The Regulation of Tax Advice and Advisers

By David Weisbach and Brian Gale

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The rules governing tax advice have been dramatically revised and extended in the last decade. They now have a level of complexity similar to that typically found elsewhere in the tax laws rather than in the broad prescriptions normally found in ethical rules. Many of the rules are intricate and their interactions unintuitive. Tax advisers must be familiar with the details of the rules or risk violations. In this report, Weisbach and Gale survey the rules regulating tax advice and tax advisers and put them in perspective by comparing them with the rules in place in 1990.

I. Introduction

Tax advisers working in 1990 would be unlikely to recognize their world in 2011. In 1990 they were subject to the general rules governing all lawyers, plus a handful of relatively modest special rules that usually did not apply or had only a limited effect. Advice had special value because it could be used to avoid penalties, and it was less likely to be discoverable than under current law. Although criminal indictments and prosecutions were used by the government, the cases rarely involved advisers at high-profile and well-respected professional firms.

Twenty years later, all of this has changed. There is now a body of rules directly regulating the content and quality of tax opinions. Opinion practice is also indirectly regulated through a substantial increase in malpractice suits and through the criminal prosecution of tax advisers and their firms. Further, the value of opinions is now much lower. Standards required to avoid penalties have been heightened, and for some transactions, clients cannot use opinions to avoid penalties (particularly if the adviser has helped structure the transaction, which is almost always the case). Opinions are also more likely to be (forcibly) disclosed, which means that they now provide a roadmap for the government, further reducing their value. Finally, giving an opinion with a high level of confidence is now more difficult because of the wide-ranging use of antibuse and similar rules in the code and regulations. In short, the costs of giving tax advice have gone up and the value down.

Most of these changes to the regulatory structure were in response to the proliferation of tax shelters in the late 1990s and early 2000s. Some advisers were selling mass-produced opinions as penalty protection without regard to the underlying merits. Many of the government’s responses were aimed at taxpayers: The government changed substantive laws, enhanced the reporting and penalty regimes,
and codified the economic substance doctrine. But it also significantly changed the rules governing tax advisers because misbehavior by advisers was a central cause of the growth of shelters.

The result is a highly complex set of regulations — only tax lawyers could have decided to regulate tax lawyers this way. To our knowledge, there is no current in-depth survey of these rules. We provide one here. To give context, we compare the current rules with those in place in 1990. This comparison gives a sense of the significant change in the rules. While as a general matter we do not comment on the wisdom of these changes, in particular or overall, we cannot help but note that the changes are dramatic and complex.

At the start, we should note the limitations in our coverage. We focus only on advisers engaged in tax planning, by which we mean experts providing tax advice before the taxpayer engages in a transaction. We do not cover return preparers and the complex set of rules governing their activities. We concentrate on tax planning because this is where some of the most striking changes have taken place and because we have to limit our scope to make the topic manageable.

It is difficult to divide into neat segments the services tax experts provide — tax planning, tax return preparation, audit, and litigation — because each step is always in anticipation of future steps. Ex ante tax advice is always to some extent return preparation, which is to some extent in anticipation of audits, and so forth. Transactions may occur over time, so that some advice is given before any steps have taken place, but other advice occurs midstream, after some steps but before others, mixing up the various stages of advice. Also, many of the rules that we discuss apply generally to all tax services. This means that we must make judgment calls about our coverage. The most difficult issue is the extent to which the rules for tax return preparers should be thought of as regulating advisers. An adviser structures a transaction so that the taxpayer may ultimately report the desired tax treatment. If the rules for what can be reported change, so must the advice. We will offer some comments on reporting standards, mostly in connection with American Bar Association Opinion 85-352, but will not discuss return preparation more generally.

The second limitation of our coverage is that we focus on lawyers rather than accountants or other providers of tax advice. We discuss the bar association rules and legal malpractice issues but do not generally discuss the regulation of accountants, such as through the American Institute of Certified Public Accountants, or accounting malpractice issues. Nevertheless, most of the rules governing tax lawyers offering planning advice apply to other providers of advice.

The third limitation is that we do not separately consider the regulation of in-house tax counsel. Although in-house counsel is generally subject to the rules we consider here, they also raise special issues. For example, the privilege rules may apply differently to in-house counsel.

The fourth limitation of our coverage is that we do not discuss the general rules applicable to all (that is, nontax) lawyers, such as the conflict of interest rules or the rules governing fee structures, client records, and the like. These rules, particularly those involving conflicts, would require a separate report. To keep the scope manageable, we do not cover these issues. Instead, we address only the rules focused on tax advisers.

The fifth limitation of our coverage is that we focus only on regulation within the United States, even though many of the firms where advisers

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2 The economic substance doctrine, now defined in section 7701(o), was codified in 2010. H.R. 4872, P.L. 111-152. For a general discussion of the codification of the doctrine, see Monte A. Jackel, “Dawn of a New Era: Congress Codifies Economic Substance,” Tax Notes, Apr. 19, 2010, p. 289, Doc 2010-6878, or 2010 TNT 75-3.

3 We pick this year because it is the year that one of the authors, Weisbach, entered tax practice, and because it is generally before the rise of modern shelters that in part brought about many of the changes to the rules.


5 For example, Circular 230 applies to all federally authorized tax practitioners, which includes tax attorneys focusing on compliance and controversy matters as well as other non-attorney individuals, such as CPAs and other enrolled agents. Circular 230 refers to those individuals collectively as “practitioners” and frames the various rules in terms of practitioner conduct, behavior, and so forth. A recent proposal by the IRS would expand the ethical standards to all paid return preparers, which could increase Circular 230’s reach to more than one million additional individuals. See 75 Fed. Reg. 51713.

6 See, e.g., Akzo Nobel Chemicals Ltd. v. Commissioner, Case C-550/07 (2010) (not yet published in ECR) (holding that communications between a company and in-house counsel were not privileged on the grounds that the counsel was not independent).

7 As of 1990 and in its current form, Circular 230 contains provisions that are substantially similar to the general ethics rules that apply to all lawyers — for example, rules regarding conflicts of interest, solicitation of clients, and fees. The main difference for advisers is that Circular 230 is enforced by the IRS while the rules governing lawyers generally are enforced at the state level by bar associations.
work are global. As a result, advisers face additional sources of regulation and rules that may have significant effects on how they act. For example, recent cases in the United Kingdom\textsuperscript{8} and European Court of Justice\textsuperscript{9} illustrate that the privilege and disclosure concerns that abound under U.S. law are international issues as well. Also, foreign governments and international institutions may impose their own restrictions on advice, further complicating the field in which advisers operate. However, those considerations are beyond the scope of this report.

While we concentrate on just a subset of tax advisers and a subset of the rules that govern them, the scope, content, and complexity of these rules is substantial. In Part II, we provide an overview of the various sources of authority for adviser regulation. While the IRS plays a paramount role through Circular 230 and its administration of the code and regulations, several other sources are also involved, including state bar associations, clients (through state malpractice claims), the Department of Justice, and the courts. In Part III, we explore the various restrictions that regulate advice and compare them to the limited provisions in place in 1990. We also analyze the evolution of the rules governing accuracy-related penalties and exceptions. Part IV then considers the increases in record-keeping and disclosure requirements that now provide government investigators access to substantially more information. After discussing the role that state malpractice claims play in regulating adviser behavior in Part V, we then survey the expanded use of criminal indictments and sanctions. This includes an exploration in Part VI of the prosecution of several advisers at high-profile firms for promoting shelters.

II. Sources of Authority

Before getting into the content of the regulations, we explore who exactly is doing the regulating. Tax advisers are subject to regulation by at least six distinct sources of authority. First, as attorneys, they are subject to the same ABA Model Rules of Professional Conduct that govern all lawyers. Second, they are regulated by the IRS through Circular 230 and its Office of Professional Responsibility. Third, there are a number of code provisions and regulations that govern tax advice. Fourth, tax attorneys are regulated through state malpractice cases. Fifth, the DOJ Tax Division regulates advisers by bringing civil and criminal charges when it deems appropriate. Sixth and finally, courts considering tax cases play a role as an indirect source of regulation, because they assess when advice may be used for penalty protection.\textsuperscript{10}

A. State Bar Associations

Tax advisers are subject to the ethical rules that govern all practicing attorneys, as set forth in the ABA Model Rules and adopted in some form by almost every state bar association. The rules are meant to regulate the behavior of lawyers in carrying out the “special responsibility” they have to maintain the quality of justice and integrity of the system. \textsuperscript{11} Attorneys who violate the rules are theoretically subject to the disciplinary authority of their state bar associations, with punishments ranging from censure to disbarment.

Because of the vast array of legal practice areas, the rules remain relatively broad and general in content. However, the ABA has also dealt more directly with the ethical regulation of tax practitioners in several of its ethics opinions. \textsuperscript{12} While these opinions explore an array of tax practice subjects, including controversy, compliance, and shelter promotion, the most recent opinion (ABA Opinion 85-352) was issued more than 25 years ago.

