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MACNIVEN V. WESTMORELAND AND TAX ADVICE: USING “PURPOSIVE TEXTUALISM” TO DEAL WITH TAX SHELTERS AND PROMOTE LEGITIMATE TAX ADVICE

SCOTT A. SCHUMACHER

The last few years have seen a flurry of activity aimed at the tax shelter industry. Beginning with the “covered opinion” rules of Treasury Circular 230 in 2005, the government has adopted several changes to the standards applicable to tax advice, all in an effort to stop abusive tax shelters. Recently, both Congress (in 2007) and the Treasury (in 2008) have revised the standards applicable to tax advice to require that a position have a “more likely than not” chance of succeeding on the merits, or the position must be disclosed to the Internal Revenue Service (IRS). While the government’s desire for reform is understandable, these changes will not stop abusive shelters and will make giving legitimate tax advice more difficult. Moreover, these changes will also not succeed in what should be their ultimate goal—providing guidance for distinguishing between legitimate tax planning and abusive tax avoidance.

My thesis in this Article is that whatever rules Congress, the Treasury, and the courts employ, these rules should be designed to encourage tax advice and to encourage that the advice given is proper. Our tax system is based on voluntary compliance, which requires a well-informed and well-advised citizenry. The recent amendments will, I fear, stifle tax advice, including legitimate advice. By the same token, the overly aggressive prior standard for tax advice of “realistic possibility of success” encouraged hyper-textualism and led too many advisors and their clients to review a position on a “can I get away with this” analysis, rather than honestly attempting to comply with the law.

The standard that I propose is what I refer to as “purposive textualism” and is taken from the British House of Lords’ opinion by Lord Hoffmann in MacNiven v. Westmoreland. Under the MacNiven analysis, one must analyze the “constructive purpose” of the tax statute and then determine whether the relevant provision of the statute, upon its true construction, applies to the facts at issue. While the House of Lords referred to this standard as “purposive construction,” the standard is more akin to the modern textualism that looks at the purpose of the statute in the context that Congress (or Parliament) enacted it. In my view, the MacNiven formulation gives us the most

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principled basis for determining what is an abusive tax shelter and what is legitimate tax planning. It is also a workable construction for tax advisors. It is my hope that a discussion of the MacNiven opinion will offer a different perspective on the issue of tax shelters and tax advice and bring a fresh debate to these issues.

I. INTRODUCTION

The last few years have seen a flurry of activity aimed at the tax shelter industry. Beginning with the “covered opinion” rules of Treasury Circular 1
the government has adopted several changes to the standards applicable to tax advice, all in an effort to stop abusive tax shelters. Recently, both Congress (in 2007) and the Treasury (in 2008) revised the standards applicable to tax advice to require that the position have a “more likely than not” chance of succeeding on the merits, or the position must be disclosed to the Internal Revenue Service (IRS). While the government’s desire for reform is understandable, these changes will not stop abusive shelters and will make the giving of legitimate tax advice more difficult. More importantly, these changes will not succeed in what should be their ultimate goal—providing guidance for distinguishing between legitimate tax planning and abusive tax avoidance. Indeed, what often gets lost in the discussion of tax shelters is the fact that the vast majority of taxpayers are trying to comply with the law and that their advisors are doing their best to inform their clients about what the law provides. Moreover, the new anti-shelter initiatives rely primarily upon disclosure and penalties to root out abusive schemes. But, as others have noted, disclosure is not the solution.

In addition, recent court decisions are unlikely to be helpful in providing guidance to advisors and helping them determine whether a position is “more likely than not” to be successful. While the economic substance and business purpose doctrines, at least in their current iterations, may generally provide

with more than mild trepidation that I wade into this area with yet another article on tax shelters.

2. 31 C.F.R. § 10.35 (2007).

3. Many of the administrative actions in this area have been taken by the Treasury Department, the Internal Revenue Service, or both. For simplicity’s sake, I will refer to the Treasury Department and the IRS collectively as the Treasury.

4. These recent legislative and administrative activities elevated the standard for return advice to more likely than not. See, e.g., U.S. Troop Readiness, Veterans’ Care, Katrina Recovery, and Iraq Accountability Appropriation Act, Pub. L. No. 110-28, § 8246(b)(2)(B), 121 Stat. 200 (2007). If the advisor cannot reach this relatively high standard, the position must be disclosed.

5. Randolph E. Paul warned of this problem in 1937 when he advised: “Care should also be used in the selection of measures to prevent avoidance which will not bear down unduly upon those who are not avoiding taxes. Taxing statutes are usually, and perhaps must always for constitutional reasons be, put in general terms, and the effect of some measures directed at tax-avoidance mechanisms is often . . . to cause, ‘like Herod’s massacre,’ great suffering without reaching the particular cases which inspired it.” RANDOLPH E. PAUL, STUDIES IN FEDERAL TAXATION: TAXATION WITHOUT MISREPRESENTATION 65 (1937) (footnotes omitted).

6. In making this statement, I reject the contention of Professor David Weisbach that all tax planning is necessarily abusive and creates nothing of value. See David A. Weisbach, Ten Truths About Tax Shelters, 55 TAX L. REV. 215, 222 (2002).


the correct result to the case at hand,9 they offer little constructive guidance to distinguish between tax planning and tax abuse.10 Indeed, while some transactions are invalidated because they lack economic substance apart from tax savings, many transactions that are entered into solely for tax purposes are acceptable under the tax laws.11 The economic substance and business purpose analyses used by courts offer little in the way of guidance for future cases.

My thesis in this Article is that whatever rules Congress, the Treasury, and the courts employ, these rules should be designed to encourage tax advice and to encourage that the advice given is proper. The system, whatever it is, must work with or at least co-opt tax professionals. Given the low audit coverage, in order for the tax system to work with any modicum of efficiency, tax professionals must be encouraged to properly advise their clients on what the law is.12 The recent amendments do just the opposite.

Ultimately, whether the analysis is being done by a tax attorney, the IRS, or a federal judge, the task should be to determine what the law is and what Congress intended. The overly aggressive “realistic possibility of success” and “reasonable basis” standards for tax advice encouraged hyper-textualism and led too many advisors and their clients to review a position on a “can I get away with this” analysis, rather than honestly attempting to comply with the law. On the other hand, selectively imposing economic realism on the tax system, a system that is based in large part on legal and fiscal fictions, provides no guidance to taxpayers or their advisors and may indeed add to the cynicism surrounding the tax system.13

9. However, the different treatment by various courts suggests that the analysis under these tests is more of an art form than a science.
10. Every case seems to turn on the Potter Stewart pornography test of “I know it when I see it.” Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (not “trying to define what may be indefinable . . . but I know it when I see it”); see also ACM P’ship v. Comm’r, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting) (“I can’t help but suspect that the majority’s conclusion . . . is, in its essence, something akin to a ‘smell test.’”).
13. The staff of the Joint Committee on Taxation has identified three ways in which the increase in shelter activity has adversely impacted the administration of the tax laws. First, the limited audit resources of the IRS have been diverted to focus on tax shelters. Second, the courts have been burdened by a substantial increase in the number of pending cases. Third, the rise of the tax-shelter industry may have contributed significantly to the general deterioration in compliance by undermining taxpayer confidence in the fairness and effectiveness of the tax laws. STAFF OF J. COMMITTEE ON TAXATION, H. CON. REP. NO. 98-794, 98TH CONG., PROPOSALS RELATING TO TAX SHELTERS AND OTHER TAX-MOTIVATED TRANSACTIONS 6 (Comm. Print 1984) [hereinafter PROPOSALS RELATING TO TAX
The standard that I propose is what I will refer to as “purposive textualism” and is taken from the British House of Lords’ opinion by Lord Hoffmann in MacNiven v. Westmoreland. Under this analysis, one must analyze the “constructive purpose” of the tax statute and then determine whether the transaction at issue is consistent with that statutory purpose. In my view, the MacNiven formulation gives us the most principled basis for determining what is an abusive tax shelter and what is legitimate tax planning. It is also a workable construction for tax advisors, which, if employed appropriately, should provide for legitimate tax advice to clients.

Part II of this Article will deal with how we got to where we are, the rise of the mega-shelter industry, and how the realistic possibility of success standard and the economics of the system led to this problem. This part will trace the role of tax advisors in the tax system from the adoption of the income tax to the present. What I hope to show is that the prior system encouraged aggressive tax positions across the board and led, at least in part, to the tax shelter wars we are mired in today. While this antebellum regimen may have been appropriate at the time, it is no longer sustainable.

Part III will look at the recent rules adopted and proposed by the government to deal with shelters. While a whole host of provisions are in play here, I will focus on the new provisions that are emblematic of the efforts of Congress and the Treasury, namely the covered opinion rules of Circular 230 and the revisions to the opinion standards by amended § 6694 of Title 26 of the U.S. Code. In this part, I will show why the current efforts are not an answer to the problem and will, in fact, create larger problems.

Finally, in Part IV of the Article, I will discuss what the standard should be. The House of Lords, in MacNiven, provides us with a method for

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14. As discussed more fully infra Part IV.B, there has, of course, been much written on the differences and similarities of the textualist and purposive approach to statutory interpretation. See, e.g., John F. Manning, What Divides Textualists From Purposivists?, 106 COLUM. L. REV. 70 (2006). My use of the phrase “purposive textualism” is not meant to diminish the distinction between these two schools. Rather, it is a description of the methodology employed by the House of Lords in MacNiven and is designed to highlight the new paradigm in textualism as recognized by Professor Manning. MacNiven v. Westmoreland, [2001] UKHL 6, [2003] 1 A.C. 311, ¶ 29 (UKHC).


16. It is only by examining the shelter problem in full (or at least, fullish) context that a suitable resolution can be found.

17. And by “prior system” I mean the rules and standards prior to 2005, when the covered opinion rules of the Department of Treasury § 10.35 of Circular No. 230 were adopted, which in my view altered the tax landscape for good. 31 C.F.R. § 10.35 (2007). One could certainly pick another date or event to demarcate the “Tax BCE,” but this date seems as good as any.

18. Some scholars have argued that the realistic possibility of success standard was misguided from its launch. See, e.g., Theodore C. Falk, Tax Ethics, Legal Ethics, and Real Ethics: A Critique of ABA Formal Opinion 85-352, 39 TAX L. 643, 643 (1986).
analyzing tax statutes, which in turn leads to a workable standard for tax advice. While the House of Lords referred to this standard as “purposive construction,” in my view the standard is more akin to the modern textualism that looks at the purpose of the statute in the context that Congress (or Parliament) enacted it. While the issues and analysis employed by the Lord Justices in *MacNiven* have much in common with the opinions of some U.S. courts, it is nevertheless my hope that a review of that opinion will offer a different perspective on the issue of tax shelters and tax advice and bring a fresh debate to these issues. I am not so naïve as to think that my new standard will be the answer to all of the ills that face tax practice or that it is a “silver bullet.”

However, like the introduction of the *MacNiven* decision into the tax shelter debate in the United States, I hope my analysis will move the debate in a salubrious direction.

II. HOW DID WE GET HERE?

And you may ask yourself
Am I right? . . . Am I wrong?
And you may tell yourself
MY GOD! . . . WHAT HAVE I DONE?

For most of the relatively brief history of the income tax, tax lawyers were given wide latitude to advise clients, with few standards governing advice, save the general standards of the ABA. When standards were eventually adopted by the government, the standards were comparatively lax. Those standards have recently been replaced by a more draconian regime. This part traces the history of tax compliance and tax lawyers’ roles in that system.

A. Tax Avoidance and the Nature of the Tax Law

Even prior to the enactment of the income tax in 1913, tax avoidance was an issue for the government, the courts, and lawyers.

The people who used the tax on tea as the spark to ignite a revolution and who had included in their constitution a prohibition against any direct tax by
their federal government were not likely to discuss morality and taxes in the same breath. The tax collector was an intruder, and if you could escape his clutches, you were in the same fortunate position as someone who had escaped smallpox or diphtheria.24

In one of the first cases to address the issue of tax avoidance, the Supreme Court held that if the tax avoidance “is carried out by the means of legal forms, it is subject to no legal censure.”25 While this formalistic approach may have stemmed in part from the anti-tax history of the United States, it is also the result of the nature of the tax laws.26

In constructing the right ethical model for tax advice, one must begin with the premise that tax planning and minimization are both inevitable and unavoidable. I do not use these terms in a fatalistic sense that all men are evil and that there are insufficient resources to rid us of the scourge of tax avoidance.27 Rather, tax planning and minimization are unavoidable because the tax laws are necessarily an exercise in line drawing.28 As Justice Oliver Wendell Holmes stated, “[W]hen the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits.”29 Thus, the line drawing that is inherent in tax law inevitably causes taxpayers and their advisors to plan their affairs to fall on one side of the law or the other.30

This idea is developed by the oft-quoted statement regarding taxes, that of Judge Learned Hand: “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”31 As with Justice Holmes’s averment, Judge Hand’s statement is not a normative judgment, nor is it, as many shelter promoters and others have argued, “a license to circumvent rules on the claim of assisting taxpayers in so

26. Norris Darrell, Responsibilities of the Lawyer in Tax Practice, reprinted in PROFESSIONAL RESPONSIBILITY IN FEDERAL TAX PRACTICE 87, 100 (Boris I. Bittker ed., 1970) (“It is for the government to determine what taxes should be paid and in what circumstances. . . . To infer that there is something morally wrong with avoiding tax in a legitimate way, there being no fraud, deceit or make-believe, is pure hypocrisy.”).
27. Much of the law surrounding this is based on Justice Oliver Wendell Holmes’s bad man theory of law. See Falk, supra note 18, at 648.
28. See PAUL, supra note 5, at 19 (“As long as taxes are imposed, there will be transactions in which the tax will be greater one way than another way, or in which one way will be above the suspicion attaching to another way.”).
31. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).
arranging their affairs.”³² Rather, it is a statement regarding the nature of the tax laws.³³ This must be fully understood in formulating an appropriate ethical standard for tax lawyers. Tax minimization, or arranging one’s affairs in such a way to comply with the tax laws, or however one wants to characterize it, is a necessary part of the tax lawyer’s role.³⁴ Policy makers must recognize the inevitability of tax advice and tax minimization in formulating appropriate standards so as to ensure both that tax advice is given and that the advice given is proper.

In addition, unlike other areas of the law that arguably have a moral component to them, there is nothing inherently moral or immoral in the tax laws.³⁵ As one commentator stated,

If there are two bridges across a river, one a toll bridge and the other free, both leading to the same destination, there is no moral reason whatsoever why the traveler shouldn’t choose the free one. If the law permits a taxpayer to arrange to make a profit in such a way that it is taxable as capital gain and not as ordinary income, there is no moral reason whatsoever why he shouldn’t do it.³⁶

Thus, the tax laws either permit a certain deduction or they do not.³⁷

There is no touchstone, apart from the law itself, requiring a taxpayer to pay a certain amount of tax.³⁸ There is no absolute right amount of tax or a

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³³ Darrell, supra note 26.
³⁵ One of the most famous quotes in this regard is from J.P. Morgan, who stated, “Income tax evasion is a legal, not a moral question. Anyone has a right to do anything the law does not say is wrong.” BERNARD WOLFMAN ET AL., ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE, at xxxii (3d ed. 1995).
³⁶ Darrell, supra note 26, at 100.
³⁷ See, e.g., Mark H. Johnson, Does the Tax Practitioner Owe a Dual Responsibility to His Client and to the Government—The Theory, 15 S. CAL. TAX INST. 25, 26 (1963) (“No taxpayer can be asked to pay a tax which he considers to be ‘fair’ under some abstract code of morality. An absolute requisite is a rule book—a written set of rules whose meaning is reasonably clear and explicit.”).
³⁸ There is, of course, a question as to whether the law, simply because it is the law, must be followed. As a result, the arbitrary provisions of the revenue laws are, and just as importantly are perceived as, quite distant from clear mandates such as “thou shall not kill” or “no parking vehicles in the park.” Thus, on a more theoretical or philosophical level is the question of whether we are bound to follow the law merely because it is the law. See, e.g., H.L.A. Hart, Positivism and the Separation of Law and Morals, 71 HARV. L. REV. 593, 594 (1958). This issue has been picked up by Professors Joseph Raz and John Finnis, among others, who have carried the debate forward. John
pure amount of tax. Certainly being straight and honest with the government should be required, but that only begs the question as to what constitutes being straight and honest with the government. Thus, despite Justice Holmes’s aphorism, “I like to pay taxes. With them I buy civilization,” not even the most pro-tax individual can decide what is the “correct” amount of tax. There is no correct amount of tax independent of what Congress has declared it to be.

