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Report to the Chairman, Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Committee on Finance, U.S. Senate

November 1991

TAX ADMINISTRATION

Standards Adhered to in Issuing Revenue Ruling 90-27

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November 19, 1991

The Honorable David Pryor
Chairman, Subcommittee on Private
Retirement Plans and Oversight
of the Internal Revenue Service
Committee on Finance
United States Senate

Dear Mr. Chairman:

This report responds to your August 20, 1990, request that we determine whether there were any violations of recusal statements,[1] conflict of interest law,[2] regulations, or Standards of Conduct (as set forth in agency regulations and Executive Order 12674) on the part of certain Internal Revenue Service (IRS) officials in connection with the issuance of Revenue Ruling 90-27. You also asked that we review the procedures used in the issuance of this revenue ruling to determine if they were proper. Revenue Ruling 90-27 involves financial instruments known, generically, as auction rate preferred stock (ARPS). The central issues in this revenue ruling were whether ARPS should have been characterized as debt or equity for tax purposes and whether they met the necessary holding period to qualify for the dividends-received deduction (DRD) to the holder. Our review did not include a determination of whether IRS should have issued a revenue ruling or whether the ruling issued was the best policy choice. The decision to issue a ruling and the appropriateness of the policy choice made are largely irrelevant to the conflict of interest questions we were asked to address.

Results in Brief

We found no evidence of any violations of recusal statements, federal conflict of interest law, regulations, or Standards of Conduct on the part of the Commissioner, the Chief Counsel, or the former Acting Chief Counsel in connection with the issuance of Revenue Ruling 90-27.

We found, however, that the way in which the Commissioner's and Chief Counsel's recusal statements are written can lead to some uncertainty as to the situations in which they apply. This is so because the

[1]Recusal statements are part of a government official's ethics agreement to resolve potential or actual conflicts of interest. They contain lists of firms or organizations for which the official disqualifies himself or herself from official action.

[2]The applicable law is 18 U.S.C. 208, which prohibits a government employee from participating in any matter that may affect a personal financial interest.

recusal statements are written so broadly they may lead to the impression that there is a violation when none has occurred.

Finally, we did not find any instances in which IRS staff failed to follow procedures set forth in the Revenue Ruling Handbook. We are concerned, however, that IRS' primary reliance on individuals representing only one brokerage house, Shearson Lehman Hutton, Inc.,[3] for consultations about ARPS and the market for ARPS could be viewed as inappropriate, even though we found nothing improper about the actions Shearson's representatives took. ARPS, although now underwritten by many brokers, were originally marketed by Shearson, which, along with other brokers, issuers, and holders of such instruments, had a major stake in seeing that ARPS were characterized as equity for tax purposes. While some disagreed, the overwhelming majority of opinion among IRS and Department of the Treasury officials and other people we spoke with would support strongly this characterization as equity on its merits. Nevertheless, the fact of Shearson's preeminent involvement remains troubling.

Background

ARPS is preferred stock typically issued to corporations. The stock has a fixed initial dividend rate; thereafter, the rate is set by auction. Investors submit bids designating the dividend rate at which they would be willing to continue to hold, buy, or sell the stock at a price unchanged from the original issue price. Thus, the stock is held, bought, or sold based on changes in the dividend rate, not on changes in the stock price. The new dividend rate is set for all purchasers at the bid of the lowest bidder, that is, the lowest rate that would result in all the shares being purchased or held. Corporations are willing to accept reduced dividend rates because, as dividends, these amounts qualify for the 70-percent DRD. (Corporations receiving eligible dividends from other corporations can generally exclude up to 70 percent of the dividends from taxable income.) The preferred stock generally comes up for renewal (reauction) after some predetermined time interval, at which time the corporation holding the preferred stock can rebid for it or sell it. Tax law requires that this "holding period" must exceed 45 days for the corporation to be eligible for the DRD.

[3]After the events described in this report, Shearson Lehman Hutton changed its name to Shearson Lehman Brothers, Inc.

ARPS are one way for corporations that have otherwise unusable net operating loss carryovers[4] to obtain funds. For such corporations, issuing debt instruments has little attraction because, without any operating income, they cannot use the interest expense deduction. On the other hand, such corporations can use equity such as ARPS to obtain funds at a lower cost than by alternative methods because the DRD feature is attractive to purchasing corporations.

Many major brokerage houses underwrite ARPS or products that are very similar to ARPS. Although data on the exact size of the ARPS market is unavailable, IRS officials have estimated that the market was around $20 to $25 billion in ARPS for the year ending December 31, 1989.

Because of the fixed length of these issues coupled with a market-determined dividend rate, some have suggested that they are very similar to short-term debt instruments, which generally have fixed maturity dates with interest rates set by market. If ARPS were treated as debt, however, the issuer would have an interest expense deduction (which for a corporation with net operating losses would be useless) while the recipient would be subject to tax on the interest received and would not be able to take advantage of the DRD. Thus, the treatment of these instruments as equity eligible for the DRD was crucial to their continued appeal to corporate investors.

On March 15, 1990, IRS issued Revenue Ruling 90-27.[5] This ruling stated that IRS would consider ARPS to be an equity interest, rather than debt, for tax purposes and that the auction mechanism would not prevent the holders from claiming the DRD for tax purposes.

The decision to issue a revenue ruling on this topic was initially made in the IRS Chief Counsel's office in September 1989. In part, the decision was prompted by concerns raised by IRS examination staff and by holders and brokers of ARPS securities. During examinations, some IRS field examination staff had begun to question the DRD that corporations had taken for ARPS dividend payments on the basis that the instruments

[4]Generally, corporations are permitted to carry over net operating losses for a period of up to 15 years to offset income in future years.

[5]Revenue rulings are official IRS interpretations published in the Internal Revenue Bulletin. Revenue rulings do not have the force and effect of regulations because they are limited in scope to their stated facts. IRS intends that taxpayers and IRS employees, including examination agents, rely on revenue rulings in the determination of the tax treatment of various transactions and in the disposition of cases.

were really debt. On the other hand, corporations and brokers had concerns that the potential recharacterization of these issues as debt would lead to a collapse of this market. IRS National Office officials decided to issue a revenue ruling to clarify IRS' position on the tax treatment, to remove uncertainty from the market, and to provide guidance for the field examiners to continue their examinations.