B. The IRS: Circular 230 and OPR

The IRS is the most significant source of authority for advisers, operating in two different realms. First, as an administrative agency, the IRS regulates attorneys (and other advisers) who practice before it. Also, the IRS regulates advisers through its interpretations of the various code sections that implicate tax advice.

The IRS regulates who is able to practice before it and therefore subject to the duties and restrictions laid out in Circular 230. \textsuperscript{13} Under current law, “practice before the IRS” is defined broadly and includes all matters connected to a presentation to the IRS, as

\textsuperscript{8}Prudential PLC v. Special Commissioner of Income Tax, EWCA Civ. 1094 (2010) (ruling that there is no general legal professional privilege for accountants, although recognizing that such a privilege is a fundamental human right).

\textsuperscript{9}For example, as explained in supra note 6, Akzo Nobel Chemicals held that communications between the company and its in-house counsel were not privileged on the grounds that the counsel was not independent.

\textsuperscript{10}Other sources of regulation — such as the firms where advisers work and professional malpractice insurers — may also have significant effects on the behavior of advisers. However, to keep the analysis manageable, we do not explore these sources in depth.

\textsuperscript{11}ABA Model Rules of Professional Conduct, preamble and scope.

\textsuperscript{12}See ABA Opinion 314 (1965); ABA Opinion 346 (1982); ABA Opinion 85-352 (1985).

\textsuperscript{13}See 31 U.S.C. section 330 (granting Treasury authority to regulate and sanction — including fining, censuring, suspending, or disbarring — those practicing before it); Circular 230, section 10.0 (discussing the scope of Circular 230 and the IRS’s source of authority).
well as the rendering of written advice regarding any transaction having a potential for tax avoidance or evasion.14 (For purposes of this report, the term “transaction” broadly includes any entity transaction plan or arrangement, or other plan or arrangement, since most restrictions in Circular 230 and the code apply to these structures and activities.)

The current definition is a significant change from the prior version, in which tax advice on a transaction having the potential for avoidance or evasion was not included in “practice before the IRS.”15 Thus, before amendments in the last few years,16 most planning advisers likely did not believe they were regulated by Circular 230, because they were not deemed to be practicing before the IRS by only offering advice.

While compliance with the ABA ethical rules is monitored by an attorney’s state bar association, Circular 230 is overseen by the IRS through OPR. Under prior law, the regulating office was not part of the IRS, but instead was part of the office of the Treasury General Counsel. Not only are violations potentially more noticeable (because the regulating body is also the adversary), but the sanctions that may be levied on advisers differ. A variety of potential sanctions are available to the IRS under Circular 230, including censure, suspension, disbarment, and monetary fines.17 The regulations under Circular 230 also elaborate on the procedural and administrative rules that apply when a disciplinary proceeding commences.18

C. The IRS: The Code and Regulations

In addition to the IRS’s regulation of advisers under Circular 230, the code and regulations also set forth several rules and regulations applicable to advisers. These include duties related to record-keeping and disclosure requirements, and civil and criminal penalties for providing advice on shelters, assisting a client in evading taxes, or submitting false statements to the IRS. Penalties for violations vary depending on the code provision, ranging from fines and injunctions to imprisonment. The extensive rules governing tax return preparers under sections 6694 and 6695, however, do not apply to pure planning advisers, although most advisers likely provide some return preparation assistance and are therefore subject to sections 6694 and 6695 to that extent.19

Also, the accuracy penalties that apply to taxpayer understatements influence the behavior of advisers. While advisers are not actually subject to penalties under these code provisions, the opinions that advisers provide may be used by taxpayers for penalty protection in some circumstances, with their value depending on the content and confidence level.

D. State Malpractice Claims

State malpractice claims act as a source of regulation of tax advisers. Unlike the regulatory restrictions overseen by state bar authorities and the IRS, there are no explicit standards of conduct that advisers must follow to avoid being held liable for malpractice claims. Instead, clients may bring actions when their advisers violate professional norms in offering tax advice, resulting in ambiguity as to what claims are actionable. Although not overseen by any central authority, potential liability for advisers on these claims is significant.

E. The DOJ Tax Division

The DOJ Tax Division regulates advisers by investigating alleged misconduct and bringing civil and criminal charges when it deems appropriate. As discussed below, the array of tools that the government has available to use against advisers is extremely powerful. That arsenal includes an array of potential charges when an adviser obstructs an investigation or the IRS’s enforcement of the tax laws — that is, entirely apart from the merits of the advice provided. As a result, DOJ attorneys are vested with significant prosecutorial discretion to

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15See old Circular 230 section 10.2(a)(4). (For purposes of this article, we denote the various statutory and regulatory provisions in place in 1990 as “old” to distinguish them from the current rules.) In the 2007 amendments, the IRS expressly noted the expansion of the definition in the preamble. T.D. 9359, Doc 2007-21746, 2007 TNT 187-9.
16The covered opinion regulation was implemented in 2004, but the change in definition to “practice before the IRS” did not occur until 2007.
17See Circular 230 sections 10.50 and 10.52.
18See Circular 230 section 10.60 et seq. We largely ignore these aspects of Circular 230 in this report.
19The penalties set forth in section 6694 apply to tax return preparers. The code and regulations provide extensive elaboration on who is considered a preparer for penalty purposes. In general, a tax return preparer is any person who prepares a substantial portion of a return for compensation. See section 6694(f) (cross-referencing the definition set forth in section 7701(a)(36)). Preparers include some individuals who provide tax advice constituting a substantial portion of a return. However, the regulations provide that an individual will not be treated as a preparer if less than 5 percent of his aggregate time is spent on advice after events have occurred, unless the timing of the advice was specifically designed to avoid potential liability. See reg. section 301.7701-15(b)(2)(i). Because advisers generally provide advice before events or transactions occur to give guidance to taxpayers, rather than to avoid section 6694 penalties, the rules in section 6694 generally do not apply to them.
regulate advisers through enforcement of civil and criminal federal statutes.\textsuperscript{20}

F. Courts

Finally, the courts serve an indirect role in regulating advisers. Ultimately, they determine when violations of the tax law occur and when taxpayers may be able to avoid penalties through the various exceptions available under the code. Also, they ascertain when misconduct by advisers should be punished through civil fines or injunctions, or when criminal penalties are appropriate. Importantly, once a case commences, the standards under Circular 230 are no longer applicable. Instead, the court’s own rules govern in determining whether penalties or sanctions are appropriate. As explored below, some recent decisions illustrate how significant a role courts can play in regulating adviser behavior.

III. The Regulation of Advice

As noted, tax advice was lightly regulated in 1990. Now it is regulated in two distinct ways: direct regulation of the content and scope of advice; and regulation on the use of advice, such as the ability to use it to avoid penalties. We address each type of regulation, first offering a brief overview of each type of advice and then turning to how it is regulated.

A. Background on Advice and Opinions

The daily work of a tax adviser is to help clients structure transactions to minimize tax obligations while complying with myriad tax rules and regulations. In so doing, tax advisers, as a matter of course, offer views on whether a given transaction or structure will receive a specified treatment. Some of these views are communicated orally to clients, but most often clients eventually want a written product.\textsuperscript{21}

In daily practice there are often distinctions between different types of written product. Opinions are formal and highly reviewed documents, typically requiring multiple reviews and approvals of partners in the firm. Informal advice, such as an e-mail or memo, does not typically get this level of scrutiny. Current law, however, does not follow this distinction. Instead, as we will discuss, it distinguishes between “covered opinions” and other written advice.\textsuperscript{22} The discussion below applies to all written advice, which we refer to collectively as opinions.

Opinions analyze how the tax law applies to a given transaction. They vary along two key dimensions: their scope and their confidence level.

1. Scope. Opinions range from full scope to limited scope. Full scope opinions consider all tax issues involved in a given plan or transaction and reach conclusions on the likely treatment of each. The rules governing tax advice generally encourage full scope opinions because they do not leave related (and often important) tax issues unaddressed.

Nonetheless, limited scope opinions, or those that consider only a subset of the tax issues involved in a given transaction, are permitted in some cases.\textsuperscript{23} For example, the regulations for the taxpayer underpayment penalty provisions do not prohibit reliance on opinions simply because they are limited in scope.\textsuperscript{24}

2. Confidence level. The other significant dimension on which tax opinions vary is the confidence level (or standard) that the desired treatment of the transaction analyzed in the opinion will be upheld. The confidence level is critically important to the level of protection from various penalties that an opinion offers to taxpayers. It may also matter to clients for a variety of other purposes, such as for accounting or internal procedures. Further, specific confidence levels are required for advisers to avoid certain penalties.