B. The Role of Tax Advisors in Tax Planning

While tax law is inherently an exercise in line drawing, the line drawn by Congress has not always been crystalline. Given that taxpayers are required to pay only their “fair share,” who decides what that amount is? Professor Raz’s position is that there is no inherent justification for following the law merely because it is the law, and citizens are entitled to question the validity of even duly enacted laws. Id. at 141. While the vast majority of citizens have never heard of Professor Raz, let alone read his work, it appears that most Americans are rather Razian in their attitudes toward the tax code.

According to most people’s moral outlook members of a community should make a contribution to the expense of meeting collective needs. . . . So members of a community have in principle a moral obligation to pay taxes. But this obligation is incomplete or, if one prefers inchoate, apart from law. It has no real content until the amount or rate of tax is fixed by an institutional decision, by law. What amounts to a reasonable contribution is not otherwise determinable, since what is required is a co-ordinated scheme which can be defended as fair not merely in the aggregate amount it raises but in its distribution. Taxpayers cannot settle it for themselves, as people can within limits settle for themselves, say, the proper way of showing respect for the feelings of others. Apart from law no one has a moral obligation to pay any particular amount of tax. An obligation to pay an indeterminate sum is not an effective obligation; it requires only a disposition, not an action. So, apart from law no one has an effective obligation to pay tax.

Id.


41. Nor, practically, can one really pay more tax than is due. Section 6402 of the Internal Revenue Code requires the government, subject to the limitations of § 6402, to refund any overpayment to the taxpayer. 26 U.S.C. § 6402 (2000); see also Jones v. Liberty Glass Co., 332 U.S. 524, 531 (1947) (“[W]e read the word ‘overpayment’ in its usual sense, as meaning any payment in excess of that which is properly due. . . . Whatever the reason, the payment of more than is rightfully due is what characterizes an overpayment.”).

42. Judge Learned Hand said about the income tax that the words that otherwise seem to “dance before [our] eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couchcd in abstract terms that offer no handle to seize hold of.” Learned Hand, Thomas Walter Swan, 57 YALE L.J. 167, 169 (1947).
Judith Freedman cogently argues that obviously it should not be the taxpayer who makes this determination. Resolving these ambiguities is delegated, at least in the first instance, to tax advisors. This highlights the fundamental role tax advisors play in the tax system. Tax attorneys and accountants help clients navigate the murky waters of the tax code and help taxpayers understand what the law requires. Tax advisors also provide clients with creative solutions to limit their tax liabilities and with protection from accuracy related penalties if the tax plan does not work out as designed. This ability to “add value” has encouraged the more risk-tolerant and wealthy taxpayers to take positions that are not legitimate and to pay large fees for the advice.

From the beginning of the income tax, there have always been those who will seek to pay as little as possible. The battle cry of the American Revolution was not “liberté, égalité, fraternité,” but rather, “no taxation without representation.” Public opinion polls have consistently shown a hostility toward taxes and the IRS. This disdain for income taxes cuts across ideological and political lines and reflects the public’s dislike of government and the programs funded by the government. Thus, whether you are an anti-war liberal or a pro-life conservative, you can find some reason not to want to

43. Judith Freedman, Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle, BRIT. TAX REV., July–Aug. 2004, at 332, 334 (“It is inevitable that there will be fundamental tensions between the essential need of governments to raise revenue and the lack of desire of taxpayers to pay for this. Quite apart from differences about the size and role of the state, which are obviously to be decided in the ballot box in a democratic society, each taxpayer will consider that he should pay only his ‘fair share.’ What is his fair share may be a matter for argument, but what is clear is that the taxpayer himself is ‘not the proper person to decide what it should be.’”) (footnote omitted).

44. Robert H. Jackson, Changes in Treasury Tax Policy, 12 TAXES 342, 343 (“In applying a technical law which few have read, and voluminous regulations known to few, and opinions and decisions some of which are not even published, errors will be made, differences of opinion will arise.”).

45. This is not to imply that tax shelters or the desire to pay less taxes is a uniquely American phenomenon. See, e.g., Donald L. Korb, Shelters, Schemes, and Abusive Transactions: Why Today’s Thoughtful U.S. Tax Advisors Should Tell Their Clients to “Just Say No,” in 1-376 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 409, 411–12 (Practising Law Institute 2006) (recounting tax dodges throughout history since the times of ancient Rome). Moreover, my solution to the shelter problem is based in large part upon the House of Lords’ decision in MacNiven v. Westmoreland, [2001] UKHL 6, [2003] 1 A.C. 311 (UKHC).


47. In two Fox News/Opinion Dynamics polls taken in 2002 and 2005, between seventy-one percent and seventy-five percent of respondents objected to how their tax dollars were spent, rather than the amount of taxes they paid. The poll is available at http://www.pollingreport.com/budget.htm (last visited Nov. 13, 2008).
fully fund the government.\textsuperscript{48} Another public sentiment is that while only fourteen percent have ever been even tempted to cheat on their own taxes, these same people believe that thirty-nine percent of their neighbors are cheating on their taxes.\textsuperscript{49} Thus, there is a belief that only a fool pays his full amount of tax, or as Leona Helmsley so eloquently stated, “Only the little people pay taxes.”\textsuperscript{50} And there is a belief that if we only find the right tax advisor, we will only be required to pay that which we are constitutionally obligated to forfeit.\textsuperscript{51}

The imposition of penalties and the role of tax attorneys in shielding clients from these penalties must be emphasized. While it is true that tax lawyers are lawyers who happen to specialize in a given area (i.e., tax), tax lawyers’ ability to insulate their clients from penalties, merely by giving them advice, is unusual in law.\textsuperscript{52} Thus, the normal generalizations and positive exhortations of the rules of professional conduct are insufficient for tax advice. Tax lawyers hold the key to understanding the tax laws and to protecting clients from penalties, and financial incentives have usually caused lawyers to side with clients. Whatever rules or standards are adopted must take into account the tax lawyer’s unique role in the tax system.

\textbf{C. Standards Applicable to Tax Advice}

Unlike many legal specialties, tax lawyers do not have a venerable tradition to compel adherence to fixed ethical rules.\textsuperscript{53} Indeed, in an article from 1953, Randolph Paul states that until that time, “very few tax lawyers

\begin{footnotesize}
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\item 48. Freedman, \textit{supra} note 43, at 337 (noting the same attitude in United Kingdom).
\item 51. See Miller, \textit{supra} note 24, at 1074 (“Most people think of us as having a bag of tricks that greatly reduces our clients’ taxes and probably gets us out altogether on our own.”).
\item 52. See, e.g., People v. Nat’l Ass’n of Realtors, 202 Cal. Rptr. 243, 248 (Ct. App. 1984) (rejecting defense to civil penalties of reliance on advice of counsel).
\item 53. Compare the archetypical duties of the zealous advocate, summarized by Lord Brougham in 1821 in his defense of Queen Caroline:

\begin{quote}
An advocate, in the discharge of his duty, knows but one person in all the world, and that person is his client. To save that client by all means and expediency, and at all hazards and costs to others persons, and amongst them, to himself, is his first and only duty; and in performing this duty he must not regard the alarm, the torments, the destruction which he may bring upon others.
\end{quote}

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[even gave] much thought to the ethics that should govern” the profession and that there was no clear set of guidelines governing how tax advice should be dispensed. 54 Despite the fact that the Treasury had been given authority in 1884 to promulgate rules of practice before it, 55 the Treasury did little to dictate the rules applicable to tax professionals in rendering return advice. The original version of Circular 230 did not contain any standards for advice or preparations of returns; 56 the first version of Circular 230 to include any standard regarding tax advice did not appear until 1938. 57 Even then, the standard required practitioners only to “exercise due diligence” in preparing or assisting in the preparation of returns and other documents. 58 This standard appeared to require tax professionals to do some independent investigation but did not set forth any criteria regarding how ambiguities in the statute should be resolved. 59 However, given the complexity of the tax laws and the broad application of these arcane statutes, disputes with the IRS as to how the Code should be interpreted were bound to occur. And, given that penalties were imposed for failure to follow the dictates of the Code, the issue of the standards applicable to taxpayers and their advisors would inevitably come to the fore.

Negligence penalties were first added to the Code in 1918. 60 The penalty was a modest five percent of the total amount of the deficiency and applied where an understatement was “due to negligence on the part of the taxpayer, but without intent to defraud,” 61 or there was an “intentional disregard of authorized rules and regulations with knowledge thereof.” 62 However, if the return was “made in good faith and the understatement of the amount in the return was not due to any fault of the taxpayer,” no penalty would be imposed because of the understatement. 63

54. Paul, supra note 34, at 412.
57. 31 C.F.R. § 10.2(w) (1938).
58. Id.
59. See id.
61. Revenue Act of 1918 § 250(b).
63. Id.; Revenue Act of 1918 § 250(b); see also Winslow, supra note 60, at 836–40.
When cases requiring application of these standards reached the courts, the resulting analyses, while conclusory, nevertheless were the foundation for the “reasonable basis” and “substantial authority” standards, and endorsed the efficacy of disclosure in eluding penalties. For example, in Senner v. Commissioner, the Board of Tax Appeals held that the petitioner should not be held liable for negligence because the issues “are questions concerning which petitioner had reasonable grounds to differ from the conclusions reached by the respondent.” In Heffelfinger v. Commissioner, the Board refused to impose negligence penalties for intentional disregard of rules and regulations but without intent to defraud where the evidence showed that the petitioner “honestly believed” that he had properly reported the income at issue and because an “explanation was given of why the income was not reported by the petitioner.” The Board reaffirmed the conclusions in these two cases in its decision in Davis Regulator Co. v. Commissioner and held that “where full disclosure is made and the taxpayer has ‘reasonable grounds to differ from the conclusion’ of the Commissioner that a tax is due, the negligence penalty should not be imposed.” Finally, in Brockman Building Corp. v. Commissioner, the Tax Court held that the Commissioner erred in determining that the petitioner was liable for negligence penalties because the petitioner attached a rider to its return, the return was prepared by a certified public accountant, and the petitioner had a “good faith,” “bona fide” belief, all of which amounted to “reasonable cause.”

Thus, as originally formulated by the courts, insulation from penalties was based on the reasonableness of the taxpayer’s actions, which could be demonstrated by, among other things, reliance on the advice of a professional and disclosure. The courts did not address the standards tax professionals must use in giving advice to clients, but it appears that underlying these

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64. The conclusory nature of this analysis persists to the current day. See, e.g., Osteen v. Comm’r, 62 F.3d 356, 358 (11th Cir. 1995) (chastising the Tax Court for its conclusory application of the substantial understatement and substantial authority provisions).

65. 22 B.T.A. 655 (1931).
66. Id. at 658.
67. 32 B.T.A. 1232 (1935).
68. Id. at 1235.
69. 36 B.T.A. 437 (1937).
70. Id. at 444 (citing Senner, 22 B.T.A. at 658; Heffelfinger, 32 B.T.A. at 1232).
71. 21 T.C. 175 (1953).
72. Id. at 191.
73. As Professors Boris Bittker and Martin McMahon noted, “[S]ince negligence is the antithesis of reasonable behavior, a showing of reasonable cause for the underpayment in effect negates the existence of negligence.” BORIS I. BITTKER & MARTIN J. McMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 45.3 (1988); see also Winslow, supra note 60, at 839.
74. See Brockman Building Corp., 21 T.C. at 191.
standards was the assumption that taxpayers and their advisors were attempting to find the right answer, or at least had an honest dispute with the IRS as to how the law should be interpreted.  

The first standards applicable to tax lawyers came not from the Treasury or the courts, but from the ABA.  

Formal Opinion 314 covers several matters, including whether the IRS is a tribunal, as well as what duties are owed to the IRS.  

Regarding the standards applicable to rendering tax advice to clients, the opinion provides that

a lawyer who is asked to advise his client in the course of the preparation of the client’s tax returns may freely urge the statement of positions most favorable to the client just as long as there is reasonable basis for those positions. Thus where the lawyer believes there is a reasonable basis for a position that a particular transaction does not result in taxable income, or that certain expenditures are properly deductible as expenses, the lawyer has no duty to advise that riders be attached to the client’s tax return explaining the circumstances surrounding the transaction or the expenditures.

Thus, the first standard applicable to attorneys giving tax return advice was the “reasonable basis” test. If the lawyer believed that there was a reasonable basis for a return position, the lawyer could freely advise that position and was not required to advise the client to disclose that position.

Formal Opinion 314 was subject almost immediately to criticism. The reasonable basis standard was described by notable commentators as

77. The ABA opined that the “Internal Revenue Service is neither a true tribunal, nor even a quasi-judicial institution.” Id.
78. Quoting various Canons of Ethics, Formal Opinion 314 provides that the lawyer may not mislead the IRS, conceal facts, or commit fraud, and “should strive at all times to uphold the honor and to maintain the dignity of the profession.” Id. (quoting ABA CANONS OF PROF’L ETHICS Canon 29 (1967)).
79. Id.
80. See id.
81. Id.
“anything you can articulate without laughing,” or as any position that can be adopted “with little more than a chuckle.” More fundamentally, the reasonable basis standard appeared to allow attorneys to advise a position that they did not believe to be correct, as long as it was “reasonable,” which might well be inconsistent with the taxpayer’s statement in the jurat. Opinion 314 also began with the premise that the IRS and tax lawyers are adversaries. “Accordingly, it viewed a tax return as a submission in an adversary proceeding and the lawyer’s ethical obligations of candor and zeal as essentially those of an advocate.”

The next development in the standards applicable to taxpayers and their advisors was the 1982 enactment of the substantial understatement penalty. Under these new penalties, a taxpayer would be liable for a twenty-percent penalty if the understatement of tax was substantial. The amount of the understatement could be reduced if there was substantial authority for the treatment or if the item was adequately disclosed. Known as the “audit lottery” penalty, the substantial understatement penalty was designed to “create downside risk for taxpayers who take aggressive, undisclosed positions.” This development in the law regarding penalties called into question the reasonable basis standard of Formal Opinion 314. Could a lawyer advise a client to take a position on a return that did not have substantial authority and advise the taxpayer not to disclose the position? Doing so would, in essence, allow a lawyer to advise a client to take a position that might subject the client to penalties.

The Treasury’s response was that a lawyer could not ethically advise such a position. In proposed regulations amending Circular 230, the Treasury

83. Falk, supra note 18, at 644 (quoting Ethics Opinion 314 and Tax Shelters Addressed at ABA Meeting, 22 TAX NOTES 757 (1984)).
85. See Rowen, supra note 82, at 250.
86. Falk, supra note 18, at 646.
made its first attempt to provide more guidance on the meaning of “due diligence” and stated that a practitioner should not, in the exercise of due diligence, place his or her client in a position of being assessed any of the accuracy-related penalties. 92 The proposed regulations were also premised on the Treasury’s concern that the ethical standards of some practitioners regarding tax advice had eroded over the years. 93 The Treasury believed this led to serious problems concerning taxpayer compliance with the revenue laws, which adversely affected the integrity of the voluntary, self-assessment tax system. 94 The proposed regulations would have required a practitioner only to recommend positions that were “supported by substantial authority”; otherwise the relevant facts were required to be disclosed. 95

These proposed regulations were never adopted as final regulations. After the substantial understatement penalties were enacted, and prior to the issuance of the proposed regulations, the ABA Standing Committee on Ethics and Professional Responsibility adopted Formal Opinion 85-352, which became the standard for tax return advice for the next twenty years. 96 In that opinion, the ABA abandoned the reasonable basis standard of Opinion 314 in an attempt to “elevate the minimum ethical standard above that which ‘reasonable basis’ had come to represent for many practitioners and others.” 97 The committee noted that the reasonable basis standard had been subjected to criticism by the tax bar, the IRS, and members of Congress, and as a result, the reasonable basis standard had been eroded as an ethical guideline. 98

Under Formal Opinion 85-352,

92. Id. at 29,114.
93. Id. at 29,113.
94. Id.
95. Id. The proposed regulations would also have prohibited a practitioner from recommending or advising a client that a position be taken if the taxpayer would have been liable for the substantial understatement penalties. Id. at 29,114.
96. See ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 85-352 (1985). Like all formal opinions issued by the ABA, Formal Opinion 85-352 was adopted by the ABA Standing Committee on Ethics and Professional Responsibility, and not the Tax Section of the ABA. Id. A contemporary commentator suggested Formal Opinion 85-352 was actually adopted in the face of a proposal developed by the ABA Tax Section’s Committee on Standards of Tax Practice and approved by the ABA Tax Section’s membership in May 1984, which would have raised the standard to require taxpayers to take a “meritorious position.” See Falk, supra note 18, at 643–44. The Tax Section’s comments on a draft of Formal Opinion 85-352 complained that the new language would fail to elevate the minimum standard and that the proposed standard that a position be “meritorious” would have been more stringent. Id. at 644 n.8.
a lawyer, in representing a client in the course of the preparation of the client’s tax return, may advise the statement of positions most favorable to the client if the lawyer has a good faith belief that those positions are warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. A lawyer can have a good faith belief in this context even if the lawyer believes the client’s position probably will not prevail. However, good faith requires that there be some realistic possibility of success if the matter is litigated.99

The ABA therefore traded in the reasonable basis standard for the “realistic possibility of success” standard.100 In the ABA’s view, the new realistic possibility of success was “an objective standard which can be enforced.”101 In addition, the opinion stated that if the position met the realistic possibility standard, the lawyer had no duty to require a client to attach riders to the return.102

While realistic possibility may have been an improvement over reasonable basis,103 Opinion 85-352 still suffered from the same flaws as its predecessor opinion. Like Opinion 314, which viewed a tax return as a submission in an adversarial proceeding and the lawyer’s ethical obligations as essentially those of an advocate,104 Opinion 85-352 continued, and in some ways heightened, that view.105 Opinion 85-352 notes, quite accurately, that an attorney must anticipate that a tax filing may result in an adversarial relationship between the client and the IRS.106 However, Opinion 85-352

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99. Id. (footnote omitted). Formal Opinion 85-352 did not quantify realistic possibility of success. However, a special task force consisting of tax luminaries later quantified this standard as something approaching one-third. WOLLMAN ET AL., supra note 35, at 63–64.