Revenue Ruling 90-27 applied to the financial community as a whole and not to any particular ARPS holder, issuer, or underwriting brokerage house. Nevertheless, the allegations of conflict of interest relate to Shearson; therefore, it is the only firm identified in this report.

How the Conflict of Interest Allegations Arose

This situation arose because of differing views between two groups of IRS officials about how to deal with the tax problems associated with ARPS securities. One group of officials, primarily field examiners and their senior field managers, believed that the problem should have been dealt with in IRS' traditional way. These officials believed that examinations underway should have been allowed to run their course until a case was developed and brought to court. They pointed out that doing such examinations was difficult because the three parties to an ARPS transaction—seller, buyer, and broker—were usually geographically separated with no one party in possession of all the necessary records. Also, some of the parties involved in examinations then underway had not cooperated in providing such records. These officials also believed that ARPS should be treated as debt, not equity, which would have resulted in denial of the DRD to holders of ARPS. Additionally, these officials thought there was evidence that the auctions in which ARPS securities were traded were in fact "shams" and that some ARPS brokers were guaranteeing the auctions so that investors were not at risk. Finally, the examiners feared that issuance of a revenue ruling, then being considered, would prevent them from examining what they believed were questionable ARPS transactions.

As the issue was considered, the then-acting Chief Counsel and attorneys within the Office of Chief Counsel developed a different approach to the problem. The officials considered the following three alternatives: (1) issuing a ruling treating ARPS as debt, thus denying the DRD to holders of such securities; (2) issuing a ruling treating ARPS as equity, thus allowing holders of ARPS to continue receiving the DRD; or (3) doing nothing, thus allowing the examinations to continue. The officials rejected the first alternative because of the difficulty of sustaining the position that ARPS were debt and because attempting to do so was seldom in IRS' best interests. They also rejected the third alternative, doing nothing and letting the examinations continue, primarily because of the view that IRS was likely to lose any cases resulting from pursuing the debt versus equity issue, thus wasting examiner resources and allowing the examinations to continue to disrupt the ARPS market. Thus, the officials chose the second alternative.

The officials decided that the problem could best be resolved by issuing a revenue ruling that defined ARPS as equity, thus allowing holders of these securities to continue to receive the DRD. However, they also decided the ruling should stipulate that guaranteed auctions or other means of providing investors with a guarantee to sell their securities would not be acceptable and that under such circumstances holders of ARPS securities would not meet the "holding period" requirement and therefore would not be allowed the DRD. The Commissioner and senior Treasury officials considered this approach and the views of field examiners who preferred that (1) a revenue ruling not be issued and (2) their examinations be allowed to continue until a case could be brought to court.

The Commissioner and Treasury officials decided to issue the ruling as proposed. The Commissioner told us that he believed issuing the ruling would avoid wasting scarce examiner resources on the debt versus equity issue—which he believed unlikely to produce cases IRS could win in court—and would stabilize what was perceived to be a shaky $20 billion capital market because of the uncertainty of IRS' position on ARPS. Documents used in considering the ruling confirm the Commissioner's views. The current Chief Counsel was not at IRS when the revenue ruling was initially proposed, but soon after he was confirmed, he concurred with its treatment of ARPS.

The Commissioner and other senior IRS and Treasury officials also believed the ruling would force brokers to structure future ARPS offerings in a manner consistent with the ruling—allowing IRS examiners to pursue cases in which some form of guarantee was provided. The revenue ruling was accompanied by directions from the Commissioner, in the form of a press release, that examinations of questionable ARPS transactions, as defined by the ruling, should continue.

Because the Commissioner had represented the parent firm of Shearson, the Chief Counsel had represented Shearson while in private law practice, and the then-acting Chief Counsel later became employed by a public accounting firm that had Shearson as an audit client, concerns about potential conflicts of interest arose in IRS. These concerns were brought to the attention of the Commissioner and Chief Counsel, both of whom consulted with the Designated Agency Ethics Official (DAEO) about the propriety of their participation in the revenue ruling. The DAEO advised both officials that their participation was proper because the ruling dealt with general policy issues affecting many taxpayers. Similarly, the then-acting Chief Counsel consulted with the DAEO about actions he should take to avoid a conflict of interest in connection with his search for employment and followed the advice given. Nevertheless, conflict of interest allegations surfaced about these officials and were ultimately brought to the attention of the Subcommittee.

The record is clear that the views of those opposing the issuance of the revenue ruling were considered carefully but were not accepted. It is also clear that examinations of ARPS transactions believed to violate the provisions of the ruling have continued, although the ruling has precluded further efforts to pursue the debt versus equity issue.

The Conflict of Interest Issue

In preparing and issuing this revenue ruling, IRS officials primarily met with representatives of Shearson, the brokerage house that was responsible for creating ARPS. IRS officials told us the meetings were designed to obtain information on how the instruments were structured and how their market worked. IRS' Revenue Ruling Handbook provides for such meetings to enable attorneys to understand the issues involved in pending revenue rulings. These meetings were attended by several Chief Counsel employees, including the then-acting Chief Counsel. The Commissioner and the subsequently appointed Chief Counsel, while involved in the decision to issue the revenue ruling, did not attend meetings at which Shearson representatives were present. In fact, the subsequently appointed Chief Counsel, who took office on February 8, 1990, was only involved at the very end of the process of issuing this revenue ruling.

A conflict of interest problem can occur when government employees take action affecting outside parties, including former employers, in which they have a continuing financial interest or with whom they are seeking employment. Where such a financial interest is involved, a potential violation of 18 U.S.C. section 208 exists. A violation of this section is a criminal matter. In other situations in which a criminal conflict of interest does not exist, an employee may nevertheless have other private interests that conflict with or raise a reasonable question of conflict with the employee's public duties and responsibilities. These noncriminal conflicts may result in violations of agency regulations or

Standards of Conduct. Penalties and remedies for such conflicts include disqualification from participation in specific matters, changes in assigned duties, or other disciplinary actions.

