1-1-2006

Tax Advice before the Return: The Case for Raising Standards and Denying Evidentiary Privileges

Linda M. Beale
Wayne State University

Recommended Citation
Available at: https://digitalcommons.wayne.edu/lawfrp/309

This Article is brought to you for free and open access by the Law School at DigitalCommons@WayneState. It has been accepted for inclusion in Law Faculty Research Publications by an authorized administrator of DigitalCommons@WayneState.
Abusive tax shelters have shone an unappealing light on tax lawyers. Some commentators suggest that these abusive shelters are the work of a small tax shelter bar. This article argues that the same practitioner norms, interpretive approaches, and tax standards that make possible the role of the so-called tax shelter bar in designing mass-marketed shelters also encourage aggressive loophole exploitation in customized tax planning by the regular tax bar.

Recent changes have set the stage for a paradigm shift in tax compliance. A new reportable transaction regime increases transparency. The 2004 Jobs Act’s stiffer penalties and heightened standards for penalty protection, at least in the context of reportable transactions that have a significant tax avoidance purpose, move the target towards better compliance. Significant changes to the rules governing practice before the Internal Revenue Service add momentum.

This article argues that the best way to stymie socially wasteful tax planning is to accelerate the paradigm shift. The statutory and ethical standards for positions taken or advised on returns should be raised. A taxpayer should not be able to take a position on a tax return, nor an advisor advise a position, unless it is considered to have a greater than
fifty percent likelihood of success on the merits if litigated. To make returns fully transparent and facilitate enforcement, Congress should amend the law to eliminate the applicability to pre-return tax planning advice of the common law attorney-client privilege and work product protection.

TABLE OF CONTENTS

I. INTRODUCTION ................................................................. 585

II. CAUSES OF SUPER-AGGRESSIVE TAX PLANNING ............... 594
    A. Tax Minimization Norms ................................................. 595
    B. Enforcement and the Audit Lottery ................................. 607
    C. Practice Standards ...................................................... 612
        1. Statutory Standards ................................................. 613
        2. Circular 230 ...................................................... 618
        3. Ethical Standards .................................................. 626
            a. Duties of Loyalty and Confidentiality ..................... 626
            b. Duty as Officer of the Court ................................ 630
        4. Evidentiary Privileges ............................................... 633

III. POLICY SOLUTIONS .......................................................... 636
    A. Institute a More Likely Than Not Standard ...................... 638
        1. Rationale for Heightened Standard ............................. 639
        2. Objections to Heightened Standard ............................. 641
    B. Eliminate Evidentiary Privileges For Pre-Return Tax Advice  644
        1. Relevance of the Self-Assessment Principle .................. 645
        2. No Viable Distinction Between Tax Planning and Nonprivileged Return Preparation Work .......... 651
        3. Privilege Often Inapplicable in Planning Contexts ......... 654
        4. 2004 Jobs Act Changes and Recent Privilege Litigation Support Repeal ................................. 656
        5. Adversarial Approach to Tax Advice is Harmful .......... 659
        6. Harms to Clients from Elimination of Privilege Overstated ............................................. 663
        7. Work Product Protection Unmerited for Pre-Return Tax Advice .................................................. 664

IV. CONCLUSION .................................................................... 668
The tax law is exceedingly complex and open to alternative interpretations, and this undoubtedly facilitates ethical rationalizations of positions taken. But how far this is pushed depends on a willingness to aggressively seek out alternative interpretations and innovative legal forms that take advantage of gaps in the law, and the unanticipated effects of combining parts of the law.¹

The tax bar is the repository of the greatest ingenuity in America, and given the chance, those people will do you in.²

I. INTRODUCTION

Recently, abusive tax shelters and customized tax planning have shone a particularly unappealing light on lawyers who single-mindedly pursue their clients' tax-reduction goals. Prominent firms have received summonses or have been sued by the Internal Revenue Service (Service) or by their clients regarding transactions with significant tax avoidance purposes.³ Instead of "pillars of our system of taxation," they have become "architects of its circumvention."⁴

⁴ Albert B. Crenshaw, Nominee to Head IRS Vows to Strengthen Enforcement, WASH. POST, Mar. 19, 2003, at A4 (quoting Commissioner Mark W. Everson at
The government's answer to abusive tax transactions has been greater transparency, tougher sanctions, and more vigorous enforcement, as evidenced by the development of corporate tax shelter regulations governing potentially abusive reportable transactions.\(^5\) Ferreting out abuse requires continuing that effort.\(^6\) Enforcement will not succeed, however, if it focuses solely on defeating cloned tax shelters.\(^7\) Congress and the Treasury Department (Treasury) must solve loophole-exploiting noncompliance of the kind that shows up as easily in customized tax planning for a particular client as in mass-marketed tax shelters.\(^8\)

This requires a shift in the treatment of tax planning. Tax advice covers a wide spectrum — from tax structuring applying unambiguous provisions to minimize taxes on ordinary business deals to potentially abusive structures that are hawked to high-paying customers to offset pre-existing gains. Compliance discussions have focused almost exclusively on the latter.\(^9\) This overlooks the inappropriateness of potentially abusive tax planning in customized deals with significant tax avoidance objectives. The same practitioner norms, interpretive approaches, and tax standards that enable the tax shelter bar to design cloned shelters also encourage aggressive loophole exploitation in

---

\(^5\) See infra Part II.C.1.


\(^7\) This term is used for abusive structures that can be duplicated and marketed to multiple clients. Some shelters have even been patented. Rachel Emma Silverman, *The Patented Tax Shelter—Lawyers, Financial Advisers Are Getting Exclusive Rights to Estate-Planning Strategies*, WALL ST. J., June 24, 2004, at D1.

\(^8\) This is supported by tax practitioners’ arguments against regulatory and statutory developments on the grounds that “one cannot tell a tax shelter transaction from respectable ‘aggressive tax planning.’” Lee A. Sheppard, *Corporate Shelters: A Snowball’s Chance of Pretax Profit*, 88 TAX NOTES 728, 728 (Aug. 7, 2000) (describing N.Y. State Bar Ass’n Tax Section arguments against shelter legislation).

\(^9\) See, e.g., S. REP. NO. 109-54, at 5–6 (2005) [hereinafter SENATE REPORT] (noting that abusive shelters and overreaching customized planning can be harmful, but focusing on the former).
customized tax planning by the regular tax bar.  

Almost any prominent case of abusive tax structuring demonstrates the use of hyper-literal interpretations to achieve a tax goal that is at odds with the underlying purpose of applicable provisions. In the case of the (infamous) Merrill Lynch partnerships, the use of installment rules in a partnership with a foreign accommodation party generated an artificial loss. The contingent liability shelter exposed in the Enron bankruptcy and now being litigated likewise disregarded statutory purpose to capture an artificial loss. Two other recent transactions manipulated the partnership allocation rules in the context of a foreign accommodation party to generate a taxpayer benefit — Long Term Capital Holdings’ loss-duplicating structure (adjudicated to be a tax shelter) and GE

---

10 See infra note 31 and accompanying text (discussing commentators’ categorization of tax lawyers as belonging to one or the other approach).


12 See, e.g., Karen C. Burke, Deconstructing Black & Decker’s Contingent Liability Shelter: A Statutory Analysis, 108 TAX NOTES 211 (July 11, 2005) (describing artificial loss structure using corporate formation excess debt rules with debt supported by parent guarantees as disregarding congressional purpose to support transfers of trade or business).

13 Long Term Capital Holdings involved two sequential transactions designed by investment bank Babcock & Brown to produce artificial tax losses at both stages: (i) a lease-stripping deal that took advantage of U.S. and U.K. tax rules to avoid taxation of arranged prepayments and U.S. corporate formation rules to provide deductions out of untaxed income to a U.S. corporate shelter client, and (ii) a tiered partnership deal that purportedly permitted the top-tier partners to benefit from a transitory partner’s contribution of inflated basis stock from the lease-stripping deal, with a partnership sale of the stock resulting in allocation of an artificial loss to the sheltering partners. Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), aff’d, 150 F. App’x 40 (2d Cir. 2005); see also Alvin C. Warren, Jr., Understanding Long Term Capital, 106 TAX NOTES 681 (Feb. 7, 2005) (analyzing transaction and decision in depth). Section 704(c)(1)(C), which does not permit a pre-contribution loss to be allocated to other partners after the contributing partner leaves a partnership, was enacted after the transactions took place. Id. at 686 n.26.
Capital's Castle Harbour financing transaction (upheld as a partnership). These latter two cases ably illustrate the artificiality of the shelter/nonshelter categorization. Castle Harbour was a customized tax deal designed to suit GE Capital Corporation's particular situation as owner of depreciated assets, while the Long Term Capital Holdings structure was marketed to the hedge fund, among others, as a capital gains eliminator. Similar manipulation of Code loopholes is evident in recent real estate mortgage investment conduit (REMIC) developments. REMIC lawyers reinterpreted a straightforward provision (designed to accommodate credit

\[\text{Id. at 98–100. The excess return can be viewed as their fees for accommodating GE's tax avoidance objectives. See ASA Investerings P'ship, 201 F.3d at 513–15 (holding that foreign bank accommodation party with guaranteed return was not partner); Karen C. Burke, Castle Harbour: Economic Substance and the Overall-Tax-Effect Test, 107 TAX NOTES 1163, 1172 (May 30, 2005) (emphasizing importance of banks' guaranteed minimum return); Darryll K. Jones, Castle Harbour and the Hobgoblins of Little Minds, 106 TAX NOTES 605, 606 (Jan. 31, 2005) (noting court's circular reasoning in accepting GE's partnership argument); Richard M. Lipton & Jenny A. Austin, Lessons from Castle Harbour: The Service Loses a Significant Tax Shelter Case, 102 J. TAX'N 32 (2005) (explaining depreciation and deferral); Lee A. Sheppard, Bury Your Tax Shelter in a Business, 106 TAX NOTES 20 (Jan. 3, 2005) (analyzing structure). But see Robert H. Scarborough, Partnerships as an Alternative to Secured Loans, 58 TAX LAW. 509 (2005) (arguing that sufficient equity characteristics permit taxpayers to structure financings as partnerships, even without business purpose for partnership, but providing little analysis of relevance of contingent and variable debt regulations to tax characterization or of participating bank's financing (rather than investment) purpose).}
enhancement to compensate for default losses in mortgage securitizations) to provide technical cover for an engineered type of shortfall that permits investment classes with maturity dates unrelated to mortgage terms. The reinterpretation enabled REMIC sponsors to create a new type of guaranteed maturity class (GMC) security desired by investors.  

In broad terms, the REMIC rules create a passive statutory vehicle for issuing interests (in addition to an ownership residual) that are backed by principal and interest payments on qualified mortgage loans and given statutory characterization as debt for tax purposes. I.R.C. §§ 860A–860G; Treas. Reg. § 1.860A-1 et seq. (2005). If a REMIC complies with the restrictive rules for types of assets permitted to be held, interests permitted to be issued and activities permitted to be undertaken, it is not subject to tax. I.R.C. § 860A. If not, there may be confiscatory REMIC-level taxes on prohibited transactions and/or failure of REMIC status resulting in taxation as a corporation. See, e.g., I.R.C. § 860F. In 2000, Freddie Mac's description of its new GMC securities explained that a REMIC would hold an option permitting it to put its mortgage loans to Freddie Mac for payment sufficient to pay off related GMC securities, even if the amount exceeded actual market price of the loans. OFFERING CIRCULAR SUPPLEMENT (To OFFERING CIRCULAR DATED JAN. 1, 2000), FREDDIE MAC MULTICLASS CERTIFICATES SERIES 2272, FREDDIE MAC'S SECURITIES SALES & TRADING GROUP S-21 to S-22 (2000), http://freddiemac.com/mbs/data/2272oc.pdf. Later disclosure merely described Freddie Mac's obligation to purchase without mentioning a put right as a REMIC asset. OFFERING CIRCULAR SUPPLEMENT (To OFFERING CIRCULAR DATED JAN. 1, 2000), FREDDIE MAC MULTICLASS CERTIFICATES, SERIES 2301, UBS WARBURG S-47 (2001), http://freddiemac.com/mbs/data/2301oc.pdf. Freddie Mac has recently announced a commitment to issue $2 billion of GMC securities annually, with set maturities of three to twelve years. See Freddie Mac, Focus on: Reference REMIC Securities (Apr. 2005) (describing introduction of regular GMC offerings), http://www.freddiemac.com/mbs/docs/remic-factsht_033005.pdf. These structures raise questions about REMIC status, since the put with shortfall guarantee is likely an impermissible REMIC asset (and may be an impermissible interest). One commentary suggests, without detailed analysis, that the put with shortfall guarantee can be viewed as a credit enhancement contract incident to related mortgage loans. JAMES M. PEASLEE & DAVID Z. NIRENBERG, THE FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS 403 (2001 & Online Supp.). This analysis is a significant stretch for a provision explicitly covering only default losses, lower-than-expected returns on cash flow investments, or unanticipated losses or expenses incurred by a REMIC. The shortfall at maturity is clearly neither a default loss nor a low investment return — it arises because of the need to convert mortgages to cash to repay GMC securities in full at an engineered maturity date that may occur at a time when market conditions have caused loan prices to decline. Such shortfalls can be expected to occur with some probability in any GMC deal. Because the shortfall is a potential cost built into the structure of a REMIC that includes GMC securities, it seems a stretch to consider a shortfall guarantee as covering an "unanticipated" loss of the REMIC (even if the shortfall itself should be viewed as a "loss," which is questionable). Guarantee payments can be expected to increase when mortgage prepayments slow, generally when interest rates rise. Thus, there
Much of this aggressive tax planning traces to an interpretive approach that encourages attorneys to view the Internal Revenue Code (Code) as a tool box of provisions that can be taken out of context by using literalist interpretations to achieve tax minimization goals. Among other failings, these aggressive tax interpretations disregard normatively important concepts critical to the function of the tax system — the endogenous principles of structural coherence and self-assessment, as well as the broader normative principle of distributive justice. Structural coherence requires practitioners to approach the Code with a view to its integrity as a coherent whole, to the extent possible, with faithfulness not only to the superficial text but also to the underlying purpose of Code provisions. Literalist appears to be a strong argument that the put with shortfall guarantee required for GMC securities would cause a GMC REMIC deal to fail REMIC status and be subject to taxation. It appears that the tax bar advising on these deals has rationalized the shortfall guarantee as credit enhancement, likely by accepting the literalist argument that the payments are “unanticipated” as long as there is a sufficiently low probability of payout as agreed among the REMIC bar. Even assuming this approach were viable, maintaining such a low probability of payout would be difficult with large issuances such as Freddie Mac’s $2 billion annual output, where product requirements could lead to pressure to accept higher probabilities of payout under the guarantee.

16 See, e.g., Peter C. Canellos, How to Curb Aggressive Shelter Activity, 105 TAX NOTES 1156 (Nov. 22, 2004) (“[A]ggressive planners and their tax-adverse clientele will always find and exploit loopholes.”); Glenn E. Coven, What Corporate Tax Shelters Can Teach Us About the Structure of Subchapter C, 105 TAX NOTES 831 (Nov. 8, 2004) (describing shelters as “a logical, if extreme, application of well established rules” where advisors “ferret[] out” gaps).

interpretations that set aside statutory, legislative or historical contexts that establish the reason for the provision fail to satisfy the coherence requirement.\textsuperscript{18}

The self-assessment criterion derives from the Code's "re[liance] on taxpayers to come clean about their taxable income, not to hide or understate it."\textsuperscript{19} Self-assessment and its implied anti-manipulation coherentist approach based on representation reinforcement); Cass R. Sunstein, Interpreting Statutes in the Regulatory State, 103 HARV. L. REV. 405 (1989) (arguing that pragmatic approach facilitates modern administrative state).

A number of tax commentators argue against purposivism in the context of the courts' use of the judicial doctrine of substance-over-form (or one of its more narrow derivatives such as economic substance) to override what are claimed to be "literal" statutory meanings. See, e.g., John F. Coverdale, Text as Limit: A Plea for a Decent Respect for the Tax Code, 71 TUL. L. REV. 1501 (1997) (arguing for textualist approach). Even some commentators who view "pure literalism [...] words shorn of all context" as problematic argue that purposivism merely permits interpreters to assert their "own tastes." Joseph Isenbergh, Musings on Form and Substance in Taxation, 49 U. CHI. L. REV. 859, 864, 879 (1982).

The principle most generally offered in substitute for both (internal) coherence and (external) distributive justice (discussed below in the text) is economic rationality (efficiency). See, e.g., Joseph Bankman, The Business Purpose Doctrine and the Sociology of Tax, 54 SMU L. REV. 149 (2001) (analyzing judicial doctrines from economic perspective); David A. Weisbach, An Economic Analysis of Anti-Tax-Avoidance Doctrines, 4 AM. L. & ECON. REV. 88 (2002) (using economic measures of income elasticity to determine economically efficient point where use of judicial doctrines equals administrative cost). Efficiency scholars generally reject any normative force for coherence arguments. See, e.g., Bankman, supra, at 156 ("The efficiency/welfarist approach regards internal coherency-based scholarship as without normative force."). Needless to say, those who view coherence and distributive justice as normatively important find that efficiency scholars have failed to resolve problems that coherence and distributive justice address, such as interpretation of potentially ambiguous statutes, consideration of noneconomic motivators of human conduct, and placement of tax within the broader institutional framework of a democratic society. See, e.g., William B. Barker, Statutory Interpretation, Comparative Law, and Economic Theory: Discovering the Grund of Income Taxation, 40 SAN DIEGO L. REV. 821 (2003) (arguing that analogical development of tax statutes in accord with distributive justice principles is historically appropriate and supportive of democracy).

\textsuperscript{18} See infra Part II.A (discussing literalist interpretations and social norm of tax minimization).
\textsuperscript{19} Beale, supra note 17, at 371; see also United States v. Arthur Young & Co., 465 U.S. 805, 815–16 (1984) (noting that fairness of tax system depends on forthright self-assessment and self-reporting, backed by governmental disclosure requirements); BERNARD WOLFMAN ET AL., ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE 37 (3d ed. 1995) ("The heart of the income tax system lies in the obligation of each taxpayer to declare what he owes.").
value\textsuperscript{20} are critical to the standards governing taxpayers’ compliance in reporting their tax liabilities and to the enforcement mechanisms, such as specific disclosure requirements and audits, used to assess whether taxpayers have appropriately reported and paid their tax liabilities.\textsuperscript{21} Again, interpretations that exploit loopholes to generate artificial tax benefits fail to satisfy the anti-manipulation value.

Finally, distributive justice focuses on taxpayers’ ability to bear the tax burden, with special regard to the circumstances of those whose resources are most thinly stretched.\textsuperscript{22} When practitioners provide aggressive tax planning that results in tax-avoidance transactions for those able to afford their services, allocative distortions result that reflect “self-help” rather than political deliberation. Taxpayers who engage in aggressive tax-avoidance transactions (whether ultimately determined by the courts to be shelters, such as the Merrill Lynch transactions, or allowable customized planning, such as GE’s Castle Harbour transaction) enjoy a reduced tax burden. Those who merely plan transactions that originate in their businesses and use well-understood mechanisms bear a heavier tax burden. This type of self-help violates distributive justice. The effects of such fairness concerns extend beyond the particular taxpayer. Any perception of general noncompliance may push taxpayers and practitioners to more aggressive planning to compensate for the perceived higher level of noncompliance, leading to a race to the bottom in tax compliance.

\textsuperscript{20} Beale, supra note 17, at 371–72 (corollary to structural coherence that underlies aversion to subjective valuations).

\textsuperscript{21} See infra Parts II.B (discussing tax enforcement and the audit lottery) and II.C (discussing practice standards).

To put an end to abusive tax planning practices will require constraints on interpretation to support coherence-favoring approaches and a corresponding change in the customary view of the tax lawyer's role. The recent development of the reportable transaction regime with an effective penalty structure and substantial amendment to Treasury's governance of opinion practice are steps in the right direction. These changes constitute the beginning of a fundamental paradigm shift in the way tax practitioners should relate to tax administration and to their advisor role.

Accelerating that paradigm shift is the best way to stymie socially wasteful aggressive tax planning. To redirect tax advice away from pushing the envelope on tax minimization and towards compliance with tax laws, the statutory standard for positions taken on returns by taxpayers and advised by tax advisors should be raised. Corresponding changes should be made in ethical requirements for tax advice. This Article proposes that a taxpayer should not be able to take a position on a tax return, nor an advisor advise a position, unless it is considered to have a greater than fifty percent likelihood of success on the merits if litigated. To make returns fully transparent in ways that will permit enforcement of the new standard and the opinion rules governing practice before the Service, pre-return tax advice should be subject to the more transparent regime that applies to tax return preparation, including inapplicability of attorney-client and work-product privileges for pre-return tax planning advice.

The argument proceeds as follows. Part II considers how current norms and standards undercut structural coherence and self-assessment objectives and, ultimately, distributive justice principles. Part II.A examines the tax minimization social norm based on a literalist interpretive approach that has permitted tax advisors to skirt — and sometimes to cross — the boundaries of legality. Part II.B considers how the lack of enforcement resources, even with some recent increases, permits abusive return positions to exploit the “audit lottery.” Part II.C discusses the adversarial-based practice standards that encourage overly aggressive tax filings and the evidentiary privileges that obscure the information most needed by the Service. Part III elaborates the two proposals for completing the paradigm shift. Part IV concludes.

---

23 See infra Part II.C.1 (discussing codification of reportable transaction regime) and Part II.C.2 (discussing changes to Circular 230 governing practice before Service).

