rewards. Can it be a wonder that standards fell?

The Push to Sell "Products"

Partners, particularly tax partners, were no longer to be full service professionals, they had budgets to sell products. Without sales, especially outside their own client base, their compensation was impacted. In order to earn fees unbounded by hourly billing rates, partners had to sell tax motivated products based on commissions. Often these arrangements were typified by the use of nondisclosure arrangements (the products were purported to be proprietary). One could question how anything in the federal tax system could be proprietary. Audit partners were not immune to sales. The proliferation of special purpose entities (SPE) can probably be linked to creative audit efforts to engineer balance sheets. I suspect that for each SPE one finds on a corporate balance sheet, there was six figure consulting fee from the outside accountants to create it and to design its reporting footprint.

Role of Law Firms:

Often tax products come with an associated tax opinion letter. Under the technical tax rules, reliance on such an opinion has the potential to insulate the taxpayer from certain penalties. Often the opinion letter is simply part of the marketing package.

Law firms also have a role outside of the opinion letter. Of particular concern to our firm is the use of counsel, because of our location in Hartford, principally in New York, as a source of tax planning. In this we are hopefully not being simply defensive. On the contrary, we would be thrilled to learn of a new idea. There is a line between "planning" and counseling fraud. Care and judgment are required.

Governmental Efforts:

Recent moves to get client lists from tax advisors have been helpful. Normally, I would object on principle to such a short cut in IRS enforcement efforts. However, this chilling effect is actually helpful to tax practitioners in the field. It helps us raise the realistic specter of audit. It encourages clients who are considering these positions be more thoughtful. There has been a dramatic change in the temperature out in the hinterlands. The idea that there is some compendium of tax magic out there is diminishing. We are feeling a change in attitude. Tax work is often a game of inches, hard fought and much studied. The notion that there is a cookie cutter, magic bullet in some firm's word processor only waiting for your check and nondisclosure agreement to make your tax go away may be on the wane.

Resume: Robert V. Lally

Robert V. Lally is a partner in the accounting firm of Federman, Lally & Remis LLC in Farmington Connecticut. Prior to forming the firm in 1991 he was partner in charge of the

Northern Connecticut tax practice for Deloitte & Touche. He had also served the firm as partner in charge of the New Jersey tax practice and had been the Firm's National Director of Insurance Tax Practice for many years. He is frequent public speaker. He and his firm present continuing education to some of the country's largest law firms in Boston, New York, Washington and San Francisco on accounting and professional issues. He has served as a Special Master in Tax Court in Connecticut. He is Member of the AICPA and the CSCPA. He is a member of the federal and State of Connecticut bar. He graduated from Middlebury College and has an MBA from the University of Hartford and a JD from Western New England School of Law.