Both the Commissioner and Chief Counsel severed all ties with their former law firms,[6] in accordance with their ethics agreement, and they had no disqualifying financial interest in Shearson or any of its affiliates, or for that matter in any companies involved in the buying, selling, or brokering of ARPS. Hence, we found no basis for or any evidence of a violation of 18 U.S.C. section 208. We also found no evidence of any conflict or appearance of a conflict of interest involving Shearson or any other parties and therefore no violations of regulations or agency Standards of Conduct.

On the basis of our review of his financial disclosure statement, we found that the former Acting Chief Counsel also had no financial interest in Shearson or any of its affiliates. Around the time of the issuance of the revenue ruling, he sought employment with Coopers and Lybrand, which at that time was the firm that audited Shearson's financial statements. The Acting Chief Counsel indicated that he sought the advice of the IRS DAEO before discussions with Coopers took place. The DAEO informed him that it was not necessary to take any action until he began serious discussions with potential employers. We found no evidence to suggest that Coopers represented Shearson before IRS in connection with the ARPS issue. Although Shearson had an auditor-client relationship with Coopers, in our opinion the fact that Shearson was only one of many Coopers clients and ARPS only one of many Shearson product lines makes the relationship between the former Acting Chief Counsel's subsequent employment at Coopers and the ARPS issue too remote to suggest any potential conflict of interest problem.

In summary, we found no evidence to support a conclusion of a violation of the conflict of interest law, regulations, or Standards of Conduct on the part of the Commissioner, Chief Counsel, and former Acting Chief Counsel in connection with the issuance of Revenue Ruling 90-27. Appendix I contains a detailed chronology of the events surrounding the issuance of Revenue Ruling 90-27. Appendix II contains a detailed legal analysis of these events as they relate to the conflict-of-interest law and related regulations and Standards of Conduct.

[6]In the case of the Commissioner, he maintained his health insurance with his former law firm as permitted under Internal Revenue Code Section 162(k), but he paid the premiums for this coverage himself.

The Recusal Statement Issue

The Commissioner and Chief Counsel prepared recusal statements as part of their ethics agreements with the Office of Government Ethics (OGE). The ethics agreements were reviewed and initially approved by the Treasury DAEO and then finally approved by OGE. Typically, presidential nominees from outside the government make ethics agreements to comply with the requirements of law and agency regulations. The agreements might include termination of their outside employment, elimination of potential financial conflicts of interest, etc.

The Commissioner's recusal statement instructs IRS officials not to bring to his attention any matters involving his former law firm and 56 companies or their affiliates, which, with one exception,[7] were clients of his former law firm. It specifically lists Shearson's parent company, American Express Company. The Chief Counsel's recusal statement instructs IRS officials not to bring to his attention any matters involving his former law firms and some 24 former clients, including Shearson.

The companies listed on the Commissioner's and Chief Counsel's recusal statements were chiefly clients of their former law firms. On the basis of our review of their financial disclosure statements, and our interviews with them, we found no evidence that either the Commissioner or the Chief Counsel had any disqualifying financial interest in these companies either before their nominations or during the time the revenue ruling was prepared and issued.[8] In any event, the Commissioner divested himself of all his holdings in publicly traded and closely held companies (with one exception) as part of his ethics agreement. The Chief Counsel also divested himself of such holdings, with the exception of several real estate partnerships, which he then added to his recusal statement.

In reviewing the recusal statements in the context of the ethics agreements of which they are a part, we believe that neither the Commissioner nor the Chief Counsel violated their recusal statements. The letters from the Treasury DAEO to OGE confirming the ethics agreements state in both cases that the Commissioner-designate and the Chief Counsel-designate would, as part of their ethics agreements, recuse themselves from any particular matter in which their former clients

[7]The Commissioner was unable to sell stock in one privately held company, and he thus added that company to his recusal statement.

[8]Around the time of the issuance of the revenue ruling, a small money market fund belonging to the Chief Counsel was transferred from bankrupt Drexel Burnham Lambert to Shearson. The Chief Counsel did not participate in the decision to transfer the fund.

were formal parties. Thus, with regard to former clients, it appears that these statements were intended to apply only to specific matters between the listed former clients and the IRS, rather than general policy matters having an effect on many taxpayers, including some former clients.

For example, their recusal statements would clearly have been violated if the Commissioner or Chief Counsel had taken action in a specific case involving a dispute with IRS about a former client's tax return. However, in the actual situation, none of the companies listed on their recusal statements were formal parties in this matter, and the revenue ruling dealt with a policy matter affecting many taxpayers. Additionally, neither of the former law firms were involved in the issuance of Revenue Ruling 90-27. Thus, there was not a violation of their recusal statements.

With respect to current financial interests, the Commissioner and the Chief Counsel must recuse themselves from both particular matters involving specific parties and any policy matters that would affect their financial interests. As discussed in detail earlier, we found no evidence that the Commissioner or Chief Counsel had any current financial interests that would have disqualified them from participating in decisions about the revenue ruling.

Unfortunately, the recusal statements themselves do not clearly make the distinction between those instances where (1) recusal from matters involving only specific parties is required and (2) recusal is required for both particular and general policy matters. Without such limiting language, it is possible to misinterpret the scope of the recusal statements. Since these recusal statements are broadly distributed throughout IRS, but the underlying ethics agreements are not, we believe that some people may misinterpret the applicability of the recusal statements if they relied solely on them.

Recommendation to the Commissioner and Chief Counsel

We recommend that the Commissioner and Chief Counsel, in consultation with the Treasury DAEO and OGE, revise their recusal statements to make the language in them consistent with their ethics agreements. The Commissioner and Chief Counsel agreed with this recommendation and said they would take steps to implement it.

The Scope and Objectives of Recusal Statements

The companies listed on the Commissioner's and the Chief Counsel's recusal statements generally mirrored those listed on their Financial Disclosure Reports (Form 278), except for those few companies, noted above, whose stock or interest they were unable to sell. Schedule D, Part II, of this form requires that nominees list sources of income, including former clients, from which they received $5,000 or more in compensation during the prior 2 years plus that portion of the current year up to the date the form is filed. Three current and former IRS officials, including a former Chief Counsel, told us that the recusal statements of past Commissioners and Chief Counsels were similar to the ones in question, that is, they listed numerous former clients. They told us the reason for this was simply that IRS had always done them that way in order to err on the side of prudence.