24 See, e.g., David Weisbach, It's Time to Get Serious About Shelters, 88 TAX NOTES 1677, 1677 (Sept. 25, 2000) (noting “tax planning deserves very little protection”).
II. CAUSES OF SUPER-AGGRESSIVE TAX PLANNING

Consideration of a tax lawyer's role in aggressive tax planning cannot begin without first acknowledging the ambiguity of the existing rules regarding a taxpayer's obligation in respect of reporting positions taken on tax returns. Taxpayers are required to report their income and tax liabilities imposed under the Code on returns filed with the Service.25 Because a taxpayer must self-assess and report the taxes due on the return, a taxpayer's obligations are determined by the confidence level that is required for each position reported on the return. Arguably, the current mosaic of statutory and regulatory provisions governing taxpayers' reporting obligations establish that any reporting position that can successfully avoid the various penalties that may be imposed under the Code and Treasury regulations is a proper reporting position.26 The penalty provisions are enormously complex and were made more so by recent statutory changes and by the overlay of Treasury's rules for practice before the Service (commonly referenced by their original 1921 publication as "Circular 230"). The accuracy-related penalties for substantial understatement, however, make clear that taxpayers will not be penalized for understatements in respect of non-shelter items if the position as reported on the return had "substantial authority" as defined in Treasury regulations.27 If a nonshelter position is adequately disclosed on the return, a taxpayer will not be penalized if there was a "reasonable basis" for that position.28 Even if a taxpayer's reporting position for nonshelter items fails to satisfy these rather low standards, the accuracy-related penalty for understatements may not be imposed.

25 Income taxes are imposed under Code sections 1 (individual and other non-corporate entities) and 11 (corporate). Return filing requirements are set forth in sections 6011 (general return requirement) and 6012 (requirement for income tax returns and related provisions).
26 But see Calvin H. Johnson, "True and Correct:" Standards for Tax Return Reporting, 43 Tax Notes 1521 (June 19, 1989) (arguing that the taxpayer's duty should be interpreted as a requirement to report the correct amount of tax due).
27 I.R.C. § 6662(d)(2)(B)(i). The regulations interpret the substantial authority standard as an "objective standard" that is "less stringent than the more likely than not standard . . . but more stringent than the reasonable basis standard." Treas. Regs. § 1.6662-4(d)(2). Most commentators consider that positions supported by substantial authority have a 40 to 45 percent likelihood of success on the merits.
28 I.R.C. § 6662(d)(2)(B)(ii). The regulations define "reasonable basis" as "significantly higher than not frivolous or not patently improper." Treas. Regs. § 1.6662-3(b)(3). Most commentators interpret such positions as having a 10 to 20 percent likelihood of success on the merits.
if the taxpayer successfully establishes an affirmative defense that the taxpayer acted with “reasonable cause” and a “good faith belief” that the position was appropriate.29

Given the ambiguity of degree of certainty required for reporting tax positions, literalism has served as a strong mechanism for supporting innovative tax minimization structures.30 The tax interpretive problem is aggravated because of its interrelation with a social norm and standards of tax practice, including a client-centered ethical structure, that favor client advocacy and tax minimization over duty to the tax system. Tax attorneys’ interpretations take place in the context of (i) a social norm that celebrates lawyers’ innovative tax minimization planning in customized transactional settings without regard to limitations deriving from purposive interpretations, (ii) statutory standards that require little regard for the public role of tax lawyers, (iii) ethical rules that cast the government as an adversary of the attorneys’ client, and (iv) minimal enforcement that creates a tempting audit lottery for taxpayers. The protection of evidentiary privileges is the icing on the cake for the tax minimization party. The following sections explore these interrelationships more fully.

A. Tax Minimization Norms

Aggressive tax planning focused on designing stand-alone loss-generating or income-deflecting/deferring transactions that can be cloned and sold to high bidders is widely viewed as crossing a line separating legitimate tax practice from abuse. Peter Canellos, a prominent New York attorney, suggests, in fact, that there are two tax bars — the legitimate bar and the shelter bar — for whom the methods used, the attitudes towards the law, and the end results are diametrically opposed or at least easily distinguishable.31 Bradley

29 I.R.C. § 6664(c)(1) (no penalty imposed for any portion of an understatement satisfying the reasonable cause/good faith standard, which may include reliance on an opinion of a tax adviser).

30 Dana L. Trier, Beyond the Smell Test: The Role of Substantive Anti-Avoidance Rules in Addressing the Corporate Tax Shelter Problem, TAXES, Mar. 2000, at 62, 64 (“At the heart of these transactions is often a technical basis for the tax advantage sought.”).

Wendel similarly argues that elite tax practitioners who are not a part of the shelter bar develop customary interpretations that provide the base line for evaluating correctness of statutory interpretations: he assumes that their work is guided by an attitude of professionalism that recognizes the need for a "stable, determinate framework of legal rights" and therefore constrains the kind of bootstrapping that plans around formal legal norms.\(^\text{32}\)

Excluding those who participate in outright criminal tax fraud,\(^\text{33}\) I suspect that there is not such a clear line between good and bad tax bars. There is instead a spectrum of behavior from prudent to abusive, with many tax advisors sometimes at the riskier end and some almost always there, depending on market pressures.\(^\text{34}\) Many of the techniques evidenced in abusive shelters are part of everyday practice in the development of customized tax transactions.\(^\text{35}\) The

\(^{32}\) See Wendel, supra note 31, at 1216 (arguing for concept of community of tax lawyers acting as custodians of the law by developing a collective understanding of statutory meaning through consultation and over time); see also Mark P. Gergen, The Common Knowledge of Tax Abuse, 54 SMU L. Rev. 131, 132 (2001) (suggesting that tax law will sometimes turn "on the common knowledge of tax professionals").

\(^{33}\) Ethical rules prohibit lawyers from assisting clients to commit criminal or fraudulent conduct or advising clients to engage in such conduct. MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2002). "Hence, a lawyer should not participate in a sham transaction; for example, a transaction to effectuate criminal or fraudulent escape of tax liability." WOLFMAN ET AL., supra note 19, at 195.

\(^{34}\) Cf. Parker, supra note 31, at 3 (discussing market pressures causing "deal creep" towards ever more aggressive interpretations).

\(^{35}\) Other analysts have recognized this parallelism between tax shelters and customized tax planning:

[Tax shelter transactions] produced results that were unwarranted, unintended, or inconsistent with the overall structure or underlying policy of the Internal Revenue Code. These transactions had no economic substance or business purpose other than to reduce taxes. Abusive tax shelters can be custom-designed for a single user or prepared as a generic tax product sold to multiple clients.
underlying tax minimization social norm is dominant throughout tax practitioner ranks — from promoters of abusive cloned shelters to tax lawyers at preeminent law firms who customize deal structures for multinational clients, from auditors for Fortune 500 companies to small-firm CPAs who almost absent-mindedly invent business purposes for their clients. In both customized planning and abusive shelters, advisors tweak and twist minute details of facts or law to steer a transaction structure through the Code with the least possible tax burden. They utilize Code provisions in new ways or in conjunction with a factual context not contemplated at the time the provision was drafted, often yielding results that fall outside the provision's purpose. Tax lawyers even discuss among themselves how far it is acceptable to push rules. It is not clear that this practice reinforces professional norms so much as it provides comfort in numbers to lawyers — sometimes representing all firms that advise particular types of deals — who apply a similar interpretation.

SENATE REPORT, supra note 9, at 1, 5–6 (noting that report focuses on marketed tax shelters).


37 See, e.g., Joel Slemrod, Tax Minimization and Corporate Responsibility, 96 TAX NOTES 1523 (Sept. 9, 2002) (noting lack of line between planning and tax evasion, and "inventiveness" of lawyers who comply with letter of the law while undermining its purpose).

38 See, e.g., Parker, supra note 31, at 3 (noting that some advisors "view the Code and regulations as technical rule books to be read literally and without regard to common sense").

39 This is, of course, what Mark Gergen called the "common knowledge of tax professionals" based on "what tax lawyers commonly do and have done." Gergen, supra note 32, at 132, 146. The difficulty with the lack of transparency in the development of such lore is that one firm's decision to push the envelope can lead to a race to the bottom, as every firm decides that it will go along with the interpretation rather than lose clients in that area of practice. Clients threaten to take their business
Perhaps the best evidence is the role of acclaimed tax experts in notorious shelter transactions. R.J. Ruble was a famed rainmaker for an upstanding law firm, Brown & Wood, before he became notorious as the creator of expensive cloned shelter opinions for basis shift transactions. Mark Kuller, a partnership expert formerly with King & Spalding and now with McKee Nelson, had a role in the Merrill Lynch shelters and then later advised the sophisticated founding partners of the Long Term Capital hedge fund (whose near collapse almost brought down global capital markets) on their abusive lease-stripping and partnership loss-generating transactions.

I agree with Wendel that tax lawyers ought to reject some applications that seem permitted under a literal interpretation, on the grounds that a structurally coherent view of the tax system (or a particular subsystem, such as partnership tax rules) requires an interpretation in line with underlying purposes. I question, however, whether professionalism is sufficient to cause tax lawyers actually to resist the business pressures to use coherence-destroying interpretations to accomplish clients' goals. The fact that professional tax bars, such as the New York State Bar Association Tax Section, in

to a more compliant attorney, and they may make good on those threats.

See Senate Report, supra note 9, at 7 (finding that Sidley Austin Brown & Wood facilitated sale of potentially abusive tax shelters with “boilerplate tax opinion letters”); Linda M. Beale, Developments May Lead SEC to Ban Certain Tax Services Under Sarbanes-Oxley Independence Rules, 16 J. Tax’n Fin. Insts. 5, 11 & nn.55–56 (2003) (describing FLIP/OPIS basis shifting transactions listed in Notice 2001-45); Paul Braverman, Still in the Shadows, Am. Law., Oct. 1, 2003, available at http://www.law.com/jsp/article.jsp?id=1063212108768 (discussing suits against R.J. Ruble and Sidley Austin Brown & Wood and Jenkens & Gilchrist and relationship between Ruble and KPMG in connection with FLIP and OPIS shelters). Others have noted this propensity for “bad” lawyers to be recognized only after they have been exposed. “Interestingly, tax shelter promoters like R.J. Ruble of [Brown & Wood] and Paul Daugerdas of Jenkens & Gilchrist, who helped hatch several large-scale suspect tax shelters, are denounced as ‘rogue’ partners by their colleagues after they are publicly exposed, but were hailed as ‘rainmakers’ before they got caught.” Sheldon D. Pollack & Jay A. Soled, Tax Professionals Behaving Badly, 105 Tax Notes 201, 205 n.26 (Oct. 11, 2004).

See Lee A. Sheppard, Shelter Opinions: The Tax Equivalent of Pasties, 87 Tax Notes 17, 17 (Apr. 3, 2000) (discussing ACM Partnership and noting that attorneys were “amply degreed lawyers that many Americans would consider among the country’s best and brightest”).


See supra note 31 and accompanying text.
their role as professional participants in the public debate sometimes provide thoughtful commentary on proposed tax provisions does not prove otherwise.\footnote{See, e.g., Tanina Rostain, Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry, 23 YALE J. ON REG. 77, 81 (2006) (discussing organized tax bar’s law reform efforts as “attempts to reinforce the professional authority of elite tax lawyers, which had been eroded by the tax shelter market”).} Individual lawyers may argue for public-regarding positions on many issues yet engage in loophole exploitation on particular issues in which their own lucrative practice resides. A bar may provide insightful commentary while nudging tax administrators towards accepting a more aggressive, client-favorable perspective on particular issues. The public function of providing commentary may even spur inventiveness that permits self-help rewriting of the tax laws when there is persistent client and market pressure for a particular type of tax product.

The current social norm among tax practitioners — whether the so-called legitimate or shelter bar — views it as reasonable for taxpayers to graft large, complex and costly structures or layers of transactions onto ordinary business transactions in order to lower tax liabilities.\footnote{See, e.g., Paul J. Sax, ABA Tax Section Chair Writes Finance on Antishelter Recommendations, TAX NOTES TODAY (Mar. 24, 2000) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2000 TNT 58-14) (letter from Paul J. Sax, Chair, Section of Tax’n, Am. Bar Ass’n, to Sen. Daniel Moynihan (Mar. 21, 2000)) (“The ethical duty of [law or accounting firms and company taxpayers] is to comply with the law, and if there are gaps in the Code, they are entitled to take advantage of them to their benefit.”).} The broadly shared social norm accepts that advisors push rules to the limits of the interpretive burden they are perceived as being able to bear by applying literal interpretations that may disregard the broader context of application.\footnote{See B. John Williams, Jr., Chief Counsel, Internal Revenue Service, Address to the Chicago Bar Ass’n Fed. Tax’n Comm. (Feb. 25, 2003), available at http://www.irs.gov/pub/irs-utl/shelters-feb25.pdf (addressing “technical tax shelters” supported by technical statutory readings but not by substance of transactions).} “Tax practitioners are well-versed in finding (or \textit{manufacturing}) loopholes.”\footnote{Richard M. Lipton & Steven R. Dixon, “Tax Shelter” and “Tax Shelter Opinion” — IRS, in Another Try at Circular 230, Strikes Out Again, 100 J. TAX’N 134, 141 (2004) (emphasis added).} And these are not merely “shady, fly-by-night” practitioners — they are “talented professionals at the top of their fields.”\footnote{\textit{SENATE REPORT}, supra note 9, at 9.} The wide acceptance of the practice results in a view that the statutory rules’ “rigidity does not allow a court to reverse an unreasonable result that the statute
mandates."

Learned Hand, more than any other person, exemplifies this view of the taxpayer's inherent right to manipulate the Code. His fame rests on a 1934 case that ironically gave birth to the economic substance doctrine—a judicial doctrine that has been used to overturn noneconomic results reached by literalist applications of tax statutes.

Anyone 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.\(^{50}\)

In practice, few tax lawyers question this norm; in fact, I would argue that most consider the Hand statement an apt expression of the tax practitioners' creed.\(^{51}\) Recent empirical research on the perception of tax evasion (a term of art referring to criminal tax fraud) found that most subjects viewed tax evasion as more or less equivalent to

\(^{49}\) James W. Colliton, Standards, Rules and the Decline of the Courts in the Law of Taxation, 99 DICK. L. REV. 265, 313–14 (1995); see also Parker, supra note 31 (discussing "Wall Street Rule" that treats technical shelters based on literal interpretations and involving large sums of money as invulnerable to enforcement); cf. Stanley Fish, There Is No Textualist Position, 42 SAN DIEGO L. REV. 629, 633 (2005) (arguing that there is no such thing as "plain meaning").

\(^{50}\) Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465, 469 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."). In a later dissent, Hand made an even stronger statement:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions.


\(^{51}\) As an inexperienced associate, I encountered quizzical looks on those occasions when I queried peers at various prestigious New York firms about the proper limits of tax minimization. Respected associates tended to quote Hand as proof that loophole-exploitation is a taxpayer right. See also David J. Miller, Pay-triot Games, AMERICA'S VOICES, Oct. 5, 2002, http://www.americasvoices.org/avarc2002/archives2002/MillerDJ/MillerDJ_100502.htm (using Hand quotation to introduce blog that discusses loophole exploitation).
minimum wage law violations and as less serious than other white collar crimes. Interestingly, tax professors and graduate tax students both considered tax evasion less serious an offense than did MBA students. Given this tendency to treat tax crimes as less serious than other offenses, even government officials may find it difficult to cast aspersions on the tax minimization approach.

A "pursue it as far as it can take you" norm inevitably loses sight of the importance of the integrity of the legal system in determining appropriate conduct within the system. There is something substantially wrong with an approach to the ethical position of lawyers that suggests that hunting for tax gold, as Mark Gergen puts it, may be an appropriate professional activity. That approach lets lawyers accept questionable interpretations, such as the REMIC structure with a put option guaranteeing a type of shortfall that was not allowed under prior interpretations of the REMIC rules.

If an attorney must conjecture a business purpose for a transaction that a client enters for tax benefits, the transaction does not have a tax-neutral business purpose. The practitioner's role should be merely to record the client's pre-existing business purpose, not to invent nontax purposes. A purpose resulting from post hoc rationalization is inherently suspect as not founded in the client's business needs but rather in its tax desiderata. In practice, the conjecture may take place in a context in which client and practitioner discuss the transaction and the practitioner effectively suggests a purpose that the client then represents to the practitioner. Such interchanges may appear almost ordinary to many practitioners. The practitioner may rationalize that the client cannot be expected to know which reason, of its different and sometimes conflicting reasons for considering a transaction, would be considered a worthy rationale for tax purposes. Even if the highlighted concern would never have been considered important or expressed by the taxpayer without the practitioner's prompting, the practitioner might argue that it was inchoate in the transaction all along — a useful outcome of an
arrangement clearly undertaken for its tax benefits, but now saved because of a serendipitous discovery.\(^{57}\) This illustrates the difficulty in drawing the proper line for the conduct.\(^{58}\)

Similarly, if an attorney must modify a transaction to produce some prospect of an economic profit independent of expected tax benefits, the transaction lacks economic substance. Wrapping a tax-avoidance transaction into a more complex arrangement with other sources of potential profits, which could have been produced without the shelter transaction costs, does not convert avoidance into mere tax planning for business transactions. Rationalizing a structure to fit it within rules that give the intended tax results may stretch the rules well beyond the purpose for which they were intended.

Correlation of the tax minimization norm and literalism has had a negative impact on the Code and court decisions. Discovery of new loopholes leads to more complex tax regimes in particular areas, heightened use of localized interpretations to invent around the new rules, and further degradation of the professional perspective on tax advice.\(^{59}\) In the 1970s and 1980s, tax shelters marketed to wealthy individuals primarily used partnership structures that combined interest deductions on nonrecourse debt with depreciation deductions to generate artificially high losses for partners with only nominal economic investments.\(^{60}\) The response to those twentieth-century individual shelters was the development of two regimes of anti-abuse statutory rules that limited availability of losses by requiring a taxpayer to track categories of income (the passive activity loss rules) and limit losses to economic investment (the at-risk rules).\(^{61}\) Much of the planning that followed involved new ways to create artificial losses

\(^{57}\) An example is Enron’s development of contingent liability shelters. 1 STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 119 (Joint Comm. Print 2003) (describing Project Tanya, designed to offset a 1995 capital gain by transferring contingent environmental liabilities but implemented with benefit liabilities when Enron discovered it did not have requisite environmental liabilities).

\(^{58}\) The main text on tax ethics considers drawing the line between acceptable planning and unacceptable tax planning “[o]ne of the more perplexing problems.” WOLFMAN ET AL., supra note 19, at 203.


\(^{60}\) See Beale, SEC Heat, supra note 6, at 229 n.43.

outside those rules. Structures like Castle Harbour, where income is deferred by using a foreign accommodation bank as a purported partner, were the result. Because the taxpayer was able to make a literal argument for compliance with partnership allocation rules (and the government slighted arguments it should have made), the court blessed the structure's use of partnership rules to turn a financing into a tax deferral. Customized tax planning, in the context of the last decade's surge of promoted and cloned shelters, therefore degrades the effectiveness of detailed modifications of statutory provisions as a means to stop abuse.

Because of the correlation between tax minimization and literalism, it is difficult to find a suitable rule-based response. For example, Congress might agree that a purported partnership transaction like Castle Harbour should not have the benefit of the partnership rules when application of those rules eliminates, or at least defers, taxation on a considerable portion of the purported U.S. partner's income because (i) the economic substance of the transaction appears to be a debtor-creditor relationship taxable under the normal rules for debt instruments and (ii) the lender is a tax-exempt entity (a charitable organization or a foreign bank that is not subject to U.S. taxation on its income from the transaction). If the courts habitually fail to apply the substance-over-form judicial doctrine to recharacterize such arrangements, Congress might well decide that it should take action to prevent foreign banks from acting as accommodation parties by merely translating their lending requirements into purported partnership documents (and side agreements, such as Castle Harbour's investment account requirement). Similarly, Congress might consider ways to prevent importation of losses into partnership settings, as in Long Term Capital Holdings.

Various anti-abuse changes to the partnership rules could be considered, and a number of provisions dealing with basis and basis adjustments were in fact finally enacted in the American Jobs

---

62 See supra note 14 and accompanying text.

63 For example, if the yield on a loan is contingent because of losses allocable to a lender only in remote circumstances, the arrangement may be a contingent payment debt instrument, the taxation of which is established under the original issue discount regulations. See Treas. Reg. § 1.1275-4 (tax treatment of contingent payment debt instruments). If the contingency is sufficiently remote or incidental, the regular original issue discount rules would govern. Treas. Reg. §§ 1.1275-4(a)(5), 1.1275-2(h). If the rate is merely variable, the arrangement may be subject to the variable rate debt instrument regulations. Treas. Reg. § 1.1275-5.
Creation Act of 2004 (2004 Jobs Act). The change to the section 704(c) allocation rule reinforces the existing partnership anti-abuse regulations to make clear that the partnership rules cannot be abused to shift a loss to a noncontributing partner as purportedly done in Long Term Capital Holdings. Congress could also consider further changes:

- disallow income allocations to nontaxable foreign partners that are not in proportion to their capital contributions for partnerships with finite terms of 10 years or less on formation;
- further limit flexibility of the partnership allocation rules by requiring remedial (or even, curative) allocations under section 704(c) and partnership basis adjustments upon any distribution or sale of an interest; or
- enact a partnership anti-abuse rule that disallows partnership characterization whenever a purported partnership functions economically as a financing in which a tax-indifferent party is allocated income inclusions the present value of which exceeds the present value of its anticipated economic returns under the transaction structure.

Each of these provisions could potentially close a number of "loopholes" or gaps in the partnership Code provisions created by literalist interpretations that fail to acknowledge the demand from

64 See, e.g., American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833(a), 118 Stat. 1418, 1589 (2004) [hereinafter 2004 Jobs Act]; I.R.C. §§ 704 (adding section 704(c)(1)(C) to disallow allocation of built-in loss to successor partner), 734 (amending section 734(a) and (b) and adding section 734(d) to require partnership basis adjustment with respect to property distribution where distributee partner’s outside basis exceeds partnership’s inside basis), 743 (amending sections 743(a) and (b) and adding section 743(d) to require partnership basis adjustments following transfer of partnership interest when partnership has substantial built-in loss), 833(b), 833(c).

65 See I.R.C. § 704(c)(1)(C) (added by the 2004 Jobs Act § 833(a)). The partnership anti-abuse regulation generally requires that partnership rules be used consistently with the intent of the partnership regime and not to shift income or losses to reduce tax liability. Treas. Reg. § 1.701-2(a).

66 See, e.g., AMERICAN JOBS CREATION ACT OF 2004: LAW, EXPLANATION AND ANALYSIS (CCH) 375 (2004) (commenting that S. 1637, the Senate version, would have repealed section 754 to make basis adjustments mandatory but conference committee relented because of real estate and other lobbying); STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 26 (Joint Comm. Print 2005) (suggesting that both Castle Harbour and ACM Partnership structures satisfy present value criterion).
structural coherence that provisions be construed, to the extent possible, as part of a coherent whole. Even with these changes, however, savvy practitioners applying literalist interpretations would seek (and inevitably find) new avoidance mechanisms, including loopholes created by the new rules themselves.