100. Report, supra note 97, at 635.

101. Id. at 637.

102. Id. Recognizing that, despite the advice from an attorney, clients might nevertheless be subject to penalties, the opinion suggested that “[i]n the role of advisor, the lawyer should counsel the client as to whether the position is likely to be sustained by a court if challenged by the IRS, as well as of the potential penalty consequences to the client if the position is taken on the tax return without disclosure.” Id.

103. It can be argued that it is practically impossible to differentiate between a ten percent and a one-third chance of success. See WOLLMAN ET AL., supra note 35, at 64.

104. Falk, supra note 18, at 646.

105. Id. at 647. The proposed revisions to Opinion 314 explicitly rejected that assumption. Id. The proposed revisions maintained that an adversarial proceeding began with an audit. Id.

106. However, the low audit rates call into question what the risk actually is. As Falk notes, because the government is not a “fairly equipped opponent,” given that less than one percent of returns will be audited, a tax return is not governed by the usual rules of adversarial proceedings. “In this view the Service is a paper tiger, not a leviathan the taxpayer should defeat by cunning.” Id. at
takes this notion a step further and asserts that when a taxpayer takes an aggressive position, it is more likely to result in an adversarial relationship. Thus, the reasoning of Opinion 85-352 appeared to take the perverse position that the more aggressive the position, the more an attorney may treat his or her role as that of a zealous advocate. Opinion 85-352 also failed to take into account the distinction the Model Rules make between lawyer as advocate and lawyer as advisor. While the filing of a return may indeed be the precursor to most tax controversies, the disclosure and self-assessment purposes of tax returns are essentially nonadversarial. Our voluntary tax system necessarily depends upon fair dealing with the government. “Failure to obey the law can result in an adversarial proceeding, but obeying the law is something one does for the government, not against it.”

Despite its shortcomings, the realistic possibility of success standard was adopted by the American Institute of Certified Public Accountants. The ABA and the AICPA also encouraged Congress to adopt this standard for the return preparer penalty of § 6694 so that a return preparer would not be liable for the penalty if the position on the return had a realistic possibility of success. In order to preserve some sense of harmony between the Code and Circular 230, the Treasury withdrew its “substantial authority” proposed regulations in Circular 230 and adopted new § 10.34 in Circular 230, which was designed to mirror the realistic possibility standards adopted by the ABA, AICPA, and the preparer penalty provisions of § 6694. Under § 10.34, a practitioner may not advise a client to take a position on a return unless the practitioner determines that there is a realistic possibility of the position being sustained on its merits, or the position is not frivolous, and the practitioner advises the client to adequately disclose the position.


108. Id.
111. Falk, supra note 18, at 648.
112. Id.
113. Id.
114. Id.
115. AICPA Statements on Responsibilities in Tax Practice No. 1 (1988). The AICPA did not, however, quantify the standard as a one-third, or any other, chance of success.
116. See H.R. REP. NO. 101-247, at 1396 (1989) (“The committee has adopted this new standard because it generally reflects the professional conduct standards applicable to lawyers and to certified public accountants.”).
“A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.”

The realistic possibility standard was adopted in final regulations in 1994. Accordingly, for non-tax shelter opinions, realistic possibility of success became the universal standard for tax advice.

**D. The Rise of Mega Tax Shelters**

The realistic possibility of success standard was designed to take into account the ambiguous nature of the tax laws and to provide an objective standard to which lawyers could adhere. However, the lax one-in-three threshold attendant upon that standard also encouraged the aggressive, pro-taxpayer side of tax lawyers. Lawyers did not need that encouragement. As Randolph Paul noted more than half a century ago, “The ethical problems presented to tax advisers are of a more subtle character. Borderline questions are presented which usually have enough potential argument in their favor to furnish some basis for rationalization leading to a decision to act in the apparent immediate financial interest of the taxpayer.” Thus, there has always been both an ethical and financial incentive to favor the client’s position.

In the 1990s, changes in the legal and accounting marketplace magnified this issue. Firms became more entrepreneurial, and “consulting” became one of the largest parts of large accounting firm practices. Prior to its demise as the result of action taken on behalf of Enron, Arthur Andersen was said to have received up to $100 million in fees per year from Enron. With larger fees, some in the millions of dollars, the temptation to use vague and aggressive tax advice standards became too great. The combination of new

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122. See Paul, supra note 34, at 413.
123. This change in the industry has occurred both in the United States and internationally. See Daniel Muzio, The Professional Project and the Contemporary Re-Organisation of the Legal Profession in England and Wales, 11 INT’L J. LEGAL PROF. 33, 34 (2004).
125. Id. at 282.
vehicles in corporate finance and the desire of public accounting firms, banks, and law firms to generate significant revenues based on contingency or premium fees, instead of traditional billable hours, led to new mega shelters. The hallmark of the new tax shelters was to develop a scheme, usually involving numerous transactions, which involved exploiting obscure imperfections in the tax law to produce results that “would not have been intended if they had been foreseen, and which are likely to be corrected soon after they are discovered.” These schemes often involved sophisticated financial products, special-use entities, and offshore banks not subject to U.S. taxation.

Some have argued that the current spate of tax shelters, while troubling, is not necessarily new. Professor James S. Eustice, for one, has dubbed current shelters as merely “old brine in new bottles.” Nor is the view that some lawyers and accountants are not acting appropriately new. Statements from eminent tax lawyers and scholars at the Tax Law Review’s 1952 banquet lamented the conduct of tax lawyers of the day. Professor Edmond Cahn stated that lawyers “may be fast losing our status as a profession and becoming nothing more than skilled merchant-clerks.”

While tax shelters are indeed nothing new, and the estimated current revenue loss is not appreciably greater than in past generations of shelters,

126. See Korb, supra note 45, at 420.
127. Id. at 421.
129. For example, Senator Paul Douglas made the following notable statement regarding tax loopholes (or “truck holes” as he referred to them) on the Senate floor on May 26, 1961: “These gentlemen [lawyers and accountants] help citizens to avoid and, in some cases, to evade the payment of taxes which in all good conscience they should pay. A bewildering variety of tax ‘gimmicks’ and arguments are developed with which the revenue officials and the courts are either unable or unwilling to cope.” 107 Cong. Rec. 9115 (1961) (statement of Sen. Douglas).
130. See James S. Eustice, Abusive Corporate Tax Shelters: Old “Brine” In New Bottles, 55 Tax L. Rev. 135, 172 (2002) (“Granting that there is a problem here—and a serious one at that—it is not a new one. Corporate ‘tax management’ has been going on as long as the corporate tax rate exceeded zero. While packaged in new and exotic wrappers, it is still the same old, same old thing.” (footnote omitted)).
132. Id. It may be argued that lawyers have never been free from the charge that they (we) will make any argument if the price is right. See, e.g., JAMES A. BRUNDAGE, THE MEDIEVAL ORIGINS OF THE LEGAL PROFESSION 478–83 (2008) (quoting commentators of the thirteenth and fourteenth centuries, who opined, “No one ever became an advocate, save to deliver himself from poverty”; “Clerks go to Bologna to learn law and duplicity, and consequently they get rich and lose their souls”; and “[D]espite lawyers’ professed devotion to justice, in reality they would take any case, no matter how flimsy, and do or say anything for any client, no matter how wicked, provided that the client paid their fees.”).
these Generation X shelters are nevertheless different. The current shelters are invested in by high net-worth individuals and corporations,134 and the magnitude of the losses claimed by each investor in these shelters dwarfs the deductions claimed by shelter investors in the 1970s.135 For example, the taxpayer in ACM Partnership claimed a capital loss of $84,997,111 resulting from its London Interbank Offering Rate (LIBOR) notes transaction.136 By contrast, the shelters of the 1970s were invested in by thousands of individuals, including middle-class taxpayers, thereby giving those shelters an oddly democratic feel about them.137 This demographic change has, I believe, exacerbated the “disrespect for the tax system” that so concerns Congress.138

Other issues outside of the shelter industry, from the $350 billion “tax gap” to the need for reform or repeal of the Alternative Minimum Tax, have put a premium on tax enforcement and have spurred the desire to “do something” about the tax shelter issue.

It can also be argued that the type of advisors involved in shelters has changed over the years. In the past, the shelter industry was populated by professionals at the periphery of the profession.139 The advisors involved in the current shelters worked for some of the most prestigious accounting and law firms. Thus, while lawyers during the early part of the twentieth century were the celebrities of the day, garnering both wealth and fame,140 tax lawyers and other tax professionals in the first part of the twenty-first century have achieved a different sort of notoriety. Arthur Andersen, the largest and oldest international accounting firm, was indicted and, as a result, went out of

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2007 dollars, that amount is $7.6 billion. The IRS estimates $10 billion in losses from tax shelters currently. Mary Williams Walsh, Treasury Department Cracks Down on Tax Shelters for Firms, L.A. TIMES, Feb. 29, 2000, at C-1. Thus, the amount of money lost, while troubling, is not appreciably higher than in past eras. 134. While they have commonly been called corporate tax shelters, many of these shelters were also marketed to high net-worth individuals. See Korb, supra note 45, at 420 n.1. 135. See, e.g., Glass v. Comm’r, 87 T.C. 1087 (1986) (a consolidated case with 1400 petitioners). 136. ACM P’ship v. Comm’r, 157 F.3d 232, 243 (3d Cir. 1998). 137. Korb, supra note 45, at 414. 138. See generally PROPOSALS RELATING TO TAX SHELTERS, supra note 13. 139. See, e.g., Goldberg v. United States, 789 F.2d 1341, 1342–43 (9th Cir. 1986) (describing “Margolis transactions” typical of shelters peddled by Harry Margolis, which were “characterized by convoluted transfers of overvalued property rights, circular money movements among foreign trusts, delayed drafting, signing and backdating of documents, and client oblivion to the financial realities of their investments”); J.P. Wenchel, Discussion of the Papers for Ethical Problems of Tax Practitioners, Address at the Tax Law Review’s 1952 Banquet, in 8 TAX L. REV. 1, 24 (1952) (“It is the blackleg—and he was always in the profession. What are you going to do about him? He is on the fringe of society.”). 140. See, e.g., JOHN CAMPBELL, F.E. SMITH, FIRST EARL OF BIRKENHEAD 112, 113–14 (Pimlico 1983).
business due to its involvement in the tax activities of Enron.141 The international accounting firm of KPMG escaped indictment only by agreeing to a deferred prosecution agreement and a $450-million fine.142 Lawyers and accountants have been indicted and pleaded guilty.143 With the involvement and indictment of leaders of the profession in the tax shelter industry, the problem is at least perceived to be larger and one requiring more attention.144 Others blame changes in the method of statutory interpretation for the increase in shelter activity. Professors Noel B. Cunningham and James R. Repetti argue that the recent proliferation of tax shelters has, at least in part, been caused by the ascendancy of textualism or hyper-textualism.145 They assert that tax advisors have become more aggressive in structuring transactions that comply with the literal terms of a statute “even though the transactions may be highly questionable in light of the legislation’s history or underlying purpose. The result has been a cottage industry where investment banks and accounting firms market tax shelters that triumph in form, but not substance, at the expense of the fisc.”146

Regardless of whether the current shelters are indeed anything new, or just “old brine in new bottles,”147 the response of the government is no doubt different. Both Congress and the Treasury have acted to curtail tax shelters in new and sometimes troubling ways. The following part will discuss several of the government’s actions.

III. RECENT GOVERNMENT ACTIONS

The government has, over the years, tried different tacks for attacking shelters. In recent years, both Congress and the Treasury have tried to define what a shelter is. As discussed more fully below, this effort has proven unsuccessful. As a result, Congress has essentially thrown up its hands, ceding more authority to the Treasury to decide what an abusive shelter is, to gather information on taxpayer positions, and to impose penalties. As I argue

141. See Coffee, supra note 124, at 281.
145. Cunningham & Repetti, supra note 1, at 2.
146. Id. (footnote omitted).
147. See Eustice, supra note 130.
below, none of these efforts will solve the tax shelter problem, and the result will, unfortunately, be fewer taxpayers getting good, solid tax advice. In this part, I will discuss the covered opinion rules and the amendments to the return advice standard in both § 6694 of Title 26 of the United States Code and § 10.34 of Circular 230. I focus on these new provisions because they are emblematic of the government’s anti-shelter efforts and provide a framework for analyzing what the government can and should do.

A. The Covered Opinion Rules

The first of the government’s most recent actions was an effort to attack tax shelters by requiring lawyers and accountants to issue extensive, long-form opinion letters in all shelter-like transactions, known as “covered opinions.” The covered opinion rules were based on the accurate premise that tax shelter opinions were essentially incomplete and misleading. Many tax shelter opinions simply ignored key facts or the implications of those facts or ignored issues entirely. The covered opinion rules sought to rectify these problems by requiring tax professionals to fully address all of the facts and legal issues in a tax shelter opinion. However, the Treasury would only require these exhaustive opinions in the case of a tax shelter, which necessarily required the Treasury to first define a tax shelter. Unfortunately, the definitions used in the covered opinion rules were so broad and unworkable that these rules appeared to cover all tax advice and negatively impacted legitimate tax advice.

1. Defining Tax Shelters

Coherently defining what constitutes a tax shelter has proven difficult for Congress, the IRS, the courts, and academics. Arguably the most accurate definition comes from Professor Michael Graetz, who defined a tax shelter as “[a] deal done by very smart people that, absent tax considerations, would be very stupid.” \(^\text{148}\) While eloquent and perfectly descriptive, this definition is not terribly helpful in deciding when tax planning has crossed the line into abusive tax avoidance. The term “tax shelter” itself is defined in the Internal Revenue Code only in § 6662(d) and is defined as a partnership or other entity, or any investment plan or arrangement, “if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.” \(^\text{149}\) While perhaps more helpful than Professor Graetz’s


\(^{149}\) 26 U.S.C. § 6662(d)(2)(C)(ii) (2000 & Supp. V 2005). Opinions on tax shelters have always been treated differently from other tax issues. Unlike non-tax shelter opinions, which only require a “realistic possibility of success on the merits” (a one-in-three chance) or “substantial
definition, it is still not very illuminating. Indeed, it could be argued that a “significant purpose” of anything a tax lawyer advises a client to do has at least as a significant purpose the avoidance of tax. Professor Eustice and other scholars have summarized the indicia of an abusive tax shelter transaction. However, these indicia are more descriptive than definitional, and they do not purport to be a general guide to demarcating the border between planning and abuse. ABA Formal Opinion 346 defined a tax shelter as

an investment which has as a significant feature either . . . or both of the following attributes: (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.

This too appeared to be a rather targeted definition of tax shelters and not a general shelter definition.

2. Covered Opinions

With this history in mind, the Treasury took its shot at defining (and deterring) abusive shelters when it amended Circular 230 and adopted the covered opinion rules. Under the rules that became effective in June 2005, if a tax practitioner provides written advice on certain types of

authority” (somewhere between one in three and fifty percent), tax shelter opinions require the practitioner to determine that the issue is “more likely than not” to succeed on the merits if challenged. The more likely than not standard is defined as greater than a fifty percent chance of success. See supra Part II.

150. Schler, supra note 1, at 329.

151. See, e.g., Eustice, supra note 130, at 158–59; see also Korb, supra note 45, at 421. In Part III.D infra, I will discuss other proposals by scholars to resolve the current tax shelter problem.