We agree that prudence is warranted when preparing and issuing recusal statements. We believe, however, that recusal statements should be designed to achieve specific purposes and that care should be exercised in crafting the statements to achieve those purposes. In our discussions with IRS officials, no one could cite the specific purposes the Commissioner's and Chief Counsel's recusal statements were designed to achieve. And no one could cite specific reasons for listing so many former clients on these statements. While there may well be good reasons for doing so, including reasons that go beyond having financial interests in those former clients, we believe that mere historical precedent is an inadequate basis for designing recusal statements in this manner. IRS needs to reexamine the objectives it is trying to achieve with its recusal statements and then recast the statements to achieve those purposes.

Recommendation to the Commissioner and Chief Counsel

We recommend that the Commissioner and Chief Counsel, in consultation with the Treasury DAEO and OGE, determine the extent to which recusal statements for the IRS Commissioner and Chief Counsel should list former clients where no current financial interest is involved. The Commissioner and the Chief Counsel agreed with this recommendation and said they would take steps to implement it.

The Issue of the Revenue Ruling Process

Chief Counsel attorneys we interviewed told us that there is no "typical" revenue ruling process. They stated that rulings can originate from many sources and can take varying amounts of time to write and issue. They also said they may or may not obtain outside views and opinions to help in understanding the issues involved.

Our review of the process used in issuing this revenue ruling showed that it followed the procedures outlined in the IRS Revenue Ruling Handbook. The Handbook focuses largely on the format of revenue rulings and the administrative process to be used in issuing them. With regard to the actual process followed in gathering information for, drafting, and issuing Revenue Ruling 90-27, given that there is no "typical" revenue ruling, we did not find anything unusual or improper about the process. From the time a firm decision to issue the ruling was made until the time of issuance, a period of about 6 months elapsed. On the basis of our conversations with groups of attorneys in IRS' Chief Counsel (Technical) who are experienced in issuing revenue rulings, we did not find this period of time unusual. As is usually the case, the proposed ruling was reviewed at many levels in the Chief Counsel's office and in Treasury. Virtually all of the reviewers agreed with the direction of the proposed ruling.

We are concerned, however, about IRS consulting primarily with Shearson representatives to seek information about ARPS and the ARPS market, particularly in view of Shearson's interest in seeing that ARPS were characterized as equity for tax purposes. In matters of broad applicability, where IRS finds it necessary to obtain outside views and opinions, we believe it is unwise for IRS to rely on only one set of views or portrayals of facts in order to obtain information to issue a revenue ruling. While we do not believe that additional administrative procedures should be imposed on the revenue ruling process, we believe it would be prudent for IRS to obtain, as simply as possible, more than one opinion or recitation of facts in preparation for issuing a revenue ruling. IRS officials generally agreed with this position.

Recommendation to the Commissioner and Chief Counsel

We recommend that, for matters of broad applicability, the Commissioner, in conjunction with the Chief Counsel, direct Chief Counsel staff to seek a range of views and opinions in cases where it is deemed appropriate to contact outside parties for information necessary to issue a revenue ruling. Such views and opinions could be easily obtained by inviting additional people to meetings to discuss proposed rulings or through telephone discussions with other interested parties. The Commissioner and Chief Counsel agreed with this recommendation and said they would take steps to implement it.

Comments on Our Report

We discussed the results of our work with the three principal individuals about whom the allegations were made. With regard to the conflict of interest issue, the Commissioner and the Chief Counsel told us they did not consider acting on Revenue Ruling 90-27 to be a conflict because even though Shearson (Shearson's parent, American Express, in the case of the Commissioner) was listed on their recusal statements, the ruling applied to the financial community as a whole and not just Shearson. The former Acting Chief Counsel told us he was unaware that Shearson was an audit client of Coopers and Lybrand until after he accepted a position. On the recusal statement issue, both the Commissioner and the Chief Counsel agreed that there must be a more appropriate way to craft a recusal statement than just to list all organizations for which they had done work. They noted that they would be ineffective in their IRS positions if they had to recuse themselves from all general policy matters in which the outcome could affect one or more of the organizations for which they had done legal work. IRS officials agreed that, although there was nothing improper in the way this revenue ruling was approved and issued, IRS should seek information and comments from several potential sources affected by a revenue ruling so that a variety of opinions could be evaluated when IRS determines the proper interpretation of the Internal Revenue Code.

We also discussed our recommendations about recusal statements with the Treasury DAEO and an official at OGE. They both agreed with our recommendations.

Objectives, Scope, and Methodology

Our objectives on this assignment were (1) to determine whether there were any violations of recusal statements, conflict of interest law, regulations, or Standards of Conduct on the part of the IRS Commissioner, Chief Counsel, or former Acting Chief Counsel in connection with the issuance of Revenue Ruling 90-27; and (2) to determine whether the procedures used in the issuance of this revenue ruling were proper.

To address the conflict of interest and related issues, we interviewed staff involved in the processing, approval, and issuance of Revenue Ruling 90-27, including the former Acting Chief Counsel, the current Chief Counsel, and the current Commissioner. We also reviewed their financial disclosure statements and, in the cases of the current Chief Counsel and Commissioner, reviewed their ethics agreements, which each made at the time of nomination for his office by the President. We discussed general ethics issues and issues specific to these cases with IRS and Treasury ethics officials and officials from OGE, and we interviewed representatives from Shearson. Finally, we discussed with IRS field examination officials their views and opinions on this revenue ruling.

To determine whether this revenue ruling followed proper procedures, we reviewed IRS' Revenue Ruling Handbook, which contains detailed procedures for issuing revenue rulings, and compared it to the procedures used in this case. We reviewed and analyzed the revenue ruling file compiled by the attorney who was its primary author. The file contained articles, drafts, and memoranda related to the issues discussed in the revenue ruling and information about the revenue ruling review process. Finally, we held group discussions with IRS Chief Counsel employees in each of the five branches of Chief Counsel (Technical). IRS had identified these individuals as having substantial prior involvement in the issuance of revenue rulings, and we asked them about the usual procedures for issuing such rulings.

We did our work from September 1990 through April 1991 in accordance with generally accepted government auditing standards. In addition, we did our work in accordance with the investigation standards promulgated by the President's Council on Integrity and Efficiency.