Cycles of after-the-fact statutory enactments to end abuses therefore present problems that suggest it may be more worthwhile to develop solutions that directly affect practitioner norms. While some of the proposed or enacted partnership rules may be meritorious, statutory responses to each new abuse generally require extensive resources through a lengthy drafting and promulgation period, limit the usefulness of the partnership form for the entrepreneurial joint ventures that the rules were intended to benefit, and add complexity that may foster other rule-arbitrage abuses. Similar problems arise with elaboration of more detailed anti-abuse corporate rules (e.g., the 2004 Jobs Act prohibition against importation of aggregate losses). If the change is too limited, avoidance behavior simply shifts to the remaining gap. Such changes may actually reward — with new clients and enhanced “tax whiz” reputations — the most aggressive advisors who respond rapidly with nominal revisions to existing planning techniques or who devise creative methods of avoiding tax using the new rules. Former Treasury Deputy Secretary Stuart Eizenstat described the use of statutory revision to eliminate old shelters only to have a crop of new ones arise in their place as similar to “the mythical Hydra, except recast in the context of modern corporate finance.”

Nor is it clear that codification of broadly worded anti-abuse rules can effectively counter these abuses, both because of the sheer difficulty in passing such legislation in the face of intense lobbying and because of the likelihood that codification would result in an under-inclusive test. For example, Congress has considered codification of the economic substance doctrine for a decade, including in the Senate versions of the 2004 Jobs Act and the 2005 highway bill. Failure of

---

67 See 2004 Jobs Act § 836 (adding section 362(e) limitation on transfers of built-in-losses); I.R.C. § 362(e); see also infra note 72.
passage may rest in part with lobbyists and those in Congress who support literalist interpretations and do not want to endorse the various substance-over-form judicial doctrines.⁷¹ Others, however, have argued against codification because of the fear that a statutory anti-abuse rule would be prone to the same problem that plagues most Code provisions — it would be interpreted literally, without regard to its purpose, by practitioners and conservative courts. As a result, its scope would be too narrow so that it would not apply in situations for which some version of the economic substance judicial doctrine might have otherwise been considered appropriately applied, and it would not limit abuse.⁷² The better solution may be to encourage continued court development of the doctrine with supportive congressional statements at each opportunity. Courts have broader scope, in particular cases, to extend the common law as needed — uncertainty about application weighs more heavily in the cost-benefit analysis than would a narrowed, codified doctrine that was seldom applied and thus may more effectively influence taxpayer norms.⁷³


⁷¹ See, e.g., Debates Continue as Hearing on ‘Corporate Tax Shelter Problem’ Concludes, TAX ANALYST’S DAILY HIGHLIGHTS & DOCUMENTS, Mar. 10, 2000, at 3664, 3666 (noting Congressman Roth’s concern that codification proposals changed relevant standards); Ryan J. Donmoyer, Archer Tells Administration No on Shelters and Be Careful with FSCs, 86 TAX NOTES 1815 (Mar. 27, 2000) (reporting Congressman Archer’s objections to shelter proposals and Congressman Doggett’s view that Congress’s failure to act on codification reflected lack of desire to curb shelters); John D. McKinnon & John Harwood, Tax Shelters Come Under Fire, WALL ST. J., June 6, 2003, at A4 (noting that shelter measures were dropped because of heavy lobbying and complaints from conservatives that it amounted to a tax increase).

⁷² See Steven A. Bank, Codifying Judicial Doctrines: No Cure for Rules But More Rules?, 54 SMU L. REV. 37, 41 (2001) (suggesting that codification will lead practitioners to expect strict adherence circumventing purpose); Lawrence Zelenak, Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters, 54 SMU L. REV. 177, 185–86 (2001) (arguing that codification may initially lead to more judicial enforcement, but ultimately will provide another tool for tax avoidance planning).

⁷³ See, e.g., CASS R. SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE 38–41 (1997) (discussing benefits of norms that support less risk-taking). The growing recalcitrance of courts to apply the judicial doctrines may moot this point. In two recent cases using the contingent liability shelter, Black & Decker Corp. v. United States, 340 F. Supp. 2d 621 (D. Md. 2004), and Coltec Indus., Inc. v. United States, 62 Fed. Cl. 716 (Fed. Cl. 2004), trial judges refused to apply the economic substance
The focus on norms suggests that there is much at stake. If we can influence norm development, we may be able to shift the tax practice norm from literalist distortion of statutory purpose towards more public-regarding behavior. Two factors may be especially noteworthy here — enhanced enforcement (aided by elimination of some privilege claims) and heightened standards. Although enforcement might theoretically discourage positive compliance tax norms, in practice it appears to support their development and maintenance. Accordingly, the audit lottery resulting from under-enforcement simultaneously reinforces the tax minimization norm and discourages compliance. Similarly, low statutory and ethical standards for tax reporting may suggest lack of concern about tax cheating and encourage the tax minimization norm, suggesting that adoption of appropriate tax standards and privileges may nurture greater compliance. Part B considers current Service enforcement efforts, and Part C explores the relevant statutory and ethical standards.

B. Enforcement and the Audit Lottery

The current enforcement push began with the attention on corporate tax shelters in the 1990s. Treasury and Congress saw noncompliance as lowering corporate tax revenues and increasing the gap between financial statement and taxable income profit reports.
Survey data also suggested cheating had become generally more acceptable between 1999 and 2001, although the 2004 survey data suggest a fairly stable attitude towards tax cheating over the last five years. The 1998 Service restructuring likely exacerbated compliance problems by reallocating resources from enforcement to service, switching the burden of proof to the Service in some contexts, and imposing restrictions on Service personnel that dampened enforcement enthusiasm. The most recent estimate of the overall tax gap, based on 2001 information, puts the excess of taxes due over taxes reported and paid between $310-$353 billion.

Taxpayers (and tax advisors) willing to take aggressive tax positions likely engage in Kaldor-Hicks cost-benefit analysis in deciding what level of avoidance to adopt in their returns. The economic model suggests that efficient breach of tax rules (except for outright fraud that might incur criminal sanctions) is acceptable:

77 See, e.g., Camilla E. Watson, Legislating Morality: The Duty to the Tax System Reconsidered, 51 Kan. L. Rev. 1197, 1219 (2003) (indicating an increase from 13% to 24%); As Audits Decline, Fewer Taxpayers Balk at a Bit of Cheating, N.Y. Times, Jan. 19, 2002, at A11 (describing drop from 87% in 1999 to 76% in 2001 in those who considered cheating “not at all” acceptable, with 3% margin of error).

78 IRS Oversight Board, 2004 Taxpayer Attitude Survey 5 (2005), http://www.treas.gov/irsob/documents/release040405.pdf (86% of respondents said cheating was “not at all” acceptable in 2004).


"taxpayers are neither honest nor dishonest, but merely rational calculators of what is in their best interest." The externality of lower tax revenues is "distributed diffusely among the public at large." Tax departments operate as profit centers, corporate managers focus almost exclusively on the bottom line, and all is helped along by the exploding use of financial derivatives that permit firms to embed avoidance techniques in purported business transactions. The result is substantial corporate underreporting (estimated at 17.4%) and noncompliance with the early form of shelter registration rules: playing the audit lottery permits corporate managers or shareholders to garner windfalls at the cost of other taxpayers or government program beneficiaries.

This economic compliance model is at odds with compliance expectations that should result from an understanding of the role of structural coherence in maintaining the tax system's integrity. It discards other-regarding attitudes as either irrelevant externalities to rational choices or, in the bounded rationality approach, as factors that can be described (though not well predicted) through modeling of heuristics and biases.

Even though this economic analysis does not adequately describe all taxpayer behavior, it suggests that structural coherence and compliance require external reinforcement to raise the visibility and costs of nonconforming behavior sufficiently to impact risk assessment. Government studies continue to point out the need for

---

83 Slemrod, supra note 1, at 882.
85 See Beale, SEC Heat, supra note 6, at 229, 242–43 (referencing studies on increasing derivatives use and pressure on tax professionals to add to corporate profitability); Slemrod, supra note 1, at 893 (suggesting that windfall gains from avoidance primarily benefit shareholders and tax managers).
86 See SENATE REPORT, supra note 9, at 60 (excerpting KPMG materials discussing low cost of registration noncompliance and not providing the Service a "road map" to aggressive transactions); Slemrod, supra note 1, at 879, 893–94; Mihir A. Desai & Dhammika Dharmapala, Corporate Tax Avoidance and Firm Value 21 (2005), available at http://ssrn.com/abstract=689562 (concluding that "tax avoidance and managerial efforts to divert value from shareholders are intertwined").
increased enforcement as a concomitant to increased sanctions. Yet the rise of literalism and the economic interpretation of legal obligations have come at a time when enforcement resources have been severely cut or diverted to taxpayer support. Even with recent increases in enforcement budgets, the Service has fewer auditors than necessary and subjects significantly fewer returns to full audits than it did in the late 1980s. Auditors are disadvantaged because of their lack of time to study returns or particular transactions, and they

---

88 See, e.g., Senate Report, supra note 9, at 7–9 (recommending increased Service enforcement of compliance rules).

89 See, e.g., David Cay Johnston, I.R.S. to Close Walk-In Centers as Agency Faces Tighter Budget, N.Y. Times, Apr. 10, 2005, at A20 (noting 1998 cuts in enforcement to fund services, current plans to cut $57 million, and problems caused by lack of funding for auditors and tax collectors). Since 1988, the number of returns filed has increased 26% and the number of permanent Service staff has fallen 31%. Transactional Records Access Clearinghouse, IRS Staff Has Declined While Returns Have Increased, http://trac.syr.edu/tracirs/highlights/current/irsStaffG.html; see also Mortimer M. Caplin, The Tax Lawyer's Role in the Way the American Tax System Works, 24 Va. Tax Rev. 969 (2005) (noting harmful effect of shift to customer service).


91 See, e.g., Tax Compliance, supra note 80, at 13–14 (noting concurrent decline in enforcement resources and increased workload resulted in decline in complex field audits and coverage that is "considerably lower than it was just a few years ago"); Slemrod, supra note 1, at 881 (noting that small corporation audits fell from 7.92% to 1.55% between 1997 and 2003 and Coordinated Industry Case Program large corporate audits were significantly reduced in quality). In 1978, audit coverage exceeded 2% of all returns. 1980 I.R.S. Ann. Rep. 68–69. In 1999, the overall audit rate dropped to a low of 0.5%. IRS Statistics of Income Tax Stats, Enforcing Laws, Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, Fiscal Year 2000, http://www.irs.gov/taxstats/compliancestats/index.html. Audit rates have increased slightly since that time, but with increasing use of correspondence audits and fewer face-to-face audits. Id. See Transactional Records Access Clearinghouse, Audits of Corporations, http://trac.syr.edu/tracirs/trends/v10/corporationsG.html (showing that the audit rate for all corporations has declined, and that large corporations providing investment advice are less audited than other corporations, with only one in five audited in fiscal years 2003-2004); Transactional Records Access Clearinghouse, Audits of Individual Income Tax Returns, http://trac.syr.edu/tracirs/trends/v10/individualG.html (showing that face-to-face audits of individual returns have declined).
are outgunned by high-profile client representatives with deep pockets to support research.

Taxpayers are often aware of resource limitations and may even query advisors about audit risks. They may take aggressive tax positions, but without adequate disclosure, in hopes that their returns will not be audited. This version of the audit lottery is successful for large numbers of taxpayers solely because of the low audit statistics. Since many large corporations are subject to continuous audits, they cannot avoid audits altogether. Winning the audit lottery for them means having their most defensible positions on the audit agenda and having their more aggressive positions examined cursorily or not at all.

The audit lottery is facilitated by ethical rules that some read to encourage attorneys to initiate advice about audit lottery advantages or at the least to respond fully to clients' questions. Under the ABA Model Rules, an advisor "may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation." In this context,

---

92 Respected attorney George Cooper envisioned a conversation contrasting a professional approach to a cost-based approach.

It has to be a long shot to put any reliance on the expectation that you can get away with a manipulation having these implications. That means... that the probability of nondiscovery is critical to your recommendation. There is nothing new or clever in seeing that playing this so-called audit lottery is a winning game for the taxpayer.


93 See Transactional Records Access Clearinghouse, *Audit Rate for Large Corporations Varies Markedly by Industry*, http://trac.syr.edu/tracirs/trends/v10/audindustryG.html (indicating large mining and manufacturing corporations are essentially subject to a 100% audit rate, but noting substantially lower audit rates for large financial institutions).


95 See, e.g., Joel S. Newman, *The Audit Lottery: Don't Ask, Don't Tell?*, 86 TAX NOTES 1438 (Mar. 6, 2000) (arguing that it is appropriate to advise clients about audit lottery).

practical considerations may be more important than narrow legal advice. The obligation to report positions carries practical economic implications: the Service is more likely to challenge a noted aggressive position than a routine one. Is it therefore appropriate for lawyers to explain that the audit lottery favors a client's ability to "get away with" an aggressive transaction without having to litigate or concede it at audit? ABA discussions in connection with the development of the Model Rules support this view.

The right to have legal advice extends to persons who have bad motives and purposes as well as those who have good ones. As adviser, a lawyer is required to give an honest opinion about the actual consequences that appear likely to result from a client's conduct and not an opinion reflecting what society might wish would be the consequences.97

The combination of limited enforcement resources, few audits in less time under weaker investigatory circumstances, and an ethical rule that supports advisors' alerting clients to audit lottery practicalities forces the conclusion that even enhanced disclosure requirements and stiffer penalties may not be sufficient to overcome an aggressive taxpayer's audit lottery advantage. Part C suggests that these problems are exacerbated by standards that govern taxpayers' return positions and tax advisors' planning advice and evidentiary privileges that affirmatively limit disclosure.

C. Practice Standards

Lack of disclosure is key to taxpayers' ability to exploit the audit lottery. The primary means of affecting compliance in this era of low enforcement resources and an "economically rational 'audit lottery' discount"98 has been to combat directly the lack of transparency that is structured into complex avoidance transactions.

97 Model Rules of Prof'L Conduct R. 2.3 cmt. (Discussion Draft 1980) (emphasis added).
1. Statutory Standards

In the 1980s, Congress adopted shelter registration requirements, but the penalties were insubstantial and compliance was spotty.\(^99\) In 1997, Congress and Treasury began the current effort to discourage abusive shelters through enhanced sanctions and disclosure, starting with the expansion of registration to cover promoted confidential transactions that had a significant purpose of tax avoidance.\(^100\) President Clinton's FY2000 budget included anti-shelter provisions, and Treasury issued proposed and temporary regulations, finalized in 2003, that identified six categories of so-called “reportable transactions” viewed as having a potential for tax avoidance (including “listed transactions” identified as abusive by the Service and transactions subject to confidentiality agreements).\(^102\)

\(^99\) Former section 6111 required organizers to register shelters, originally defined to cover then-current investment shelters. See I.R.C. §§ 6111(d) (1997) (applying to significant purpose transactions offered under confidential terms in which promoter earned fees in excess of $100,000), 6111(c) (1984) (applying to certain investments with a high ratio of deductions and credits to base investment). Former section 6112 required shelter promoters to maintain lists of investors. See I.R.C. § 6112 (1984) (repealed by the 2004 Jobs Act) (applying generally to registration-required shelters and to other arrangements determined under regulations to have potential for tax avoidance). Penalty provisions were insubstantial. I.R.C. § 6700 (as enacted in 1982 and amended in 1984 and 1989) (generally imposing a $1,000 promoter penalty). In 2004, the promoter penalty was significantly increased. See infra note 104 and accompanying text. The aiding and abetting penalty remains insubstantial. I.R.C. § 6701 (as enacted in 1982 and amended in 1989) (generally imposing a $1,000 penalty, or $10,000 for corporate taxpayers, for aiding and abetting).


\(^102\) See T.D. 9017, 2002-2 C.B. 815 (disclosure requirements); T.D. 9018, 2002-2 C.B. 823 (list maintenance requirements applicable to “material advisors”); T.D. 9046, 2003-1 C.B. 614 (finalizing regulations); I.R.S. Ann. 2000-1, 2000-1 C.B. 294 (announcing release). Included in the reportable transactions are: listed transactions identified by the Treasury and certain confidentially marketed, contractually-protected-fee, loss, divergent book-tax, and tax credit transactions. Once the confidentiality factor became a trigger for disclosure (for transactions with adviser fees of $250,000 or more, in the aggregate), aggressive tax planners likely began doing
Although the reportable transaction regulations were intended to change the cost-benefit analysis by making misreporting riskier, the lack of penalties rendered them ineffective.\(^{103}\) Expansion of abusive planning from corporations to wealthy individuals finally led Congress to act. The 2004 Jobs Act codified the reportable transaction rules, with some changes, and created new penalty categories for taxpayers and “material advisors.”\(^{104}\) These changes increased the likelihood of discovery of abusive transactions and of taxpayer or advisor penalties.\(^{105}\) Codification also demonstrated the importance that Congress places on strengthening the transparency regime to reduce detection avoidance, even though the final changes did not reach nonshelter transactions, as proposed by the Senate.\(^{106}\)

similar transactions with transaction documents that disclaimed any confidentiality requirement so that they could “remain confidential in fact.” Rizzi, supra note 98, at 23; see Beale, SEC Heat, supra note 6, at 251–54 (discussing regulations).

\(^{103}\) See, e.g., Burgess J.W. Raby & William L. Raby, Jobs Act Penalty Provisions and Tax Practitioners, 105 Tax Notes 675, 675 (Nov. 1, 2004) (indicating that “the absence of meaningful penalties . . . meant that practitioners tended to assume their clients were not participating in abusive tax shelter transactions and ignored the whole subject”).

\(^{104}\) 2004 Jobs Act §§ 812, 815–16, 819; I.R.C. §§ 6111–12, 6662, 6662A, 6664, 6707 (2004). The former registration and list rules were replaced with rules requiring material advisors to report reportable transactions and maintain lists of investors. See I.R.C. §§ 6111 (material advisor reporting requirement, defining material advisor as persons who advise or assist in planning or implementing reportable transactions for fees of at least $50,000 for individuals or $250,000 if advising an entity), 6112 (material advisor list maintenance requirement). Existing penalties were increased and new penalties added for material advisor reporting and list maintenance requirements and for taxpayer reportable transaction reporting requirements. See I.R.C. §§ 6662A (new taxpayer 20% understatement penalty for reportable transactions with significant tax avoidance purposes, increased to 30% if not disclosed), 6700 (organizer penalty for a false statement increased from $1,000 to 50% of the gross income derived from the activity), 6707 (new penalty replacing $500 penalty for failure to register with penalty for failure to report reportable transactions of $50,000 or $200,000 for listed transactions), 6707A (new taxpayer penalty for failure to report a reportable transaction, ranging from $10,000 to $200,000), 6708 (new penalty replacing $50 penalty for failure to maintain lists under § 6112 with $10,000 a day penalty for failure to turn over information after twenty days, without reasonable cause).


\(^{106}\) The Senate version would also have replaced the general “realistic possibility of success” undisclosed position standard for return preparers, I.R.C. § 6694(a), with a “more likely than not” standard, and would have replaced the “not frivolous” disclosed position standard for preparers, I.R.C. § 6694(a)(3), with a “reasonable
The 2004 Jobs Act also stiffened reporting requirements for most transactions that have a significant tax avoidance purpose (significant purpose transactions or SPTs). Prior to the Act, a noncorporate taxpayer's substantial underpayment penalty for an SPT would be reduced if the taxpayer had substantial authority and the taxpayer reasonably believed that the position was more likely than not correct (without, under regulations, taking the audit lottery into account). That reduction was not available to corporate taxpayers, but both corporate and noncorporate taxpayers could affirmatively defend against the penalty if they could establish reasonable cause and good faith, which often meant reliance on a favorable practitioner opinion.

After the 2004 Jobs Act, the new substantial understatement penalty with respect to reportable transactions that are listed or SPTs can be avoided (for corporations or individuals) only if the taxpayer satisfies a more stringent affirmative defense requirement, summarized as follows:

1. the position must be adequately disclosed;\(^\text{107}\)
2. the position must be based on substantial authority;\(^\text{108}\)
3. the taxpayer must reasonably believe that the position is more likely than not (MLTN) correct;\(^\text{109}\)
4. to be reasonable, the taxpayer's belief must be based on the facts and law at the time the return is filed and must not take the audit lottery or settlement potential into account;\(^\text{110}\)
5. if the taxpayer relies on a tax advisor's opinion, it must not
be based on unreasonable assumptions, fail to discuss relevant facts or unreasonably rely on taxpayer or third party representations (the "disqualified tax opinion" rule); and

6. advisors and all members of their firms on whose opinion a taxpayer relies for penalty protection purposes must be divorced from the structuring and implementation of the transaction or arrangement that is the subject of the opinion (the "disqualified tax advisor" rule).

As a result, a taxpayer who wishes to have a tax expert develop a structure and deal with each potential tax issue as it arises can rely on that tax advisor's opinion only in the sense that the advisor's expertise and views as to probability of success provide some assurance that the position is sustainable. If the taxpayer desires something more substantial — i.e., an opinion that may deflect penalties by establishing substantial authority for a position that is MLTN correct, the taxpayer must engage a second tax advisor from another firm who cannot materially modify the transaction. This creates a dilemma that should discourage abusive transactions, in that the cost of engaging in an avoidance transaction is significantly increased if the taxpayer wishes to have a penalty protection opinion, yet the second advisor may not be able to provide a satisfactory penalty protection opinion because of flaws in the structure unnoticed by the first advisor.