There appears to be a distinction between the confidence levels discussed in the code or other authorities and the confidence levels often demanded by clients.\textsuperscript{25} In particular, the code and other regulatory authorities do not refer to “should” or “will” level opinions. Many clients,

\begin{itemize}
\item \textsuperscript{20}In addition to fines and penalties, the government may also seek an injunction under section 7408. See infra note 125.
\item \textsuperscript{21}No direct restrictions on oral advice exist aside from the adviser’s general duties under the ABA Model Rules and any potential civil or criminal sanctions. Therefore, we do not discuss oral advice below.
\item \textsuperscript{22}See Circular 230 sections 10.35 and 10.37.
\item \textsuperscript{23}For covered opinions under section 10.35, attorneys may issue limited scope opinions if, among other requirements, (1) there is an agreement between the attorney and client that reliance on the opinion for purposes of avoiding penalties is limited to those issues discussed in the opinion; (2) the opinion is a covered opinion only because of the significant purpose category (defined below) and is not a marketed opinion; and (3) the opinion includes the appropriate disclosures, as provided in section 10.35(e). Circular 230 section 10.35(c)(3)(v)(A).
\item \textsuperscript{24}Reg. section 1.6664-4(c)(1)(i)-(ii).
\item \textsuperscript{25}For a survey of the various confidence levels used in practice, which are more expansive than those discussed in the authorities, see Jasper L. Cummings, Jr., “The Range of Legal Tax Opinions, With Emphasis on the ‘Should’ Opinion,” Tax Notes, Feb. 17, 2003, p. 1125, Doc 2003-4373, or 2003 TNT 33-19.
\end{itemize}
however, require “should” opinions for other reasons, such as obtaining the correct accounting treatment of a transaction or for internal purposes.26

Limiting ourselves to the confidence levels mentioned in the code and regulations, there are five main standards that are discussed. In increasing level of confidence, the standards are:

1. non-frivolous27;
2. reasonable basis28;
3. realistic possibility of success on the merits29;
4. substantial authority30; and
5. more likely than not proper.31

Despite their importance both to taxpayers and advisers, several of the standards are not precisely defined, at least in percentages, but rather are framed in ordinal terms.32 Yet the standards are used throughout the code, the related regulations, and Circular 230.

Notably, an opinion is not necessarily exempt from coverage under section 10.35 of Circular 230 just because it does not contain a specific confidence level. Thus, an adviser issuing an informal opinion is in a particularly precarious position, because he may be less scrupulous in following the applicable regulations, even though the advice still falls under section 10.35 coverage.

B. Direct Regulation of Opinions

The regulatory rules have evolved since 1990 from a regime that focused on syndicated tax shelters to one in which a significant amount of advice is now subject to (or at least directly influenced by) various restrictions. In particular, finalization of the covered opinion rules in section 10.35 dramatically altered the landscape for planning advice, greatly increasing Circular 230’s coverage and placing significantly higher requirements on advisers.

1. 1990: ABA opinions 346 and 352 and old section 10.33. The key distinction in 1990 was whether the advice constituted a tax shelter opinion. If it did, heightened standards applied. However, most advice fell outside the scope of tax shelter opinions, which meant that the only arguably applicable regulation was ABA Opinion 85-352, which governed advice on tax return positions.

a. Tax shelter opinions. In 1990 the only regulations that explicitly regulated planning advice applied to a so-called tax shelter opinion, which was defined as advice concerning the federal tax law applicable to a tax shelter if the advice was referenced either in offering materials or in connection with sales promotion efforts directed to persons other than the client who engaged the lawyer to give the advice.33 In essence, this was an opinion that was part of a syndicated shelter of the sort that was being sold in the 1970s. If the advice was a tax shelter opinion, it was governed by ABA Opinion 346 and old Circular 230 section 10.33 (which then applied to tax shelter opinions).34

ABA Opinion 346, which still technically contains the ethical rules regulating tax shelter opinions,

26Cummings explores the evolution of the “should” standard and its relationship to financial accounting and SEC reporting requirements. Id. at 1130. Also, a CFO or tax director may demand “should” opinions as a way to monitor the activities of employees in their departments.

27While not precisely defined in percentage terms, the standard is described as significantly lower than other confidence levels. For example, the reasonable basis standard is described as being below the substantial authority standard but significantly higher than the non-frivolous standard. Reg. section 1.6662-3(b)(3).

28Neither the code nor the regulations provide a fixed percentage of the likelihood of success sufficient to satisfy the standard. Instead, it is simply described as being significantly higher than the non-frivolous standard but below the substantial authority standard. Reg. section 1.6662-3(b)(3). Because no fixed percentage is provided, the exact ordering of the reasonable basis and realistic possibility of success standards is unclear. However, the reasonable basis standard is often equated with a 20 percent likelihood of success. See, e.g., Joint Committee on Taxation, “Comparison of Joint Committee Staff and Treasury Recommendations Relating to Penalty and Interest Provisions of the Internal Revenue Code,” JCX-79-99 (Nov. 5, 1999), at 13, Doc 2000-2825, 2000 TNT 19-12.

29The realistic possibility of success standard is one of the few given an exact probability — defined as a one-in-three likelihood of success. See reg. section 1.6662-3(a) (cross-referencing reg. section 1.6694-2(b)). (Although reg. section 1.6662-3(a) references the definition set forth in reg. section 1.6694-2(b), the standard discussed in reg. section 1.6694-2(b) has since been changed to the more likely than not standard. Thus, one must refer to the prior version of reg. section 1.6694-2(b) for the definition of realistic possibility of success.)

30Like the reasonable basis standard, neither the code nor the regulations provide a fixed percentage of success that is required. The standard is instead described as falling between the reasonable basis and more likely than not standards. Reg. section 1.6662-4(d).

31More likely than not is the highest confidence level discussed in the various regulatory rules. It is, by definition, a greater than 50 percent likelihood of success.

32For example, both the reasonable basis and substantial authority standards are defined in this manner.

33ABA Opinion 346 (1982); old Circular 230 section 10.33(c)(3). Note that the definition requires the advice to be related to a tax shelter, so advice in normal offering materials, such as securities offerings, is unaffected. A tax shelter is a transaction with deductions or credits in excess of income from the investment so as to offset income or taxes from other sources.

34Because the two authorities overlapped significantly — the IRS explicitly acknowledged that its intent was to follow the (Footnote continued on next page.)
provides that it is a violation of the disciplinary rules to issue an opinion that ignores or minimizes serious legal risks or misstates the facts as law, knowingly or through gross incompetence. Moreover, a practitioner must be diligent in gathering facts from the promoter. A variety of ethical requirements apply, including addressing all material tax issues and providing an analysis of the likely outcome of each. The ABA opinion does not prohibit an adviser from issuing a tax shelter opinion even if he does not conclude that the tax benefits will be realized — it just requires that full disclosure of the negative conclusion be stated.

Similarly, old section 10.33, which included similar definitions for the terms “tax shelter” and “tax shelter opinion,” set forth diligence requirements for fact gathering and legal analysis. It required that the adviser provide an opinion whether the more likely than not standard was satisfied for each material tax issue as well as for the transaction as a whole. The regulation also provided that a favorable overall evaluation may not be rendered unless the more likely than not standard is met for at least half of the material tax benefits. Any conclusion below that confidence level — or a conclusion that the material tax benefits would not be realized in the aggregate — was required to be clearly and prominently disclosed in the offering materials.

b. Other advice. Most advice did not constitute a tax shelter opinion, because it was not part of a syndicated shelter. Instead, it was given directly to (and was for the use of) a particular client. The standards for tax shelter opinions therefore did not affect much everyday practice. There was a significant body of hortatory commentary, but it did not have any binding effect. For example, commentators debated whether tax attorneys had a duty to the government (or revenue system) in addition to the duty to their clients.35 Others simply encouraged practitioners to use their own morality as a guide in providing advice on transactions when the tax treatment was unclear.36

The most relevant regulation was contained in ABA Opinion 85-352, which provides that an attorney may not advise reporting a position on a return unless there is a realistic possibility of success. The exact scope of coverage is unclear because the ABA opinion refers to return preparation, but that term does not appear to be defined in the limited manner as found in section 7701(a)(36), and it therefore likely applies to pure advisers. Regardless, because clients receiving advice before a transaction will ultimately want to report the desired position on their return, ABA Opinion 85-352 effectively regulates advisers even if they are not return preparers.

The standard contained in Opinion 85-352 is quite low from today’s perspective. It is, however, higher than what governed previously under the ethical rules. ABA Opinion 314 provided that a reasonable basis was required for attorneys advising their clients in the preparation of a return. The standard in Opinion 314 was construed by attorneys to support nearly any colorable claim to justify exploitation of the audit lottery.37 In fact, the standard was perceived as being so low that it had obtained the moniker of the “laugh aloud” standard, under which an attorney met his ethical duties as long as he could suggest a position without laughing aloud.38 With these low standards governing most advice offered, advisers faced few direct restrictions on their practices in 1990.


Unlike the regulatory regime governing advisers in 1990, the current rules regulating opinions are vast, with Circular 230 setting forth the key rules for written advice. The provisions in Circular 230 directly relevant for that advice are sections 10.35 and 10.37, with section 10.35 undoubtedly the most significant. Section 10.35’s coverage and key organizational concept is the covered opinion. If advice constitutes a covered opinion, the adviser issuing it is subject to heightened standards and requirements.

a. What is a covered opinion? Whether written advice constitutes a covered opinion under section 10.35 depends both on the type of transaction involved and, in some cases, the form of the advice. First, written advice is a covered opinion if it involves a listed transaction.39 Listed transactions are defined as those the same as or substantially similar to transactions that the IRS has specifically identified by notice, regulation, or other form of published guidance to be tax avoidance transactions.40

Also, section 10.35 applies to written advice on any transaction when the principal purpose is

37ABA Opinion 85-352 (explaining why a reconsideration of ABA Opinion 314 was necessary).
40Reg. section 1.6011-4(b)(2).
avoidance or evasion (principal purpose transactions).41 By “principal purpose,” it is meant that the tax avoidance purpose exceeds any other. However, if the statute or congressional purpose intends specific tax benefits, a transaction seeking to claim those benefits is not deemed a principal purpose transaction.