152. Nevertheless, Congress and the Treasury have used some of these indicia in defining what is a “reportable transaction,” which would require taxpayers to disclose investments in transactions that possess these indicia. See 26 U.S.C. § 6111 (2000 & Supp. V 2005). Again, what constitutes a “reportable transaction” was never intended to provide a global definition of what constitutes a tax shelter.


investments, defined as a “covered opinion,” the advice must be given in the form of a “covered opinion” consistent with the rules of § 10.35. Thus, both the type of investment and the type of opinion letter required were referred to as covered opinions. As set forth below, the type of investment that constitutes a covered opinion (read tax shelter) is far from clear under the regulations. Moreover, the requirements that must be followed in drafting a covered opinion are detailed, time-consuming, and expensive for clients. However, if the written communication does concern a covered opinion and the practitioner does not satisfy all of the covered opinion requirements of § 10.35, the practitioner can face disciplinary action by the Treasury. As a result, practitioners were loathe to provide any advice and defaulted to a strategy of “legending out” of the covered opinion rules by attaching disclaimers denying penalty protection for their clients.

Under the regulations, a “covered opinion” is any written communication, including emails, letters, and memoranda, that give advice on any tax issue as long as the opinion concerns one of three types of investment. The first type of investment is so-called listed transactions. Listed transactions are investments or schemes that the Treasury has specifically listed in public announcements as being abusive tax shelters. If the investment is, or is substantially similar to a listed transaction, a covered opinion must be issued.

The second type of investment is one that has as its “principal purpose” the avoidance or evasion of any tax (not just income taxes) imposed by the Internal Revenue Code. For purposes of the covered opinion rules, the principal purpose of an investment is the avoidance or evasion of any tax imposed by the Internal Revenue Code “if that purpose exceeds any other

157. The covered opinion rules echo the language of § 6662(d) and use the phrase “a partnership or other entity, any investment plan or arrangement, or other plan or arrangement.” 31 C.F.R. § 10.35(b)(10). Throughout this discussion, I will use the word “investment” to cover this more latitudinous definition. See 26 U.S.C. § 6662(d) (2000 & Supp. V 2005).
158. 31 C.F.R. § 10.35(c) (2005).
159. This redundant use of the term “covered opinion” contributed to the confusion surrounding the requirements of § 10.35.
160. See 31 C.F.R. § 10.31(d) (2005).
161. 31 C.F.R. § 10.60 (2005).
166. See 26 C.F.R. § 1.6011-4(b)(2).
Commentators were concerned about the broad definition of "principal purpose" and the difficulty a practitioner would have in determining whether a client’s purpose in investing in an entity involved primarily tax avoidance or some other purpose. In addition, many practitioners rightly expressed concern that some investments have as their principal purpose the avoidance of federal tax and are yet perfectly acceptable under the Code. For example, family limited partnerships, where one of the main reasons for such investment plans is the avoidance of federal estate tax, could be a covered opinion. Likewise an S corporation, arguably the sole purpose of which is to avoid corporate level tax and/or self-employment taxes, would also be a covered opinion. Commentators wondered whether every piece of written advice recommending the use of an S corporation must be made via a long-form covered opinion.

When the final regulations were adopted, the "principal purpose" definition was limited to provide that the principal purpose of an investment is not to avoid or evade federal tax if that investment "has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose." This language resolved the thorny issue raised by the commentators and, by doing so, the Treasury acknowledged that some tax planning, and indeed some "tax shelters," are acceptable under current law.

The third type of investment is one in which a "significant purpose" is the avoidance or evasion of any federal tax. Standing alone, this definition would cover any advice given by a tax practitioner. This broad definition is limited by the qualifiers that the written advice be either (1) a "reliance opinion," (2) a "marketed opinion," (3) "subject to conditions of confidentiality," or (4) subject to "contractual protection." Because

170. 31 C.F.R. § 10.35(b)(10).
171. Id.
173. 31 C.F.R. § 10.35(b)(10).
174. I will return to the limiting language, "consistent with the statute and Congressional purpose," in the discussion of a workable standard for tax advice.
175. 31 C.F.R. § 10.35(b)(2)(C) (2005).
177. 31 C.F.R. § 10.35(b)(2)(C)(2) (2005) (emphasis omitted) (an opinion that is used by promoters to market a particular investment plan, 31 C.F.R. § 10.35(b)(5)(i) (2005)).
178. 31 C.F.R. § 10.35(b)(2)(C)(3) (2005) (emphasis omitted) (the taxpayer can only learn of the investment if he or she promises not to disclose the terms of the plan, 31 C.F.R. § 10.35(b)(6) (2005)).
179. 31 C.F.R. § 10.35(b)(2)(C)(4) (2005) (emphasis omitted) (the taxpayer may obtain a refund of fees paid to the professional should the IRS challenge the plan and the taxpayer has to repay the tax benefits, 31 C.F.R. § 10.35(b)(7) (2005)).
typical tax advice does not involve marketed opinions or opinions subject to contractual protection or confidentiality requirements, the most important qualifier concerns reliance opinions.

Unlike the other covered opinion definitions, in which the definitions are based on the kind of investment the taxpayer is seeking advice on, a reliance opinion is determined by the level of certainty reached in the opinion. A reliance opinion is any written advice “if the advice concludes at a confidence level of at least more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer’s favor.” Conversely, a written communication or email will not be treated as a reliance opinion “if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.” This dichotomy left many practitioners with the impression that all tax advice, including emails, was required either to be in the form of a covered opinion or contain a no-reliance disclaimer. This impression was reinforced by an unrelated section of the covered opinion rules requiring that if an opinion does not reach a conclusion at a confidence level of at least more likely than not, the opinion must contain the no-reliance disclaimer.

However, a close reading of the reliance opinion rule shows that written advice will be a reliance opinion (and therefore a covered opinion) only if the practitioner reaches a more likely than not opinion. If a practitioner reaches a conclusion at a confidence level less than more likely than not, it is not a covered opinion. Nothing prevented a practitioner from giving a favorable opinion at less than the more likely than not opinion standard, and clients could rely on that advice and obtain protection from penalties in most cases.

180. Many “modern” tax shelters had as one of their characteristics that they were marketed to many potential “investors,” that they offered protection to the investor in the form of contractual protection, or that they would only be disclosed to potential investors on the condition that the investor/target agreed not to disclose the details of the investment. See, e.g., Korb, supra note 45, at 421. Given that these types of investments or plans were more typical of tax shelters, making advice regarding these investments more difficult does not impede legitimate tax advice.

182. Id.
185. 31 C.F.R. § 10.35(c)(4) (2005).
187. Id.
Moreover, while the seemingly categorical statement of subsection (e)(4) that all opinions that do not reach a more likely than not conclusion must include a no-penalty disclaimer, a closer reading of this provision shows this is not the case. Clause (4) is part of subsection (e), which begins: “A covered opinion must contain all of the following disclosures that apply.” Since an opinion given at less than a more likely than not level is not a covered opinion, a no-reliance disclaimer is not required.

Despite the limited coverage of the reliance opinions, given the ambiguity of the regulations and the possibility of sanctions for failure to follow the covered opinion rules, practitioners determined that discretion—and disclaimers—were the better part of valor. It has therefore become standard practice for most firms that give tax advice to include in every email or written product, even routine, non-tax related communications with clients or other lawyers, language to the effect that “this communication may not be relied upon for penalty protection.” The ubiquitous nature of the penalty-protection disclaimer soon lowered the disclaimers to a farcical level, with one internet vendor marketing coffee mugs, t-shirts, and even underwear emblazoned with the no-penalty-protection mantra.

The result of the covered opinion rules was that practitioners became more careful and parsimonious with their tax advice. While the covered opinion rules can be parsed with some effort, the breadth and coverage of these rules are still far from clear in many cases. Moreover, the provisions are unacceptably complex with numerous defined terms and overlapping standards and definitions. The standard for giving tax advice simply cannot consist of numerous pages of dense text—such a standard is completely unworkable. Tax lawyers and accountants cannot be spending more time trying to figure out what the tax advice standard means than applying it to provide tax advice. The truly bad actors who do not care about real tax advice will still peddle abusive transactions, and there is little to be gained by an unadvised taxpayer community. As Mark Johnson argued:

6694(a)(1) (2000) (authorizing penalties for understatements due to unreasonable positions). In addition, as is discussed in the next part, providing an opinion below the more likely than not standard may now require disclosure of the position on the return.

189. See 31 C.F.R. § 1035(e)(4).
190. 31 C.F.R. § 10.35(e) (2005) (emphasis added).
193. See 31 C.F.R. § 10.35.
194. In addition to being bad policy, the covered opinion rules may also be unconstitutional. See David T. Moldenhauer, Circular 230 Opinion Standards, Legal Ethics and First Amendment Limitations on the Regulation of Professional Speech By Lawyers, 29 SEATTLE U. L. REV. 843, 844 (2006).
195. See Freedman, supra note 43, at 346 n.68.
If he [the average taxpayer] can receive expert advice which he trusts, he will follow that advice. If he does not, he will use a do-it-yourself kit of his own. It is this latter prospect at which we should all shudder—not as tax experts who will be done out of fees, but as citizens facing the breakdown of our voluntary compliance system. It is vital for us to distinguish between tax avoidance under a system of respectable expert advice, and the wholesale tax evasion which would be accomplished by a skeptical and unadvised citizenry. Right now, all the highly publicized tax avoidance gadgets amount to a narrow strip of gray between the accepted blacks and whites of the law. That small blemish on the purity of our tax structure is indeed a slight price to pay for keeping the black and the white as separate as they are; the alternative could be one large smudge of dirty gray.196

B. Revised Opinion Standards: More Likely Than Not

The other major course of action, presumably undertaken to improve tax advisors’ ethics and deter tax shelters,197 was the amendment of the tax preparer penalties. As discussed at length above,198 the general standard applicable to tax advice since the mid-1980s has been the realistic possibility of success standard.199 That standard was enforced in part by § 6694, which imposes penalties against tax return preparers who give tax advice that falls

“It is important not to make life more difficult for the compliant, but to concentrate regulatory resources on the non-compliant. If the uncertainty at the borderline affects those who wish to comply it will be unacceptable but if it simply makes it difficult for those who wish to manipulate the rules then it may be acceptable.”

Id.

196. Johnson, supra note 37, at 30; see also Thomas J. Graves, Responsibility of the Tax Adviser, 114 J. Acc’y No. 6, 33, 35 (1962) (“Certainly a well-advised taxpayer is more likely to observe good standards than one who is ill-advised and, being uninformed, feels himself free to take refuge in his own subjective views of what the law might be.”).

197. I use the word “presumably” because there is no indication in the legislative history as to why Congress enacted the revisions to 26 U.S.C. § 6694. See Staff of J. Comm. on Taxation, 110th Cong., Technical Explanation of the “Small Business and Work Opportunity Tax Act of 2007” and Pension Related Provisions Contained in H.R. 2206, at 34 (Comm. Print 2007) [hereinafter Technical Explanation of H.R. 2206]. One can only presume that it was undertaken to improve practitioner conduct. Whether it will have this beneficial effect remains to be seen.

198. See supra Part II.

below the realistic possibility standard. Indeed, it was after the adoption of this standard in § 6694 that the Treasury embraced the realistic possibility standard as the general standard for tax advice in § 10.34 of Circular 230. Congress and the Treasury substantially altered that standard with the amendment of § 6694 by the Small Business and Work Opportunity Tax Act of 2007 and the Treasury’s proposed changes to § 10.34 of Circular 230.

Prior to its amendment in 2007, the penalty under § 6694(a) applied to any income tax return preparer if (1) any part of an understatement of liability was due to a position for which there was not a realistic possibility of being sustained on its merits; (2) the return preparer knew or reasonably should have known of such position; and (3) the position was not disclosed or was frivolous. Thus, for purposes of § 6694, as long as the position met the realistic possibility of success standard, the penalty was not applicable.

As amended, § 6694(a) broadened the application of the penalty from “income tax return preparers” to “[a]ny tax return preparer,” including preparers of estate tax, gift tax, and employment tax returns. The amendments also increased the amount of the penalty from a relatively modest $250 per return to the greater of $1,000 or fifty percent of the income derived or to be derived by the practitioner. With fees for tax advice routinely in the thousands, if not hundreds of thousands of dollars, this penalty could be substantial indeed. The revised penalty would apply if (1) the preparer knew or should have known of the position; (2) the position did not meet the more likely than not standard; and (3) the position was not disclosed or there was no reasonable basis for the position.

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204. As discussed above, the Treasury’s adoption of the realistic possibility standard as part of Circular 230 in 1994 was in reaction to Congress’s enactment of § 6694 and its realistic possibility standard. See supra note 201 and accompanying text.
206. Id.
207. Given the ambiguity of the more likely than not standard, these penalties threaten the righteous as well as the evil (in fact, they are probably more of a threat to the righteous).
This revision to the penalties applicable to return advice was not proposed by the Treasury or the IRS. In fact, the Chief Counsel of the IRS admitted that the Treasury was “blindsided” by the amendments. 209 Moreover, the amendments originated not in the Senate Finance Committee nor in the House Ways and Means Committee, but rather in the House Rules Committee, and there is little legislative history on this portion of the Act. 210 In part because of this dubious lineage, the implications of these amendments were not fully vetted, and the amendments created several implementation problems for the Treasury. 211

C. Problems Fitting In

The first change wrought by the § 6694 amendments, and one of the most necessary, was the Treasury’s proposed regulations amending the general standard providing tax advice under Circular 230. 212 As discussed above,


210. The only legislative material on this portion of the Act is the Joint Committee’s Technical Explanation of the “Small Business and Work Opportunity Tax Act of 2007” and Pension Related Provisions Contained in H.R. 2206. That report provides as follows:

The provision also alters the standards of conduct that must be met to avoid imposition of the penalties for preparing a return with respect to which there is an understatement of tax. First, the provision replaces the realistic possibility standard for undisclosed positions with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The provision replaces the not-frivolous standard accompanied by disclosure with the requirement that there be a reasonable basis for the tax treatment of the position accompanied by disclosure.

211. In addition to dealing with the implementation problems, the Treasury attempted to shape the meaning of the amendments by putting its own spin on what § 6694 provides. A close reading of the 2007 amendments to § 6694 shows that a return preparer will be liable for the penalty only if (1) the preparer knew or reasonably should have known of the position; (2) the position did not meet the more likely than not standard; and (3) the position was not disclosed or there was no reasonable basis for the position. 26 U.S.C.A. § 6694(a). Thus, as drafted, as long as there was a reasonable basis for the position, whether disclosed or not, the penalty should not apply. Id. The Treasury was clearly troubled by the literal terms of the statute, since the penalty would not apply regardless of disclosure or the position met the more likely than not standard. Id. Hence, the amendments would lower, not raise, the standard applicable to tax advice. One IRS employee told me that, in his opinion, Congress could have been “a little clearer” in its wording of § 6694(a). In an effort to effect what it believes the intent of Congress to be, the Treasury issued Notice 2007-54, in which the Treasury interprets § 6694 to read that the penalty will be applicable if the position was not disclosed and there was no reasonable basis for the position. I.R.S. Notice 2007-54, 2007-27 I.R.B. 1, 12. This interpretation appears to be contrary to the plain meaning of the statute.

212. 31 C.F.R. § 10.34 (2007). As discussed, supra note 201 and accompanying text, the Treasury initially employed the realistic possibility of success standard in Circular 230 in response to the inclusion of that standard in the § 6694 penalties in 1994. With the 2007 amendments to § 6694, the Treasury now feels free to revise the Circular 230 standards.
under § 10.34 of Circular 230, a practitioner could advise a client to take a position on a return as long as the position had a realistic possibility of success on the merits. Obviously, that standard had to be changed to resolve the conflict between amended § 6694 and § 10.34. Under the revised version of § 10.34, a practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless (1) the practitioner has a reasonable belief that the position satisfies the more likely than not standard; or (2) the position has a reasonable basis and is adequately disclosed. The proposed amendments thus revise § 10.34 to conform to amended § 6694 (or at least the Treasury’s interpretation of § 6694), and more likely than not (i.e., a greater than fifty-percent chance of success).

Unfortunately, the amendments to § 10.34 create their own downstream problems as well. For example, the revision to § 10.34 may require the Treasury to revisit the covered opinion rules—more specifically, the rules applicable to reliance opinions. As discussed above, advice is a reliance opinion—and therefore a covered opinion—only if the practitioner opines that the position has a more likely than not chance of success. With the amendments to § 6694, a practitioner would face penalties of up to fifty percent of the fees earned unless he or she issued a more likely than not opinion or the position was disclosed. As a result, unless the covered opinion rules are modified, it appears that all written tax advice will either have to be in the form of a covered opinion or contain the no-reliance disclaimer, or the position with respect to that advice will have to be disclosed on the return. This makes the reliance opinion standard nearly superfluous.