These restrictions may help deter the cloned shelters that accounting and law firms promoted during the 1990s. If a taxpayer engages an independent advisor who is able to give an opinion that satisfies the 2004 Jobs Act standards, then it is likely that the transaction has more merit than expected. On the other hand, a

116 See, e.g., Beller, supra note 105, at 489 (noting that having second advisor who could not suggest structure modifications "would represent a sea change in the way that tax practitioners traditionally operate in connection with the rendering of tax opinions").
117 The statement in the text assumes, of course, that there is no pattern of reciprocity or explicit collusion among groups of tax advisors in such situations. In other words, if tax advisor A were to structure a transaction and tax advisor B were to provide an opinion supporting the availability of the desired tax benefits from the transaction, the value of B's opinion may be undermined by a pattern of reciprocity between A and B whereby B generally affirms the benefits for transactions structured by A and A generally affirms the benefits for transactions structured by B. In the
cloned opinion produced by a promoter who structures a reportable SPT is worthless as penalty protection. Furthermore, cloning and marketing activities subject to the material advisor reporting rules are more likely to be reported because of the substantial penalties for failure to report. Combined with the enhanced penalties for improper reporting, this limitation on the use of opinions from those who help to structure transactions changes the cost-benefit balance in favor of more conservative reporting.

The disqualified tax advisor rule could be understood to categorize an opinion from a tax advisor who participates in the planning and implementation of a transaction more as business advice than as legal advice. That clearly fits the marketed opinions in the Merrill Lynch shelters. These opinions were a commodity offered for sale to buyers whose tax situations (e.g., unrelated capital gains) predisposed them to accept the sales pitch and enter into the marketed transaction structure. The rule may also apply to customized planning under the new “profit center” model of tax departments, where advisors design solutions to tax problems that fit the business context.

The new restrictions, however, may have less impact (other than cost and attorney disgruntlement) on customized tax planning involving reportable SPTs. In customized transactions, tax advisors work alongside bankers, bankruptcy experts, and corporate advisors to shape and fine-tune a proposed transaction until each different legal regime’s requirements are satisfied. Tax advisors provide suggestions about business purpose, enhancing economic substance, and additional document provisions to comply with regulations — even though the deal cash flows may not realistically be expected to trigger the application of the provisions, as in the Castle Harbour

corporate scandals that came to light beginning with Enron, there is evidence of such reciprocal support among both accounting firms and law firms.

118 See I.R.C. §§ 6707 (advisor failure to furnish information on reportable transactions subject to a minimum $50,000 fine, increased for listed transactions to as much as $200,000), 6707A (taxpayer failure to report a reportable transaction subject to a minimum $10,000 fine for individuals and $50,000 fine for entities, increased for listed transactions to $100,000 and $200,000, respectively).

119 See, e.g., Richard M. Lipton, Reliance on Tax Opinions: The World Changes Due to Long Term Capital Holdings and the AJCA, 101 J. TAX’N 344, 344 (2004) (suggesting that 2004 Jobs Act rules and Long Term Capital Holdings decision discounting respected firms’ opinions “change all of the operating assumptions that most taxpayers (and their advisors) have relied on for many years in assessing whether the IRS is likely to impose penalties”).
Taxpayers purchase the basic idea for dealing with a tax problem (exhaustion of depreciation allowances, in the case of the Castle Harbour deal) and the planning assistance to see the idea through, rather than a penalty-protection opinion. Accordingly, further changes will be necessary to ensure a more balanced tax minimization norm.

2. Circular 230

A separate set of standards, commonly referred to as Circular 230, governs practice before the Service. Final regulations in 1994 adopted the "realistic possibility" litigation-based standard for signing return preparers, but did not otherwise change requirements for shelter advice. Treasury proposed various amendments in 2001, including new opinion standards for shelter opinions, but finalized the regulations in 2002 without those requirements. Modifications

---

120 See supra note 14 and accompanying text.

121 James M. Peaslee, Circular 230: Make Room for Informal Written Advice, 106 TAX NOTES 1457, 1459 (Mar. 21, 2005) (noting that taxpayers "want their advisers to serve as a filter, to tell them where the real risks are and how they can be addressed (including how a transaction could be planned or changed to minimize risks)").

122 31 C.F.R. pt. 10 (2005) [hereinafter Circular 230]. Circular 230 defines "practice before the Internal Revenue Service" broadly to include "all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees." 31 C.F.R. § 10.2(d). Although there may be a technical argument that some tax opinions would not be covered because Circular 230 does not explicitly include tax advice to taxpayers, James P. Holden, Dealing with the Aggressive Corporate Tax Shelter Problem, 82 TAX NOTES 707, 710-11 (Feb. 1, 1999), or because an attorney has not actually filed a power of attorney to practice before the Service, Arthur L. Bailey & Alexis A. MacIvor, New Circular 230 Regulations Impose Strict Standards for Tax Practitioners, 57 TAX EXECUTIVE 28 (2005), advisors will likely conform because of the potential relevance of any opinion to a tax controversy.

123 T.D. 8545, 1994-2 C.B. 415. Signing return preparers may generally recommend positions that do not have a realistic possibility of being sustained on the merits only if the position is adequately disclosed. I.R.C. § 6694(a). A nonsigning preparer may recommend a position that is merely nonfrivolous, even if it is not disclosed on the taxpayer's return, so long as the preparer advises the taxpayer that the position lacks substantial authority and adequate disclosure could avoid a penalty. Treas. Reg. § 1.6694-2(c)(3)(ii)(A). Tax shelter opinion rules were added to Circular 230 in 1984 but targeted the earlier shelters of the 1970s and 1980s. See Lipton & Dixon, supra note 47, at 137 (noting that 1984 shelter provisions were "aimed at transactions that no longer exist"); supra notes 60-61 and accompanying text.


were again proposed in December 2003\textsuperscript{126} and finalized with changes in December 2004.\textsuperscript{127} Further changes, providing additional exceptions, were promulgated in mid-2005 in response to commentary from practitioners that the regulations as finalized would have unintended consequences for ordinary opinion practice.\textsuperscript{128}

The new Circular 230 opinion standards are quite detailed, though the basic opinion practices underlying the changes (e.g., thorough consideration of law and facts, rejection of unrealistic assumptions) are not substantially different from that which has traditionally been considered good lawyering. The amendments include a section of aspirational best practices\textsuperscript{129} and two new sets of rules governing written tax opinions: those for covered opinions\textsuperscript{130} and those for other written opinions (referred to here as noncovered opinions).\textsuperscript{131} Opinions that would otherwise be treated as covered opinions in some cases may be converted to noncovered opinions with disclaimers.\textsuperscript{132} The rules are intended to "target . . . written advice that present[s] a significant cause for concern and avoid undue interference with the practitioner-client relationship."\textsuperscript{133} They require grounding opinions in the actual factual situation of the client rather than relying on assumptions about the applicable facts. An advisor is expected to verify that a client is engaging in a business transaction by asking for, and evaluating the weight of, the client's actual business purpose for entering into a transaction.

\textsuperscript{126} Prop. Treas. Reg. 31 C.F.R. pt. 10, 68 Fed. Reg. 75,186 (Dec. 30, 2003) (proposing best practices and opinion standards applicable to any written advice concerning tax shelter items, where tax shelters are defined as any arrangement with a significant purpose of tax avoidance).

\textsuperscript{127} T.D. 9165, 2005-4 I.R.B. 357 (including aspirational best practices and standards for covered opinions and all other written opinions not specifically exempted).

\textsuperscript{128} T.D. 9201, 2005-23 I.R.B. 1153.

\textsuperscript{129} 31 C.F.R. § 10.33 (2005) (aspirational standards caution tax practitioners to avoid unreasonable factual or legal assumptions or unreasonable reliance on representations or statements from a taxpayer or third party and not to base conclusion as to possibility of success on probability of being audited, of position being discovered on audit or of settlement).

\textsuperscript{130} 31 C.F.R. § 10.35.

\textsuperscript{131} 31 C.F.R. § 10.37.

\textsuperscript{132} Disclaimers must be in a separate section and in at least the same type size as the discussion sections so that they are "readily apparent" under the applicable facts and circumstances, including taxpayer sophistication and opinion length. 31 C.F.R. § 10.35(b)(8).

The covered opinion standards apply to listed transactions, transactions for which the principal purpose is tax avoidance, and certain SPTs. A transaction will not be treated as having a principal purpose of tax avoidance if the tax benefits are claimed consistently with the statute and congressional purpose, what practitioners sometimes call the “slam dunk” case of conforming to congressional intent. Opinions in respect of listed and principal purpose transactions are per se covered opinions. SPT opinions will be covered opinions if they are marketed, reliance, contractually protected or confidential opinions.

A marketed opinion is one that is expected to be used by someone other than the practitioner (or practitioner’s firm) to promote, market or recommend an arrangement. Marketed opinions without a “no-reliance” disclaimer are covered opinions and cannot be provided unless they reach a MLTN confidence level as to the overall conclusion and as to each significant tax issue. Marketed opinions with a no-reliance disclaimer cannot provide penalty protection for taxpayers.

Reliance opinions are also covered opinions: they provide an opinion at the MLTN confidence level as to at least one significant federal tax issue and do not provide penalty protection as to issues that do not reach the MLTN level. SPT opinions that would otherwise be reliance opinions because they reach a MLTN confidence level can satisfy the less strict standards for noncovered opinions only if they carry a disclaimer indicating that they cannot be relied upon for penalty protection.

---

134 31 C.F.R. § 10.35(b)(2)(i).
135 A principal purpose of tax avoidance is defined, as in regulations under section 6664, as one for which the tax avoidance purpose exceeds any other purpose, excluding transactions for which benefits are “consistent with the statute and Congressional purpose.” 31 C.F.R. § 10.35(b)(10); see also Treas. Reg. § 1.6662-4(g)(2)(i)–(ii).
136 31 C.F.R. § 10.35(b)(2)(i)(C).
137 31 C.F.R. § 10.35(b)(5)(i).
138 31 C.F.R. § 10.35(b)(5) (disclaimer requirements for noncovered marketed opinion), (c)(3)(iv) (requiring MLTN conclusion for each significant tax issue), (c)(4)(ii) (requiring overall MLTN conclusion), (e)(2) (requiring disclosure that marketed opinion was written to promote transaction and that taxpayer should consult independent advisor).
139 31 C.F.R. § 10.35(b)(4)(i) (definition of reliance opinion), (e)(4) (prohibiting reliance on covered opinions for significant federal tax issues at less than MLTN confidence level).
140 31 C.F.R. § 10.35(b)(4)(ii).
The remaining categories of covered SPT opinions — opinions subject to conditions of confidentiality or subject to contractual protection — are relatively straightforward. They are defined similarly to those categories under the reportable transaction regulations and are per se covered opinions.\textsuperscript{141}

If any covered opinion does not reach a MLTN conclusion in respect of any significant tax issue, that fact must be disclosed prominently and the opinion will not provide penalty protection for that issue.\textsuperscript{142} All covered opinions must reach an overall conclusion or explain why no overall conclusion can be reached.\textsuperscript{143}

Under Circular 230, SPT opinions that are not marketed opinions, do not reach a MLTN confidence level, and are not issued for listed, principal purpose, confidential or contractually-protected-fee transactions are noncovered opinions subject to less stringent standards. Thus, advice opining that there is substantial authority for a taxpayer's position, but at a confidence level less than MLTN and without the no-reliance disclaimer, would be permitted under the Circular 230 noncovered opinion rules in respect of some SPTs. Such an opinion would nonetheless fail to provide penalty protection against the reportable transaction understatement penalty if the SPT were a \textit{reportable} transaction, because the section 6664(d) reasonable cause defense for reportable SPTs requires a MLTN level of confidence.\textsuperscript{144} Furthermore, even though the 2004 Jobs Act

\textsuperscript{141} 31 C.F.R. § 10.35(b)(6) (defining conditions of confidentiality to cover limitations on disclosure of tax strategies), (b)(7) (defining contractual protection as right to refund of advisor fees if intended tax consequences are not sustained or as fee arrangement contingent on realization of tax benefits).

\textsuperscript{142} 31 C.F.R. § 10.35(c)(3)(ii), (e)(4).

\textsuperscript{143} 31 C.F.R. § 10.35(c)(4).

\textsuperscript{144} I.R.C. § 6664(d)(2)(C). This anomaly results from a lack of symmetry between Circular 230 categories, reportable transaction penalties and defenses codified in the 2004 Jobs Act and the former definition of tax shelters as SPTs in the section 6662 understatement penalty provision and in the section 6664 affirmative defense. Prior to the 2004 amendments, a taxpayer would need to show both substantial authority and a MLTN confidence level to eliminate the ordinary understatement penalty in respect of an SPT. See I.R.C. §§ 6662(d)(1)(C) (2003) (requiring noncorporate taxpayers to show substantial authority and MLTN to "reduce" penalty in respect of a tax shelter item), 6664(d) (requiring corporate taxpayers to show substantial authority and MLTN to affirmatively defend against penalty in respect of a tax shelter item); Treas. Reg. § 1.6664-4(f)(2) (same). After the 2004 Jobs Act, SPTs that are not reportable are penalizable under section 6662 and not under the new section 6662A with its stiffer affirmative defense. I.R.C. § 6662A (as added in 2004) (new penalty for \textit{reportable} SPTs); I.R.C. § 6664(d) (as amended in 2004) (affirmative defense for \textit{reportable} SPTs). Although substantial
amendments do not raise standards under section 6694 for practitioners who advise in respect of tax return positions (i.e., the realistic possibility standard still applies), practitioners will nonetheless need to provide MLTN assessments to avoid violating Circular 230 whenever a written opinion is provided for penalty protection purposes as to a significant federal tax issue in a transaction that requires a covered opinion. 145

There is a significant exception, however, that diminishes the covered opinion requirement. Reliance opinions and opinions for transactions with confidentiality requirements or contractual fee protection may be offered as "limited scope" opinions. This subcategory of covered opinions permits advisors to address selected issues and assume factual and legal issues that are important to the


145 31 C.F.R. § 10.37(e)(4).
transaction, with appropriate disclosure.\textsuperscript{146}

Several other types of advice are also excepted, including preliminary opinions.\textsuperscript{147} A lawyer who provides only oral advice on structuring and reporting a transaction need not satisfy the covered opinion requirements. Negative advice and advice from in-house counsel are excepted from the covered opinion requirements.\textsuperscript{148} Perhaps most significantly, post-return advice is not a covered opinion, unless the attorney has reason to know that the taxpayer will rely on the opinion in taking a return position after the opinion's date.\textsuperscript{149}

In summary, the statutory and regulatory changes now set stringent requirements for the reasonable cause affirmative defense for reportable SPTs.\textsuperscript{150} The defense will only be available if there is adequate disclosure, substantial authority, and a reasonable belief that the position is MLTN correct. That belief cannot be based on the advice of a tax advisor who served as a material advisor in the development or marketing of the structure. If a written opinion is

\textsuperscript{146} See 31 C.F.R. § 10.35(c)(3)(v) (permitting limited scope opinions), (e)(3) (requiring disclaimers noting limited scope, possibility of additional issues, and inability to rely on opinion for issues not within its scope).

\textsuperscript{147} 31 C.F.R. § 10.35(b)(2)(ii)(A).

\textsuperscript{148} 31 C.F.R. § 10.35(b)(2)(ii)(D)-(E); see supra note 144 (discussing negative advice).

\textsuperscript{149} 31 C.F.R. § 10.35(b)(2)(ii)(C).

\textsuperscript{150} There is a peculiar gap between Circular 230 and the Code. See supra note 144 and accompanying text. After amendment, the ordinary understatement penalty is a strict liability penalty that is not subject to reduction for tax shelters, defined as SPTs. I.R.C. § 6662(d)(2)(C). The tax shelter understatement penalty and the tax shelter affirmative defense apply only to listed transactions and to reportable transactions that are SPTs. I.R.C. §§ 6662A (penalty), 6664(d) (affirmative defense). Circular 230 applies to listed, principal purpose and significant purpose transactions. Listed transactions are always reportable, but the latter two categories may or may not also be reportable transactions under the regulations. Treas. Reg. § 1.6011-4(b) (2005). SPTs that are not reportable could therefore be subject to the Circular 230 covered opinion rules, be subject to penalty under section 6662 rather than section 6662A, not be eligible for reduction under the section 6662 substantial authority standard because they are SPTs, yet still be eligible for the ordinary section 6664(c) affirmative defense (reasonable cause/good faith belief) without the 2004 Jobs Act additional requirements. An opinion for such a transaction could therefore fail to reach the MLTN level (unless the former tax shelter regulation is still considered validly applied to such transactions) and not satisfy the disqualified advisor rules yet still provide penalty protection. This anomaly results from the Code's use of the reportable transaction categories to limit the reach of the former section 6662 tax shelter definition, and adds both complexity and potential for avoidance transactions to slip through the cracks.
relied upon, it cannot make unreasonable factual representations or assumptions and, assuming that the advisor practices before the Service, it must also satisfy more stringent Circular 230 opinion requirements.\footnote{151}

Commentators have objected to the broad scope of the Circular 230 opinion requirements, suggesting that they may damage the relationship between tax lawyers and clients, complicate tax practice, and represent a radical change in applicable standards.\footnote{152} The use of significant tax avoidance to define the scope of covered transactions suggests that the Circular 230 standards could cover almost any transaction that provides a substantial tax benefit. That led at least one commentator to aver that now “[e]verything is a shelter.”\footnote{153}

\footnote{151} Concurrent changes to auditor provision of tax services for SEC reporting companies support the paradigm shift noted here. I earlier recommended that the Public Company Accounting Oversight Board (PCAOB) incorporate the Service’s reportable transaction categories to ban auditor tax services and that it require sharing of information about aggressive tax transactions with company boards and the public. Beale, SEC Heat, supra note 6, at 241, 259. The 2004 Jobs Act included a provision requiring public companies to disclose certain tax penalties in their SEC reports. 2004 Jobs Act § 811(a) (adding I.R.C. § 6707A(e)); see also Rev. Proc. 2005-51, 2005-33 I.R.B. 296 (providing guidance on penalty reporting). The PCAOB has also adopted rules restricting tax services along the lines suggested in the referenced article. PUB. CO. ACCOUNTING OVERSIGHT BD., PCAOB RELEASE NO. 2005-014, ETHICS AND INDEPENDENCE RULES CONCERNING INDEPENDENCE, TAX SERVICES, AND CONTINGENT FEES (2005), http://www.pcaobus.org/Rules/Docket_017/2005-07-26_Release_2005-014.pdf (restricting auditors of public companies from providing tax advice on listed and confidential transactions, and banning SPT advice unless auditor can reach MLTN confidence level). The Financial Accounting Standards Board has also released an exposure draft adjusting accounting for uncertain tax positions in ways that may well flag aggressive transactions for company boards and the Service. FIN. ACCOUNTING STANDARDS BD., FILE REF. NO. 1215-001, EXPOSURE DRAFT, ACCOUNTING FOR UNCERTAIN TAX POSITIONS (2005), http://www.fasb.org/draft/index.shtml.

\footnote{152} Sheryl Stratton, Circular 230 Regs “Federalize” Tax Practice, Treasury Told, TAX NOTES TODAY (Jan 14, 2005) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2005 TNT 10-2) (reporting views of Julian Kim of Latham & Watkins); see also Beller, supra note 116, at 491; Dan W. Holbrook, Imagine the Worst the U.S. Treasury Could Do to Us — They’ve Done It: Revenge of the IRS: Circular 230 Changes Law Practice, TENN. B.J., Aug. 2005, at 28, 30 (claiming rules “will drive a wedge between taxpayer[s] and professional advisor[s].” lead to “intimidation tactics” and cause clients to ask insurance salesmen for tax advice); Sheryl Stratton, Tax Officials Spar with Tax Bar over Circular 230, 107 TAX NOTES 1082, 1082-84 (May 30, 2005) (noting complaints that rules are “irrational” “impediments to practice”).

Others suggest that advisors may simply ignore the rules through "pervasive noncompliance" or drive taxpayer-clients away through the high costs of overcompliance.\(^{154}\)

The concerns about impacting client relationships seem overblown. Clients will continue to use advisors to structure ordinary business transactions tax-efficiently. To the extent that they hesitate to engage an attorney for primarily tax-motivated planning because of their concerns about the costs implied by the two-advisor requirement or the additional scrutiny and potential penalties that may apply because of the now-codified reporting requirements, that is a net social good. Abusive shelter planning and tax customization rob the fisc and push compliance rates down while creating significant fairness concerns and perpetuating distorted practice norms.

The noncompliance response, however, raises a significant enforcement concern. The Circular 230 provisions are mandatory, and practitioners in charge of a firm's tax practice may be subject to discipline for failure to ensure compliance.\(^{155}\) Opinions, however, are not routinely provided to the Service as an attachment to tax returns or at the beginning of audits. Much attorney tax advice is likely privileged and, at least in some circuits, protected under the work product doctrine.\(^{156}\) Accordingly, except in those cases when the Service is offered a tax opinion as evidence of a good faith effort to comply with the law, the Service will not be able to assess advisor compliance. Even if the Service becomes aware of a failure to comply, it may not have sufficient resources to pursue disciplinary action. The past culture of inadequate Circular 230 enforcement may continue in spite of these higher standards.\(^{157}\) Members of the bar are undoubtedly taking the new requirements seriously, but with a clear awareness of the Service's difficulty in policing the new rules absent

\(^{154}\) Lipton & Dixon, supra note 47, at 141.

\(^{155}\) 31 C.F.R. §§ 10.35(a) (2005) (stating opinion giver's compliance as mandatory), 10.36(a) (2005) (requiring practitioner in charge of firm's tax practice to "take reasonable steps to ensure that the firm has adequate procedures in effect" and subjecting to discipline under a gross incompetence standard for failing to take steps to create procedures or to take action when practitioner "knows or should know" of noncompliance).

\(^{156}\) See infra Part II.C.4.

\(^{157}\) See, e.g., Burgess J.W. Raby & William L. Raby, Confidence Levels, Circular 230, and Practitioner Penalties, 106 TAX NOTES 187, 190 (Jan. 10, 2005) (noting Service has not vigorously enforced Circular 230 in the past and suggesting that any new enforcement pattern would require a "concerted effort" in face of inadequate funding).
further changes.

3. Ethical Standards

The development of legal ethics can be summarized briefly. The American Bar Association (ABA) promulgated Canons of Professional Ethics in 1908. In 1969, the Model Code of Professional Responsibility replaced the Canons, combining aspirational statements with mandatory disciplinary rules. In 1983, the Model Rules, providing authoritative rules and explanatory comments, were adopted by the Tax Court and most states. To provide interpretive guidance, the ABA's Standing Committee on Ethics and Professional Responsibility promulgates general ethics opinions, and its Standards of Tax Practice Committee addresses issues of concern to tax practitioners. These rules, of course, do not have legal force of themselves; as a result, the ABA rules are akin to a restatement or model act. They acquire legal force only upon adoption, in whole or in part, by a particular state as part of that state's regulation of attorneys.