Finally and most importantly, written advice constitutes a covered opinion if it involves any transaction when a significant purpose is avoidance or evasion (significant purpose transactions) and the written advice is either a reliance opinion, a marketed opinion, or is subject to conditions of confidentiality or contractual protection.42 The regulation defines a reliance opinion as written advice that includes a confidence level of at least more likely than not that one or more significant federal tax issues would be resolved in the taxpayer’s favor. A marketed opinion is written advice when the adviser knows (or has reason to know) that the advice will be used or referred to by a person other than the adviser in promoting, marketing, or recommending a plan or arrangement to taxpayers.

A central question is when a transaction has a significant purpose of avoiding taxation. Section 10.35 does not define significant purpose, although it does define principal purpose.43 An important exception to the principal purpose definition is that a transaction is not a principal purpose transaction if its purpose is to claim tax benefits in a manner consistent with the statute or congressional purpose. If this limitation carries over to the scope of significant purpose — and it is hard to see why it would not — much of the day-to-day advice given by advisers may be exempt. Determining the scope of this exception, however, will often be difficult, because many transactions do not fall squarely within the clear intent of a particular statute — taxpayers do not go to advisers for the easy cases. Because of uncertainty over the scope of this definition, advisers are therefore likely to want to follow section 10.35 in most cases.

b. Requirements for covered opinions. If advice is a covered opinion, section 10.35 requires that it meet specified standards for identifying and ascertaining the facts, for relating the law to the facts, for evaluating significant federal tax issues, and for reaching an overall conclusion.44 For example, covered opinions may not contain internally inconsistent legal analyses. Many opinions assert in one part of the analysis that unambiguous words in the code may be relied on regardless of congressional intent, while in another part of the analysis, they assert that words should be interpreted based on the legislative history. This sort of inconsistent legal analysis may not be allowed for covered opinions.

Another important requirement when evaluating significant federal tax issues is that for listed transactions, marketed opinions, and principal purpose transactions, advisers must address each significant tax issue. Limited scope opinions are allowed only for significant purpose transactions, and then only with a specific agreement with the client on the scope of the opinion and with the appropriate disclosures to the client.

Finally, section 10.35 imposes requirements regarding the level of confidence expressed in an opinion. For a marketed opinion, advisers must reach an overall conclusion that the tax treatment is more likely than not correct. An adviser need not reach this level of confidence for other opinions (such as significant purpose opinions), but if he does not, the adviser is required to disclose that the standard is not met and to notify taxpayers that the opinion cannot be used to avoid penalties.45

Note, however, that the required disclosure may actually be false. As we discuss below, taxpayers may rely on opinions to avoid the negligence penalty, which requires only a reasonable basis. Moreover, taxpayers may avoid penalties for negligence and substantial understatements under section 6664 through reasonable cause and good faith. Taxpayers may rely on advice to meet this standard, and for noncorporate taxpayers, the advice does not need to reach the more likely than not level.46 It appears,

41Circular 230 section 10.35(b)(2)(i)(B).
42Circular 230 section 10.35(b)(2)(i)(C). Some types of written advice that would otherwise qualify as a covered opinion are explicitly exempted from these significant purpose transactions, including written advice (1) that satisfies the requirements of the section when an attorney is reasonably expected to provide subsequent advice; (2) that would otherwise be a covered opinion by way of the significant purpose category and concerns specified issues; (3) that was provided after a tax return has been filed (assuming no expected reliance on the taxpayer); (4) that was provided to an employer by an employee; and (5) that does not resolve a federal tax issue in the taxpayer’s favor at any confidence level. Circular 230 section 10.35(b)(2)(ii)(A)-(E).
43See Circular 230 section 10.35(b)(10).
44See Circular 230 section 10.35(c).
45See Circular 230 section 10.35(e)(4). When a disclosure is required, the attorney is also banned from providing any advice that is contrary to or inconsistent with the required disclosure. Circular 230 section 10.35(e)(5). Additional disclosures are required for some circumstances. See Circular 230 section 10.35(e)(1)-(3).
46Note that the disclosure would be correct for reportable transactions, because taxpayers must establish a reasonable belief that the more likely than not standard is met for reportable transaction understatements. Not all covered opinions

(Footnote continued on next page.)
nonetheless, that advisers may not tell their clients that the disclosure is false, because section 10.35 prohibits advisers from providing advice that is contrary to the disclosure.\textsuperscript{47}

These requirements represent a substantial change from the rules in place in 1990, when the only related restrictions applied to opinions on tax shelters, defined narrowly. Section 10.35 applies to a much larger class of transactions and advice, including most transactions in which advisers’ opinions are likely to offer value to taxpayers as penalty protection.

c. Requirements for other written advice. If written advice is not a covered opinion, it is subject to the lesser requirements of section 10.37. Section 10.37 imposes due diligence and reliance requirements on attorneys rendering advice, but in a more general fashion than the specific rules of section 10.35, and the differing rules for limited (versus full) scope opinions do not apply. Moreover, section 10.37 does not require that opinions meet any particular confidence level (or require disclosure if that level is not met).\textsuperscript{48} A heightened standard of care applies for advice that the attorney knows (or has reason to know) will be used by another person in promoting, marketing, or recommending a plan or arrangement when a significant purpose is avoidance or evasion of tax. Still, no explicit confidence level is mandated even under this heightened standard.

C. Value of Advice

One of the central benefits of obtaining an opinion is to protect against the possibility of penalties.\textsuperscript{49}

Entail advice on reportable transactions, however. For example, principal purpose transactions may not be reportable transactions.

\textsuperscript{47} Also note that if an adviser cannot reach an overall more likely than not conclusion, it may not make sense for the advice to conclude that the more likely than not standard is satisfied for any one issue. If the opinion reaches that level for any single issue, the opinion may be a covered opinion (as reliance opinions are defined). But if none of the issues reaches that level, it is not. This would seem to be an unintended result.

\textsuperscript{48} Circular 230 section 10.37.

\textsuperscript{49} Although not all the standards included in sections 6622, 6622A, and 6664 (and the associated regulations) explicitly discuss the use of professional opinions or advice, those opinions are critical to establishing that the various standards are met in practice. Also, the regulations establish that while legal opinions may not serve as authority for positions, the authorities underlying those opinions may give rise to authority for the tax treatment. See reg. section 1.6662-4(d)(3)(iii). Moreover, a taxpayer will likely have substantial difficulty arguing good faith if no opinion supporting his position is obtained. Some commentators suggest that the primary reason for obtaining opinions is not about penalty protection but thorough documentation and development of a case. See, e.g., Robert W. Wood, “What Good Is a Tax Opinion, Anyway?” Tax Notes, Sept. 6, 2010, p. 1071, Doc 2010-17703, or 2010 TNT 174-6. Nonetheless, even this desire for thorough documentation and evaluation contributes heavily to a taxpayer’s argument of good-faith reliance.

For example, obtaining an opinion can establish a reasonable attempt to comply with the law or help show a reasonable belief that a given tax position is correct, thereby avoiding penalties. The rules for when taxpayers may avoid penalties have changed significantly since 1990, and in general, the changes have reduced taxpayers’ ability to rely on opinions.

1. Accuracy-related penalties and exceptions in 1990. The penalty rules in 1990 were relatively straightforward. There were two relevant penalties: the negligence penalty and the substantial understatement penalty.\textsuperscript{50} The negligence penalty applied to tax underpayments resulting from a failure to make a reasonable attempt to comply with the law.\textsuperscript{51} Taxpayers could avoid the negligence penalty if they had a reasonable basis (or a realistic possibility of success, if the position was contrary to a revenue ruling or notice).\textsuperscript{52}

The substantial understatement penalty applied to understatements of a specified size.\textsuperscript{53} If the transaction was not a tax shelter, the penalty could be avoided if there was substantial authority for the position or there was adequate disclosure.\textsuperscript{54}

If, however, a substantial understatement under section 6662(b)(2) related to a tax shelter, taxpayers could avoid penalties only by satisfying heightened requirements. A tax shelter was defined as a transaction in which the principal purpose is avoidance

Footnote continued in next column.)

2010, p. 1071, Doc 2010-17703, or 2010 TNT 174-6. Nonetheless, even this desire for thorough documentation and evaluation contributes heavily to a taxpayer’s argument of good-faith reliance.

Other underpayment penalties were included in the statute, including the valuation penalties. But we focus on negligence (or disregard of the rules) and substantial understatements.

\textsuperscript{50} Old section 6662(b)(1); old reg. section 1.6662-3.