As agreed with your office, we will make no further distribution of this report for 30 days. At that time, we will make copies available to others upon request.

Major contributors to this report are listed in appendix III. If you have any questions, please call John M. Lovelady on (202) 272-7904.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
Assistant Comptroller General

A Brief Chronology of Events Surrounding the Issuance of Revenue Ruling 90-27

The following chronology is based on the evidence we collected in the course of our investigation. In most cases, the statements below are based on testimonial evidence because they involve meetings, conversations, etc., that happened some time ago for which there are no written records. In these cases, except where indicated, the events were confirmed by at least two individuals and were not disputed by anyone. In most cases we have corroboration from several individuals.

In July 1984, Shearson filed the first prospectus with the Securities and Exchange Commission for the issuance of auction rate preferred stock (ARPS).

In September 1987, an examination involving dividend-received deduction (DRD) issues and ARPS began in the Internal Revenue Service's (IRS) Central Region.

In late 1987 or early 1988, a Shearson client (a purchaser of ARPS) under examination by IRS called Shearson. A Shearson employee called an attorney at the law firm of Simpson Thacher & Bartlett, which represented Shearson. The Shearson employee asked the attorney to contact IRS to try to resolve the problem.

During 1988, the original IRS examination continued and others were initiated. Additional facts and information were requested from the taxpayers.

On October 24, 1988, the Chief Counsel issued a memo to Department of the Treasury officials regarding an ongoing examination on ARPS in the Western Region. He stated that IRS planned to let the examination process run its course.

In November 1988, the Chief Counsel resigned. The Deputy Chief Counsel replaced him as Acting Chief Counsel until a successor was appointed by the President and confirmed by the Senate.

In January 1989, the attorney representing Shearson met with IRS officials in the National Office. Attendees included attorneys from IRS' Office of Chief Counsel, including the Acting Chief Counsel, and field examination officials. At the meeting, the attorney explained the ARPS market and how it worked.

Sometime in mid-January 1989, the Acting Chief Counsel decided to let examinations proceed and try to get a case into the National Office. The resulting technical advice[1] would be a way of providing guidance to examiners and taxpayers.

On May 20, 1989, the Commissioner-designate submitted his ethics agreement to Treasury for review. In it he agreed to sever all ties with his former law firm, except for his continued participation, at his own expense, in the firm's health plan, as allowed under Internal Revenue Code section 162(k). He agreed to try to sell shares in two closely held corporations, the only stock he owned. He disposed of the stock in one of the corporations but could not find a buyer for the remaining stock. He later recused himself from dealings involving this company.

On July 5, 1989, the Commissioner-designate was sworn into office.

During the summer and fall of 1989, field exam staff experienced difficulty in securing requested information about ARPS from taxpayers under examination. The taxpayers argued that some of the information requested was in the hands of brokerage houses and was not in their possession.

On August 25, 1989, the Commissioner distributed his recusal statement to key IRS employees. The recusal statement included American Express, Shearson's parent company.

Sometime in the summer of 1989, the Simpson Thacher attorney telephoned the Commissioner concerning the IRS examinations of the ARPS issue. The Commissioner said he did not discuss the matter with the attorney but immediately referred him to the Acting Chief Counsel. At the time of the call, the Commissioner said he was not aware that the attorney was representing Shearson.

In September 1989, another meeting with Shearson representatives was held in the National Office. The Acting Chief Counsel called the meeting at the request of the attorney representing Shearson. The apparent reason for the meeting was that additional examinations of ARPS were now under way, and the taxpayers and examination staff were, by that time, at an impasse in the effort to get a case into National Office for technical advice. Numerous attorneys from Chief Counsel's Office and staff from IRS' field examination groups were at the meeting. A Shearson

[1]Technical Advice Memoranda contain guidance or advice as to tax laws, regulations, and rulings with respect to a specific set of facts furnished, at the request of an IRS district or appeals office, in response to any technical or procedural question that develops during the examination or appeals process. IRS district offices generally must follow technical advice.

employee also attended to explain the "auction" part of ARPS. The Shearson employee and the attorney representing Shearson took the position that if IRS was not willing to take on the whole issue of ARPS (debt vs. equity), perhaps IRS could issue something to support the idea that at least the auction was legitimate and thus, per se, did not disqualify ARPS holders from taking the DRD.

During the fall of 1989, the Acting Chief Counsel came to the conclusion that IRS should take on the ARPS issue in the form of a revenue ruling. The Associate Chief Counsel (Litigation) and Associate Chief Counsel (Technical) had differing approaches on certain aspects of the issue. Each group provided the Acting Chief Counsel with a draft position paper.

In the fall of 1989, the Acting Chief Counsel began discussions with potential employers. The Acting Chief Counsel indicated that he sought the advice of the IRS Designated Agency Ethics Official (DAEO) before these discussions took place. The DAEO informed the Acting Chief Counsel that it was not necessary to recuse himself until he began serious discussions with potential employers.

In late fall 1989, the Acting Chief Counsel issued a memo to the Assistant Treasury Secretary for Tax Policy and the Commissioner taking the position that a revenue ruling was needed but that it should approve as equity only those ARPS transactions that had certain characteristics that would be set out in the revenue ruling.

On November 2, 1989, the now-current Chief Counsel was nominated to that position.

On November 7, 1989, the Chief Counsel-designate submitted his ethics agreement in which he agreed to divest himself of his entire portfolio within 90 days of taking office.

In early December 1989, the Commissioner and the Assistant Treasury Secretary for Tax Policy tentatively decided to go ahead with the revenue ruling, as proposed by the Acting Chief Counsel.

Sometime in mid- to late December 1989, Office of Chief Counsel attorneys began work on the revenue ruling.

In early 1990, an IRS Regional Commissioner, from one of the regions where ARPS examinations were ongoing, called an official in the National

Office to raise the issue that Shearson was involved in the ARPS issue and that Shearson was on the recusal statement of the Chief Counsel and that American Express (Shearson's parent) was on the recusal statement of the Commissioner. (Note: We did not verify that this telephone call took place other than with the Regional Commissioner, but subsequent events support that it did.) Sometime later, the Senior Deputy Commissioner raised the issue with the IRS DAEO. The DAEO later notified the Regional Commissioner that there was no conflict of interest present.