A Code of Professional Conduct (CPC) established by the American Institute of Certified Public Accountants (AICPA) governs accountants. Like the legal standards, the CPC includes principles that set aspirational standards of integrity, objectivity and due care, as well as mandatory rules establishing minimal levels of conduct. Interpretations, rulings and aspirational Statements on Standards for Tax Services supplement the CPC.

a. Duties of Loyalty and Confidentiality

This brief history encompasses a "profound transformation in lawyer ideology from the self-image of a free professional to the self-image of a zealous advocate" serving as "mere agents of their clients." At the core of this transformation are strong fiduciary

---

158 This summary is based on WOLFSMAN ET AL., supra note 19, at 5–7.
159 In tax, the two most significant opinions are ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982) (applicable to marketed shelters), and ABA Comm. on Ethics and Prof'l Responsibility, Formal Opinion 85-352 (1985) (generally applicable).
162 Charles W. Wolfram, Toward a History of the Legalization of American Legal
duties of loyalty to the client and confidentiality that require an attorney to aggressively pursue a client’s interests and maintain in strict confidence all communications that a client has shared in the course of representation. The duties of loyalty and confidentiality are said to serve the public interest: the knowledge that attorneys will provide conflict-free, independent advice without betraying confidences may encourage clients to seek out legal assistance that helps them comply with the law. The ABA has consistently protected the rights of attorneys to counsel clients about the potential risks of alternative courses of action, resisting any pressure to require attorneys to “resolv[e] all doubts in favor of regulatory restrictions.”

The presupposition is that a lesser loyalty to clients, or limitation on the duty to assist clients in carrying out their objectives (other than the prohibition against helping a client to commit fraud) could lead attorneys to put their own personal circumstances above clients’ needs.

The formal tax opinions promulgated by the ABA reinforce this view of tax practitioners, in spite of what appear to be profound differences between the tax self-assessment context and other public contexts where legal representation is necessary, such as securities regulation. Securities regulation serves a public benefit by creating

---


*Id.* at 1086.

See *id.* (The client’s options “should not be improperly narrowed through the insistence of an attorney who may, perhaps unconsciously, eliminate available choices from consideration because of his concern over possible personal risks if the position is taken which, though supportable, is subject to uncertainty or contrary to a known, but perhaps erroneous, position.”).

See Watson, supra note 77, at 1210–13, 1236–37 (evaluating issues that would be decided differently if lawyers owed a special duty to tax system and concluding that an enforceable normative standard is needed because an ideal duty cannot discourage aggressive tax minimization planning).

*See also infra* notes 199–205 (drawing out distinctions in more detail).
more transparent markets where public investors receive sufficient information to invest successfully without being taken for a ride by insiders with critical information on particular entities. 169 Tax rules serve a similar public benefit by establishing a relatively transparent system of taxation so that taxpayers can comply relatively easily with their tax reporting obligation. Tax rules, however, are also indispensable to the collection of revenues necessary to fund government programs. Thus, there is a decidedly strong public interest component to the tax regime that may not be comparable to any other public context.

Ethical standards for tax opinions do not adequately reflect this strong public interest. Formal Opinion 314, an early opinion dealing with tax standards, required only a reasonable basis for tax advice. It failed to draw clear distinctions among the advisor, advocate and return preparer roles, ultimately concluding that lawyers owe the Service no more deference than to any other adverse party. 170 Formal Opinion 346, promulgated in 1982, provided best practice guidelines for promoted tax shelter opinions similar to those included in Circular 230. Tax opinions used in promoting shelters violated the guidelines only if they knowingly or through gross incompetence disregarded or minimized serious legal risks or misstated the facts or law. 171

Promulgated in the context of an expectation that Treasury would strengthen the opinion standards for practice before the Service, the ABA’s Formal Opinion 85-352 moved from a reasonable basis or “not frivolous” standard to a slightly higher litigation-based standard for tax practice, still treating the relationship between attorneys and the


170 ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 314 (1965) (superseded) (describing Service as “itself an adversary party rather than a judicial tribunal” and suggesting that it “is not designed and does not purport to be unpredisposed . . . in the judicial sense”), reprinted in WOLFMAN ET AL., supra note 19, at 55, 56. See generally Franklin L. Green, Exercising Judgment in the Wonderland Gymnasium, 90 TAX NOTES 1691 (Mar. 19, 2001) (providing history of Formal Opinions 314 and 85-352); Watson, supra note 77, at 1199–1202 (discussing in depth).

Service as adversarial.\textsuperscript{172} The standard developed there (later incorporated by the Treasury in Circular 230 and by Congress in the return preparer penalty provision) required that lawyers advising on undisclosed positions must conclude that there is a reasonable possibility of success if the position is litigated. The opinion explains that advice on undisclosed positions is permitted even when the lawyer does not find that the position is supported by substantial authority and believes that the position probably will not prevail, so long as it is one that the lawyer believes “is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law.”\textsuperscript{173} Advice on disclosed positions satisfies ethical requirements so long as it is not frivolous.\textsuperscript{174} Thus, the opinion appears to bring into all aspects of tax planning the adversarial, edge-seeking approach of a litigating attorney acting on behalf of a client. It supports wholesale incorporation of the “zealous advocate” perspective in the tax return and audit context without viewing the self-assessment function as establishing any special context governing the attorney-client relationship. Because of the discrepancy between preparer and taxpayer standards,\textsuperscript{175} there will

\textsuperscript{172} See Kenneth L. Harris, \textit{Resolving Questionable Positions on a Client’s Federal Tax Return: An Analysis of the Revised Section 6694(a) Standard}, 47 TAX NOTES 971 (May 21, 1990) (discussing Op. 85-352’s failure to link advisor’s duty to taxpayer’s obligations); Watson, \textit{supra} note 77, at 1202–03 (discussing advent of realistic possibility standard and ABA’s view that filing a return could be first step in adversarial process).

\textsuperscript{173} ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985) [hereinafter Op. 85-352], \textit{reprinted in} WOLFMAN ET AL., \textit{supra} note 19, at 60. This standard replaced that of Formal Op. 314, which permitted attorneys to “freely urge” favorable positions that had a reasonable basis, considered to be a ten to twenty percent chance of success. The standards in Formal Op. 85-352 were then adopted by Congress in 1989 as the tax return preparer standard under I.R.C. § 6694(a).


\textsuperscript{175} Watson articulates the problematic tension between preparer and taxpayer standards.

[A] tax practitioner who advises her client to disclose a position that is not frivolous, but is questionable as to whether it has a reasonable basis (i.e., the position is merely arguable or colorable), will be insulating herself from liability, but will be exposing her client to the risk of an accuracy-related penalty. If the position does not have a reasonable basis, the disclosure will highlight the position while insulating the preparer, but will place the client at risk of incurring the penalty.

On the other hand, if the return position has a reasonable basis... and it is not contrary to a rule or regulation, nor will it result in a substantial understatement of tax, the taxpayer is justified legally in taking the position
also be constant pressure from clients for advisors to modify their view that disclosure is required for an aggressive position.\textsuperscript{176}

These standards encourage the tax minimization norm. The emphasis on loyalty and confidentiality suggests that “loophole-seeking is not merely permitted but is demanded” with the line drawn only at outright prevarication or deception about the nature of the tax claim.\textsuperscript{177}

\textit{b. Duty as Officer of the Court}

The failure of the bar to dampen the emphasis on loyalty to clients in the tax planning and tax return context is not redeemed by corollary statements about an attorney’s duty as an officer of the court to uphold the law and duty of candor toward the tribunal.\textsuperscript{178} Although extolled in the past as a mark of professionalism among attorneys,\textsuperscript{179} this duty may be interpreted to impose at most a vaguely defined limitation on the practitioner’s obligation to the client.\textsuperscript{180} The Preamble to the Model Rules states:

\begin{quote}
A lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a
\end{quote}

\begin{itemize}
\item without disclosure since it will not subject her to an accuracy-related penalty. But according to the preparer’s penalty provision, as well as Circular 230, the preparer will be subject to sanction and fine if she does not recommend that the taxpayer disclose the position.
\item \textit{Watson, supra} note 77, at 1210–11.
\item \textit{Id.} at 1212–13. The stricter standard for the affirmative defense in reportable SPTs may ease this tension somewhat.
\item \textit{See} WOLFMAN ET AL., supra note 19, at 204, 210–11 (quoting Cooper, \textit{supra} note 92, and citing Randolph Paul, The Lawyer as Tax Advisor, 25 ROCKY MTN. L. REV. 412, 420 (1953)).
\item \textit{See} MODEL RULES OF PROF’L CONDUCT pmbl. (2003) (duty to uphold law); \textit{id.} R. 3.3 (duty of candor).
\item \textit{See, e.g.,} Harlan F. Stone, The Public Influence of the Bar, 48 HARV. L. REV. 1, 2 (1934) (describing attorneys ideally as “guardians of the law, cherishing the legitimate influence of their guild as that of a profession charged with public duties and responsibilities”).
\item \textit{See, e.g.,} Kristy Brewer, Tax Shelter Information and How the Confidentiality Rule Protects Clients: The Relevance of Recent Changes to ABA Model Rule of Professional Conduct 1.6, 13 U. MIAMI BUS. L. REV. 31 (2004) (analyzing conflict between duty to protect client confidentiality and implicit duty to protect tax system); Lee A. Sheppard, What Should We Do About Corporate Tax Shelters?, \textit{TAX NOTES TODAY} (Dec. 14, 1998) (LEXIS, FEDTAX lib., TNT file, elec. cit., 98 TNT 239-79) (noting view of some “that tax advisors are mere advocates for their clients’ return positions”).
\end{itemize}
public citizen having special responsibility for the quality of justice.

... As advocate, a lawyer zealously asserts the client’s position under the rules of the adversary system.\textsuperscript{181}

The primary text in tax practice standards attributes this duty to the system to “a general obligation — derived from the practitioner’s status as a professional — to encourage compliance with the law (including the tax laws).”\textsuperscript{182}

This seems to be a grudging acknowledgment of the duty within the broader context of duty to client. There is an implicit assumption, deriving from the adversarial foundation of much of the bar’s understanding of ethical norms, that the duty to uphold the law is in fact served by zealous advocacy of the client.\textsuperscript{183} Given the assumption that a tug of war between two equally committed opponents in the litigation context is the best process for arriving at the truth, a fierce loyalty to the client’s interest is seen as also serving the public’s interest. Balancing that focus on the client with public responsibilities receives little attention.\textsuperscript{184}

Commentators admit that tax controversies between taxpayers and the government “put[] the public interest into the equation” but nonetheless consider it proper for attorneys to exploit literal interpretations of the Code “to protect for a taxpayer a right secured to him by a statutory loophole.”\textsuperscript{185} For many, the public interest’s part in the equation is de minimis — a right of the government not to be deceived as to the nature of the transaction through a taxpayer fraud or misrepresentation.\textsuperscript{186}

\textsuperscript{181} MODEL RULES OF PROF’L CONDUCT pmbl. (2003).

\textsuperscript{182} WOLFMAN ET AL., ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE (6th ed. 2004), at 4.

\textsuperscript{183} See, e.g., Richard C. Stark, Let’s Reconsider the “Reasonable Basis” Standard, 59 TAX NOTES 1845 (June 28, 1993) (arguing against proposed change in H.R. 2264 from “not frivolous” to “reasonable basis” for both taxpayers and tax return preparers as improper in that it imposes higher standard than required of litigable position).

\textsuperscript{184} Schwarez, supra note 84, at 13 (suggesting that, although lawyers’ officer-of-the-court function may “appear to imbue attorneys with some measure of public responsibility,” focus on balancing client and public responsibilities has not spread far beyond securities regulation).


\textsuperscript{186} Id. at 384 (noting that transactions should be reasonably disclosed in essential
Yet there is reason to think that limiting taxpayer aggressiveness through constraints on the behavior of advisors has merit. As one commentator noted in the context of securities regulation, constraining private parties can be beneficial for the social welfare, remedy the tragedy of the commons problem, achieve allocative fairness, maintain norms, and enhance the efficiency of markets.\footnote{See Schwarcz, supra note 84.}

These same benefits apply in the tax area. Aggressive tax planning exacts significant governmental costs in lost revenues and expenditures of audit and enforcement resources. Taxpayers waste their funds on tax avoidance expenditures. Taxpayers who comply without excessive planning around tax liabilities bear the brunt, while aggressive taxpayers retain a larger share of their income for their personal satisfaction. Excessive tax planning activity likely breeds noncompliance when those in the compliant group view the results for those in the noncompliant group.\footnote{See Lederman, Interplay, supra note 75, at 1487–88 nn.190–92 and accompanying text (describing “chump effect”).}

In the end, general tax rates will have to be higher to recoup the revenues lost to aggressive tax planning.\footnote{See, e.g., THE PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM, REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM (2005), at 216 and tbl. 9.1, http://www.taxreformpanel.gov/final-report (reporting different required retail sales tax rates necessary to raise equivalent revenues, depending on taxpayers' evasion rates).} All of these distortive effects could be ameliorated, at least in part, if tax advisors tempered their advice with a coherence-preserving viewpoint based on respect for anti-manipulation values.

The emphasis on the attorney as advocate in a traditional adversarial role discounts lawyers' public-service roles. This adversarial focus is not compatible with either the coherence or self-assessment characteristics of the tax regime. In particular, it fails to recognize the material differences between counseling advice that is provided during the pre-return planning stages of a transaction and the strategic decision making and preparation that are necessary once a transaction becomes the subject of litigation. During the planning stage, there are no clear adversaries — all parties work together to plan the transaction. Even if parties push for a particular advantage, the negotiations are primarily cooperative or at least focused on making the transaction happen.\footnote{See, e.g., Richard Lavoie, Making a List and Checking it Twice: Must Tax Attorneys Divulge Who's Naughty and Nice?, 38 U.C. DAVIS L. REV. 141, 146–48} Similarly, when a client reports a
completed transaction on its return, the government is less an adversary than a repository of the client's self-assessment documents.

Opinion practices generally require more conservative approaches that can be fairly substantiated through research of the law and facts. For any public deal, the lawyer's opinion needs to be fair so that all those who may refer to it in making their decision about an investment have adequate information, not unlike public accountants who serve as public gatekeepers for information about companies' financial health. The Model Code clearly differentiated these roles by requiring that an advocate should resolve doubts in the client's favor, while an advisor should provide an independent professional judgment regarding the likely decision of courts. Thus, Wolfman, Holden, and Schenk conclude that "[c]onduct that would be acceptable for the advocate may be considered off limits for the adviser." It is not clear that the ethical standards provide sufficient impetus to this duty as an officer of the court.

4. Evidentiary Privileges

Closely related to the ethical rules that ascribe paramount importance to fiduciary duties to clients are the evidentiary attorney-client confidentiality privilege and work product doctrine. The attorney-client privilege, with reputed origins in Elizabethan England as a protection of attorney status, has become a litigation-based protection of clients' communications to their attorneys (and, in some broader interpretations, attorneys' communications to clients). The classic Wigmore definition asserts that

[w]here legal advice of any kind is sought from a professional legal adviser in his capacity as such, the communications relating to that purpose, made in confidence by the client, are at his instance permanently protected from disclosure by himself or by the legal adviser, except the protection be

\footnotesize{(2004).}

\footnotesize{191} See, e.g., \textit{Restatement (Third) of the Law Governing Lawyers} § 95 cmt. c (2000) (recognizing that lawyer's duty to third-party opinion recipients is essentially same as that of accountant certifying financial statement — to provide independent and fair review).

\footnotesize{192} \textit{Model Code of Prof'l Responsibility} EC 7-3 (1986).

\footnotesize{193} \textit{Wolfman et al., supra} note 19, at 193.

Because application of the privilege inevitably results in information loss that could be materially relevant to the case outcome, the privilege requires considerable justification. The rationale ordinarily offered is that it benefits society as a whole, and compliance with the law in particular, by creating an environment in which clients will provide the fullest possible information to their attorneys. This argument assumes that full information permits attorneys to do the following:

- prepare cases more appropriately (including defending against expected damaging evidence or asserting defenses that otherwise would have been overlooked);
- appraise the merits more realistically and better advise the client on the wisdom of litigation or settlement (and, as a corollary, assist the court system by helping clients avoid inefficient litigation); and
- educate the client more adequately about the law's requirements and possibly dissuade the client from taking inappropriate or illegal actions.

This rationale for the privilege is highlighted in much-quoted language from *Upjohn Co. v. United States*, the Supreme Court's seminal pronouncement on privilege: the evidentiary privilege is intended "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."

Privilege will not apply to much tax planning advice, however, because circumstances typically surrounding tax planning either negate a key element of privilege or constitute a waiver of the

---

197 See id.; Kate Kraus, Attorney-Client Privilege Under Fire, Tax Notes Today (Sept. 20, 2004) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2004 TNT 183-27) (arguing that courts interpret privilege too narrowly in transactional settings); Lavoie, supra note 190 (noting points similar to those in text).
198 Upjohn, 449 U.S. at 389. For a representative sample of other cases dealing with privilege in the tax context, see United States v. Mass. Inst. of Tech., 129 F.3d 681 (1st Cir. 1997); In re Grand Jury Subpoena Duces Tecum Dated Sept. 15, 1983, 731 F.2d 1032 (2d Cir. 1984).
privilege that would otherwise exist. These circumstances include the following:

- tax structuring that is primarily business rather than protected legal advice;\(^{199}\)
- tax work that is considered mere “return preparation”;\(^{200}\)
- legal tax advice of a kind for which there is no expectation of privacy because of applicable disclosure and list-maintenance requirements;\(^{201}\) or
- legal tax advice as to which privilege is waived because the advice is voluntarily disclosed to third parties or placed at issue to avoid penalties.\(^{202}\)

Assertions of privilege in the tax setting are particularly damaging to the public interest because they “hinder[] the ability of the [Service] to obtain . . . the most instructive documents.”\(^{203}\) Because of the range

---

\(^{199}\) See, e.g., United States v. Adlman, 68 F.3d 1495 (2d Cir. 1995); Colton v. United States, 306 F.2d 633, 638 (2d Cir. 1962); Olender v. United States, 210 F.2d 795 (9th Cir. 1954). See generally Robin L. Greenhouse et al., The Service’s Tax Shelter Disclosure Initiative: What Has Become of Privilege?, 97 J. TAX’N 212 (2002) (discussing circumstances to which privilege applies); Lavoie, supra note 197, at 179 (noting that courts generally allow privilege claims only for advice that is “predominantly legal, as opposed to business, in nature” and providing various sources for that view); Sheryl Stratton, IRS Battles Promoter Privilege Claims, TAX NOTES TODAY (June 7, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 110-3) (discussing distinction between protected legal advice and mere business advice).


\(^{201}\) See, e.g., In re Pioneer Hi-Bred Int’l, Inc., 238 F.3d 1370 (Fed. Cir. 2001) (disclosure of tax opinion in SEC proxy statement); Lavoie, supra note 190, at 191 (noting lack of reasonable privacy expectation for many transactions, and particularly abusive shelters, in light of new reportable transaction disclosure and list-maintenance requirements).

\(^{202}\) Third-party disclosures typical in tax planning transactions include disclosures in the course of structuring transactions with multiple participants, disclosure to the SEC, or, as in the Castle Harbour and Merrill Lynch transactions, to banks or other accommodation parties to establish the risks connected with loans. See, e.g., Kayle, supra note 194, at 524–25.

\(^{203}\) STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., WRITTEN TESTIMONY ON
of situations in which privilege questions can arise, from audit through settlement and litigation, and the current government focus on abusive transactions, the Service is litigating privilege issues with increasing frequency. In various settlement initiatives in connection with shelter enforcement, the Service has sought full disclosure of documentation, including legal memoranda providing legal analysis.

III. POLICY SOLUTIONS

My thesis is that professionalism as it is currently practiced cannot adequately counter the pressures that encourage tax advisors' aggressive interpretations. Tax returns are treated confidentially, and tax opinions written in support of structured transactions are generally privileged and accessible only to the client and her attorney. Even the work product doctrine may reach back to protect pre-adversarial tax planning advice, due to the statutory requirement that tax advice assess possibility of success on the merits, which implies an ultimate judicial review. Because of the Service's limited enforcement resources, the audit lottery remains a manageable risk for many sophisticated taxpayers. As a result, numerous transactions that the government would consider abusive likely remain obscured within a complex layer of business transactions and are never exposed to litigation. Even if litigated, privilege may protect crucial information about participants' business purposes from the Service. Something further is necessary to discourage literalist interpretations as tax-avoidance mechanisms and the no-holds-barred tax minimization norm.

Although the changes put in place in the 2004 Jobs Act and Circular 230 amendments make promotion and marketing of cloned shelters a riskier business, the effectiveness of the new provisions in


204 See, e.g., infra note 272.


206 For cloned shelters of the type marketed in the 1990s, taxpayers and advisors must consider the risks of failing to report under the new disclosure requirements, I.R.C. §§ 6011 (taxpayer), 6111 (advisor), because they cannot be sure that other participants or taxpayers using the same structure will not report. The strict liability penalties for failure to report, I.R.C. §§ 6707A (taxpayer), 6707 (advisor), also increase the likelihood of appropriate reporting. The stiffened requirements for defending a position taken in connection with a reportable transaction with a
modifying the tax bar practice norms in customized transactions is less demonstrable. Because an advisor in a customized transaction is hired to plan the structure for tax avoidance and not for penalty protection, the affirmative defense provided in section 6664(d) may not come into play. If the taxpayer does not offer the tax opinion as evidence of its good faith, the defense’s stiffer requirements disqualifying certain advisors and opinions will not be material to the taxpayer’s reporting of the transaction. The advisor is expected to use the Code for the taxpayer’s benefit, creating intricate structures that satisfy literal fit requirements.