\textsuperscript{51} Old section 6662(b)(1); old reg. section 1.6662-3. Also, the regulations set forth an additional exception when the position was not frivolous and the taxpayer adequately disclosed the transaction. The taxpayer was also required to keep adequate books and records and properly substantiate items for the exception to be available. However, unlike with substantial understatements, discussed below, the exception for adequate disclosure (and a non-frivolous position) is laid out in the regulations rather than expressly in the code. And the exception was included in one of the few subsections of the regulations that was not made retroactive to 1989.

\textsuperscript{52} Old section 6662(b)(2); old reg. section 1.6662-4.

The regulations imposed several additional requirements for the adequate disclosure exception to be available, including a non-frivolous standard and the maintenance of adequate books and records. Unlike for understatements resulting from negligence or disregard of the rules, the exception was available in 1990 because it was expressly incorporated into the statute. However, the additional requirements (non-frivolous standard and maintenance of records) were not mandated in 1990, since they were contained in the few subsections of the regulations that were not made retroactive.
or evasion of taxes. There were two requirements for avoiding penalties for tax shelters: substantial authority for the position, and the taxpayer’s reasonable belief that the treatment was more likely than not correct. The regulations provided that reasonable belief could be based on the taxpayer’s own analysis or on a professional adviser’s opinion unambiguously stating that the more likely than not standard was met. Unlike for non-shelter items, disclosure was not available to escape penalties for understatements due to tax shelter items.

In addition to the various exceptions included in section 6662 and the related regulations, a general exception existed in section 6664 for instances of reasonable cause and good faith by the taxpayer. All facts and circumstances were taken into account in ascertaining whether the exception applied, with the extent of the taxpayer’s effort to determine his proper tax liability being the most important factor. Reliance on the advice of a professional adviser could constitute reasonable cause and good faith if that reliance was reasonable. No explicit confidence level was required for the exception to be available, and no other requirements were imposed on the form or content of the advice.

As can be seen, in 1990, opinions could provide substantial protection from penalties. They could protect against the negligence penalty because obtaining an opinion is an attempt to comply with the law. While not authority, they could help establish that the confidence levels were met for both negligence and substantial understatement penalties. They protected against an understatement penalty for a tax shelter because they could help establish a reasonable belief that the more likely than not standard was met. Finally, they could help meet the section 6664 exception to penalties by establishing reasonable cause and good faith.

2. Accuracy-related penalties and exceptions in 2011. Several major developments since 1990 have significantly reduced the value of advice. First, section 6662 was amended to increase its coverage and reduce the available exceptions. Second, regulations under section 6664 increased the standards for tax opinions that the taxpayer seeks to rely on. Third, Congress enacted section 6662A, which imposes heightened standards and requirements for taxpayers seeking penalty protection from understatements stemming from listed and most reportable transactions. The corresponding amendments to section 6664 (adding subsection (d)) included direct restrictions on what advice could be relied on by taxpayers asserting a defense of reasonable cause and good faith. Finally, the courts imposed additional requirements on advice for taxpayers seeking to avoid penalties. Also, the Tax Court’s recent decision in Canal Corp. v. Commissioner raises serious concerns for taxpayers (and their advisers).

a. Amendments to sections 6662 and 6664. Over the last two decades, Congress and the IRS significantly modified sections 6662 and 6664 and the associated regulations. Some of the amendments increased the potential coverage of section 6662, resulting in penalties on a larger number of understatements. However, most of these changes make it more difficult for taxpayers to qualify for penalty exceptions. Changes were made to both the special rules for tax shelters and to the rules governing other transactions.

For transactions that are not shelters, the following are among the most important changes to section 6662:

- Even if a transaction is adequately disclosed, a reasonable basis is now required for penalty protection, compared with a non-frivolous standard under prior law.
- The adequate disclosure exception is no longer available when a corporation is involved in a multiple-party financing transaction and the treatment does not clearly reflect the corporation’s income.
- Most recently, a new class of underpayment was added: any disallowance of tax benefits after determination that the transaction lacked economic substance under section 7701(o).

There are no exceptions to this rule.

For substantial understatements attributable to tax shelters, the changes to section 6662 include the following:

- tax shelters are defined more broadly to include any transaction in which a significant

55Old section 6662(d)(2)(C); old reg. section 1.6662-4(g)(2). The regulations elaborated that avoidance or evasion is the principal purpose when that purpose exceeds any other. Old reg. section 1.6662-4(g)(2)(i). “Tax shelter items” were simply items of income, gain, loss, deduction, or credit related to the tax shelter transaction. Old reg. section 1.6662-4(g)(3).
56Old section 6664(c); old reg. section 1.6664-4.
purpose is avoidance or evasion of taxes instead of the principal purpose; and

- taxpayers are no longer protected from penalties by establishing substantial authority and reasonable belief that the claimed treatment was more likely than not proper.

The relevant text of section 6664 is the same as it was in 1990, but there were changes to the regulations. Under current regulations, for a taxpayer to rely on advice to avoid penalties, (1) the advice must consider all facts and circumstances; (2) the advice must not make unreasonable assumptions; and (3) a taxpayer may rely on the invalidity of a regulation only if he adequately discloses the challenged position. The regulations under section 6664 have separate rules for tax shelter items of corporate taxpayers. They require the demonstration of substantial authority and a reasonable belief that the more likely than not standard is satisfied. For purposes of the latter requirement, the regulations provide that belief can be established through the corporation’s own analysis or reasonable reliance in good faith on a professional adviser’s opinion.

b. Section 6662A: Reportable transaction understatements. The most significant statutory change since 1990 to the accuracy-related penalties was the enactment of section 6662A and corresponding amendments to section 6664, imposing heightened requirements on taxpayers seeking penalty protection from understatements on some reportable transactions. A reportable transaction understatement is defined as any understatement due to a listed transaction or any other reportable transaction when a significant purpose is the avoidance or evasion of federal tax. (See Part IV.A.2 for a discussion of the definition of reportable transaction.)

As under section 6662, tax opinions and other advice serve a valuable role in making specified exceptions available for taxpayers to avoid penalties under section 6662A. The key differences between understatements under section 6662 and reportable transaction understatements under section 6662A are the opportunities to avoid penalties. For reportable transaction understatements, the general exceptions discussed in section 6662 and the related regulations do not apply. Instead, section 6664(d) sets forth heightened requirements for the reasonable cause and good-faith exception to be available, including that (1) all relevant facts of the transaction are disclosed in accordance with section 6011 and the associated regulations; (2) substantial authority for the position exists (or did exist at the time of the transaction); and (3) the taxpayer reasonably believed that the treatment was more likely than not the proper treatment. To be reasonable, the taxpayer’s belief must be based on the facts and law at the time of the return filing, and no considerations of audit or settlement probability may be factors.

Moreover, the code explicitly provides that some advisers and opinions may not be relied on to form a taxpayer’s reasonable belief. These include advice from a material adviser who participates in the organization, management, promotion, or sale of the transaction (or that is related to any person who participates), and an adviser who is compensated directly or indirectly by a material adviser or who has a fee arrangement that is contingent on the transaction being sustained. These rules have a significant effect on taxpayers and advisers, because they restrict the amount and type of advice on which taxpayers may rely when seeking protection from penalties. They could potentially foreclose taxpayers from relying on opinions from their regular tax advisers because most advisers have a role in structuring transactions. After paying an adviser to structure the transaction, a taxpayer seeking penalty protection may then be required to pay a second adviser for an opinion, significantly increasing costs.

The effect of this rule depends on the breadth of the definition of the term “organization, management, promotion or sale,” because most advisers issuing opinions make at least some suggested changes to the organizational structure of the transaction. Shortly after enactment of section 6662A, the
IRS issued guidance that allows material advisers to continue recommending modifications to the proposed transaction as long as the suggestions are immaterial. While this may alleviate some concerns that nearly any adviser issuing an opinion is disqualified, there is ambiguity surrounding what modifications will be considered material. After all, if a change is truly immaterial, why is an adviser suggesting it?

A second important change is that the statute now, for the first time, provides rules for the content of opinions. An opinion is disqualified if it is based on unreasonable factual or legal assumptions; unreasonably relies on representations, statements, findings, or agreements of the taxpayer; or does not identify and consider all relevant facts. These rules are similar to the rules found in Circular 230, so they may be largely duplicative. Nevertheless, inclusion of these requirements in the statute itself is significant because it is now Congress regulating the content of tax opinions, not just an administrative agency. It remains to be seen how aggressively the IRS plans to use sections 6662A and 6664(d) as enforcement tools, but when coupled with the changes to section 6662, they represent a significant change from prior law.


The last key source of authority affecting the value of advice to taxpayers is the courts, because they scrutinize claims of reasonable reliance by taxpayers seeking to avoid penalties. Although the issue of reasonable reliance is not new to the courts, it has taken on an increased importance. In response to the boom in shelters in the late 1990s and early 2000s, there appears to be an increase in shelter litigation in recent years. The IRS seems more aggressive in levying penalties, thus requiring greater consideration by courts. In addition to assessing the statutory and regulatory requirements in the code, regulations, and Circular 230, the courts also impose restrictions on when taxpayers may rely on advice to avoid penalties. Although the statutory and regulatory authorities contain some parallel provisions — for example, under section 6664(d), taxpayers may not rely on opinions from disqualified advisers to escape penalties for reportable transaction understatements — the courts’ requirements are independent.