In late January or early February, the Acting Chief Counsel orally recused himself from any matters dealing with firms he was considering for employment.

On February 8, 1990, the Chief Counsel-designate took office as Chief Counsel. The Acting Chief Counsel resumed duties as Deputy Chief Counsel.

In a February 23, 1990, memorandum, an Assistant Chief Counsel advised the Chief Counsel that a planned briefing on March 1 would deal with ARPS and that Shearson was a major player in this market. He suggested that the Chief Counsel might want to consider whether or not to participate in the briefing because Shearson was listed on his recusal statement.

The Chief Counsel indicated that he contacted the IRS DAEO sometime in late February or March 1990. The DAEO assured him that because ARPS was an industrywide issue and because he had no financial ties to Shearson, there was no apparent conflict of interest.

On March 1, 1990, a briefing for the Commissioner and the Assistant Secretary of the Treasury for Tax Policy on the proposed issuance of Revenue Ruling 90-27 took place. The briefing attendees included many of the Chief Counsel attorneys involved in the revenue ruling review process, a field examination agent, the Chief Counsel, the Deputy Chief Counsel, the Commissioner, the Assistant Secretary for Tax Policy, and other Treasury staff. The final decision was made by the Commissioner and Assistant Secretary for Tax Policy to go ahead with the revenue ruling treating ARPS as equity.

In early March 1990, the Commissioner called the IRS DAEO. The call was prompted by the fact that Shearson was mentioned at the March 1 briefing, and American Express, Shearson's parent corporation, was listed on the Commissioner's recusal statement.

On or about March 8, 1990, the Commissioner called a second meeting because he was concerned that some people in Examinations were disappointed in the way the ARPS issue was resolved. The meeting was attended by a field examination representative, Chief Counsel attorneys, the Commissioner, the Chief Counsel, and the Deputy Chief Counsel. As a result of this meeting, an agreement was reached to issue a notice simultaneously with the revenue ruling. The notice would advise taxpayers that IRS will continue to pursue those ARPS issuances where "guarantees" of resale are implied or stated or where there were any other facts or circumstances that did not fit the fact pattern of the revenue ruling. The Commissioner stated he made this point clear to examination staff at this meeting.

On March 13, 1990, the DAEO issued a written opinion to the Deputy Commissioner stating that the Commissioner's involvement in the ARPS issue raised no conflict of interest questions.

On March 14, 1990, the Deputy Chief Counsel recused himself from any dealings with Coopers & Lybrand.

On March 15, 1990, Revenue Ruling 90-27 and accompanying notice were issued.

In May 1990, the Chief Counsel, on the advice of Office of Government Ethics (OGE) officials, received an extension of time to dispose of certain of his assets. The extension was granted because OGE regulations were pending that would implement certain tax provisions of the Ethics Reform Act of 1989, which would affect his holdings.

On July 30, 1990, the Chief Counsel completed divestiture of his assets, except for certain real estate partnerships and some other interests, within the time period of the extension granted him, as required in his ethics agreement. He then included the entities in which he still retained an interest on his recusal statement.

Legal Analysis of Effect of Participation by IRS Officials in Consideration of Revenue Ruling 90-27

I. Participation by the Commissioner in consideration of Revenue Ruling 90-27.

A. Facts.

The current Commissioner, formerly a partner in the law firm of Skadden, Arps, Slate, Meager & Flom, was nominated by the President to serve as Commissioner of IRS and took office on July 5, 1989. As part of his Senate confirmation process, the Commissioner-designate submitted his financial disclosure statement (SF-278) to the Treasury DAEO. An attachment to the form listed clients for whom the Commissioner had performed services generating compensation in excess of $5,000 during 1987, 1988, and the first 5 months of 1989. Those clients included American Express Company, the corporate parent of Shearson. However, the Commissioner indicated that he did not represent American Express Company in connection with ARPS issues.

The Commissioner-designate negotiated an ethics agreement, dated May 20, 1989, with agency officials. The ethics agreement indicated that he agreed to withdraw from Skadden, Arps, Slate, Meager & Flom. He retained no interest in the firm's retirement or other benefit plans but retained his coverage under the firm's health care plan, reimbursing the firm for all premium costs. He retained, with one exception,[1] no interests in publicly traded or closely held stock or partnerships. Additionally, the Commissioner-designate agreed to

> recuse [myself] from participation in any particular matter in which any individual, entity or organization listed on the attachment to my public financial disclosure report is a formal party or appears before the Internal Revenue Service.

The Commissioner's recusal statement, executed on August 20, 1989, states that "no case, question, correspondence, pleading, or other material should be brought to the attention of the Commissioner (and he recuses himself from handling such materials) involving the following individuals, organizations, corporations, or their subsidiaries or affiliates." The list of entities was drawn from the attachment to the Commissioner's public financial disclosure statement and included American Express Company.

[1]The Commissioner retained interests in an issue of closely held stock but included that company on his recusal statement.

Generally, revenue rulings prepared by the IRS Office of Chief Counsel are reviewed by the Commissioner. The Commissioner's participation in the consideration of Revenue Ruling 90-27 involved his attending two major meetings at which the policy and technical implications of the ruling were discussed. The Commissioner also participated in the decision to address the tax treatment of ARPS through the revenue ruling process.

During consideration of the issue of the proper federal income tax treatment of ARPS, the Commissioner became aware that concern had arisen about the propriety of his participation in light of the directions contained in his recusal statement and the information provided by Shearson and its representatives to IRS personnel who considered the revenue ruling. As a result, the Commissioner requested the opinion of IRS' DAEO concerning the implications of his participation in consideration of the revenue ruling. The Office responded that the Commissioner's participation would not be prohibited by 18 U.S.C. section 208.