Similarly, although the complex set of Circular 230 rules governing opinions may frustrate the customized transaction advisor, they may have little effect on the type of transactions the advisor is willing to advise or the taxpayer willing to undertake. For many customized transactions, a detailed opinion that examines each potential tax issue will satisfy the covered opinion requirements and would have been provided without the rule changes. For many transactions that would otherwise require covered opinions, advisors may provide limited scope opinions without advising (or advising at a lower confidence level) on issues not within the scope. The advisor may simply provide a disclaimer opinion.207 Some may decide to provide preliminary opinions under the Circular 230 exception without providing a final covered opinion or an SPT opinion at lower-confidence levels without complying with the covered opinion restrictions. If the transaction is not a reportable SPT, the ordinary penalty and defense provisions will apply. The net result may be no change in underlying norms.

significant avoidance purpose against a substantial understatement penalty, I.R.C. § 6664(d), should make some taxpayers hesitate to undertake otherwise costly transactions and more likely to disclose as required if they do undertake them. Even if participants agree orally to play the audit lottery, the threat of sanctions may ultimately lead them to comply.

Similarly, the Circular 230 modifications make selling opinions for cloned shelters less useful. Many transactions will require covered opinions. Taxpayers will discount a marketing opinion that bears disclaimers, and advisors will risk sanctions if they produce a marketed opinion without disclaimers that does not satisfy the covered opinion requirements. The 2004 Jobs Act requirement for independent advisors for penalty protection opinions makes listed and reportable transactions more costly and reduces the potential for strategies to serve as “profit engines” for the designer.

207 See Holbrook, supra note 152, at 29 (suggesting disclaimer will be “most widely used” way to avoid stiffer requirements).
There are two steps that should be taken that may dramatically affect norms and at the same time significantly simplify the Code in the penalty area. First, the penalty standard for taxpayers and return preparers should be strengthened across the board to acknowledge the self-assessment principle and to reinforce structural coherence. Second, Congress should act to remove privilege issues from contention in respect of any documents or other materials, including legal memoranda or opinions, created in connection with the planning and implementation of transactions prior to the reporting of the transactions on a taxpayer's return.

A. Institute a More Likely Than Not Standard

Strengthening the standard for taking positions on a return is particularly appropriate in the context of the recent revisions to the statutory penalty provisions and Circular 230. Those amendments reflect a growing concern in Congress and at Treasury about tax-motivated transactions that disregard the underlying purpose of statutory and regulatory provisions. There is a tension between strengthening standards and stiffening penalties for reportable transactions and retaining a lower standard in other contexts, even for SPTs. When combined with the possibility of winning the audit lottery, the reasonable possibility standard may encourage practitioners and taxpayers to incorrectly treat an aggressive transaction that should be subject to the higher "shelter" standard as an ordinary transaction. It would be reasonable to establish a standard for taxpayers and advisors that requires them to report and advise, respectively, only positions that they believe in good faith more likely than not to reflect proper application of the tax laws based on substantial authority, whether in the context of a super-aggressive tax transaction or one which is borderline or even ordinary.

See, e.g., Caplin, supra note 89 (suggesting need to reconsider requiring MLTN confidence level); Loren D. Prescott, Jr., Challenging the Adversarial Approach to Taxpayer Representation, 30 Loy. L.A. L. Rev. 693, 746–51 (1997) (suggesting enhanced disclosure requirements with MLTN standard for undisclosed positions); Lee A. Sheppard, What Are Penalties For?, 85 Tax Notes 709 (Nov. 8, 1999) (supporting higher standard); supra note 106 (noting Senate proposal, rejected in conference, to increase standard to more likely than not).

This position would require taxpayers to file returns resolving doubts in the interest of the government and permit them to file for refunds to test positions that they believe have a reasonable basis in the law. Most ordinary taxpayers likely already file returns with the "right answer," and only sophisticated taxpayers with adequate resources pursue aggressive reporting positions (other than outright tax
1. Rationale for Heightened Standard

The first and most important supporting rationale is the effect the higher standard should have on tax compliance norms. If tax lawyers' duty to uphold the law is comparable to their duty towards their clients, then they should be permitted to advise a position at the pre-return stage only if they believe the position is correct and will prevail if litigated.\(^1\) This approach forces practitioners to adopt coherence-reinforcing interpretations rather than literalist interpretations that break the connection between language and underlying purpose.\(^2\)

Tax practitioners' own statements support this argument that raising standards changes norms: they complain that the 2004 Jobs Act penalty provisions and Circular 230 opinion requirements require a radical shift in perspective, especially if significant purpose transactions are interpreted to encompass a broad range of tax planning advice.\(^3\)

The current standard still results in a mixed message, even for significant purpose transactions. Although taxpayer penalty protection for many SPTs and other "shelter" transactions is only available under more exacting conditions,\(^4\) advisors' ability to provide oral advice generally, and written opinions at a level lower than MLTN (even though they cannot be relied upon for penalty protection in respect of many significant-purpose transactions), invites exploitation of loopholes. So long as advisors can advise taxpayers to take return positions that they do not expect to prevail on the merits, taxpayers will continue to adopt aggressive positions that might succeed depending on the luck of the draw in the audit lottery and forum selection process.

\(^1\) See Jay A. Soled, *Third-Party Civil Tax Penalties and Professional Standards*, 2004 Wts. L. REV. 1611, 1627-28 (discussing ABA's earlier rejection of Treasury's proposal for more likely than not standard based on importance of attorney role as client advocate); Watson, *supra* note 77, at 1213-15 (considering what applicable standards should be if based on ethical duty to uphold law that has normative force).

\(^2\) Cf. Soled, *supra* note 210, at 1640, 1649 (in support of MLTN standard, noting that virtually all tax positions can satisfy weak "realistic possibility of success" standard, with result that Code complexities and inconsistencies "open the doors to transactions... which Congress never intended to sanction").


\(^4\) See *supra* Part II.C.1.
In contrast, adoption of a MLTN standard supported by substantial authority that is applicable to taxpayers and advisors in respect of all tax positions reported on a return would mandate a new approach to tax planning that appropriately encourages taxpayers and advisors to find the most likely correct answer.\textsuperscript{214} Aggressive loophole exploitation relying solely on literalist interpretations should be curtailed, as those applications would lack authority other than the bare language of the purportedly applicable Code provisions.

Another benefit of a MLTN standard (and expanded applicability of the stiffer disqualified advisor and disqualified opinion rules of section 6664(d)) is that it would apply a uniform standard for averting substantial understatement penalties in respect of all tax positions, for both taxpayers and advisors.\textsuperscript{215} A uniform standard would remove the potential conflict of interest that exists currently because the advisor and taxpayer standards differ.\textsuperscript{216} It would also resolve any ambiguity about the scope of the new 2004 Jobs Act tax shelter standard and the interrelationship between the Code’s penalty standards and Circular 230 opinion requirements.\textsuperscript{217} Without such a uniform standard, it can be expected that at least some practitioners will interpret the shelter requirements to apply narrowly and assume the lower standards apply to their clients’ transactions, continuing to rely in part on the audit lottery as a shield. The line between “just enough” support for litigation and a frivolous suit is very thin, but a practitioner who does not sign a return is permitted to advise nonfrivolous positions upon advising the client of the need to disclose to avoid potential penalties.\textsuperscript{218} With clients pressing for assistance in lowering their tax liabilities, decisions as to which side of the thin line a position falls within may be influenced, in spite of best intentions, by client advantage, as in the case of the REMIC development of the credit enhancement contract argument for a more taxpayer-favorable

\textsuperscript{214} See, e.g., Johnson, supra note 26 (arguing for a taxpayer duty to file a correct return).

\textsuperscript{215} A negligence penalty should likely be retained but with reinterpretation of reasonableness requirements appropriate to the new standard for nonnegligent reporting penalties. Consideration of the interrelationship of the new negligence penalty and the MLTN standard is beyond the scope of this paper.

\textsuperscript{216} See Watson, supra note 77 (discussing problems resulting from inconsistent standards).

\textsuperscript{217} See supra notes 150, 144 (discussing complexity and anomalies in treatment of SPTs).

\textsuperscript{218} I.R.C. § 6694(a)(3); see Beale, SEC Heat, supra note 6, at 244–45 (discussing standards and probabilities typically attached).
analysis.

Furthermore, a uniform standard removes considerable complexity from the Code. Instead of the current tangle of standards, it would provide a single, comprehensible standard for substantial understatements for taxpayer and return preparer alike that would apply to all transactions. This is particularly important given the recent focus on simplification as a tax reform goal.219

2. Objections to Heightened Standard

Some commentators will undoubtedly object that imposing a MLTN confidence requirement on all taxpayers and practitioners will cause more harm than good, perhaps making the kinds of arguments typically raised against increasing transparency and augmenting sanctions.220 A heightened standard should not discourage appropriate consultation about reporting novel business transactions, because the goal would be to get the right answer, rather than just an answer that is not so wrong as to be laughable. The pressures that exist in the current system to find a more accommodating advisor, however, would not apply.221

Stiffer reporting requirements should not discourage taxpayers from engaging in legitimate business transactions.222 The MLTN standard does not make tax planning illegitimate: it merely requires that reporting for tax purposes conform to the most likely correct view of a transaction. If a taxpayer plans to engage in a novel transaction that arises in the ordinary course of business planning and presents an

219 See, e.g., 1 I.R.S. TAXPAYER ADVOCATE SERV., NATIONAL TAXPAYER ADVOCATE: 2004 ANN. REP. TO CONGRESS 2–3 (proclaiming complexity to be the single most important issue for taxpayers); THE PRESIDENT’S ADVISORY PANEL ON FED. TAX REFORM, AMERICA NEEDS A BETTER TAX SYSTEM (2005), http://www.taxreformpanel.gov/04132005.pdf (focusing on simplification).

220 Practitioners, for example, might claim that detailed disclosure and heightened standards will scare taxpayers away from lawyers when they most need them, cause taxpayers to forego legitimate business planning transactions out of fear of compromising their tax returns and create so much uncertainty regarding the proper interpretation of the Code that practitioners and taxpayers alike will simply disregard the new requirement, resulting in higher levels of noncompliance than before the changes.

221 See Watson, supra note 77 (discussing pressure on advisors because of inconsistent advisor and taxpayer standards).

222 But see Beller, supra note 105, at 491 (without much support, suggesting that, while 2004 Jobs Act provisions may discourage marketed tax products that are extraneous to taxpayers’ businesses, it “could have the effect as well of dampening the desire to engage in legitimate creative tax planning”).
apparent opportunity for substantial tax savings, the taxpayer may
decide to request a ruling from the Service to resolve the uncertainties
about the ultimate benefits of the transaction. The likely increase in
ruling requests in these circumstances may mean increased
government resources would be needed to accommodate those
requests, but generally should mean that taxpayers can proceed to go
about their business without undue complications from the change. In
fact, additional rulings might not be necessary if an expedited
refund claim procedure were also enacted. Taxpayers would report
their tax liability based on the MLTN standard and pay that tax with
the return. With the return, they could also file a refund claim and
request immediate denial of the claim to expedite judicial review. A
taxpayer in a refund suit would continue to be able to contest a tax
liability so long as the claim was not frivolous.

On the other hand, a taxpayer’s decision not to engage in a
transaction after an initial assessment of the MLTN tax consequences
would be allocatively efficient if there were not sufficient support to
report the transaction in the way that provided the desired tax benefit
and the transaction costs were too high to merit entering the
transaction without those benefits.

Any law change may result in some deciding to continue current
behavior and risk sanctions. The audit lottery worsens this problem
for tax, suggesting that some positions that do not satisfy the
heightened standard would continue to be advised and taken on
returns without discovery. Just as enforcement tends to increase
compliance, the heightened standard may support a different view
of the relationship between taxpayers and the government that
reinforces the self-assessment norm rather than undermining it. It
may well be that taxpayers would respond positively to that
reinforcement and increase their efforts to report positions accurately.

Another likely objection to raising standards is that tax advice,
even in the pre-return stage, is sufficiently adversarial in nature to
require the current litigation-based standards. The definition often

---

223 If the heightened standard and removal of privilege is indeed successful in
fostering significantly better compliance, the Service should not view increased ruling
requests as a problem. Resources that would otherwise be devoted to policing
compliance under the lower standard could be freed to aid the ruling process.

224 See, e.g., Lederman, Interplay, supra note 75 (noting that enforcement tends to
increase compliance).

225 “The ‘not frivolous’ and ‘reasonable basis’ standards are grounded in a view
of the tax system as an adversarial one.” Sheppard, supra note 208, at 710 (quoting
U.S. Dep’t of Treas., Office of Tax Pol’y, Treasury Releases Penalty and Interest
given for tax opinions implies advocacy:

A legal opinion is typically a lawyer's expression of her professional judgment as to how the legal issues considered by her would be resolved if presented for decision to the appropriate legal forum.226

There are many difficulties with assuming that tax advice is adversarial. That assumption cuts directly counter to the self-assessment compliance norm, in that it assumes that the taxpayer has no common ground with the government but seeks purchase in a battle for a lower tax liability. It disregards the anti-manipulation value by pitting taxpayer against government in a battle of wits.227

In sum, the potential objections to a higher standard for tax reporting fall short of a persuasive argument for retaining the status quo. A uniform standard would remove existing conflicts between attorneys and clients and simplify the Code compliance requirements. Raising the standard should directly affect the social norms governing tax planning and encourage coherence-preserving interpretations over literalist applications of Code provisions to new contexts inconsistent with statutory purpose. Although concerns about the attorney-client relationship are not trivial, it does not seem that raising the standards would adversely affect that relationship. In fact, the need for greater certainty should lead clients considering aggressive transactions to seek more thorough vetting of potential tax risks. Raising the standard should not impact legitimate business transactions, but should encourage more prudent, less aggressive advice in respect of the reporting of those transactions. At worst, taxpayers and advisors will more frequently request rulings from the Service on tax consequences of novel transactions, though even that process may be rendered unnecessary with appropriate expedited refund claim mechanisms for initiating review under litigation standards. The higher reporting standard should help change the tax minimization norm towards a more balanced one that takes the integrity of the law into account. Taxpayers should curtail some of their most aggressive tax planning activity — whether in the form of marketed shelter


226 WOLFMAN ET AL., supra note 19, at 221 (emphasis added).

227 As Sheppard bluntly states, "it is hard to see how any advisers can maintain responsibility to the system when they are allowed to take litigating positions on returns." Sheppard, supra note 208, at 710.
participation or customized tax planning — because of the need for greater certainty about tax results and the correspondingly higher transaction costs of satisfying that goal.

B. Eliminate Evidentiary Privileges for Pre-Return Tax Advice

The different standards for tax positions and the unique pressures on advisors to satisfy their clients’ goals for tax minimization argue for a new paradigm governing the relationship between tax advisors and clients. In light of the increased emphasis on attorney regulation under the 2004 Jobs Act and Circular 230 amendments (and in particular the attention there to the difference between pre-return and post-return advice), the time has come to modify the application of attorney-client privilege and work product protection for documents or other materials created in connection with pre-return tax planning. A focus on the public interest would support a broad repeal of privilege for all tax planning other than in the context of criminal tax fraud litigation (e.g., whether at the return filing stage, the audit stage, or even when a notice of deficiency may be said to initiate an actual controversy).\(^228\) A narrower limitation — one that eliminates attorney-client privilege for any materials related to pre-return tax planning but not necessarily for all pre-return advice — might also be considered, but would leave opportunities for manipulation by delaying advice to a post-transactional planning, pre-return period in order to ensure privileges could still apply. I believe that a tax-specific rule that limits privilege to only those communications and related materials prepared as post-return advice, combined with the MLTN standard, would be the best approach.\(^229\) It would strike an

\(^{228}\) See Kayle, supra note 194, at 551–52 (suggesting this approach to privilege in tax context).

\(^{229}\) Other commentators have suggested a similar limitation on privilege. See, e.g., Lee A. Sheppard, Confidentiality and Customer Relations, 99 TAX NOTES 1303, 1304–06 (June 2, 2003) (arguing that all tax planning advice is nonprivileged return preparation work). Sheppard argues that there is no valid basis for distinguishing between return preparation work and planning and that the public interest is better served if they are both free of privilege claims, but she recommends a narrower privilege-free zone than the one proposed by Kayle, in that the return filing would mark the beginning of possible privilege application. Note that limiting privilege to the post-return setting results in a significantly smaller amount of material eligible to enjoy the attorney-client privilege protection during adversarial processes. A taxpayer would not be permitted to claim the attorney-client privilege during audits or litigation in respect of materials and information related to pre-return conversations, planning or advice. Similarly, work product protection would not cover any materials prepared during that pre-return period. See infra Part III.B.7.
appropriate compromise with the conflicting views that practitioners and taxpayers may have regarding the audit stage of tax disputes, in line with the Circular 230 focus on pre-return advice and the 2004 Jobs Act "disqualified advisor" affirmative defense focus on the planning stages of transactions.\textsuperscript{230}

The following sections advance the arguments for eliminating privilege and work product protection from pre-return tax planning. Section 1 discusses characteristics peculiar to the tax system that argue for a different interpretation of privilege than that accorded to client communications in other legal regimes. Section 2 notes the lack of a nonarbitrary distinction between work that has traditionally been considered nonprivileged "tax return preparation work" and other kinds of pre-return tax planning. All such work is directed towards determining the way items will be reported on tax returns. Section 3 reviews the reasons why privilege may be inapplicable to tax planning under current law. Section 4 notes that the 2004 Jobs Act changes and recent privilege litigation provide further reasons for repeal. Section 5 explains why the adversarial foundation of the privilege is harmful in the tax context, and Section 6 demonstrates that supposed harms to clients from eliminating the privilege are overstated. Finally, Section 7 makes the argument against work product protection for pre-return advice.

1. Relevance of the Self-Assessment Principle

Some commentators have asserted that the attorney-client privilege either is not or should not be generally applicable in the tax planning context.\textsuperscript{231} Others suggest that privilege should in practice rarely be found applicable because of the nature of tax advice and

\textsuperscript{230} I.R.C. § 6664(d).

\textsuperscript{231} Disclosure is the purpose of a tax return. A tax return is an attested document. It is signed by the taxpayer and the preparer under penalties of perjury. It is not an opening offer. It is not a submission in an adversarial proceeding. It is not a criminal representation calling for a zealous advocate of the client's innocence. It is not a vehicle for playing the audit lottery; it is filed with the expectation that it will be examined. Sheppard, supra note 229, at 1304 (concluding that tax return advice, interpreted broadly to include tax planning preparatory thereto, is not privileged under current law either because it is not legal advice or because of the disclosure purpose). \textit{But see} Lavoie, supra note 197, at 190–91 (rejecting Sheppard's claim as "not overly persuasive under current law").
modern transactional practice, which together practically ensure that privilege assertions will fail one or another of the basic requirements. These arguments for denying (or strongly limiting) privilege for any pre-return tax advice rest on several factors that are peculiar to the tax context.

First, unlike other legal regimes, tax is a set of rules that characterize the results of taxpayer transactions for purposes of determining appropriate assessment. It is not a set of prohibitory rules that are intended to ensure that a person's transactions stay on the legal side of a fixed line between legal and illegal conduct. Other legal regimes set out strict requirements that regulated entities must follow to avoid sanction for committing a proscribed act (such as insider trading under the securities laws) or for failing appropriately to implement a required act (such as maintenance of reserve funds for

---

232 See, e.g., Kayle, supra note 194, at 514–16, 551–52 (suggesting that privilege claims related to tax planning in modern transactional practice will often fail one or more critical elements and proposing that no privilege should be permitted in any tax controversy other than criminal litigation). But see Michael W. Loudenslager, Cover Me: The Effects of Attorney-Accountant Multidisciplinary Practice on the Protections of the Attorney-Client Privilege, 53 BAYLOR L. REV. 33 (2001) (arguing that privilege is necessary because clients will be less likely to consult attorneys for transactional work if they know that damaging information may be obtained from them).

233 Narrowing of privilege in the tax context would not necessarily result in similar narrowing in other areas where legal representation has a public interest component, such as securities regulation. First, the proposal advanced here is a tax-specific proposal applicable to the narrow pre-return planning context and not to other contexts where taxpayers may seek tax counsel. Since it can be sufficiently cabined within the tax system, there is no reason that it must affect privilege in other areas of regulation where there are third-party beneficiaries of a more transparent system. Second, while in any context evidentiary privileges protect a private litigant at some cost to the public good relative to a full airing of information, the tax system has a number of unique characteristics that separate it from other regulatory regimes, as discussed further in the accompanying text. For example, securities regulation is viewed as important to permit the markets to function more transparently and aid small investors in participating alongside sophisticated insiders. Transparency requirements are imposed through reporting that is itself available to the public. Transparency requirements are modified in private offerings from which small investors are excluded, because sophisticated investors are presumed not to need the extra protections. The tax system, in contrast, functions to collect revenues to run the government, a quintessentially public function where the benefit of the system is dispensed over all citizens and residents. Because tax requires self-assessment, aided by withholding and information reporting for many ordinary taxpayers, the tax minimization planning of the most sophisticated taxpayers may threaten the system. Yet the Code generally protects all tax returns from public scrutiny.

234 See, e.g., Kayle, supra note 194, at 551; Lavoie, supra note 197.
banking institutions or appropriate sanitation in hospital operating rooms). For these regimes, violators are subject to punishment, whether or not they relied on advice from counsel.\textsuperscript{235} In contrast, the Code neither prescribes nor mandates that taxpayers conduct their activities by means of particular transactions. A company may decide to conduct an acquisition under the rules for a statutory merger or may instead acquire a company in a form governed by the taxable acquisition rules. The choice as to mode of arranging affairs is the taxpayer’s business, but the decision as to how those arrangements will be taxed is the government’s business. Congress has legislated rules that are intended to be adequate to the taxpayer’s self-assessment task of determining the tax consequences adhering to actions undertaken for non-Code reasons.\textsuperscript{236}

There are only two coercive elements in the Code enforced through the audit process and penalty sanctions — tax reporting and tax payments.\textsuperscript{237} A taxpayer (and certain third parties who have control of funds and can provide information reports to substantiate taxpayer reporting) must file a return that reports tax-relevant transactions based upon the taxpayer’s determination regarding application of the substantive Code provisions to the particular situation. A taxpayer must also actually pay over to the government an amount equal to the tax liability thus determined. Even here, the Code is much more forgiving than other regimes such as antitrust, in that it generally foregoes penalizing mistakes made in reliance on advice from tax counsel.