Second, the Treasury has issued interim guidance and proposed regulations designed to deal with what it has termed “the complexities and anomalies” resulting from the inconsistent treatment of return preparers under the § 6694 amendments and of taxpayers under the accuracy-related penalty provisions applicable to taxpayers, as well as the inconsistencies between the § 6694 amendments and Circular 230. For example, the 2007 amendments to § 6694 provide, in essence, that a practitioner may not advise a taxpayer to take a position on a return unless the position has a more likely than not chance of success or the position is disclosed to the IRS. However, under §

6662(d), a taxpayer may take a position on a return without disclosure as long as the position meets the lower standard of “substantial authority.” Thus, as a result of the amendments to § 6694, tax practitioners were subject to a higher standard than their clients. Given these divergent standards, what may the practitioner advise his or her client? Should the practitioner advise: “There is something called substantial authority but I cannot advise you take a position that meets that standard.”? The differing standards between advisor and client, and the real possibility that the advisor could face substantial penalties, thus created a conflict of interest between advisors and their clients.

The Treasury recognized this problem and essentially declined to enforce certain provisions of amended § 6694. Under the proposed regulations, a return preparer may advise a client to take a position on a return even though the return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, as long as the position has a reasonable basis and the position is “disclosed” in one of the following ways: (1) the position is actually disclosed on the return or on a properly completed Form 8275; (2) the return preparer provides the client with the prepared tax return that includes the disclosure statement; or (3) if the position meets the substantial authority standard (and therefore the client is not required to disclose the position), the return preparer “advises the taxpayer of all the penalty standards applicable to the taxpayer under section 6662.” Thus, while Congress mandated in its 2007 amendments to § 6694 that a position on a return either meet the more likely than not standard or the position is required to be disclosed on the return, the Treasury will not impose the penalty against tax professionals as long as they advise their clients on the ways to comply with the substantial authority standard. Moreover, the requirement of § 6694 that the position must be disclosed may be satisfied by the return preparer “disclosing” to the client (and not the IRS). The net

219. Id. at 34,565. The return preparer must also contemporaneously document the advice in the tax return preparer’s files. Id. at 34,566. In addition, return preparers may satisfy the disclosure requirement in the case of a tax shelter or reportable transaction, as defined in 26 U.S.C. § 6662(d)(2)(C) (2000 & Supp. V 2005) or 26 U.S.C. § 6662A (Supp. IV 2004), if the return preparer advises the taxpayer that there must be, at a minimum, substantial authority for the position, that the taxpayer must possess a reasonable belief that the tax treatment was more likely than not the proper treatment in order to avoid a penalty under § 6662(d) or § 6662A as applicable, and that disclosure will not protect the taxpayer from assessment of an accuracy-related penalty if either § 6662(d)(2)(C) or § 6662A applies to the position. Id.
221. Lee A. Sheppard, Diluting the Preparer Penalties by Regulation, 118 TAX NOTES 1213,
effect of these rules is that, contrary to the explicit intent of revised § 6694, the substantial authority standard appears to be the standard applicable to tax professionals. Congress has apparently recognized the problems with its amendments to § 6694 and, in the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, modified the penalty standards yet again. Under the most recent version of § 6694, a return preparer will not be liable for the penalty if there is substantial authority for the position or the position has a reasonable basis and is disclosed. Thus, the amendments appear to be consistent with Treasury’s position in the proposed regulations.

D. More Fundamental Issues

While averting a conflict between the standards of more likely than not and substantial authority, the IRS Notices and proposed regulations underscore, but do not resolve, the two largest problems with the amendments to § 6694 and the proposed revisions of § 10.34: the shortcomings of the more likely than not standard and the problems attendant to disclosure.

1. More Likely Than Not, Not to Work

While it is an improvement over the realistic possibility and reasonable basis standards, the more likely than not standard suffers from the same fundamental flaw as its predecessors. Basing opinion standards on a “chance of success” should a matter be litigated is in many, if not most, cases an exceedingly difficult determination, particularly in cases where the law is new or developing. More troubling, it takes the focus off what I believe the real question tax advisors should be giving advice on—what does the law provide?

Making a prediction on a chance of success in tax law is fraught with difficulties. First, by looking at the chance of success should the matter be litigated, the focus is necessarily directed toward a hypothetical event, judicial review, which often has yet to occur. Yet, in making this determination, the tax advisor may not take into account that the matter may not be subject to


222. See id. at 1216.


224. The amendments generally apply to returns prepared after May 25, 2007. Id. § 506(b).

225. Id. § 506(a). The more likely than not standard continues to apply to tax shelters. Id.

226. Given that these amendments to § 6694 occurred during the final production of this Article, a full analysis of these amendments is not possible.

Given the low audit rates, the determination of success if the matter is litigated is necessarily specious, which plays into the cost-benefit analysis of, if not advisors, then certainly taxpayers. Moreover, as Professor Sarah Lawsky points out, a percentage chance of success, whether it be one in three or greater than fifty percent, cannot be determined based on the frequency with which it has succeeded. The standard is thus inherently disingenuous. For example, if a circuit court in the taxpayer’s jurisdiction has upheld a position, then even if the numerous district court opinions in that circuit struck it down, the position is “correct” in that circuit. Thus, the more likely than not calculation cannot be made based solely on the number of times a position has succeeded or failed in litigation.

In calculating the frequency with which a position is upheld, an advisor must also determine the cases with which the matter at issue should be compared. This requires an advisor to determine whether the position in question is “like” another position, which can be troubling given that the decisions on any tax issue tend to be highly fact-specific. Thus, knowing that five out of ten “similar” positions have been upheld does not tell us that there is a fifty-percent chance that this particular position will be upheld, nor that if the court looks at all ten of the positions on the taxpayer’s return, it will find that five of them are correct. Most of the case law on gray-area tax issues provides at best only anecdotal evidence of how a court might rule and provides no real basis for an advisor to determine a chance of success. The old saw that “the plural of anecdote is not data” is especially apt here. In addition, the quality of the lawyering or whether the case was handled pro se in the Tax Court could well have impacted the court’s decision, or the court’s decision might be so fundamentally flawed as to be objectively “wrong.”

Thus, the fact that a court ruled against the position at issue may well not be the end of the inquiry. Furthermore, with many newly concocted tax shelters, as well as legitimate but cutting-edge tax questions, neither the specific issue nor any issue similar to it may ever have been ruled on by a court. Thus, there would be no data, or even an anecdote, for an advisor to consider in determining a chance of success from a predictive perspective.

The Treasury appears to be fully aware of the limitations of basing opinion standards on the chance of success, especially in relatively new areas of the law. The proposed regulations under § 6694 provide that a “tax return

230. Id.
231. Id. at 16.
233. See Rowen, supra note 82, at 243.
preparer may reasonably believe that a position more likely than not would be sustained on its merits despite the absence of other types of authority if the position is supported by a well-reasoned construction of the applicable statutory provision." The Treasury has thus acknowledged that there will be cases in which an advisor cannot practicably determine whether a position meets a certain chance of success based on a comparison of existing authorities, but will instead base his or her opinion on an interpretation of the statute. Professor Lawsky refers to this as a subjectivist interpretation of probability. Under this approach, the focus is not on the chance of success from a numerical point of view, but on the advisor’s degree of belief in the position. Thus, while still focusing on a chance of success, the subjectivist interpretation acknowledged in the Treasury’s position in section 1.6694-2(b)(1) moves the inquiry away from what a court might decide based on a historical inquiry and closer to a focus on the rules themselves and the lawyer’s opinion with respect to those rules.

This distinction was made by H.L.A. Hart, who provided a useful analogy in demonstrating the pitfalls of the predictive theory of law, i.e., “the law . . . is what the courts say it is.” Hart analogizes the law and judges’ role in the law to a game of cricket or baseball played first without, and then with, an official scorer. Prior to the use of the scorer, the players all agree to the rules and more or less abide by those rules in resolving any disputes. When an official scorer is inserted into the game, the scorer’s decision is the final word on the application of the rules. Players can predict what the

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235. Lawsky, supra note 227, at 10–11.
236. Id.
237. It should be noted that the quoted portion of section 1.6694-2(b)(1) is only one sentence in a thirty-page set of regulations. Other parts of the proposed regulations employ a decidedly frequentist or numerical interpretation of probability. See, e.g., Prop. Treas. Reg. § 1.6694-2(b)(4) ex. 4, 73 Fed. Reg. 34,560, 34,574 (June 17, 2008). Thus, it cannot be said that the Treasury has abandoned a numerical or frequentist approach to these questions.
238. H.L.A. HART, THE CONCEPT OF LAW 141 (2d ed. 1994). Falk noted his criticism of the realistic possibility of success standard when it was adopted in 1985:

Legal realism—at least in the crude predictive version espoused by Holmes, Gray, Llewellyn, and Hughes—is the position that law is whatever a judge says it is. As a general theory of law, this predictive version of legal realism has been thoroughly discredited for over a generation. Yet Opinion 352 defines the term “good faith” in terms of this crude legal realism—i.e., the predicted result of adjudication.

Falk, supra note 18, at 653–54 (footnotes omitted).
239. HART, supra note 238, at 142.
240. Id.
241. Id.
scorer will do in a given situation, but these are merely unofficial statements as to what the scorer will officially decide. The players can predict what the scorer’s ruling will be because they know and have used the rules, and because the scorer will, in the vast majority of the cases, follow the rules. While the scorer could in theory make any ruling he or she wished, if the rules are disregarded too frequently, the game ceases to be cricket or baseball and becomes the game of “scorer’s discretion.” Applying this analogy to law, judges have considerably more discretion than official scorers in a game, but they nevertheless are bound by laws, constitutions, and rules. Hart argues:

Such standards could not indeed continue to exist unless most of the judges of the time adhered to them, for their existence at any given time consists simply in the acceptance and use of them as standards of correct adjudication. But this does not make the judge who uses them the author of these standards . . . .

. . . . [P]redictions of what a court will do are like the prediction we might make that chess-players will move the bishop diagonally: they rest ultimately on an appreciation of the non-predictive aspect of rules, and of the internal point of view of the rules as standards accepted by those to whom the predictions relate.

In determining whether a position on a tax return meets the more likely than not standard, advisors are asked to predict how a court will ultimately rule. Thus, it is the rule, not what the judge determines it to be, that should be controlling. As Theodore Falk noted in his criticism of ABA Formal Opinion 85-352: “Whether one can in good faith believe in the lawfulness of a position is not the same as predicting that the courts will adopt it. Rather, a position is lawful if the courts ought to adopt it.”

Moreover, for purposes of taxpayers’ reliance defense, it is the mere saying of the phrase “more likely than not” by the tax professional that makes

242. Id. at 143.
243. Id.
244. Id. at 142.
245. Id. at 145.
246. Id. at 145, 147.
247. Falk, supra note 18, at 655. According to Falk, the purpose of the standard should be to “improve lawyers’ arguments, not their footnotes.” Id. at 657.
it so. If a lawyer or accountant advises a taxpayer that a position has a more likely than not chance of success, then, at least as to that taxpayer and that tax position, the position does meet that standard, since taxpayers are generally allowed to rely on the advice of tax experts.\textsuperscript{248} While predicting whether something has a certain chance of success is in most cases difficult if not impossible to calculate, by the same token, proving that a position does not meet that chance of success is equally difficult to prove, especially in the context of negligence penalties. Thus, under the predictive standards as applied to tax law, the more likely than not standard turns legal realism on its head by making the law what the lawyer says it is, since, for purposes of the reliance defense, the lawyer’s determination that a position meets the more likely than not standard makes it so. Accordingly, basing the standard for tax advice on a chance of success is both unrealistic and ripe for abuse. The standard should be based on what the lawyer believes the law is. Focusing on the law itself, rather than on some mythical chance of success, more properly emphasizes the role of tax advisors and puts the responsibility squarely on advisors’ shoulders.

2. Disclosure

The second fundamental problem with the new tax advice rules is related to the issues of disclosure. Those return positions that do not meet, or cannot definitively be said to have met, either the more likely than not standard or the substantial authority standard must be disclosed. Notice 2008-14 outlines the nuts-and-bolts procedures for how a taxpayer is to disclose a position. However, neither the Notice nor any other guidance informs taxpayers or their advisors as to how much information must be disclosed for it to be a sufficient disclosure to avoid penalties.\textsuperscript{249} A simple example might prove useful: Suppose you are advising clients, Dr. and Dr. Smith, who are both physicians. In addition to their downtown condo, the Smiths own a pied-de-terre to which they pair each weekend. They raise and train horses on the farm, and their plan is to sell horses at some point and make a profit. This year, as with each year in the past, the farm has lost money. The Smiths would like to claim an ordinary business loss deduction on their Form 1040 for the farm and ask your advice. During the course of the many conversations you have had with the Smiths, you learn that they have three teenage daughters, each of whom is


\textsuperscript{249} For example, Treasury Regulation section 1.6662-4(f)(1) merely provides: “Disclosure is adequate with respect to an item . . . if the disclosure is made on a properly completed form attached to the return . . . .” The regulations do not define or explain what amount of disclosure is “adequate.” Treas. Reg. § 1.6662-4(f)(1) (2007). The Revenue Procedures in this area suffer from the same lack of specificity. See, e.g., Rev. Proc. 2001-52, 2001-46 I.R.B. 491.
crazy about horses and riding. While the clients hope to sell the horses they are raising, their daughters are resisting any effort to sell “their pets.”

This, of course, is the classic hobby loss scenario. Given the law in this area, it would be difficult to determine that the Smiths have a more likely than not chance of succeeding on the hobby loss issue, and a disclosure would be necessary. If they claim a loss from the horse farm, what must be disclosed in order for the disclosure to be sufficient? Must the taxpayers disclose that it is a potential hobby loss, that their children ride the horses, that the farm has lost money each year, or that their daughters consider the horses to be pets and not inventory? Those taxpayers and their advisors who want to make adequate disclosures but not raise unnecessary red flags are given little guidance in the new disclose-everything regime.

Beyond the practical difficulties with disclosure for those taxpayers and their advisors who want to make sufficient disclosure, there is also a risk that the disclosure regime will become the refuge of the knaves and villains much in the way the tax shelter opinion itself was in the 1990s. First, for those members of the tax bar who wish to conceal their knavery, the disclosure statement will permit them to act as if they are complying, but without providing truly helpful information. The carefully-worded-but-eminently-misleading disclosure statement will therefore become more about deceiving the IRS than actually disclosing anything. The other risk is that the new strategy will be to disclose everything regardless of whether the position is settled or not. In some cases, over-disclosure will be made out of an excess of caution, and there is little to be lost in disclosing transactions that the IRS will ultimately bless.

But the bar is also capable of flooding the government with paper, thereby making it all the more difficult for the government to find the truly useful disclosure. As Professor David Schizer noted, “[t]here is no penalty . . . for adding hay to the haystack, in order to make the needle harder to find.” With already low audit rates, the IRS simply does not have the staffing to deal with the torrent of disclosure statements that may occur.

Moreover, as Professor Boris Bittker noted a generation ago, Congress should not fall back on the requirement of disclosure to resolve the ambiguities inherent in the tax code. The IRS is fully capable, given its blanket authority to prescribe the forms taxpayers must use, of specifying the

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250. See, e.g., Osteen v. Comm’r, 62 F.3d 356, 358 (11th Cir. 1995).
251. Schizer, supra note 8, at 369.
252. Overreaction by the tax bar was indeed the response to the covered opinion rules. See supra text accompanying notes 160–62.
253. Schizer, supra note 8, at 370.
254. See id. at 331–32.
items that are frequently debatable, and “the Internal Revenue Service ought not to depend on a vague concept of taxpayer disclosure for debatable items and transactions.” The Treasury has lessened the impact of Congress’s disclosure mandate in the proposed regulations under § 6694 by allowing, in essence, disclosure to the client. However, it is unclear whether Congress will permit this emasculating of the preparer penalties to stand, and also whether Congress will insist on full disclosure to the IRS of questionable positions. Finally, if disclosure does become the new default position for taxpayers and their advisors, this propensity to disclose could have serious implications for the attorney-client privilege in tax advice. The reach and contours of the attorney-client privilege in tax matters is murky at best, with some courts holding that return advice is not subject to the privilege. What is evident, however, is that when a position is disclosed on a return, the privilege is waived. Thus, by establishing a system in which disclosure is more or less compelled, Congress and the Treasury are essentially requiring taxpayers to waive the attorney-client privilege in many instances. While I do not believe Congress’s nudging toward more disclosure is part of a concerted effort to undermine the attorney-client privilege, it may, nevertheless, be an unintended consequence.

Accordingly, as with the covered opinion rules in which the arcane provisions begat disclaimers rather than advice, the amendments to § 6694, which could result in the imposition of substantial penalties and the waiver of the attorney-client privilege, will mean that fewer taxpayers are given useful tax advice. As discussed above, this result is antithetical to sound tax administration.