B. 18 U.S.C. section 208

Generally, 18 U.S.C. section 208(a) makes it a crime for a government employee to participate personally and substantially in any "particular matter" in which he, his spouse, minor child, or organization with which he is affiliated has a financial interest. Specifically, 18 U.S.C. section 208(a) provides:

"208. Acts affecting a personal financial interest "(a) Except as permitted by subsection (b) hereof, whoever, being an officer or employee of the executive branch of the United States Government, of any independent agency of the United States, a Federal Reserve bank director, officer, or employee, or an officer or employee of the District of Columbia, including a special Government employee, participates personally and substantially as a Government officer or employee, through decision, approval, disapproval, recommendation, the rendering of advice, investigation, or otherwise, in a judicial or other proceeding, application, request for a ruling or determination, contract, claim, controversy, charge, accusation, arrest, or other particular matter in which, to his knowledge, he, his spouse, minor child, general partner, organization in which he is serving as officer, director, trustee, general partner or employee, or any person or organization with whom he is negotiating or has any arrangement concerning prospective employment, has a financial interest—shall be subject to the penalties set forth in section 216 of this title."

18 U.S.C. section 216 provides for criminal penalties.

The term "particular matter" includes general policy matters, notwithstanding the lack of involvement of any specific party, because 18 U.S.C. section 208(a), unlike provisions in 18 U.S.C. sections 203, 205, and 207, does not limit the "particular matter[s]" covered by the section to those "involving a specific party or parties." See 2 Op. Off. Legal Counsel 151, 153-155 (1978).

While the term "financial interest" is not defined by 18 U.S.C. section 208(a), the Supreme Court has held that if, under the logic of all the circumstances relating to the potential outcome of a particular matter, there exists a substantial probability of financial gain or loss to the affected entity, the requisite "financial interest" exists. United States v. Mississippi Valley Generating Co., 364 U.S. 520, 555-557 (1961). OGE has cited the "direct and predictable effect" test set forth in the Federal Personnel Manual, Ch. 735, app. C, as another way of expressing the appropriate test of whether a financial interest exists. (OGE Informal Advisory Opinion 85 x 10). In the Office of Government Ethics Formal Advisory Opinion, 83 OGE 1 (Jan. 7, 1983), a real possibility of gain or loss as a result of developments in the matter is used as the appropriate test for the existence of a financial interest.

Further, 18 U.S.C. section 208 applies only to present interests. In Center for Auto Safety v. FTC, 586 F. Supp. 1245 (D.C. Cir. 1984), the court held that an official was not required to disqualify himself from a matter involving a major client of his former consulting business notwithstanding the possibility that he would return to that business, partly for the reason that 18 U.S.C. section 208(a) applies only to a "present interest."

It is clear that 18 U.S.C. section 208(a) would have prohibited the Commissioner from participating in the IRS' consideration of matters that would have had a "direct and predictable effect" on a covered financial interest held by him. However, the Commissioner held no such interests at the time of his involvement in Revenue Ruling 90-27, as he had divested himself of all publicly traded stock and other interests in carrying out his ethics agreement. Consequently, there is no evidence that suggests that violations of 18 U.S.C. section 208 occurred.

C. Standards of Ethical Conduct.

A broader set of Standards of Conduct for executive branch officials is found in Executive Order 12674 and in the regulations promulgated pursuant to Executive Order 11222.[2] Under the standards of ethical conduct in Executive Order 12674, as amended, 5 U.S.C. section 7301 note, a government employee is prohibited from holding financial interests that conflict with the conscientious performance of duty and must act impartially and not give preferential treatment to any private organization or individual. Employees must endeavor to avoid any actions creating the appearance that they are acting improperly. Treasury regulations set forth a similar standard, prohibiting any action which might create the appearance of using public office for private gain (31 C.F.R. section 0.735-30 (1990)). The regulations also provide that an employee shall not have a direct or indirect financial interest that appears to be in conflict with his government duties and responsibilities (31 C.F.R. section 0.735-36(a)(1) (1990)). IRS' Rules of Conduct define conflicts of interest as situations where an IRS employee's private interest conflicts or raises a reasonable question of conflict with the employee's public duties and responsibilities.

Applying these standards, we conclude that the Commissioner's connection with Shearson was too remote to create an appearance problem. Additionally, the Commissioner acknowledged concerns involving his former relationship with American Express Company and sought the advice of the IRS DAEO concerning the issue. With regard to these concerns, it should be noted that the Commissioner's recusal statement was worded so that it could be interpreted to preclude his consideration of matters of broad applicability that might involve former clients or their affiliates. However, the terms of his ethics agreement are more narrowly drawn and prohibit involvement with particular matters where former clients are formal parties or appear before IRS. As a general matter, it should be recognized that precluding IRS employees with significant experience in the private practice of law from participating in the consideration of policy matters of broad applicability that affect former clients where there are no continuing financial interests would prevent them from effectively carrying out their responsibilities.

[2]Executive Order 11222 was revoked by Executive Order 12674 of April 12, 1989. However, regulations issued under Executive Order 11222 are to remain in effect until properly amended, modified, or revoked.

II. Participation by the Chief Counsel in consideration of Revenue Ruling 90-27.

A. Facts.

The current Chief Counsel was nominated on November 2, 1989, for the position of Assistant General Counsel, Department of the Treasury, Chief Counsel of IRS. On November 7, 1989, the Chief Counsel-designate entered into an ethics agreement with Treasury in which he agreed to withdraw from Jones, Day, Reavis and Pogue, the law firm with which he was a partner. In his ethics agreement, the Chief Counsel-designate also agreed to recuse himself from participating in any particular matter in which the firm is a formal party or in which it represents a taxpayer. His recusal also extended to any particular matter where any individual, entity, or organization listed on his SF-278 is a formal party or appears before IRS. The form listed Shearson as a former client for whom the Chief Counsel had provided legal services generating compensation in excess of $5,000 during 1987, 1988, and 1989. However, the Chief Counsel indicated that he did not represent Shearson in connection with ARPS issues.

On February 1, 1990, the Chief Counsel-designate executed a recusal statement in which he informed all personnel in the Office of Chief Counsel that "no case, question, correspondence, pleading, or other material should be brought to the attention of the Chief Counsel (and he recuses himself from handling such materials) involving the following individuals, organizations, corporations, or their subsidiaries or affiliates." Shearson is among the listed organizations.

On February 8, 1990, the current Chief Counsel assumed his duties as Chief Counsel of the IRS. He attended two briefings in March 1990, at which Revenue Ruling 90-27 was discussed. He indicated that he had contacted the IRS DAEO concerning the propriety of his participation in these meetings. The DAEO had assured him that because the revenue ruling involved an industrywide issue and because he had no financial ties to Shearson, there was no conflict of interest.