To get a sense of what restrictions courts have imposed on taxpayers seeking to rely on opinions, we reviewed all the son-of-BOSS cases. Because this was one of the most prominent shelters, those cases provide a survey of how courts generally evaluate taxpayer claims of reliance in tax shelter cases, which is when penalties are most often imposed. Of the 10 cases discussing accuracy-related penalties in depth, the courts found penalties appropriate in 9 of them.

Several key aspects of the courts’ analysis affect when opinions may be reasonably relied upon. First, when antiabuse rules are implicated, courts generally require that an opinion appropriately consider relevant antiabuse rules and document why the transaction (and reporting position) is nonetheless valid. For example, in Palm Canyon X Investments LLC v. Commissioner, the Tax Court concluded that the advice could not be relied on because it did not make a reasonable evaluation of the law regarding economic substance. As a result, even when there is sufficient authority to otherwise maintain a reporting position, taxpayers may be

72 Courts determine when the various statutory and regulatory requirements are satisfied. For example, they weigh the authorities and determine when specified confidence levels are met under section 6662. They also determine when assumptions and representations included in advice are unreasonable, as discussed in the regulations — for example, reliance is unreasonable when a presumption of profit is incorporated into the opinion. See, e.g., Jade Trading LLC v. United States, 80 Fed. Cl. 11 (2007), Doc 2007-28072, 2007 TPT 248-5, aff’d, 598 F.3d 1372 (10th), Doc 2010-6335, 2010 TNT 56-10.
73Moreover, many of the new rules, including sections 6662A and 6664(d), were enacted after the facts in the shelter cases transpired and thus are not explored in the opinions.
74Our review was limited to cases that were litigated and in which an opinion was issued, thus excluding cases that settled. We restricted our search to cases discussing accuracy-related penalties (specifically, sections 6662 and 6664) and Notice 2000-44, 2000-2 C.B. 255, Doc 2000-21236, 2000 TNT 157-7 (which was issued by the IRS to prohibit son-of-BOSS transactions). To keep our discussion manageable, we do not consider jurisdictional issues under the 1982 Tax Equity and Fiscal Responsibility Act, including whether some partner-level defenses are available, and we focus on accuracy-related penalties for negligence and substantial understatements (and the related exceptions), excluding discussion of valuation penalties.
75The only exception of the cases reviewed is NPR Investments LLC v. United States, in which the court concluded that the taxpayers reasonably believed there was a chance for profit and reasonably relied on an opinion from R.J. Ruble (later convicted and imprisoned in the criminal case against KPMG and Sidney Austin Brown & Wood). 2010 WL 3199621 (E.D. Tex., Aug. 10, 2010), Doc 2010-4106, 2010 TNT 38-12. NPR Investments seems to be an outlier, however, and we will not discuss it in depth.
77T.C. Memo. 2009-288 at *35-36.
unable to rely on an opinion if it did not provide an appropriate evaluation of the relevant antiabuse rules.

Second, and perhaps more significantly, courts prohibit taxpayers from relying on advice to avoid penalties when there is a conflict of interest, finding reliance to be unreasonable or good faith to be lacking in those cases. For example, a taxpayer is prohibited from asserting a defense of reasonable cause and good faith when the opinion comes from a shelter promoter whose compensation is contingent on completion of the shelter (such as through a fixed percentage of the tax savings). In those cases it may seem reasonable to prohibit reliance since the taxpayer is not receiving advice from a truly independent party. However, in recent cases some courts take a broader view in finding a conflict of interest far beyond the promoter context. For example, in Canal Corp., the court held that Canal could not reasonably rely on the opinion it received from PricewaterhouseCoopers because any advice received was tainted by "an inherent conflict of interest." In so concluding, the court focused on several facts, including the $800,000 fixed fee that could not reasonably rely on the opinion it received from PwC issuing a "should" opinion. Although issued recently, the decision in Canal Corp. has already drawn substantial criticism from practitioners.

Finally, for advice to offer penalty protection to taxpayers, advisers must ensure that the opinions discuss the exact transactions at issue and are received before the taxpayers take a reporting position. While these additional requirements may seem somewhat obvious, the failure to meet them has led to penalties in several prominent cases. For example, in Santa Monica Pictures LLC v. Commissioner (which was not a son-of-BOSS case), the taxpayer claimed reasonable reliance on a number of opinions and other advice, but the court held that many did not discuss the exact transaction at issue, preventing reliance. Also, in Long Term Capital Holdings v. United States, the court held that the lack of receipt of any formal opinions negated the taxpayer’s claims of reasonable reliance. These cases demonstrate that courts are scrupulous in requiring that specified formal and procedural elements be met as well.

Aside from the recent developments in Canal Corp., the requirements from courts may not be substantially different from how reliance claims were evaluated under prior law. However, with the proliferation of shelters and the resulting increase in litigation, courts are becoming more experienced in (and likely more adept at) evaluating reasonable reliance claims. And as the use of antiabuse rules grows, courts are likely to require more thorough analyses in opinions. Overall, the manner in which courts evaluate reasonable reliance claims and the additional requirements they impose further narrow the availability of penalty protection for taxpayers and may force advisers to adjust their client relationships to ensure the advice’s value is maintained.

IV. Record Keeping, Disclosure, and Privilege

In addition to restrictions on the form and content of advice and increased requirements for advice to be relied on by taxpayers, advisers also face complicated rules regarding protection of their clients’ identities and the disclosure of written advice and work. In recent years the trend is toward less protection on both fronts. As compared with the rules in place in 1990, the code now imposes substantially greater record-keeping and disclosure requirements on advisers, inhibiting protection of client identities. Further, increased demands by auditors and the IRS, as well as heightened requirements for taxpayers seeking penalty protection, have greatly increased the amount of written advice and work available to the government.

A. Protection of Client Identity

Ordinarily, lawyer-client confidentiality extends only to communications between lawyers and clients, and the identity of a client is not a communication. Yet if identifying the client effectively discloses communications, the client’s identity may also be privileged.

This issue was litigated in the tax shelter context in United States v. BDO Seidman. In that case, several unnamed taxpayers filed a motion to prevent BDO Seidman from disclosing their identities to the IRS. They argued that their identities were protected from discovery by the tax practitioner

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Footnotes:

79134 T.C. No. 9.
80Id. at 32, 36-38.
84337 F.3d 802 (7th Cir. 2003), Doc 2003-21218, 2003 TNT 187-17.
85The accounting firm was being investigated for its alleged involvement in tax shelter marketing and, more specifically, failure to comply with the registration and record-keeping requirements under sections 6111 and 6112. As part of the
privilege. The Seventh Circuit rejected the privilege arguments and held that the identities were not protected from disclosure on the grounds that there was no expectation of confidentiality because of the disclosure and record-keeping requirements imposed by sections 6111 and 6112.

Shortly after the ruling in BDO Seidman, the class of transactions to which the record-keeping and disclosure requirements apply was expanded significantly — from tax shelter transactions to all reportable transactions — making protection of client identities even more difficult.

1. 1990: Record-keeping and disclosure requirements for tax shelter transactions. Under the rules in effect in 1990, the IRS could issue John Doe summonses requesting disclosure of client and transaction information, but the explicit statutory burdens on advisers were not very onerous. Tax shelter organizers were required to register their shelters with the IRS and furnish specified information. An organizer was the person primarily responsible for organizing the shelter (or, in some cases, individuals participating in its sale or management). The rules employed a complicated calculation method for determining what constituted a tax shelter, which included computing a so-called tax shelter ratio.

Also, organizers or sellers were required to maintain a list of investors in the tax shelter, as well as other plans or arrangements that had the potential for avoidance or evasion, as prescribed in the regulations at the time. Because of the limited number of transactions that qualified as shelters and the small number of advisers that constituted organizers, the requirements were not a substantial burden. Penalties for individual violations of the provisions were relatively insubstantial, although they could be quite large when aggregated for syndicated shelters. For example, as part of its deferred prosecution agreement, KPMG agreed to pay $100 million in fines for failing to register tax shelter transactions with the IRS.

2. 2011: Record-keeping and disclosure requirements for reportable transactions. The record-keeping requirements on advisers are now much more significant, and penalties for violations are substantially greater. Under section 6111, material advisers of reportable transactions must file a return identifying the reportable transaction and the potential tax benefits that may be derived. Reportable transactions include: (1) listed transactions and substantially similar transactions; (2) confidential transactions; (3) transactions with contractual protection; (4) loss transactions when losses over a specified size are claimed under section 165; and (5) transactions of interest (which essentially includes anything the IRS identifies in published guidance).

In addition to the requirement to disclose the existence of a reportable transaction, advisers must also maintain lists of advisees for any reportable transaction for which they act as material advisers. The basic penalty for failure to disclose is now $50,000. If the transaction is a listed transaction, the penalty is the greater of $200,000 or 50 percent of the gross income from advising on the transaction (or 75 percent for intentional failure to disclose). While the basic requirements — disclosure and record keeping — are the same, the number of covered transactions (and potential penalties) increased significantly from 1990.