IV. TOWARD A MORE BENEFICIAL STANDARD FOR TAX ADVICE

While it is tempting to remain on the sidelines and merely jeer at those in the game, in this part, I will set forth what I believe to be a better, more straightforward, standard for tax advice. I start with the premise that whatever rules or standards are adopted, the rules or standards should both make tax

256. Id.
257. Disclosure has been one of the mainstays of Congress’s efforts to combat tax shelters. See, e.g., 26 U.S.C. §§ 6011(a), 6707A(a) (2000). It is therefore likely that Congress will continue to require real disclosure.
261. See supra text accompanying notes 169–72.
shelters and other abusive transactions more difficult and facilitate legitimate tax advice and legitimate tax planning. While tax shelters need to be dealt with, and I have no quarrel with going after shelter promoters, investors, and the professionals who advise them, the vast majority of taxpayers are simply trying to navigate their way through the system and the vast majority of tax professionals are just trying to find the right answer. The tax advice rules should not be geared only toward stopping the bad actors, thereby making legitimate tax advice more difficult. Rather, given the complexity of tax law and the ubiquitous nature of taxes, an effective tax system requires that knowledgeable tax professionals properly advise their clients. The recent actions by Congress and the Treasury get in the way of professionals providing this advice. Thus, the new provisions threaten to create an environment where taxpayers are less well-advised and the only taxpayers and professionals who do any type of planning or receive any kind of advice are those with the highest risk tolerance. This is not good for anyone.

So where should we go from here? We cannot return to the status quo ante of realistic possibility of success or the wild-west days of the pre-reasonable basis era. History has shown that those standards are unworkable and many of the criticisms leveled against the recent amendments can be aimed even more pointedly at the prior standards. It would also be naïve to think that policy makers would lower standards in the face of the tax shelter problem.

An antecedent inquiry is whether the new canon should be a rule or a standard. As Brian Galle has noted, the tax academy has arrived rather late to the rules-versus-standards debate and interpretive theory, but much has been written outside the tax literature on the efficacy of adopting a rule or set of rules to deal with specific issues as opposed to a standard of more general application. Resolving this rich debate is far beyond the scope of this

262. See Weisbach, supra note 6, at 222.
263. As Lester Thurow stated:

No modern tax system or society can work without honest voluntary compliance and cooperation from nearly all of its citizens. . . . The Internal Revenue Service can collect taxes from the dishonest few, but it cannot collect taxes from a dishonest majority or even a large minority. When everyone begins to feel that he is a "sucker" if he pays taxes, it is only a matter of time until the tax system collapses. America is close to this point.

Lester C. Thurow, The Dishonest Economy, N.Y. REV. BOOKS, Nov. 21, 1985, at 35.
265. Galle, supra note 1, at 358.
266. See, e.g., Colin S. Diver, The Optimal Precision of Administrative Rules, 93 YALE L.J. 65, 65–66 (1983); Duncan Kennedy, Form and Substance in Private Law Adjudication, 89 HARV. L.
Article. Without diminishing the distinctions, I do not believe that in our context it is an either-or question. Rules certainly have had a salutary impact on shelters in the past. The enactment of the passive activity loss and at-risk rules essentially shut down the shelter industry that thrived in the 1970s and early 1980s.267 However, as Professors Marvin A. Chirelstein and Lawrence A. Zelenak point out, narrowly tailored legislative responses to particular types of shelters are not an adequate solution to the shelter problem overall.268 While many rules do indeed close loopholes, they also create a fixed target at which tax lawyers may then aim. Perhaps the best example of this is the use of the anti-Logan installment sales regulations by the taxpayer in ACM Partnership v. Commissioner.269 Moreover, any rules adopted would be prospective in application and, like the adage applied to generals, Congress is always fighting the last tax shelter war. It simply cannot keep up.270 Thus, while rules do have their place, standards must be used to fill the gap.

More importantly, rules designed to thwart tax shelters are only designed to do just that—stop shelters. They offer little in the way of defining legitimate tax advice. Indeed, as discussed at length above, a key problem with the recent anti-shelter initiatives is that they make legitimate tax planning more difficult. Thus, the standard or rule must promote legitimate tax advice while deterring abusive transactions. Standards, because of their more general application, are better at this.

A. The Statute is the Thing

In formulating an appropriate standard for return advice, one must first take into account the nature of the tax return, i.e., what it is that a return is supposed to do. While there are other views of what a tax return is designed to accomplish, our tax system has been based primarily on what Professor

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268. Chirelstein & Zelenak, supra note 1, at 1953. Professors Chirelstein and Zelenak’s proposal to combat tax shelters is to have Congress enact a Code provision disallowing all noneconomic losses. Id. at 1952. Other scholars have offered other solutions to the tax shelter problem in recent years. See, e.g., Cunningham & Repetti, supra note 1, at 59–60; Schler, supra note 1, at 367–83; Alexandra M. Walsh, Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism, 53 STAN. L. REV. 1541, 1545–46 (2001). Each of these solutions has merit; however, a full discussion and dissection of these proposals is beyond the scope of this Article.
269. 157 F.3d 231, 234 (3d Cir. 1998). The taxpayer in ACM Partnership used regulations designed to prevent accelerated recovery of basis in an installment sale, known as the anti-Logan installment sales regulations, to devise an elegant, and nearly successful, tax avoidance scheme. See generally id.
270. Chirelstein & Zelenak, supra note 1, at 1953.
Bittker refers to as the “honest-belief approach.”

Returns are signed under penalty of perjury that they are true, correct, and complete to the best of the taxpayer’s knowledge. Thus, tax returns are viewed as expressing taxpayers’ opinions of their liability under the tax laws, and taxpayers discharge this obligation to the government by expressing this opinion honestly. The negligence penalty and the relief from that penalty has, since 1918, been based on the idea that taxpayers may have an honest disagreement with the government as to the meaning of certain Code provisions, and that taxpayers should not be punished for such an honest disagreement. Finally, and perhaps most important to our inquiry into tax advisor standards, the reliance defense to the accuracy-related and fraud penalties is premised on the idea that taxpayers may reasonably rely on the advice of experts in attempting to discharge their obligations under the law.

If tax returns are indeed the honest attempts of taxpayers to report their income and expenses, tax advisors may only satisfy their role in the system by helping their clients meet that obligation. The reliance-on-counsel defense is based on the premise that tax law is unknowable to most mortals and that taxpayers may utilize experts with more knowledge of the law to help them satisfy their obligations under the law. It is not a license to be more aggressive, nor is the defense designed to provide lucrative incomes to lawyers and accountants. Thus, the role of advisors is to assist their clients in honestly reporting income and deductions. Advisors will disagree about the

272. Rowen, supra note 82, at 250.
273. See supra text accompanying notes 60–72.
275. See Falk, supra note 18, at 660.

Whether he is a tax cheater or Justice Holmes, the taxpayer seeks the attorney’s advice about what tax law requires. When tax law is uncertain, the attorney’s advice will concern legal risks and depend on the client’s attitude. Some clients are aggressive, others conservative, and others leave it to the attorney to decide what risks to take. But uncertainty in the law—a condition hardly unique to tax law—does not alter the attorney’s basic advising function. The attorney advisor tells the client what it takes to comply with the law.

Id.

276. Returning again to first principles, Canon 32 of the Canons of Professional Ethics, which were adopted by the ABA in 1908, provides:

[The lawyer] must also observe and advise his client to observe the statutory law, though until a statute shall have been construed and interpreted by competent adjudication, he is free and is entitled to advise as to its validity and as to what he conscientiously believes to be its just meaning and extent.

ABA Comm. on Code of Prof’l Ethics, Final Rep. (1908). Thus, Canon 32 does not dictate that lawyers make whatever arguments they deem reasonable or arguable, but rather to advise as to what
meaning of words and phrases. However, in dealing with ambiguous provisions in the Code, taxpayers and their advisors must attempt to discern what Congress meant in enacting a given provision. This in turn requires the advisor to focus on the language of the statute at issue. The practice of law, including tax law, is fundamentally the practice of statutory interpretation, and the tax advice standard should require advisors to focus on the language of the Code.

The risk of basing the tax advice standard on the text itself is, of course, that such a formulation will only play into the hands of the hyper-textualists who have been the cause of the current plague of shelters and other abusive transactions. After all, the courts have dealt with many of these shelters using a broad economic substance or business purpose doctrine. These tests are needed, so the argument goes, to override the tendency of lawyers and accountants to view the Code in isolation. In the next section, I will show that the economic substance and business purpose doctrines have drifted far from their original moorings and that the true focus of those doctrines is consistent with my proposed standard that focuses on the language and purpose of the statute at issue. Moreover, the economic substance and business purpose tests have only clouded the inquiry and often offer little to the analysis of whether a transaction is proper. I will analyze the economic substance test in the context of the British House of Lords’ recent opinion in MacNiven v. Westmoreland Investments Ltd., which rejected a broad-based economic

Under the textualist approach, it is much easier for an attorney to write a favorable opinion for transactions that are designed to comply with the letter of the law, but not its spirit, for at least two reasons. First, the attorney is permitted to ignore, or at least downplay, any legislative history that would argue against, or undercut, the desired tax results. Second, under a textualist approach, it is arguable that various well-accepted judicial doctrines, such as the business purpose doctrine, are suspect. At the extreme, a textualist might argue that these doctrines are the product of judicial activism and either should no longer be followed, or at a minimum should not be extended into new areas of the law.

Id. Cunningham and Repetti blame the ascendancy of textualism for the recent tax shelter crisis. Id.

Cf. Percy H. Winfield, Ethics in English Case Law, 45 HARV. L. REV. 112, 115 (1931) (quoting Lord Justice Bowen’s statement that the state of “a man’s mind is as much an ascertainable fact as the state of his digestion”).

substance doctrine in favor of a standard that examines the meaning of the statute and intent of the legislator.

B. MacNiven v. Westmoreland

As economic substance cases go, the transaction in MacNiven was quite straightforward. The issue in MacNiven was whether an interest deduction should be allowed on amounts paid from a subsidiary to its parent. The taxpayer, Westmoreland Investments Ltd., owed the trustees of its parent, the Electricity Supply Pension Scheme, over £70 million, including more than £40 million in accrued interest. Westmoreland’s liabilities greatly exceeded its assets, and all the liabilities were owed to the trustees. Given this rather bleak balance sheet, Westmoreland was valueless with no great expectations of a turnaround, and it would have a dickens of a time finding a buyer. But Westmoreland did have one potential asset, which ironically was also its biggest liability—its substantial accrued interest liability. Under section 338 of the United Kingdom’s Income and Corporation Taxes Act 1988, “payments of interest, other than interest on bank loans, may be set against profits, and any unused excess may be carried forward under section 75 of the Taxes Act 1988.” Thus, if Westmoreland could pay the pension scheme trustees the £40 million of interest it owed, it would have value as a company with substantial established tax losses. A purchaser could then transfer income-producing assets to Westmoreland and take advantage of the losses to offset any future profits.

But first Westmoreland had to pay the interest it owed to the trustees of the pension scheme. Westmoreland was obviously unable to make any payments out of its own resources, and no bank or other third party was likely to loan it the £40 million necessary. As a result, the trustees of the pension scheme itself lent the money to Westmoreland, which then used the funds to pay off its interest liability, claiming an interest deduction for the amount paid. Significant to the House of Lords’ opinion, the initial trier of fact

283. MacNiven, 1 A.C. 311, ¶ 19.
284. Id. ¶ 9. The word “scheme” does not appear to be used in the pejorative American sense.
285. Id.
286. Id. ¶ 10.
287. Id.
288. Id.
289. Id.
290. Id.
291. Id. ¶ 11.
292. Id.
293. Id.
found “that the steps involved in these transactions were genuine,” and there was no allegation that any of the steps were shams.294

The case ultimately came before the House of Lords on the issue of whether the interest deduction claimed by Westmoreland should be allowed.295 The government’s position was that the amounts paid by Westmoreland did not constitute “payments” within the meaning of section 338 because the payments had no commercial purpose, were purely for the purpose of avoiding tax, and therefore fell within the Ramsay principle.296 The Ramsay principle, from W.T. Ramsay Ltd. v. Inland Revenue Commissioners,297 is the House of Lords’ iteration of the economic substance and business purpose doctrines.298 The position of Westmoreland was that the payments made to the trustees of the pension scheme were legitimate transactions that met the definition of “payment” within the meaning of the statute.299 The House of Lords was therefore required to determine whether transactions that meet the terms of the statute, but which may have no apparent commercial purpose, should be respected for tax purposes.300

Giving the main speech for the House was Lord Hoffmann, who began by rejecting the Crown’s broad application of the Ramsay principle.301 Finding that the Ramsay principal was being applied as “an overriding legal principle, superimposed upon the whole of revenue law without regard to the language or purpose of any particular provision,” Lord Hoffmann held that there is “ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute.”302

294. Id. ¶ 12.
295. Id. ¶ 19.
296. Id. ¶ 27.
299. MacNiven, 1 A.C. 311, ¶ 19.
300. Id.
301. Id. ¶ 28–29.
302. Id. ¶ 29. It is fair to say that the U.S. courts’ usage and treatment of the economic substance, business purpose, and sham transaction doctrines have not been consistent. A complete treatment of these doctrines in the U.S. courts is well beyond the scope of this Article. For an excellent summary of these cases, see Leland Gardner, An Elephant in the Room: Double Deductions and the Economic Substance Doctrine in Coltec Industries, Inc. v. United States, 60 TAX L. 519 (2007). As Gardner explains, the courts of appeals use essentially three approaches in analyzing transactions. “Some circuits apply a conjunctive test: a transaction must satisfy both the business purpose and the economic substance inquiries.” Id. at 525–26. See, e.g., Illes v. Comm’r, 982 F.2d 163, 165 (6th Cir. 1992); Shriver v. Comm’r, 899 F.2d 724, 725–26 (8th Cir. 1990); Rice’s Toyota World, Inc. v. Comm’r, 752 F.2d 89, 91 (4th Cir. 1985). Other circuits use a disjunctive test and consider each of the tests independently and may disregard a transaction if it lacks either a business purpose or economic substance. See, e.g., Nicole Rose Corp. v. Comm’r, 320 F.3d 282, 284 (2d Cir.}
Lord Hoffmann began his support of this form of textualism, which he has referred to as the “purposive approach,” with the idea that words and phrases used in the law, particularly freestanding codes like the income tax, have their own independent meaning. For example, when an economist says that “real” income has fallen, the economist is not intending to contrast real incomes with imaginary ones. Rather, the comparison is between incomes that have been adjusted for inflation and those that have not. Thus, in order to know what an economist means by “real,” one must first identify what Lord Hoffmann referred to as the “relevant concept” (in this example, inflation adjustment) by reference to which speaker is using the word.

Lord Hoffmann then pointed out that tax statutes often use terms and refer to purely legal concepts that have no meaning (or at least a different meaning) outside the tax laws. For example, the term “basis” is a term of common understanding in tax law, but its tax definition only has meaning in the unique world of tax law. In viewing these statutes, one must examine them within the relevant concept of the particular Code provision and statutory schema.
Lord Hoffmann then addressed whether general principles like the Ramsay principle could be used to decide whether the taxpayer’s actions constituted acceptable tax mitigation or unacceptable tax avoidance. Lord Hoffmann held that when the statutory provisions at issue do not contain words like “avoidance” or “mitigation,” it does not help to introduce them. Thus, whether steps that are taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case, rather than a test for deciding whether the statute applies or not. Lord Hoffmann argued that it does not promote “clarity of thought” to use terms like “stratagem or device.” Transactions either work or they do not.

If they do not work, the reason . . . is simply that upon the true construction of the statute, the transaction which was designed to avoid the charge to tax actually comes within it. It is not that the statute has a penumbral spirit which strikes down devices or stratagems designed to avoid its terms or exploit its loopholes. The House of Lords therefore allowed the deduction.

_MacNiven_ thus stands for the proposition that in evaluating the reach of a statute, one must employ a “purposive approach” to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answers to the statutory description. This means that the question is always whether the relevant interactions within the relevant community").

309. _MacNiven_, 1 A.C. 311, ¶ 58.
310. Id. ¶ 62.
311. Id.; see also PAUL, supra note 5, at 91–92.

In the field of tax avoidance there is special need to be distrustful of glib rules of thumb and formulae masquerading as authoritative general principles—special need because the general propositions commonly employed in the subject are so broad and have such an elastic vocabulary. Words like “reality,” “fiction,” “essence,” “form,” and “substance” have little displacement, and usually mean little more than what is desired for the occasion. They are amorphous, question-begging words without fixed content, and their chief function is to make an unsure conclusion sound well.