B. 18 U.S.C. section 208(a) and Standards of Conduct

As noted above, the term "particular matter" includes policy matters. Given this test, it is clear that 18 U.S.C. section 208(a) would have prohibited the Chief Counsel from participating in IRS' consideration of matters that would have had a direct and predictable effect on a financial interest covered by 18 U.S.C. section 208(a). However, as part of the confirmation process the Chief Counsel had withdrawn from the law firm in which he was a partner and divested himself of all publicly traded and closely held securities and all partnership interests (with the exception of certain real estate partnerships that he added to his recusal statement, as previously explained). While the Chief Counsel did have an interest in a Money Market Fund managed by Shearson, any possibility of gain or loss to the Chief Counsel in connection with this interest as a result of his participation in consideration of Revenue Ruling 90-27 is speculative. Consequently, there is no evidence to indicate that the resolution of the issues involved in Revenue Ruling 90-27 would have a direct and predictable effect on interests held by the Chief Counsel.

Additionally, it appears that the Chief Counsel's connection with Shearson was too remote to create a problem of an appearance of a conflict of interest under the regulatory standards set forth above.

III. Participation by the Acting Chief Counsel (Deputy Chief Counsel) in consideration of Revenue Ruling 90-27.

A. Facts.

The Office of Chief Counsel was headed by the Acting Chief Counsel from November 1988 until February 1990. In February 1990, with the appointment of a new Chief Counsel, the Acting Chief Counsel resumed his duties as Deputy Chief Counsel. On March 14, 1990, the Deputy Chief Counsel agreed to accept a position as principal in the accounting firm of Coopers and Lybrand. On that date, he executed a recusal statement that informed various IRS officials that "no questions, correspondence, or other material from [Coopers and Lybrand] partners or employees thereof or individuals or entities affiliated with the firm are to be brought to my attention."

While serving at the IRS the Deputy Chief Counsel participated in the consideration of federal income tax issues involved in the issuance of ARPS. During the consideration of the issue, he met with and consulted with attorneys representing Shearson and with individuals representing other investment houses. He recommended the issuance of a revenue ruling as the proper method of dealing with concerns that had been raised about ARPS. The Deputy Chief Counsel has indicated that he sought the guidance of the IRS DAEO concerning his exploration of employment possibilities in the fall of 1989 before speaking with potential employers. The Deputy Chief Counsel began discussions with potential employers in late 1989; he characterized these discussions as exploratory. The Deputy Chief Counsel further indicated that he narrowed potential firms with which he would discuss prospective employment in late January or early February of 1990. He indicated that at that time he informed IRS employees working closely with him of the identity of these firms. He has indicated that he commenced discussions with Coopers and Lybrand concerning the terms and conditions of employment and made the decision to join Coopers and Lybrand in early March of 1990. He has further indicated that he did not become aware that Coopers and Lybrand performed accounting services for Shearson until after he made the decision to accept employment.

B. 18 U.S.C. section 208 and Standards of Conduct

18 U.S.C. section 208 prohibits an employee of an executive branch agency from participating personally and substantially in any particular matter that affects the financial interests of an entity with which he is negotiating for employment. In Airline Pilots Association, International v. United States Department of Transportation, 899 F.2d 1230 (D.C. Cir. 1990), the District Court found that the Secretary of the Department of Transportation was not required by 18 U.S.C. section 208(a) to recuse himself from a matter involving a client of a law firm that was the Secretary's potential employer, where the firm did not represent the client in the matter at issue but did represent the client in other matters pending before Transportation. Citing 83 OGE 1, the court found the possibility of gain or loss was speculative and therefore did not have a direct and predictable effect on a financial interest covered by 18 U.S.C. section 208(a). See also Center for Auto Safety v. FTC, 586 F. Supp. 1245, 1249 (D.D.C. 1984).

Coopers and Lybrand did not represent Shearson, or any other client, before the IRS in connection with the issue of the proper federal income tax treatment of ARPS. Consequently, it is speculative to predict a real possibility of financial gain or loss to Coopers and Lybrand as a result of the issuance of Revenue Ruling 90-27. Therefore, because no financial interest named in 18 U.S.C. section 208(a) was affected, there is no evidence to indicate that a violation of section 208(a) occurred.

Office of Personnel Management regulations published at 5 C.F.R. section 735 provide that an employee shall avoid any action that might result in or create the appearance of using public office for private gain, giving preferential treatment to any person, or losing complete independence or impartiality (5 C.F.R. section 735.201a (1990)). For Treasury employees that prohibition is reiterated in 31 C.F.R. section 0.735-30(a) (1990).

Treasury regulations specifically state that an "employee who is negotiating for, or has an arrangement concerning, prospective employment may not participate in a matter in which the prospective employer has a financial interest." Financial interest for this rule includes "an indirect interest, such as when the prospective employer is representing a client which has a direct interest in the matter" (31 C.F.R. Section 0.735-36(c) (1990)). The regulations also state that the types of matters that the employee must refrain from participating in include not only individual cases but general matters, such as the drafting of regulations, that would have a direct and predictable impact on the prospective employer (31 C.F.R. section 0.735-36(c)(3) (1990)). The regulations provide that negotiating situations exist either during active negotiation, where an employee solicits employment, or where an employee does not promptly reject an unsolicited offer of employment (31 C.F.R. section 0.735-36(c)(2) (1990)).

It is clear that the issuance of Revenue Ruling 90-27 would be a general matter covered by the Standards of Conduct and the Treasury regulations. Those regulations would prohibit participation by the Deputy Chief Counsel in consideration of the revenue ruling if the resolution of the issues involved would have directly affected Coopers and Lybrand. This might have occurred if Coopers and Lybrand had represented a client in connection with the matter. Additionally, according to a Coopers representative, Coopers had no other direct involvement with the ARPS market. Therefore, as noted above, any impact of the revenue ruling on Coopers and Lybrand is speculative. Consequently, we conclude that the Deputy Chief Counsel's participation in consideration of Revenue Ruling 90-27 did not give rise to an appearance of a conflict of interest.

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