B. Protection of Written Advice and Work

In addition to protection of client identities weakening, the amount of protection for written advice has fallen in recent years. The IRS has extensive summons powers under the code to allow it to determine whether taxpayers have accurately reported their tax liabilities. Changes to the IRS’s ability to use that power (and its willingness to exercise it) have increased the chances that written advice will be disclosed.

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90Failure to register was punishable by a fine equal to the greater of 1 percent of the aggregate amount invested in the shelter or $500, and additional penalties applied for failure to furnish a shelter identification number or to include the number on a return. Old section 6707. Failure to maintain such a list was punishable by a fine of $50 for each person not included, with a maximum fine of $100,000 in one year. Old section 6708.

91Reg. section 1.6011-4(b). The commissioner may exempt specified transactions in published guidance (or through individual letter rulings) that would otherwise constitute reportable transactions under the regulations. Reg. section 1.6011-4(b)(8).

92Section 6112(a).

93Similarly, failure to keep a list of advisees is subject to a fine of $10,000 for each day after a 20-day grace period. Section 6708(a). However, a reasonable cause exception is available. Under section 7408, the IRS also has authority to seek an injunction against advisers for violations of sections 6707 or 6708.

94See section 7602.
Before the proliferation of tax shelters in the late 1990s and early 2000s, the IRS was relatively conservative in its requests for written work. The Supreme Court in *United States v. Arthur Young & Co.*, held that there was no work product privilege for accountants regarding their tax accrual workpapers. Nonetheless, after *Arthur Young*, the IRS established a policy of self-restraint and requested workpapers only in extraordinary circumstances. However, to combat shelter activity, the IRS revised its policy in 2002 to request workpapers when taxpayers engaged in listed transactions, including requesting all workpapers (not just those for the relevant transaction) when disclosure was not made.

Ideally, the IRS would like access to all materials discussing the tax positions claimed by taxpayers, including formal opinions, memorandums, e-mails, and other documentation. However, the IRS’s discovery authority is subject to the traditional limitations and privileges that apply to an adversary in litigation, including the attorney-client and work product privileges.

The attorney-client privilege protects confidential communications between attorneys and their clients when those communications are made with an expectation of confidentiality and for the purpose of rendering legal advice. When any significant portion of the communications is disclosed to a third party, the privilege is waived.

In contrast, the work product privilege protects documents prepared in anticipation of litigation. Unlike the attorney-client privilege, the work product privilege is not absolute — adversaries may still obtain access to some documents if they demonstrate substantial need and undue hardship. Heightened protection is provided for mental impressions or opinions offered in the documents. However, the work product privilege is more difficult to waive than the attorney-client privilege. Generally, the privilege is waived only when a document is disclosed to an adversary or when disclosure would allow an adversary to obtain access.

The protection of written advice and work under the attorney-client or work product privilege ultimately depends on whether it was disclosed and, if disclosed, to whom and why. If written advice is not disclosed, the core rule remains: It is protected by privilege. However, in recent years the amount of disclosure required of taxpayers — both by the IRS and third parties (such as auditors) — has increased significantly. Also, the rules governing when privilege is waived have evolved. Collectively, these changes have resulted in far more frequent findings of waiver and increased disclosure of written advice and work to the government. Advisers effectively have to assume that all written advice may or will be available to the government.

1. Increased work disclosure to auditors under FIN 48 and Textron. Recent changes to financial accounting reporting and auditing rules have significantly increased the amount of client disclosures that auditors now require. As a result, there is an increased risk that written tax advice will become available to government investigators as well.

In the past, auditors were generally amenable to helping clients keep their written work privileged. However, in light of the corporate scandals that dramatically changed auditing firms and how audits are conducted, the focus of auditors changed. No longer concerned with helping their clients maintain privilege, auditors were driven to obtain all relevant information to enable a thorough and independent review of companies’ financials.

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95 Fed. R. Civ. P. 26(b)(3)(B). When disclosure is mandated, the mental impressions and other opinions are to be redacted.
96 Assuming the other requirements of the attorney-client and work product privileges are satisfied (e.g., the communications relate to legal advice for the attorney-client privilege and the work is prepared in anticipation of litigation for the work product privilege), there is no waiver because there has been no disclosure. While the work product privilege may be overridden in cases of substantial need and undue hardship, mental impressions are still protected. And no similar exception applies to the attorney-client privilege.
Even more significantly, in 2006 the Financial Accounting Standards Board issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes,” to improve the accuracy of tax positions reported in a company’s financial statements, requiring auditors to review workpapers and written advice even more thoroughly. FIN 48 essentially prohibits companies from recognizing a tax benefit unless the position will more likely than not be sustained on the merits, and it restricts the amount of tax benefit that may be recognized based on the associated confidence levels. To verify the positions that their clients claim, auditors began requiring even more supporting documentation. More recently, the IRS finalized new requirements mandating that some corporations\textsuperscript{106} report uncertain tax positions on a separate schedule.\textsuperscript{107} However, in conjunction with the new schedule requirement, the IRS announced that it will not require tax positions on a separate schedule.\textsuperscript{108} How- ever, in conjunction with the new schedule requirement, the IRS announced that it will not assert a claim of privilege waiver when materials that are otherwise privileged are provided only to an accounting firm as part of an independent audit (and do not involve unusual circumstances or listed transactions).\textsuperscript{108}

Disclosure by taxpayers of opinions and other work product to their auditors and accountants is generally thought to result in a waiver of attorney-client privilege since there is no longer an expectation of confidentiality.\textsuperscript{109} However, the work product privilege is generally not waived when materials are shared with a taxpayer’s auditors. In contrast to the attorney-client privilege, which is waived through disclosure to any third party, work product protection is waived only when the material is disclosed (or made available) to an adversary. Thus, when work product is shared with a firm’s auditors, the privilege is generally maintained, since the auditors are not viewed as an adversary.\textsuperscript{110}

The more troubling issue for clients and their advisers seeking work product protection regards the anticipation of litigation requirement. To determine when the requirement is met for a dual purpose document — which most tax advising work is — most circuits use a “because of” test, while the Fifth Circuit employs a principal purpose test.\textsuperscript{111} Under these tests, the court decisions are mixed as to whether work product privilege protects tax accrual workpapers.\textsuperscript{112}

Recently, in United States v. Textron Inc.,\textsuperscript{113} an en banc First Circuit held that tax accrual workpapers prepared by lawyers and others in Textron’s tax department were not protected by the work product privilege. The court established a new dual purpose test that is even more restrictive than the principal purpose test used in the Fifth Circuit, asking whether the documents in question were “prepared for use” in litigation.\textsuperscript{114} Concluding that the documents were instead prepared for use in preparing financial statements, the court held that no privilege protection existed.\textsuperscript{115} Notably, the decision in Textron preceded FASB’s issuance of FIN 48,\textsuperscript{116} which may make it even more difficult for clients seeking protection.

As a result of the conflicts in authority, it is uncertain when written advice will be protected by the work product privilege. Workpapers prepared to support financial accounting reporting receive less protection than in the past, given the increased requirements from FIN 48 and demands from auditors. However, formal opinions and other planning advice will more likely be treated as created in anticipation of litigation — or at least as otherwise

\textsuperscript{106}Specifically, those that issue or are included in audited financial statements and have assets of at least $100 million. See Instructions to IRS Form 1120 Schedule UTP.

\textsuperscript{107}See IRS Schedule UTP; Instructions to Schedule UTP, Doc 2010-8705, 2010 TNT 75-8.


\textsuperscript{109}Williams et al., supra note 105, at 88; Monks, supra note 105, at 908. How frequently auditors require opinions or other planning advice is unclear. Much of the existing authority discusses work product related to calculating a taxpayer’s tax accruals and reserves for financial reporting purposes. In contrast, opinions and other advice from advisers are more focused on interpreting and applying the tax law and thus are more likely protected under the privileges.

\textsuperscript{110}Many courts seem to embrace this view. See, e.g., New Phoenix Sunrise Corp. v. Commissioner, 106 AFTR 2d 2010-7116 (6th Cir. 2010), Doc 2010-24825, 2010 TNT 224-13; United States v. Deloitte, 610 F.3d 129, 139-141 (D.C. Cir. 2010). However, others have found that the privilege is waived in some circumstances.

\textsuperscript{111}For a detailed discussion of the tests and the courts’ use of them, see Everett et al., supra note 110, at 87-88. The because of test requires only that the document be prepared because of the prospect of litigation. The principal purpose test requires that the primary motivation in preparing the document is to aid in potential future litigation.

\textsuperscript{112}See Everett et al., supra note 110, at 90-92.


\textsuperscript{114}Id. at 30. The First Circuit asserted that the only other case on point outside its circuit was the Fifth Circuit’s decision in United States v. El Paso Co., Id., citing 682 F.2d 530 (5th Cir. 1982).

\textsuperscript{115}Textron, 577 F.3d at 30.