PAUL, supra note 5, at 90–91 (footnotes omitted).
312. _MacNiven_, 1 A.C. 311, ¶ 62.
313. Id. ¶ 62 (quoting Norglen Ltd. v. Reeds Rains Prudential Ltd. [1999] 2 A.C. 1, 13–14 (H.L.)) (citations omitted).
314. Id. ¶ 74.
provision of the statute, upon its true construction, applies to the facts of a particular case.\footnote{315} In an article published in the\textit{British Tax Review},\footnote{316} Lord Hoffmann explains that the “purposive construction” he applied to tax statutes in\textit{MacNiven} had as its origin Judge Hand’s opinion in\textit{Helvering v. Gregory}.\footnote{317} The irony of using the source of the economic substance and business purpose doctrines to overturn a broad economic substance doctrine was not lost on Lord Hoffmann, who used the genesis of those doctrines as part of his call to return the focus to the statute. Quoting at length from Judge Hand’s opinion in\textit{Gregory}, in which Judge Hand finds that Ms. Gregory’s plan for a corporate reorganization\footnote{318} was not entitled to tax free treatment because her artificial scheme was “not what the statute means by a ‘reorganization,’” Lord Hoffmann argues that Judge Hand’s decision is based on statutory construction and not some overriding business purpose doctrine.\footnote{319} According

\footnote{315} Id. ¶ 8 (Nicholls of Birkenhead, L.J.).  
\footnote{317} See id. at 197–99. Lord Hoffmann has also applied this purposive construction to patent disputes. See, e.g., Kirin-Amgen Inc. v. Hoechst Marion Roussel Ltd. [2004] UKHL 46, [2005] 1 All E.R. 667 (UKHL) (Hoffmann, L.J.).  

“Purposive construction” does not mean that one is extending or going beyond the definition of the technical matter for which the patentee seeks protection in the claims. The question is always what the person skilled in the art would have understood the patentee to be using the language of the claim to mean. And for this purpose, the language he has chosen is usually of critical importance.\footnote{Id. ¶ 34.}  

\footnote{318} In\textit{Gregory}, the taxpayer was the sole shareholder of a corporation holding appreciated shares of a subsidiary corporation. In an attempt to distribute these appreciated shares to herself without the transaction being taxed as a dividend, the taxpayer organized a new corporation, transferred the shares to the new corporation, and immediately dissolved the new corporation. As the sole shareholder of the new corporation, Gregory received the shares. Gregory then sold the shares and paid tax on the proceeds at the capital gain rate. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).  

\footnote{319} Hoffmann, \textit{supra} note 316, at 197–98. Lord Hoffmann quoted the following language from Judge Hand’s opinion:  

\begin{quote}
If what was done here was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of income tax, as it certainly was. . . . [But] the purpose of the section is plain enough; men engaged in enterprises . . . might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as realizing any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution . . . . We cannot treat as inoperative the transfer of shares . . . . The transfer passed title . . . and the taxpayer became a shareholder in the transferee. All these steps were real and their only defect was
to Lord Hoffmann, the reorganization in *Gregory* was not given tax-free treatment because the concept of a “plan of reorgani[z]ation” in the statute contemplates doing something for a business purpose and not solely to avoid tax.\(^{320}\) Thus, the requirement of a business purpose was dictated by the statute itself, and Judge Hand did not apply any rule taken from outside the statute.

*Gregory* cannot, according to Lord Hoffmann, be read to hold that whatever the provisions of a statute might be, a transaction that has no business purpose will not be respected for tax purposes.\(^{321}\) As discussed above, there are too many instances in the Code in which transactions entered into solely for tax purposes are respected for there to be any real viability to such a broad application of the rule.\(^{322}\) Lord Hoffmann asserts that tax avoidance should be a contradiction in terms, if by tax avoidance we mean transactions successfully structured to avoid a tax that the legislature intended to impose.\(^{323}\) The only way in which a legislature can express an intention to impose a tax is by a statute that imposes such a tax.\(^{324}\)

Lord Hoffmann asserts that he is applying a “purposive construction” to a text.\(^{325}\) However, while styling himself as a purposivist, Lord Hoffmann is, in reality, a modern textualist. In his recent article, *What Divides Textualists from Purposivists?*,\(^{326}\) Professor John Manning discusses the common ground, as well as the differences between purposivists and textualists. Professor Manning argues that purposivists from the legal process tradition believe that it is unrealistic to believe “that Congress collectively knows or cares about the semantic detail of often complex statutes.”\(^{327}\) For purposivists, enforcing the purpose or policy of a statute, rather than the minutiae of its semantic detail, better serves the legislative supremacy that they argue textualists are trying to defend.\(^{328}\) Professor Manning argues that in contrast, textualists believe that the purposivist approach ignores the legislative compromise that created the particular text at issue.\(^{329}\) Textualists assert that legislative supremacy is best served by “attributing to legislators the understanding that a reasonable person conversant with applicable conventions would attach to the enacted text in

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\(^{320}\) *Id.* at 197–98 (quoting *Gregory*, 69 F.2d at 810–11).

\(^{321}\) *Id.* at 198.

\(^{322}\) *Id.* at 199.

\(^{323}\) See *supra* note 11.

\(^{324}\) *Hoffman,* *supra* note 316, at 206.

\(^{325}\) See *id.*

\(^{326}\) *Manning,* *supra* note 14, at 70.

\(^{327}\) *Id.* at 91.

\(^{328}\) *Id.*

\(^{329}\) *Id.* at 92.
Textualists point out that purposivism cannot deal adequately with legislative compromise because semantic detail, in the end, is the only way legislators can actually set forth the agreed-upon legislative compromise. Despite the significant differences, recent scholarship has recognized the common ground among modern textualism and modern purposivism. Modern textualists are cognizant of context as well as text, while modern purposivists give great weight to statutory text.

Given the common ground, what differentiates modern purposivists and textualists is that purposivists will give deference to the policy concerns underlying the legislative choice, even when those policies are contrary to the language of the text. It is in this vein that Lord Hoffmann and his opinion in MacNiven part company with the purposivists. The problem with using policies like business purpose or economic substance is that these are not consistent policies throughout the Code. As indicated, there are numerous instances in which transactions entered into solely for tax purposes are perfectly acceptable and no business purpose is required for those positions to be upheld. To paraphrase Lord Hoffmann, one cannot superimpose the economic substance and business purposes as overarching legal principles upon the whole Internal Revenue Code without regard to the language or purpose of any particular provision.

Thus, Lord Hoffmann’s purposive construction is in reality textualism in which one looks at the purpose or policy behind the particular statute at issue, rather than some overarching policy permeating the entire Code. Given the capricious use of the economic substance doctrines, MacNiven is a clearer treatment of shelters and provides a more principled basis for evaluating whether a transaction is legitimate tax planning or an abusive tax shelter. The purposivist construction of MacNiven provides a real service to tax analysis:

330. Id.
331. Id.
332. Id. at 75 (citing Larry Alexander & Saikrishna Prakash, “Is That English You’re Speaking?” Why Intention Free Interpretation is an Impossibility, 41 SAN DIEGO L. REV. 967, 974–78 (2004) (arguing that textualism is, at root, a form of intentionalism); Caleb Nelson, What is Textualism?, 91 VA. L. REV. 347, 353 (2005)).
334. Manning, supra note 14, at 96.
335. See, e.g., PAUL, supra note 5, at 90 (Economic substance and business purpose doctrines are too often maxims that “have little displacement, and usually mean little more than what is desired for the occasion.”).
336. Indeed, Professors Chirelstein and Zelenak in their proposal that would disallow noneconomic losses would permit some noneconomic losses to be deductible, noting that “Congress would not want to disallow every type of noneconomic loss, and that some mechanism is needed to separate the deductible wheat from the nondeductible chaff.” Chirelstein & Zelenak, supra note 1, at 1955.
textualists may not rely solely on the text, applying it out of context or contrary to the purpose for which a particular tax statute was enacted. Nor may the purposivists indiscriminately fire policies like business purpose or economic substance to overturn the otherwise plain meaning of texts. The MacNiven doctrine recognizes that tax definitions are unique to the Code and that there is no economic substance apart from the legal definition the Code places on these definitions. When we say something lacks a business purpose or lacks economic substance, what we are saying is that the purpose or substance behind the action is not that which was contemplated by the statute. Therefore, we should focus on the purpose for which the statute was enacted, focusing primarily on the language Congress used. 338

Many have decried the rise of textualism in tax advice and lay the blame for the increase in shelter activity at the feet of the textualists. 339 I fully recognize that rejecting a broad application of the economic substance and business purpose doctrines will likely be ill-received. However, in my view, the problem with the strain of textualism that has given rise to tax shelters is not that these lawyers focused too much on the text. Rather, the problem lies in the fact that they applied the text out of context and inconsistent with the

338. Focusing on both the text of the statute and the purposes for which that provision was enacted is important not only for properly interpreting the tax laws but also for promoting compliance with and respect for the law. Freedman, supra note 43, at 346. Taxpayers often enter into transactions structured in a way to maximize tax benefits because they have been advised by accountants to structure them in that manner. Some taxpayers do not truly need structures like S corporations for their business operations, but they have been advised that this is the way to set up a business in a tax-efficient way. And if they find the advice odd, they simply believe this is one of the mysterious things about the way the tax system works. If taxpayers are then told that they cannot structure a transaction in a certain way because it was done solely for tax purposes, they are left more than a little perplexed. As Professor Freedman asks:

What message are such people being given by the tax system? Are they to think of tax in terms of economic reality, fairness and rationality when it at first appears that incorporation will legitimately save tax and they then find that some of those benefits have been negated in a complex way that will probably cost them considerable amounts in professional fees? The law has real substance here because it has consequences in terms of rights and obligations. . . . Right from the start he has been given a signal that it is necessary to take account of taxation when making commercial decisions and that the rules can change. The culture of artificiality is established and so it continues. . . . In the light of this, it is not surprising that business owners will soon come to believe that it is perfectly natural to do artificial things for tax purposes and that this impression permeates right up the scale to large companies whose directors, used to tax impacting on all their decisions, consider it fair game to take tax into consideration in all planning and then to go on to undertake tax driven activities.

Id. at 344–45. One of the reasons for attacking tax shelters is that it breeds cynicism toward the tax system. But the ad hoc use of maxims like business purpose does the same thing.

339. See Cunningham & Repetti, supra note 1, at 4; Galle, supra note 1, at 359–60; Weisbach, supra note 6, at 222.
true purpose of the statute. The gamesmanship engendered by the realistic possibility of success and the more likely than not standards only adds to these problems.

In addition, as Professor David A. Weisbach has noted, the use of purposivist doctrines like economic substance and business purpose have made shelters more exotic and complicated. The basis of these doctrines is that transactions undertaken solely for tax purposes are disallowed. The doctrines thus create the incentive to put just enough window dressing—some business activity, some element of risk—to pass the business purpose or economic substance test. By encouraging the addition of layers of entities and transactions, these doctrines have had the perverse effect of making modern shelters more complicated and therefore more difficult to detect. The solution is to return advisors to the text, not to further divorce them from it. Fidelity to the statute simply is not the cause of shelters.

Moreover, in many instances, the creation and promotion of tax shelters was the result of out-and-out fraud and was not the result of a misreading or misapplication of complex doctrines. Just as Professors Chirelstein and Zelenak’s proposal would distinguish between traditional tax planning and planning that generates abusive tax shelters, policy makers must distinguish between aggressive tax planning and criminal tax fraud. We must recognize that neither a silver bullet nor a broad-spectrum antibiotic will stop truly fraudulent and abusive shelters. We should leave the eradication of these types of shelters to law enforcement and develop a standard that will encourage legitimate tax advice and discourage tax advice that amounts to little more than game-playing.

C. Using the MacNiven Analysis as a Return Advice Standard

While the standard set forth in MacNiven is designed to be used by courts in statutory construction, its principles can also provide guidance to lawyers in advising clients. Like courts in the analysis of completed transactions, tax advisors should apply a “purposive textualist” approach to the Code. This requires lawyers to give a purposive construction to the statute to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) is consistent with the statutory description. This means that the question is

340. Weisbach, supra note 6, at 237.
341. Id. at 237–38.
343. Id. at 1951.
always whether the language and purpose of the statute apply to the facts of the transaction.  


345. Paul, supra note 34, at 417 (“The tax adviser must accept interstitial judicial legislation as one of the realities of life. Legislative words are not inert, but derive vitality from the obvious purpose at which they are aimed.”).

346. The proposed revisions in turn borrowed this language from Proposed Treasury Regulation § 1.6661–3(b)(3), 48 Fed. Reg. 10,862 (Mar. 15, 1983). Falk, supra note 18, at 656–57. Unfortunately, for tax administration, the proposed revisions were not adopted by the ABA Rules Committee, which elected to espouse the realistic possibility of success standard. Id.

347. 31 C.F.R. § 10.35(b)(10) (2007). The standard is also consistent with the portion proposed regulations under § 6694 where a more likely than not conclusion cannot be reached because of insufficient authorities: The proposed regulations provide that a “tax return preparer may reasonably believe that a position more likely than not would be sustained on its merits despite the absence of other types of authority if the position is supported by a well-reasoned construction of the applicable statutory provision.” Prop. Treas. Reg. § 1.6694–2(b)(1), 73 Fed. Reg. 34,560, 34,574 (June 17, 2008) (emphasis added).

348. See supra text accompanying notes 60–75.
employ a sound construction of the statute, which, if employed in good faith, would reduce tax shelter advice. If the advisor, in good faith, believes a position is consistent with the statute and congressional intent, that should be sufficient for the advice to be given. If taxpayers reasonably rely on the advice of competent advisors, then they can sign their returns under penalty of perjury believing them to be true, correct, and complete. If there is substantial authority for the position, taxpayers need not disclose their position under § 6662(d).349 Likewise, if substantial authority does not exist, but an advisor nevertheless believes the position meets the standard, an advisor may advise the taxpayer to take the position without disclosing it.350

Will this standard put an end to tax shelters? Clearly not. The desire by lawyers and accountants to make money and please clients will always create pressures to take aggressive positions on tax returns.351 However, as I hope I have shown, those pressures are exacerbated by a system (now, more than forty years old) that encourages taxpayers and their advisors to push the envelope of statutory interpretation. My modest proposal amounts to this: If we change the question from “what can I get away with?” to “what is the right answer?”, we might get a better answer.

A good-faith belief would require a tax advisor to examine the entire Code, legislative history, the Treasury’s position in regulations and other written guidance, as well as court cases. Nevertheless, an advisor still could give good-faith advice on a position in the face of court cases and Treasury regulations to the contrary, if the advisor believes the position represents a sound construction of the statute and is consistent with the purpose of the statute.352

D. Applying the Standard

The proposed standard would be consistent with the way in which many tax advisors operate currently, and it would be consistent with much of the advice already being given. Many advisors are already attempting to ascertain the “right answer,” and many clients just want to know what the tax law requires. The standard is more important in cases where the client wishes to be more aggressive. There will, of course, be cases in which reasonable minds will differ as to whether a position represents a good-faith and sound

350. This was the position of the committee that sought the revisions to ABA Formal Opinion 314. Matthew C. Ames, Formal Opinion 352: Professional Integrity and the Tax Audit Lottery, 1 GEO. J. LEGAL ETHICS 411, 421 (1987).
351. See, e.g., Cooper, supra note 121, at 1577–78.
352. Professional responsibility dictates would require the lawyer, however, to inform his or her clients that they could be subject to penalties for taking a position contrary to established precedent. See, e.g., 26 U.S.C. § 6662(d) (2000 & Supp. V 2005).
construction of the applicable statutory provision that is consistent with the statute and congressional intent. In order to examine the outer limits of the proposed standard, I will analyze the standard in the context of two notable, perhaps notorious, cases: *Gitlitz v. Commissioner*353 and *ACM Partnership v. Commissioner.*354

1. *Gitlitz v. Commissioner*

In *Gitlitz*, the taxpayers were shareholders of an S corporation that had a large amount of losses that could not be deducted because the shareholders had insufficient basis in their stock (so-called “suspended losses”).355 The corporation received cancellation of indebtedness income (“COD income”), which, because the corporation was insolvent at the time of the discharge, was not subject to tax.356 The issue was whether the COD income was an “item of income” subject to pass-through under § 1366(a)(1)(A), which the shareholders could then use to increase their basis in the corporation’s stock, thereby freeing up the suspended losses.357 The Supreme Court held that the COD income was an item of income and allowed the increase in basis.358 Many have argued the Supreme Court’s decision was incorrect.359 However, does the taxpayer’s position represent a good-faith and sound construction of the applicable statutory provision, and is the position consistent with the statute and congressional intent?