This regime of rules that characterize and assess rather than label and punish argues for a different view of privilege. In other legal regimes, a person at the moment of undertaking an activity is either within or without the law — eligible for treatment as an upstanding citizen or subject to civil or criminal sanctions. The purpose of the evidentiary privilege to foster attorney-client consultations is clearly implicated. An attorney engaged before the activity takes place may well be able to dissuade a client from engaging in the activity, thus furthering compliance with the law. An attorney engaged after the activity takes place will be the client’s advocate in a per se adversarial


\textsuperscript{236} “Overly aggressive reporting of a transaction may be illegal, but engaging in such a transaction itself is not illegal or prohibited by the Code.” Lavoie, \textit{supra} note 197, at 196.

\textsuperscript{237} \textit{Id.}
controversy. The fact that a client relies on supportive advice in undertaking the activity does not excuse wrong actions.

In the tax system, however, the result is the opposite. An attorney engaged before the activity takes place generally has no need to dissuade a client from undertaking a transaction in any particular fashion — the only obligation is to report the resulting tax liability fairly. Similarly, engagement of an attorney to assist in transaction planning does not signal the initiation of an adversarial process. It may be that the client and the Service will agree in all respects as to the tax treatment of the planned transaction, and the planning process may even take advantage of the ruling request process to ensure that no adversarial relationship ensues. In practical terms, the process during the tax return, audit and even proposed adjustment phase is cooperative rather than adversarial. A clearly adversarial relationship arises only at the point that a dispute cannot be resolved through the cooperative give and take of the audit process and a notice of deficiency is issued forcing the taxpayer to choose between compliance with the government’s characterization of the transaction or litigation. Even if the taxpayer ultimately is found to have underpaid taxes, reliance on tax counsel may well avoid any penalty assessments.

Second, the tax system established by the Code relies on individual taxpayers to self-assess, file a return disclosing the relevant facts necessary to determine the taxpayer’s tax liability, and pay over the tax due. The government does not send out tax police to inventory each taxpayer, log activities and calculate a tax fine as appropriate. Because a return requires disclosure of all relevant tax facts, any records, documents, and other information or analyses used to arrive at the particular information included are directly relevant and material. They are impliedly available for review to ascertain whether the taxpayer has followed the rules appropriately.

There are, however, some state experiments in which the government provides completed returns for some taxpayers (primarily those whose wages are reported by employers). See Joseph Bankman, Simplifying the Tax System for Average Citizens: The California “ReadyReturn,” http://www.law.stanford.edu/faculty/bankman/Forthcoming_article_Tax_Notes.doc (discussing a pilot state project).

See, e.g., United States v. Merrell, 303 F. Supp. 490, 492–93 (N.D.N.Y. 1969) (suggesting that reasons supporting availability of accountants’ tax accrual work support availability of any records the information on which is used in connection with return preparation; since return discloses information derived from underlying documents, it is appropriate to assume that underlying information was prepared to be disclosed).
assessment system and corollary anti-manipulation value underlying the tax regime elevate the importance of the return disclosure requirement compared to other legal systems, since self-assessment cannot function successfully if taxpayers do not provide accurate information on their returns. Both the Service and the democratic polity require fair and inclusive reporting to function appropriately. The Service does not have sufficient resources to examine every return, and the public at large bears the burden in higher taxes or lesser services when taxpayers successfully play the audit lottery to avoid their fair shares of the tax burden. As Treasury, the Service, and the Department of Justice argued when Congress debated extending the attorney-client privilege to accountants in some contexts, the public good is harmed by an evidentiary shield that inhibits investigation, impedes the search for truth, and encourages taxpayers to risk litigation rather than resolve disputes.\(^{240}\)

The public policies underlying the increased disclosure requirements under the 2004 Jobs Act and this self-assessment system accordingly argue for a different approach to privilege than that applicable in other legal regimes. A taxpayer who can conduct planning for its activities behind closed doors (and control, to some extent or entirely, the public information related to those activities) remains in sole possession of the critical information relevant to assessment of its tax liabilities. The government — in this case not an adversary but merely the transactional counterpart in the tax determination process — remains essentially at the mercy of the taxpayer to provide it sufficient information so that it may, in the few returns actually audited, come to its own determination as to tax liability and evaluate the taxpayer’s assessment effort. An evidentiary privilege rooted in the adversarial litigation process that is used to protect the most basic and most relevant information from the transactional planning stage directly and substantially hinders assessment.\(^{241}\)


Critics’ likely argument that disallowance of privilege in this context would eviscerate the fundamental goal of encouraging client communications with lawyers because clients will fear their damaging information will be made public carries a not-so-subtle irony.\(^2\) It amounts to an argument that the legal rules should work to encourage taxpayers to use attorneys to plan aggressive tax sheltering transactions that have no social value by preventing the government from access to information about the tax liability that a taxpayer has proclaimed through the self-assessment system. The converse is true: recent evidence of corporate malfeasance supports sunshine laws, not closed door operations.

Third, Treasury’s strategy of enhancing disclosure to combat shelters — reinforced now by Circular 230’s opinion standards and the 2004 Jobs Act’s codification of the disclosure regime with enhanced penalty requirements — establishes a broad transparency principle that overlays the self-assessment regime. Companies and taxpayers should be aware of the various rules requiring them to disclose information about tax strategies in many situations. They should recognize a special need to be forthcoming with their attorneys in discussions about tax consequences for all their transactions, in case those transactions ultimately are subject to the heightened reporting requirements. The reporting requirements should therefore generally encourage more openness between attorneys and clients whether or not the discussions are protected by privilege.\(^3\)

In spite of these strong arguments favoring elimination of privilege in the tax planning stage, courts continue to take a fairly broad view of the application of the common law privilege to tax controversies.\(^4\) In fact, actual practice confers a broader scope of

demands, which suggests that privilege encourages compliance, with “regulatory” model that assumes attorneys strategically stymie enforcement, which suggests that elimination of privilege is necessary to law enforcement).

\(^2\) See Loudenslager, supra note 232 (arguing that privilege supports frank communications between attorney and client because clients will otherwise not disclose unfavorable information to attorneys).

\(^3\) See, e.g., Sexton, supra note 241, at 463–64 (noting that regulatory state puts into question underlying premise that privilege is necessary to encourage frank communication). “[C]orporate clients are candid with their attorneys not because of the privilege but because they realize that the costs of withholding information are likely to be far greater than the disadvantages flowing from the risk that the communication will later be divulged.” Id. at 464.

\(^4\) See, e.g., United States v. BDO Seidman, LLP, 2005-1 U.S. Tax Cas. (CCH) \(\S\) 50,264 (N.D. Ill. 2005) (finding various tax advice privileged under both attorney-client and statutory privileges); TIFD III-E Inc. v. United States, 223 F.R.D. 47 (D.
privilege to tax planning advice than to other legal advice by applying the privilege in the *administrative* phases of tax controversies as well as the litigation phase.245

2. No Viable Distinction Between Tax Planning and Nonprivileged Return Preparation Work

Although their arguments differ and the scope of the material included is not clear, federal circuit courts have generally concluded that attorneys' tax return preparation work is not privileged.246 The main rationale for finding a lack of privilege is the comparison of tax preparation work by attorneys to similar tax work done by tax accountants who are not authorized to practice law. An accountant must be knowledgeable about tax law in order to prepare the self-assessment return forms, but the forms are viewed by the courts as "primarily informative in character and not of the nature of strict legal instruments, which establish, limit, or terminate rights and liabilities."247 Another supporting rationale is that an accountant’s accrual work papers are not considered made in confidence because they are expected to be disclosed in accordance with security regulations and upon the Service’s request.248

Conn. 2004) (applying privilege to protect law firm opinion letters); Long-Term Capital Holdings v. United States, 2003-1 U.S. Tax Cas. (CCH) ¶ 50,304 (D. Conn. 2003) (finding work product protection for tax opinion, and deferring consideration of privilege until decision on advice-of-counsel defense); Lavoie, *supra* note 197, at 190-92 (suggesting broader view of tax return preparation work as encompassing all tax planning and nullifying privilege is not supported in current law); McMahon & Shepard, *supra* note 200, at 407 (noting general application of privilege to tax planning).

245 See *Kayle, supra* note 194, at 509.

246 See *supra* note 200. See generally Bruce Graves, *Attorney Client Privilege in Preparation of Income Tax Returns: What Every Attorney-Preparer Should Know*, 42 TAX LAW. 577 (1989) (discussing cases and arguing that only materials actually disclosed are intended to be disclosed). Some commentators disagree with the trend towards transparency in this area. See, e.g., *Kraus, supra* note 197, at 1448 (arguing that disallowing privilege in pre-litigation tax return preparation context because of disclosure requirement improperly holds transactional lawyers to different standard).

247 Katherine D. Black & Stephen T. Black, *A National Tax Bar: An End to the Attorney-Accountant Tax Turf War*, 36 ST. MARY’S L.J. 1, 17, 23 (2004) (quoting 1950 ALR entry and noting that this assessment is "ridiculous" because “even the simplest tax return may... establish legal rights”).

It is relevant that the courts' rationales for denying privilege for attorney tax preparation work are almost all based on the law prior to enactment of section 7525's limited accountant-client privilege and generally piggy-back on conclusions about accountant tax advice. For example, the Fourth and Fifth Circuits consider tax preparation work generally not privileged because it is "primarily an accounting service." The Eleventh Circuit considers tax preparation work more similar to nonprivileged accountant work than to legal advice. The Eighth Circuit concluded that an attorney who fills out tax returns is merely acting as a scrivener rather than rendering legal advice. The Ninth Circuit agrees with this approach to evaluating attorneys' tax return work. The Second Circuit holds similarly that attorney tax return preparation work is not privileged, but does so based on the rationale that there is no expectation of confidentiality in the tax return context where disclosure to the government is mandated by law.

United States v. Frederick, a recent and much-cited Seventh Circuit case, is explicit in drawing a distinction between privileged and non-privileged work based on the activities in which an attorney is engaged. According to Frederick, attorneys who are in actuality doing little more than the accountant-like behavior of tallying numbers for a return are not engaged in the provision of privileged legal advice, but tax planning outside that context is protected by the

---

249 See supra note 240; infra Part III.B.4.


251 In re Grand Jury Investigation, 842 F.2d 1223, 1225 (11th Cir. 1987).

252 Canaday v. United States, 354 F.2d 849, 857 (8th Cir. 1966).

253 United States v. Gurtner, 474 F.2d 297, 298 (9th Cir. 1973).

254 Colton v. United States, 306 F.2d 633, 638 (2d Cir. 1962); cf. Kenneth L. Harris, On Requiring the Correction of Error Under the Federal Tax Law, 42 TAX L. 515, 530–31 (1989) (suggesting that intended disclosure rationale is weak, because taxpayers may reveal materials to attorney for legal advice as to whether item should be reported).

255 182 F.3d 496, 500 (7th Cir. 1999) (noting that documents and information held by attorney were those accountants generally produce in preparing clients' returns).
The case holds that information furnished to a preparer is furnished "for the purpose of enabling the preparation of the return, not the preparation of a brief or an opinion letter."  

Taken together, these decisions point out the similarities between accountants' and attorneys' roles in tax planning and tax preparation and provide various rationales for treating tax planning work as nonlegal, business planning that should not be protected by the attorney-client privilege. That tax is a noncoercive legal regime that cannot be avoided by any business enterprise makes the factual and legal line between privileged planning and nonprivileged tax return preparation or business advice conceptually and practically difficult to draw, however.  

The current line appears to be an arbitrary distinction primarily protective of lawyer work on behalf of a client's self interest rather than of the rule of law.  

Recent court decisions on identity privilege (e.g., protection of information regarding a client's identity) and waiver have given even more credence to the business nature of tax planning advice. These cases suggest that judges who analyze the typical language included in tax opinions — "you have requested our opinion regarding the U.S. federal income tax consequences of" and concluding that there is a "greater than 50 percent likelihood that the following positions will be upheld if challenged" — may rule that such language presupposes that the opinion advice will be used to determine how to report the

---

256 Id.
257 Id.
258 See, e.g., B. John Williams, Jr., Chief Counsel, Internal Revenue Serv., Address to the Tex. Fed. Tax Inst. (June 6, 2002), http://www.irs.gov/pub/irs-uti/williams-60602.pdf (stating promoted opinions are unlikely to be privileged because of wide dissemination among unrelated third parties and likelihood of being based on hypothetical circumstances rather than particularized taxpayer facts); see also Black & Black, supra note 247, at 52 (noting difficulty in distinguishing legal advice and business advice in corporate context); Sheppard, supra note 229, at 1305 (noting that "[t]he question is how far back in the tax advice process the concept of return preparation reaches" and suggesting that the tax return should be viewed similarly to financial statements as a disclosure document intended for public purposes).
259 See, e.g., Janice A. Alwin & Jason P. Eckerly, Raising the Tax Bar: Redefining the Roles of Accountants and Lawyers for a Practical Solution to the Multidisciplinary Practice Debate, 1 DEPAUL BUS. & COM. L.J. 257 (2003) (considering corporate scandals and pressure on SEC to ban auditor provision of tax services as proof of need to regulate tax services at time when distinction between tax and accounting, or tax and legal, services is at best difficult to delineate).
260 See McMahon & Shepard, supra note 244, at 422–28 (discussing identity privilege cases).
transaction that is the subject of the opinion. There would be no reason for an advisor to reach a conclusion about the strength of a tax return position if the client were not interested in the reporting of the position on a return. The ultimate goal of the tax planning in respect of any customized tax transaction is to decide how the structure should be carried out so that it implements the agreed-upon tax objective of reporting the results from the structure to derive a particular tax benefit. It would therefore be reasonable for a court to determine that any information and opinions regarding tax consequences of a transaction are principally connected with the filing of the tax return reporting the transaction rather than with litigation prospects (though undoubtedly concerns about litigation are latent in any transaction that cannot garner a "will" level opinion).

3. Privilege Often Inapplicable in Planning Contexts

The majority view appears to be that legal advice regarding the tax consequences of a transaction, even at the planning stage, is not "tax return preparation work" and therefore may qualify for protection under the attorney-client privilege. Even if it does not qualify for attorney-client privilege protection, courts may find that it can qualify for protection under the work product doctrine. Assuming that tax planning can be eligible for privilege protection, however, does not mean that much of the typical tax planning work actually is protected. In many planning situations, the privilege will not exist because one or another of the privilege requirements will not be satisfied.

For example, confidentiality between attorney and client does not exist if the attorney and client do not have a legal representation relationship. In promoted tax-avoidance transactions, an attorney's opinion that has been provided to a promoter and then by the promoter to the client would not satisfy the confidentiality standard.

261 See, e.g., United States v. KPMG LLP, 237 F. Supp. 2d 35, 42 (D.D.C. 2002). The cited language led the KPMG court to conclude "that [the opinion letter] was prepared in conjunction with preparation of a tax return" in part because the Service cannot become aware of a position "by a means other than a tax return." Id. (emphasis in original).

262 "[I]nformation received from, and opinions provided to, clients of tax practitioners regarding the tax consequences of a proposed transaction are highly unlikely to be considered privileged. Tax advice is likely to be considered tax return preparation and, therefore, not privileged." Joe Walsh, Recent Court Decision Virtually Eliminates Tax Practitioner Privilege, 70 PRAC. TAX STRATEGIES 324, 335 (2003) (commenting on KPMG decision).
for either the promoter (who has given the opinion to third parties) or the client (who has not developed a direct relationship with the attorney).\textsuperscript{263} Even in many customized tax transactions, planning takes place with representatives of many central and peripheral parties to the arrangements, and tax attorneys’ views of the necessary structure, the problems that may be presented, or the flaws in a proposed structure are shared with all. In a transaction like Castle Harbour, there were at least two parties — the GE financing entities and related parties and the foreign banks — that undoubtedly discussed in full the tax advisors’ views of the partnership allocation provisions, because they were central to the parties’ expectations of payments from the deal. Those circumstances may result in waiver because of sharing beyond the attorney-client relationship with parties not covered by the “common interest” exception to waiver.\textsuperscript{264}

Similarly, the trend towards enhanced disclosure requirements suggests a much narrower purview for privilege claims. The reportable transaction rules, essentially codified through passage of the 2004 Jobs Act, require detailed reports to the Service about various types of transactions. Claims of privilege are more likely to be denied on the basis that information required to be disclosed is not expected to be kept confidential.\textsuperscript{265} As privilege claims are litigated, the critical mass of new disclosure requirements may be viewed as having eroded the rationale for the privilege in the tax planning context.

Although many federal courts apply a broader rule, the traditional scope of the attorney-client privilege is limited to communications from the client to the attorney.\textsuperscript{266} Attorney opinions,

\begin{footnotesize}
\begin{enumerate}
\item See, e.g., Doe v. Wachovia, 268 F. Supp. 2d 627, 634 (D.N.C. 2003) (finding no attorney-client relationship where Jenkens & Gilchrist merely marketed a package including a memorandum describing potential tax consequences of a marketed transaction).
\item See Chuck Gnaedinger, IBA Panel Discusses Attorney-Client Privilege, Sarbanes-Oxley Effects, 2003 WORLDWIDE TAX DAILY 181-2 (Sept. 18, 2003) (suggesting disclosure will make privilege claims more difficult).
\item See, e.g., United States v. Amerada Hess Corp., 619 F.2d 980, 986 (3d Cir. 1980) (affirming lack of privilege but rejecting in dicta district court’s application of traditional view that privilege applies only to client communications and not to legal analysis). The privilege rationale does not support the broader view, which may have been accepted by federal courts through confused incorporation from diversity cases where broader state law privileges applied. Roger W. Kirst, A Third Option: Regulating Discovery of Transaction Work Product Without Distorting the Attorney-
\end{enumerate}
\end{footnotesize}
mental impressions, conclusions or legal theories are not protected under the privilege, unless revelation would reveal communications from the client. Accordingly, even client facts learned from a third party are unprotected. While the work product doctrine may provide broader protection, the traditional scope of that doctrine limits it to situations where litigation is actually threatened or imminent. Thus, in courts that do not apply the broader derivative privilege rule protecting any communication between attorneys and clients in the course of a legal representation or the broader work product rule, tax planning materials—including legal analysis—would not be protected from disclosure except to the extent they reveal client communications.

Finally, voluntary disclosure of confidential information by a client waives privilege. Use of tax opinions prepared in connection with structuring of transactions for penalty protection acts as a waiver of the privilege for all documents related to the subject matter of the opinion.

4. 2004 Jobs Act Changes and Recent Privilege Litigation Support Repeal

Two aspects of the 2004 Jobs Act and recent litigation provide further support for repeal of the privilege in the pre-return context. The first is narrowing of the application of the relatively new accountant-client privilege provided under section 7525. The second is the stiffening of requirements for penalty protection for reportable transactions with a significant tax avoidance purpose.

Briefly, the accountant-client privilege was enacted in 1998 as an extension of the attorney-client privilege to accountants and other advisors who may be admitted to practice before the Service. The language of the privilege appears on its face to apply to (and possibly limit other privileges of) all who are considered tax practitioners for purposes of practice before the Service, including attorneys, accountants and commercial tax return preparers. The legislative history, however, states that the section 7525 privilege was not

---


267 See infra notes 294–304 and accompanying text.

268 A broader work product doctrine that protects materials prepared "because of" litigation applies in some courts. See infra notes 297–299.

intended to abrogate the attorney-client privilege. Accordingly, the statutory section 7525 privilege may apply to attorneys and accountants (among others) in the limited settings provided, but the broader attorney-client privilege applies only to attorneys (and not other authorized tax practitioners) in any setting — including in the context of potentially abusive shelter transactions. Prior to the 2004 Jobs Act, the statutory practitioner privilege applied only to noncriminal proceedings before the Service or in federal court where the United States was a party, and was not available in the case of a corporate taxpayer’s SPT. The 2004 Jobs Act narrowed the statutory privilege still further, making it inapplicable to any taxpayer in respect of an SPT. That narrowing of the practitioner privilege should be viewed as reflecting a growing concern in Congress about potential privilege abuse.

There are, however, real concerns about the effectiveness of this narrowing of the practitioner privilege. Without concomitant language narrowing the common law attorney-client privilege, the change is only half a loaf. The result may merely provide an incentive to shift more aggressive individual tax planning back to attorneys and away from accountants. While the language of the provision could be taken to include the attorney-client privilege, it is highly unlikely that courts will interpret the language in derogation of the common law privilege, given the clear statement in the 1998 legislative history.

Furthermore, recent privilege litigation suggests that at least some courts will give short shrift to the clear text of the shelter exception to the statutory privilege. In a recent decision in connection with BDO Seidman-sponsored shelters, the district court refused to accept the Service’s characterization of the transaction as a “cookie cutter”

270 STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998, at 87 (Joint Comm. Print 1998), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=1998-joint-committee_on_taxation&docid=f:52240.pdf (“The provision does not modify the attorney-client privilege of confidentiality, other than to extend it to other authorized practitioners.”); see, e.g., Lavoie, supra note 197, at 176 & n.163 (arguing that attorney-client privilege applies, in spite of technical inclusion of attorneys in the accountant-privilege section, absent clear statement from Congress to contrary).


shelter, based on the large number of identical letters for numerous clients, for purposes of applying the crime-fraud exception to the common law attorney-client privilege. The common law privilege applied, because "[t]he question of whether the [parties] engaged in unlawful activity, or alternative[ly] properly complied with the tax code, is one of the ultimate questions for this litigation." Without any analysis of the significant difference between the crime-fraud exception and the statutory exception for SPTs, the court also ruled that the SPT exception could not be said as a matter of law to limit the statutory practitioner privilege. This approach to the privilege eviscerates the statutory "significant tax avoidance purpose" language: it is hard to see how any transaction that yields significant tax benefits would not per se satisfy the broad language. If privilege determinations cannot be made by reaching a preliminary conclusion about tax avoidance purpose, the exception is in danger of being written out of the Code. Documents protected by privilege will likely be necessary to demonstrate that the purported tax benefits from the transaction are not available. Repeal of the common law privilege altogether in the pre-return context would better comport with tax needs.

The second significant 2004 Jobs Act change is the more stringent requirement for penalty protection in respect of listed and other reportable transactions that have a significant tax avoidance purpose, including the distinction between independent advisors and those who participate in transaction planning. The disqualified tax advisor rule provides that an advisor who structures such transactions cannot provide an opinion that establishes a reasonable cause/good faith

---

274 See id. at *30 ("The fact that the IRS characterizes a business or individual's transactions as abusive and unlawful cookie cutter tax shelters does not mean that this characterization is a proper conclusion as a matter of law.").
275 Id. at *31 n.6.
276 See, e.g., United States v. Sidley Austin Brown & Wood LLP, 2004 U.S. Dist. LEXIS 6452, at *17–18 (N.D. Ill. Apr. 15, 2004) (determining whether the firm sold shelters would be "a complicated question"); but client identities were not privileged because they were not communications, whether or not transactions were shelters; Robert E. McKenzie & Vernon Hoven, The Tax Advisor Privilege: How the Confidentiality Privilege Applies to Practitioners 9 (1999) (on file with Va. Tax Rev.) (suggesting that the significant purpose definition of shelters "might be broad enough to encompass virtually any item on a corporate return that might give rise to civil or criminal fraud scrutiny" and worrying that the privilege determination might give rise to collateral estoppel in subsequent tax litigation).
277 See supra notes 107–18 and accompanying text.
penalty protection defense for the new reportable transaction understatement penalty.\textsuperscript{278} Only the opinion of an independent advisor who merely evaluates a transaction can provide penalty protection.\textsuperscript{279} The elimination of penalty protection in respect of an opinion of a tax advisor who assists with the development and structuring of a transaction suggests that Congress viewed such an advisor as not providing disinterested legal advice but rather participating in the development of a business deal. Removing any privilege from advice provided during this structuring stage would comport with this differentiation between independent advisors and participating advisors.

The May 2005 modifications of Circular 230 further supported this distinction by adding an exemption for post-return advice.\textsuperscript{280} These changes suggest that Congress and Treasury view the pre-return situation as uniquely susceptible to regulation and scrutiny.

5. Adversarial Approach to Tax Advice is Harmful

Much of the ambiguity about the proper scope for claims of attorney-client privilege relates to the unique system of reporting and administrative compliance checks that serves to support self-assessment of tax liabilities within a range of acceptable conduct tested by audits and, in some cases, through litigation. The filing of a tax return is not the first step in an adversarial process but rather, in most cases, a trivial event that is many steps removed from potential litigation. The taxpayer reports its self-assessment and the government accepts that assessment. The return becomes a point in the data collected to monitor the system. Except for large public companies that are constantly under audit due to the extraordinary scope of their businesses, the filing of a return is not the automatic start of an audit process. An audit may or may not ensue, the audit may or may not result in the Service proposing adjustments, proposals of adjustments may or may not be resolved through the same cooperative process that governs the filing of return and the initial audit requests for information, notices of deficiency may or may not


\textsuperscript{279} Even that opinion is subject to heightened standards for the affirmative defense. I.R.C. § 6664(d)(2) (substantial authority and MLTN requirement, originally part of section 6662(d)(2)(C), (d)(3)(A)(ii) (disregard of audit lottery or settlement possibilities), (d)(3)(B)(iii) (best practice requirements for shelter opinions).

\textsuperscript{280} See supra note 149 and accompanying text.
be issued, and a taxpayer may or may not resolve to fight a deficiency claim through the courts. Only when taxpayers are asserting super-aggressive positions that they expect the Service to view as abusive is it fair to say that the filing of the tax return initiates a series of steps that are likely to end in litigation. Even in those cases, the audit lottery ensures that litigation remains a remote possibility and that even flagrant disregard of the rules may go unnoticed.

In spite of the remoteness of adversarial litigation from the tax filing stage, practitioners argue that adversarial duties attach at early stages of the return process and courts tend to consider the audit stage sufficiently adversarial to support evidentiary exclusion under claims of attorney-client privilege. In Frederick, the court considered the audit both a “possible antechamber to litigation” and a “stage in the determination of tax liability,” requiring a balancing of potential fairness concerns against the Service’s evidentiary needs. In an opinion that was first released with a strong rejection of privilege in the audit context and then rewritten to provide considerable protection of legal analysis in the audit context, the court concluded that matters related to accounting-type tax preparation work could not be protected (even under the new section 7525 privilege), but that materials involving statutory or case law interpretations could be protected from disclosure.

Proponents of interpreting the availability of privilege protection claims to extend to audits often claim that fairness requires the broader interpretation. These pro-privilege fairness arguments

---

281 Sheppard, supra note 208, at 709 (noting that “many practitioners have come to regard return filing as adversarial [and t]hat is only one step away from the now-accepted view of audits as adversarial”).

282 United States v. Frederick, 182 F.3d 496, 502 (7th Cir. 1999).

283 Id.

284 See, e.g., Burgess J.W. Raby & William L. Raby, The CPA Tax Practice Privilege — Less Than Meets the Eye, TAX NOTES TODAY (Oct. 30, 1997) (LEXIS, FEDTAX lib., TNT file, elec. cit., 97 TNT 210-55) (discussing 1990 debates on amending evidence rules to protect all tax return work, in which Sen. Symms claimed it is “grossly unfair” that “the IRS can demand these notes and working papers to try to outguess the taxpayer”); Sheryl Stratton, University of Chicago Conferees Take on Privilege and Workpaper Policy, TAX NOTES TODAY (Nov. 18, 2003) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2003 TNT 222-6) (reporting comments by Norma Lauder, Bank One tax director, that shorter audit cycles and routine requests for tax accrual workpapers will be perceived negatively because “they’ve got your thinking” and will not be likely to engage in substantive discussions); Andrea I. Mason, Casenote, Counsel as Tax Preparer, An Unprivileged Position: United States v. Frederick, 69 U. Cin. L. Rev. 411 (2000) (discussing Frederick arguments).
simply do not hold. Attorneys have always been viewed to have some
duty toward the legal system — that clients would like to encourage
the trend of elevating the fiduciary duty to client far above the
companion duty to the law is not a persuasive argument for doing so.
In fact, the fundamental compliance-enhancing purpose of the
privilege is better served in this context when clients are made more
aware of the companion duty to uphold the integrity of the legal
system. The analogy with the adversarial process as a basis for
fairness arguments puts undue emphasis on loyalty. Similarly, basing
the fairness argument on concern about government investigative
tools overlooks the reason those tools are necessary — to give the
government some means of evaluating and assessing the actual facts
rather than merely taking the taxpayer’s word for all material matters
in connection with a tax return. The government is the party at an
information disadvantage because of the asymmetries inherent in the
tax planning situation: permitting a taxpayer to use the privilege shield
to maintain that inherent disadvantage and hide improper tax
reporting is problematic. It encourages tax minimization social
norms that flirt with outright fraud. It may also increase taxpayer
contempt for the audit process and future noncompliance with
disclosure requirements because audits that are not based on full
disclosure of fact will inevitably be flawed.

Furthermore, the litigation of privilege issues creates a spiraling
cycle of problems that add to the inefficiency of litigation as a means
of resolving potential ambiguities in the tax rules. Privilege “is the
most common discovery dispute and is one of the most frequent issues
arising in civil [tax] litigation.” Court dockets are increasingly

\[\text{See e.g., Robert W. Gordon, A New Role for Lawyers?: The Corporate}
\text{Counselor After Enron, 35 CONN. L. REV. 1185, 1207 (2003) (“The real lesson from}
\text{the defense lawyer’s or advocate’s role is simply that the lawyer is... a public agent}
\text{of the legal system, whose job is to help clients steer their way through the maze of}
\text{the law, to bring clients’ conduct and behavior into conformity with the law — to get}
\text{the client as much as possible of what the client wants without damaging the}
\text{framework of the law.”}).\]

\[\text{See supra note 203 and accompanying text. “The privilege essentially protects}
\text{private communications about motives, mistakes and misfeasance in the face of a}
\text{regime created to provide access to information. Privilege thus protects what}
\text{arguably is the most important information for the Service to know and the most}
\text{difficult for it to obtain.” Kayle, supra note 194, at 552.}\]

\[\text{See, e.g., Sheryl Stratton, Privilege Sidelines Shelter Actions, Government}
\text{Changes Tack, 100 TAX NOTES 295 (July 21, 2003) (commenting on extensive identity}
\text{privilege litigation in response to promoter investor list summonses).}\]

\[\text{Michael Wilson, Note, Careful What You Wish For: The Tax Practitioner-}\]
jammed with litigation cases, with resort to special masters to review large sets of documents and evaluate assertions of privilege protections. Litigation on privilege issues often becomes more complex because of intervenors, such as tax shelter clients who want their shelter promoters to withhold their identification from Service requests under the list-maintenance requirements. These costs can skyrocket in major cases with hundreds of emails and other documents at stake.

Court expenses are not the only costs. To the extent that the Service must resort to summonses or other processes to access information necessary to an adequate conclusion on audit, costs of evaluating taxpayer compliance increase and the salutary influence of effective enforcement dwindles, leading to more noncompliance, further privilege battles, and wasted resources. The documents most desired to be protected will be planning documents that reveal the way the transaction came to the taxpayer’s attention, the taxpayer’s purpose for entering into the transaction, and the taxpayer’s awareness of other participants’ roles (e.g., whether amounts projected to be paid to other participants are indeed fees to accommodation parties rather than entrepreneurial returns from a joint venture, as claimed in the Castle Harbour transaction). Without that evidence, the Service may be unable to prove essential elements of its case.

Privilege disputes also draw out tax controversies and substantially delay any court decision that ultimately may hold a reporting position improper and assess penalties against the taxpayer and/or advisor. The ability of court decisions to serve as bellwethers to give taxpayers and advisors notice of the kind of tax minimization conduct that oversteps the line is therefore substantially restrained. A court decision’s impact on the development of social norms around tax minimization practice will likely be insubstantial when the decision deals with activities that took place five or even ten years before the opinion is issued. Taxpayers and practitioners can rationalize current procedures as being based on substantially different facts or understandings of law that were not available to the litigating taxpayers at the time. Once again, the fundamental fairness of the tax system is jeopardized, as aggressive taxpayers lower their tax burdens at the cost of compliant taxpayers.


These arguments suggest, as I have proposed, that the scope of attorney-client privilege should be significantly limited. Communications and materials prepared in the pre-return, tax planning stage should not be eligible for privilege protection. At most, there are some arguments that communications during the audit stage should be eligible for privilege protection, under the Frederick “antechamber to litigation” approach.

6. Harms to Clients from Elimination of Privilege Overstated

The arguments for the broad scope of privilege in the tax context rely on the basic goal of the privilege to encourage communications with clients. Practitioners opposed to removal of the common law privilege protection for all pre-return tax planning advice are likely to claim that clients will fail to seek out advice altogether, especially in respect of more aggressive transactions, rather than risk loss of confidentiality. This argument is not convincing. For taxpayers who enter into legitimate business transactions, the need for guidance in structuring to avoid unnecessary tax liability will lead them to seek help from qualified advisors. That their tax structuring discussions may come to the Service’s attention should not be a deterrent, when the transactions arose in their business and they are in any event required to report them on their returns. Providing a true, accurate and complete disclosure of a transaction’s impact on a reporting position could only be seen as a detriment if a taxpayer intends to secure an illicit tax benefit. The threat of disclosure here does no harm. Others have noted that even in cases for which an attorney may be required to maintain lists of clients and provide reports under the material advisor rules, there is no reason to suppose that “a taxpayer would be dissuaded from seeking tax advice regarding the structuring and reporting of those transactions.” In that case, there does not seem to be a rational basis for maintaining the privilege. The substantial, harmful impact of withholding information, letting the audit lottery exempt a large number of inaccurate returns, and

---

290 See, e.g., Kirst, supra note 266 (arguing generally for extending work product doctrine to cover transactional work to allow attorneys to better plan for potential litigation and to protect attorney advice from disclosure).

291 See, e.g., Elizabeth G. Thornburg, Sanctifying Secrecy: The Mythology of the Corporate Attorney-Client Privilege, 69 NOTRE DAME L. REV. 157 (1993) (arguing against three myths about need for privilege — to get clients to talk to lawyers, to get lawyers to advise clients, and to protect lawyer-client relationship).

292 Lavoie, supra note 197, at 198.
requiring the Service to engage in intensive investigative work in respect of any return position that does come to its attention on audit is not counterbalanced by any need for special encouragement to clients to seek legal advice. In fact, it appears that the main function of privilege in the pre-tax return context is as a cover for potentially abusive tax advice.

A related objection is that the lack of privilege will highlight problems on a taxpayer's return and increase the probability that a weak position will be challenged at audit. It can be expected that the more worried a taxpayer is about a potential challenge, the more likely the issue will be addressed in a tax opinion. Without privilege, the opinion will serve to flag the issue for the Service. A somewhat flippant response to such a concern might be — so what? The self-assessment nature of the tax system presupposes that taxpayers will provide all information relevant to the correct assessment of their tax liabilities. "[T]he impact of increased scrutiny is only that the correct tax treatment of an item will be determined." The taxpayer will pay neither more nor less tax than what is actually owed. Furthermore, penalties will not apply when a taxpayer reports properly in accordance with the applicable standards (whether the heightened standard proposed here or the current litigation-based standards).

7. Work Product Protection Unmerited for Pre-Return Tax Advice

The work product doctrine, developed in the seminal Hickman case and then incorporated in court rules, provides an evidentiary privilege at court for materials prepared "in anticipation of litigation" (and not some other reason). The rationale for fact and opinion work product protection in this context is that investigative efforts and material preparation shape the client's course of conduct throughout the adversarial process. The existence, or imminent existence, of an

---

293 Id. Elimination of the privilege should therefore not increase noncompliance even for taxpayers and tax practitioners on the fringes of ethical behavior. The privilege is a factor that protects noncompliance by removing access to otherwise relevant materials at the audit and litigation stages. Elimination of the privilege should foster greater compliance in the same way that increased enforcement does.

294 Hickman v. Taylor, 329 U.S. 495 (1947) (providing work product protection for attorney's investigation into ship's sinking, because company reasonably expected sinking would result in litigation and wanted to timely capture information to prepare).

295 FED. R. CIV. P. 26(b)(3). The doctrine distinguishes between fact and opinion work product, with almost absolute protection given to an attorney's opinion work product.
adversarial process is central. Because of the likelihood that withholding potentially relevant information from trial could substantially impact a trial outcome, the burden is on the party asserting the privilege to establish its applicability. The general interpretation is that a lawyer must have had a subjective belief that litigation was a reasonable possibility and that belief must have been objectively reasonable.

There are essentially two standards for the doctrine among federal courts. Some circuits apply a narrow view of the doctrine to tax cases, setting the timeline for protection of tax documents at the point when litigation is reasonably anticipated or expected and the primary purpose for the documents is to aid in possible future litigation.296 This approach rests closely on the evidentiary rules and Hickman case.

A broader view of work product doctrine in the tax context has emerged in other courts. In United States v. Adlman, the Second Circuit rejected privilege claims for a lengthy legal memorandum analyzing the tax implications of a proposed restructuring, but ruled that work product doctrine could cover the document if it was prepared “because of” litigation possibilities.297 The Adlman test would not protect documents prepared in the ordinary course of business or that would have been created in the same form if there were no prospect of litigation, but it would protect documents prepared in connection with planned transactions if the documents considered potential litigation strategies. Although the decision maintains that a remote prospect of future litigation would be insufficient, it appears under the facts of the case that the mere fact that the memorandum considered the possibility that the recommended position would be sustained on the merits would bring it into the scope of work product protection.298 Commentators have seized upon this broader “because of” test for the work product doctrine to argue that courts should embrace a new transactional work product doctrine explicitly intended to protect the broad range of materials produced in connection with attorney participation in

297 United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998) (rejecting Fifth Circuit’s “primarily or exclusively to assist in litigation” standard and finding that memoranda prepared before transaction and before filing of returns could be considered prepared in anticipation of litigation, when taxpayer was constantly under audit and had substantial loss).
298 Id. at 1202-04 (elaborating on “because of” standard).
In line with the proposal for denying attorney-client privilege claims to pre-return advice, the less stringent "because of" test for work product protection should not be applied to protect pre-return tax advice from disclosure in the course of audits or litigation. Ironically, the broader concept of the doctrine would almost invariably shield from discovery most or all materials that could shed light on the actual nature and purpose of tax-motivated transactions. Tax-motivated planning inevitably looks forward to potential litigation because successfully avoiding difficulties at that point is a primary goal driving the structuring. Tax opinion letters, even those that are specifically requested by a taxpayer to advise on what position may be taken with respect to a tax return, are inevitably forward-looking. Tax standards for determining what positions can be reported are formulated in sufficiency of support and generally understood as translating into probability assessments of success on the merits if the position were to be litigated. The 2004 Jobs Act provisions for the application of the affirmative defense require an analysis that considers success on the merits without regard to the audit lottery or settlement opportunities to avoid actual litigation. The standards applicable to advisors are even more clearly related to probability assessments: the "reasonable possibility of being sustained on the merits" standard requires advisors to consider the likely course of a position through audit and litigation.

Furthermore, conflicting pressures from the customary industry practice of aggressive tax planning based on literalist interpretations, the apparent condoning of that practice in the Code standards, and, until recently, in the de minimis sanctions for violations, are at odds with the possible application in a court of judicial doctrines that tend to undercut literal interpretations of the Code. Because the Service may raise specific anti-abuse provisions or broad judicial doctrines on audit, advisors must consider the potential application of judicial doctrines to provide a complete analysis of the applicable substantive

---

299 See, e.g., Kirst, supra note 266, at 273–76 (acknowledging that extraordinarily broad work product protection in respect of "such a distant or indirect prospect of litigation... plac[es] some strain on the language of the [evidentiary] rule," but claiming it is justified to assure clients of protection from future litigation about course of transaction planning).

300 As in the case of the attorney-client evidentiary privilege, there is also a good argument that the audit stage of a tax controversy should not be treated as an adversarial process and that work product protection should not apply to any advice prepared specifically for discussion at that stage.
law. In fact, opinions that merely assume business purpose and pre-tax profit potential would fail the Circular 230 covered opinion standard.\textsuperscript{301}

Tax opinions thus focus both on statutory provisions applicable to a contemplated transaction and on judicial doctrines that may arise in litigation.

A tax opinion letter, sometimes called a legal opinion letter when issued by a law firm, is intended to provide written advice to a client on whether a particular tax product is permissible under the law and, if challenged by the IRS, how likely it would be that the challenged product would survive court scrutiny.\textsuperscript{302}

The per se forward-looking nature of tax planning should not allow those planning documents to leapfrog into work product protection. If work product protection is extended back to the planning stage, the basic purpose of the evidentiary privilege is lost. It becomes merely a taxpayer cloaking device that could well prevent the IRS from discovering almost all materials related to the reasons that the taxpayer entered into the transaction at issue or whether there was any economic substance to the transaction. Ironically, the work product doctrine, if applied to tax planning advice, would tend to be most obviously applicable to advice in respect of advisors and taxpayers who are most aggressive in advising and engaging in potentially abusive tax transactions, since the potential for litigation, if discovered on audit and addressed in depth on audit, would be substantially more certain for those transactions than for less aggressive positions.

The rationale for work product protection, like the rationale for the attorney-client privilege, is actually less convincing in the tax planning context. Clients will not avoid involving tax advisors in planning their transactions out of fear of exposing litigation strategies: instead, their focus will be on structuring transactions so well that litigation will not be necessary.\textsuperscript{303} Nor is work product protection

\textsuperscript{301} See 31 C.F.R. § 10.35(c)(1)(ii) (unreasonable to assume business purpose or pre-tax profit), (c)(1)(iii) (inappropriate to rely on business purpose representation if inadequately described or advisor should know it is incorrect or incomplete).

\textsuperscript{302} \textit{SENATE REPORT, supra} note 9, at 55.

\textsuperscript{303} Transaction structuring, in fact, pre-determines most litigation strategy. For example, once advisors designed the Castle Harbour transaction, \textit{supra} note 14, to support an allocation of 98% of the partnership's income to the foreign bank (in spite
needed “to prevent a litigant from taking a free ride on the research and thinking of his opponent’s lawyer.” In tax cases, the self-assessment system and the compliance norm that supports it require transparency about positions and reasons for failing to adopt coherence-supporting conclusions about a particular transaction’s tax consequences. In particular, if the heightened standards for reporting positions are adopted as recommended here, it would be inappropriate to allow taxpayers and practitioners to stymie enforcement by hiding behind either the attorney-client privilege or work product protection. Failure to disclose information could effectively hamstring the Service by making it extraordinarily difficult for the government to demonstrate a failure to comply with compliance norms relating to opinion giving, disclosure requirements or substantive tax law provisions.

IV. CONCLUSION

This article argues that the stage is set for a paradigm shift in the way we expect taxpayers and tax advisors to comply with tax laws. The existing norms for tax advisors encourage zealous advocacy for clients’ positions even in nonadversarial transactional planning stages. The general trend towards literal interpretations of statutes is exacerbated, with many if not most tax practitioners viewing it as their right to seek out and exploit loopholes in the way the provisions apply to innovative structures. Because the penalty standards and ethical standards for reporting and advising positions are based on litigation standards, there is constant pressure to achieve tax minimization and little pressure to get the right answer. The corporate tax shelter regulations and the reportable transaction regime inaugurated a shift towards greater transparency, and the 2004 Jobs Act’s enactment of stiff penalties and stiffer standards for penalty protection, at least in the context of transactions that have a significant tax avoidance purpose, move the target for taxpayer and advisor behavior towards better compliance. Circular 230’s significant changes to opinion practices continue the momentum. Moving from a focus on the “cookie cutter” tax shelters that are marketed to scores of taxpayers to a broader focus on customized tax planning reveals a need to

of the bank’s much lower capital contribution), the taxpayer had little choice at trial not to follow the form of the transaction. See Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967) (seminal case stating strong form of rule that taxpayer cannot disavow the form of its transaction).

United States v. Frederick, 182 F.3d 496, 500 (7th Cir. 1999).
systematize the changes already initiated and complete the shift to a compliance expectation that undercuts the force of aggressive tax minimization planning. Two further changes hold promise of accomplishing the goal: to extend the MLTN substantial authority standard to taxpayers and advisors in respect of any position and to eliminate the application of evidentiary privileges to the pre-return tax planning context.