The position of whether COD income was an “item of income” for purposes of § 1366 certainly had clear support in the statute and regulations. Section 1366(a)(1) defined the term “items of income,” to include “tax-exempt income,”360 and Title 26 of the Code of Federal Regulations § 1.1367–1(d)(2) provided: “[A basis] adjustment for a nontaxable item is determined for the taxable year in which the item would have been includible or

354. 157 F.3d 231 (3d Cir. 1998).
355. 26 U.S.C. § 1366(d) (2000); *Gitlitz*, 531 U.S. at 210. Losses at the S corporation level flow through to the shareholders of the corporation and reduce the shareholders’ basis in their stock. Losses in excess of basis are suspended until the shareholders increase their basis, thereby freeing up the suspended losses.
357. *Gitlitz*, 531 U.S. at 212.
358. Id. at 218–19.
360. 26 U.S.C. § 1366(a)(1) (2000). The government chose instead to litigate the issue in the face of the plain meaning of the statute and regulations. *Gitlitz*, 531 U.S. at 212. While it is true that the Treasury adopted new regulations tightening the definition of “tax-exempt income,” those regulations were adopted during the course of the litigation of *Gitlitz* and the other cases, and the regulations proposed read curiously like the government’s briefs filed with the courts in those cases.
deductible under the corporation’s method of accounting for Federal income tax purposes if the item had been subject to Federal income taxation.‖

Hence, the Code and regulations appeared to contemplate basis increases for tax-exempt or nontaxable items, and the taxpayer’s position thus was at least arguably a sound reading of the Code provisions at issue. There was certainly no obvious reading to the contrary, and the result was consistent with the congressional purpose of the statute to provide tax-free treatment to discharges of indebtedness and to allow increases in basis for all items of income, including tax-exempt income. Even if one were to look outside the language and purpose of the statutes, there was also no general purpose in the Code preventing the result obtained—the lone dissenter in the Supreme Court was left to resort to “Congress’s likely intent” that ambiguous statutes should be read as “closing, not maintaining, tax loopholes.” Thus, while one may disagree on a policy basis with the decision of the Court in Gitlitz, the position was one that had strong support in the statute and regulations.

Moreover, I submit that this is the type of issue for which tax advisors should be able to give positive advice. First, the transactions were not entered into to obtain the tax benefit, but were the result of real discharges of indebtedness between unrelated parties. Thus, the taxpayers did not order their affairs to obtain a certain result or create a transaction out of whole cloth, but merely took advantage of the tax law (“exploited the loophole”) to get the


362. Full disclosure: I was a member of the law firm, Chicoine & Hallett, that represented the taxpayers in Gitlitz from the Tax Court through the Supreme Court. I therefore cannot claim to be completely objective about the decision issued by the Supreme Court.

363. Indeed, the government took one position in the Tax Court, Nelson v. Comm’r, 110 T.C. 114, 115 (1998), another position in the United States Court of Appeals for the Tenth Circuit, Gitlitz v. Comm’r, 182 F.3d 1143, 1148 (10th Cir. 1999), and yet another position in the Supreme Court, Gitlitz, 531 U.S. at 212 n.5. The Tax Court based its decision on one interpretation of the Code, which the government did not defend on appeal, while the Tenth Circuit’s decision was grounded on different reasoning, which the government, again, did not defend in the Supreme Court. See Gitlitz, 531 U.S. at 212 n.5; Gitlitz, 182 F.3d at 1148; Nelson, 110 T.C. at 115. This game of legal whack-a-mole belies any contention that the law “clearly” disallowed the claimed increase in basis.

364. It is safe to say that Congress did not contemplate this issue one way or another.

365. Gitlitz, 531 U.S. at 223 (Breyer, J. dissenting). Justice Breyer cited no authority for whence this congressional intent was obtained. However, Justice Breyer did cite legislative history that purported to support the IRS’s position. Id. at 221 (citing H.R. Rep. No. 103-111, at 624–25 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 855–56). However, the House Report cited dealt with elections by taxpayers to exclude from gross income the discharge of qualified real property business indebtedness. H.R. Rep. No. 103-111 at 624–25. The House Report did not purport to provide a general explanation regarding the workings of § 108 in the context of S corporations.

366. See, e.g., Witzel v. Comm’r, 200 F.3d 496, 497 (7th Cir. 2000) (“It is hard to understand the rationale for using a tax exemption to avoid taxation not only on the income covered by the exemption but also on unrelated income that is not tax exempt.”).

367. For a contrary view, see Cummings, supra note 359, at 865.

368. Gitlitz, 531 U.S. at 209.
most favorable tax treatment for their genuine transaction. Second, *Gitlitz* is one of the rare circumstances where the plain meaning of the statute created a result that was probably not intended by Congress, but there was no language extant in the Code, regulations, or legislative history from which that intent could be divined. Indeed, Professor Eustice warned Congress and the Treasury years before the *Gitlitz* litigation that the plain reading of the Code and regulations required the result ultimately reached by the Court.\(^{369}\) Congress ultimately changed the law,\(^{370}\) thereby showing its intent (or at least the intent of that Congress). Accordingly, while I generally disagree with the notion that encouraging aggressive tax return positions creates a better Code, *Gitlitz* might well be one case in which well-advised, risk-tolerant taxpayers did improve the Code. Regardless, a tax advisor could, prior to the amendment of §108, advise a client in good faith that COD income is an item of income that increases the basis in S corporation stock.

2. **ACM Partnership v. Commissioner**

In *ACM Partnership*, the taxpayer, Colgate, entered into a series of transactions to take advantage of the contingent installment sales regulations.\(^{371}\) A contingent installment sale is “a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs.”\(^{372}\) Where the total sales price is contingent on some future event, but the sales agreement provides a specific period over which payments may be received, the temporary regulations generally require the taxpayer to allocate a portion of its basis pro rata over each of the taxable years in which payments are to be received.\(^{373}\) The taxpayer’s income for each year from a contingent installment sale is therefore the excess of the payments received in that year over the pro rata portion of the basis allocated to that year.\(^{374}\)

The transaction entered into by Colgate was very convoluted and had numerous steps and players.\(^{375}\) Reduced to its simplest terms, Colgate entered into a partnership with Merrill Lynch and an offshore bank not subject to U.S.

371. 157 F.3d 231, 235–36 (3rd Cir. 1998).
373. *Id.* § 15a.453-1(c)(3).
374. *See id.*
375. *See ACM P’ship*, 157 F.3d at 233–38. For an excellent explanation of the transaction, see Chirelstein & Zelenak, *supra* note 1, at 1943–45. Similar transactions were entered into by the taxpayers in *Saba Partnership v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001); *ASA Investments Partnership v. Commissioner*, 201 F.3d 505, 508–11 (D.C. Cir. 2000); and others.
The bank held an eighty percent interest in the partnership, Colgate held a nineteen percent interest, and Merrill Lynch held a one percent interest. Each of the parties contributed cash, totaling $175 million, and in year one, the partnership bought and sold various securities. Ultimately, but still in year one, the partnership sold $175 million in Citicorp notes and received in return cash (equal to the cash contributed by the offshore bank) and new notes, which were to be paid quarterly over a five-year period, and which had an interest rate that varied each quarter depending upon the London Interbank Offerings Rate (LIBOR) interest rate. Since the amount of the payments were to vary each year, the transaction was subject (or so the taxpayer hoped) to the contingent installment sales rules. As a result, the $175 million basis was required to be recovered ratably over the next five years.

In year one, under the contingent installment sales rules, the partnership used twenty percent of the basis to offset the payments received, which generated a large gain, eighty percent of which was allocated to the offshore bank. The bank, of course, did not mind the large amount of gain attributed to it because it was not subject to tax in the United States. The bank’s interest in the partnership was then liquidated, and it received back all of the cash it had contributed. This left Colgate with a ninety-nine percent interest in the partnership and Merrill Lynch with a one percent interest.

In year two, the partnership sold the LIBOR notes. Under the contingent installment sales rules, since the contingent sales contract was now to be closed, the partnership could offset its entire remaining basis against the amount realized on the sale. Not surprisingly, this resulted in a large loss to the partnership, and ninety-nine percent of the loss was allocated to Colgate. When the dust settled from these transactions, the offshore bank had a $90 million gain, which again was not subject to U.S. tax, and Colgate

376. See ACM P’ship, 157 F.3d at 235.
377. Id. at 240.
378. Id.
380. ACM P’ship, 157 F.3d at 240.
381. Id.
382. Id. at 250.
383. Id. at 242.
384. Id.
385. Id. at 244.
386. Id. at 242.
387. Id. at 252.
388. Id. at 252 n.40.
had a $90 million loss, which of course could be used to offset its U.S. tax
liability.389

While extraordinarily clever, does this transaction reflect a good-faith and
sound construction of the applicable statutory provision, and is the position
consistent with the statute and congressional intent? In my view it is not, and
thus, under the proposed standard a tax advisor could not give a positive
opinion on this transaction. An entire article could be devoted to dissecting
this transaction, and I cannot do it justice here. While the transaction could be
attacked on other grounds, at bottom, this transaction fails for the same reason
Judge Hand disallowed tax-free treatment to Ms. Gregory’s proposed
reorganization: the installment sale of the notes was not within the purpose of
the statutory definition of a “sale.”390 The term “sale” contemplates a bona
fide disposition of property between unrelated parties. A pre-arranged series
of transactions designed to create a tax loss are not the sort of business
transactions contemplated by the terms “sale” or “installment sale.”391 As the
Tax Court found, the LIBOR note transaction was a mere artifice designed to
create a tax loss:

Each of the steps in the section 453 investment strategy was
planned and arrangements commenced considerably in
advance of execution. Before the negotiations to form ACM,
Merrill had already begun negotiations to purchase the
Citicorp Notes. Before their purchase, Merrill was negotiating
for their disposition. By the time ACM acquired the LIBOR
Notes, Merrill was arranging with Sparekassen the terms on
which some of them would be sold. The contingent payment
sale was scheduled to take place before the end of ACM’s
first taxable year in order to permit the partnership to spread
its tax basis in the Citicorp Notes over 6 years instead of 5.
The distribution and sale of the BFCE Notes was scheduled to

389. ACM P’ship v. Comm’r, 115 T.C.M. (CCH) 1, at 83.

The purpose of the section is plain enough; men engaged in enterprises—
industrial, commercial, financial, or any other—might wish to consolidate, or
divide, to add to, or subtract from, their holdings. Such transactions were not
to be considered as “realizing” any profit, because the collective interests still
remained in solution. But the underlying presupposition is plain that the
readjustment shall be undertaken for reasons germane to the conduct of the
venture in hand, not as an ephemeral incident, egregious to its prosecution.

Id.

391. See Comm’r v. Court Holding Co., 324 U.S. 331, 334 (1945) (“To permit the true nature
of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would
seriously impair the effective administration of the tax policies of Congress.”).
occur before the end of Colgate’s 1989 taxable year in order to offset Southampton’s share of the contingent payment sale gain on Colgate’s consolidated return. It was the understanding of the principals that Kannex would retire from the partnership by the fall of 1991 so that the LIBOR Notes could be sold in time for Colgate to carry back the taxable loss to its 1988 taxable year. No supervening market forces or other nontax considerations disrupted the scheduled execution of these steps.  

Therefore, the transaction was not a genuine sale in the sense contemplated by the statute and thus was not consistent with the language of the statute or intent of Congress when it enacted the provision.  

The obvious criticism of this conclusion is that it is really no different from the court’s determination in ACM Partnership that the transaction lacked economic substance. Admittedly, in many respects, the factors and the analysis are the same. Both the proposed standard and the economic substance look at the nature of the transaction and not whether the transaction superficially satisfied the language of the statute. And there is a certain “I know it when I see it” aspect to the conclusion that a pre-ordained set of transactions between accommodating parties is not a true sale. But the crucial distinction is that the proposed standard does not look outside the language and the purpose of the statute at issue to find the answer, while employing the economic substance doctrine requires the use of “an overriding legal principle, superimposed upon the whole of revenue law without regard to the language or purpose of any particular provision.”

As I hope I have shown, the selective invocation of the economic substance and business purpose doctrines is problematic. What the analysis of the ACM Partnership transaction does show is that a standard that focuses on the text and the purposes of the statute can be used to limit shelters and other

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392. ACM P’ship, 115 T.C.M. (CCH) at 139–41. The court cited the IRS’s expert witness, who testified that:

[T]he transactions and the returns were the result of a carefully crafted and faithfully executed sequence of sophisticated and costly financial maneuvers that left little to chance or market opportunities. The score for the Partnership’s actions was very detailed and the libretto even included the writing of the minutes of the Partnership meetings weeks before those meetings occurred.

Id. at 140 n.26.

393. Compare a Subchapter S election, which admittedly is only done to avoid corporate-level taxes. However, making such an election to avoid taxes is clearly contemplated within the language and purpose of the statute.

abusive transactions. The proposed standard was not designed to deal specifically with tax shelters, but was intended as a standard of broad application that would encourage legitimate tax advice. If we can base the standard on the language and purpose of the statute and still restrain shelters, the debate has, in my view, moved in the right direction.

E. The Role of the Bar

If the current bottling of the tax shelter brine has taught us anything it is that the IRS cannot solve the shelter problem without the help of the bar and tax professionals in general. Professor Eustice noted the efficacy of enlisting the tax bar, and others have noted the bar’s key role in these matters. The enforcement budget is insufficient for the government to ever fully win the tax shelter war. The bar must therefore recognize its role as both the cause of the problem and as part of the solution. The tax shelter boom and related problems could not have occurred without lawyers and accountants. Thus, if tax professionals and taxpayers are stymied by the government’s actions in this area, we have ourselves primarily to blame.

The tax bar can, of course, adhere to its position that the filing of a tax return is the first step in an adversary proceeding and that tax lawyers may advocate any position that has just a realistic possibility of succeeding. But if we do so, we must follow the lead of Mark Johnson and ask ourselves: “Are we sentimentally defending an outworn morality with anachronistic shibboleths? Or, worse, are we cynically defending a code of convenience as

395. Eustice, supra note 130, at 164.
396. See, e.g., Schizer, supra note 8, at 369.
397. I am not as sanguine about this as Pamela Olson, who stated, “The tax shelter war is over. The government won.” Pamela F. Olson, Now That You’ve Caught the Bus, What Are You Going to Do With It? Observations from the Frontlines, the Sidelines, and Between the Lines, So to Speak, 60 TAX L. 567, 567 (2007).
398. Matthew Ames noted:

Changing the ethics of tax advisors and return preparers is such a collateral method [of altering taxpayer ethics]; the less willing a tax advisor is to go along with a scheme, the less likely the client is to embark on it. “[T]he tax practitioner plays a dominant and most responsible role. His attitude becomes the attitude of his clients, his basic honesty becomes their standard of comparison, his sense of morality becomes a guide to them, for they feel that others are abiding by the same high or low standard.” Ames, supra note 350, at 411 (quoting Merle H. Miller, Morality in Tax Planning, 10 N.Y.U. ANN. INST. ON FED. TAX’N 1067, 1083 (1952)).
399. Ames, supra note 350, at 426 (“For a supposedly self-regulating profession to wash its hands of a problem of which it is an intimate part is shameful.”).
the product of sacred professional obligations?401 The bar must also recognize that there is no guarantee that the reliance on the advice of a professional as a defense to tax penalties will or should continue. And without the reliance defense, taxpayers will be less likely to obtain—and pay for—the advice of lawyers and accountants. Professor Weisbach has convincingly argued that there is nothing immutable about the current system of penalties and the reliance defense.402 Indeed, Congress has already enacted one penalty (§ 6707A)403 and proposed another (as part of the codification of the economic substance doctrine)404 for which reliance on the advice of a professional is not a defense. Moreover, other areas of the law, including environmental law and securities law, do not permit people to avoid civil penalties by relying on the advice of counsel. Thus, tax advisors must recognize their central role as gatekeepers and their duty to the system,405 if not for the sake of the system, then at least for the sake of their own livelihood.406

V. CONCLUSION

The government’s desire to “do something” about the tax shelter problem is understandable. However, in attempting to fix the shelter problem, Congress and the Treasury should not make legitimate tax advice and legitimate tax planning more difficult. The tax system is based on voluntary compliance, which requires a well-informed and well-advised citizenry. In addition, the rules and standards for tax advice should encourage tax planning to be legitimate. The general standard for tax advice must be understandable and straightforward. Moreover, it must promote advice that hews as close to the intent of Congress as possible. Basing the standard on a true construction of the statute, rather than a chance of success, has the greatest chance of accomplishing that goal.

401. Johnson, supra note 37, at 25.
402. Weisbach, supra note 6, at 221.
405. See, e.g., Darrell, supra note 26, at 131; Schizer, supra note 8, at 370–71.

The current self-assessment system relies on the integrity of taxpayers and tax advisors for its success. It is currently in trouble, at least partly because that integrity is lacking. The profession must at least attempt to mitigate the problem by protecting that integrity. By exercising leadership, lawyers may perform a valuable service for themselves and for society.

Id. (footnote omitted).