\textsuperscript{116}Although the en banc decision was not issued until 2009, the underlying facts preceded FIN 48. Thus, the court did not address the new requirements.
protected by the requirement that mental impressions and advice remain confidential. Since planning advice is received before a transaction occurs, the taxpayer is more likely to succeed in arguing that FIN 48 or other financial accounting requirements were not the primary purpose. However, knowing financial statements will be prepared in the future, taxpayers and their advisers face substantial uncertainty in claiming work product protection.

2. Disclosure for penalty protection. In addition to satisfying financial reporting and auditing requirements, clients may also be required to disclose written work materials when they are seeking to use advice to avoid penalties under sections 6662, 6662A, and 6664. When a client attempts to use the written advice for penalty protection, privilege is necessarily waived. Because the taxpayer is putting the content of the advice directly at issue, he may not then assert that the materials are privileged and prevent the government from reviewing them.

As discussed above in Part III, the type of advice that may be relied on has been limited in recent years, particularly for reportable transactions. Further, when understatements stem from the disallowance of benefits through the economic substance doctrine, strict liability applies. These changes have two distinct effects on disclosure of written advice. They reduce the ability to rely on advice to avoid penalties, but they also reduce the need to disclose materials, because there is less potential benefit to disclosure. Thus, the net effect on the amount of disclosure by taxpayers is ambiguous. In other cases, however, the strengthened requirements for clients to avoid understatement penalties result in the need for increased disclosure. Consequently, a greater portion of written advice is now potentially available to government investigators, increasing liability exposure and reducing the value of advice.

V. State Malpractice Claims

State malpractice law acts as an independent and significant source of regulation of tax advisers. It sets minimum standards for advice, and advisers that fall below these standards may face claims for significant damages. Instead of a public enforcer — the IRS or the DOJ — malpractice claims involve a private enforcer. The regulatory effect is similar nonetheless.

There have been few clear changes in the content of state malpractice laws (as applied to tax advisers) since 1990. Instead, the biggest change appears to be in the frequency of suits. Although there are no good data, we are under the impression that malpractice claims against tax advisers have increased significantly in recent years, mostly in response to advice given in connection with tax shelters. There have been several high-profile class actions, some of which have been settled for large sums. Moreover, we are aware of several individual cases, many of which have ended in arbitration (and therefore produced little public record). This may just be a wave, and after the tax shelter litigation works its way through the system, the level of suits may return to 1990 levels. But as we write, there appears to have been a substantial increase in suits.

A detailed discussion of state malpractice law is beyond our scope. Instead, we offer four observations. First, it is unlikely that the standards for malpractice are significantly different than the standards imposed by the federal government under Circular 230 and under the rules for reliance on opinions. As a technical matter, the two are different; an adviser can satisfy the federal requirements and still be liable under a state malpractice claim, and vice versa. Nevertheless, for an adviser seeking to comply with the relevant legal standards, meeting the federal rules will be sufficient in most cases.

One reason for this is that tort laws (of which malpractice is a variety) often look to federal regulatory standards for guidance. The more central reason, however, is that the federal rules are a sensible set of guidelines for most cases. Making a

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118That is, the code explicitly prescribes that section 6664 is unavailable in cases when the economic substance doctrine applies.


121There could, of course, be any number of unusual situations in which a particular type of error is not covered under the federal rules but still creates malpractice liability.
reasonable attempt to determine the relevant facts, applying the law to those facts, evaluating all the issues (or, if specified, those issues that the client has asked to be addressed), and providing an overall conclusion are the core features of giving tax advice. The lack of one or more of these makes it likely that the attorney has not performed adequately. As we will discuss below, state malpractice law does not require that the attorney be correct on all issues; it only requires the exercise of good judgment and care. The federal standards require the same.

Second, a caveat to the above claim is what we call the ex post problem. Malpractice suits are inevitably brought once it is determined that the tax strategy at issue does not work.\textsuperscript{122} This creates an almost inevitable bias in evaluating the advice. To illustrate, suppose that an adviser determines that there is a two-thirds chance that a position will be upheld and a one-third chance it will not. That the position is not upheld says nothing about whether the advice is correct. After all, if the adviser had the odds right, in one-third of cases of this sort, the position will not be upheld. (And conversely, this logic does not imply that the advice was not in fact good advice.) Nevertheless, once the taxpayer (and judge and jury) know that outcome was bad, it is difficult not to view the opinion in a worse way.

Third — and offsetting this second factor — the greater use of antibuse rules has increased uncertainty in the tax law, and increased uncertainty may actually reduce the number of successful malpractice suits. This is because of the “error in judgment” rule. The rule holds that a mere error in judgment on an unsettled proposition of law is not malpractice.\textsuperscript{123} As tax law uncertainty increases, advisers must make more judgments, which means that advice about more areas of the law are subject to the error in judgment rule. A perhaps unintended consequence of the increased use of antiabuse rules, which are designed to reduce shelters, is that they may make one policing mechanism — malpractice suits — less likely.

Fourth, a central issue will be damages. The key issue is whether tax advisers are liable for lost opportunities.\textsuperscript{124} To illustrate, suppose that a tax adviser recommends a strategy without taking due care, and he is ultimately held liable. Is the adviser liable for taxes that could have been avoided with an alternate strategy that was not pursued because the taxpayer followed the bad advice instead? For a taxpayer to recover, he must establish the traditional elements of a negligence claim, including that the bad advice was the “but for” cause of the damages. That causation may be readily established for tax penalties, which may often be quite significant, that are incurred in following the bad advice. Also, clients may argue that the bad advice also caused lost opportunities — that is, the tax benefits that would have been available had good advice been provided — by preventing them from obtaining other (good) advice. The law is uncertain whether these damages may be recovered, but with the extent of potential adviser liability, state malpractice claims serve as yet another significant source of regulation for advisers.

VI. Other Statutory Penalties and Sanctions

Finally, advisers are also potentially subject to various civil and criminal penalties for misconduct. In recent years prosecutors have shown an increased willingness to pursue criminal charges against advisers that engage in wrongdoing and to impose substantial restrictions on firms through deferred prosecution agreements. While the statutory provisions at issue have changed little, if at all, since 1990, the recent cases against individuals at KPMG, Ernst & Young, and Jenkens & Gilchrist demonstrate the tough stance the government is taking on some types of illegal behavior.

A. Other Civil Penalties: Sections 6700 and 6701

Advisers are subject to civil penalties in the code, beyond the record-keeping and disclosure requirements for reportable transactions in sections 6111 and 6112. These provisions, which were substantially the same in 1990, apply to tax shelter promotion activities and general aiding and abetting activities.

Section 6700 prohibits the promotion of abusive tax shelters, subjecting violators to a penalty if two requirements are met.\textsuperscript{125} First, the person must organize a plan or arrangement, or participate in

\textsuperscript{122}Some have been brought before a final determination on tax liability has been made, but as far as we know, all shelter-related malpractice suits have been brought after strong indications from the government that the transaction does not work.

\textsuperscript{123}See Todres, “Investment in a Bad Tax Shelter,” supra note 119.

\textsuperscript{124}For an excellent recent discussion of the multitude of issues involved with tax malpractice damages, see Todres, “Tax Malpractice Damages,” supra note 119.

\textsuperscript{125}The penalty imposed depends on what type of misstatement is involved. If it is a gross valuation overstatement, the individual is subject to a penalty equal to the lesser of $1,000 or all gross income derived, for each instance. Section 6700(a). However, when the misstatement is false or fraudulent, the individual is subject to a penalty of 50 percent of the gross income derived. This second clause did not exist in the 1990 version of the statute. In addition to the monetary penalties laid out above for reportable transactions and tax shelters, the IRS also has authority to seek an injunction against advisers for violations of sections 6700, 6707, or 6708. See section 7408.
the sale of an interest. Second, the person must make or furnish (1) a statement regarding tax benefits that the person knows or has reason to know is false or fraudulent, or (2) a gross valuation overstatement. As with the prior versions of sections 6111 and 6112 (regarding tax shelter requirements), the scope of section 6700’s application is narrow.\(^{126}\)

In comparison, the aiding and abetting penalties under section 6701 potentially apply much more broadly. Section 6701 imposes a penalty of $1,000\(^{127}\) on any person that (1) aids or assists in, procures, or advises regarding the preparation or presentation of any portion of a return; (2) knows (or has reason to believe) that that portion will be used in connection with a material tax matter; and (3) knows that if so used, that portion would result in an understatement of the tax liability of another person.\(^{128}\) The penalty is expressly limited to one penalty per person per period. While section 6701’s coverage is potentially much greater, the penalties are relatively small, particularly with the one-person/one-period limitation.

**B. Criminal Penalties and Enforcement**

The criminal penalties in the code and other relevant federal criminal law provisions are perhaps of greater concern to advisers and have received much more attention in recent years. Although these penalties have changed little, if at all, in recent years, federal prosecutors have increasingly used them in challenging abusive planning activities. As explored below, many convictions of advisers were based on obstruction or cover-up activities rather than problems with the technical aspects of the advice provided. As illustrated in KPMG’s case, deferred prosecution agreements can also severely affect employees remaining in a firm, even when the misconduct involves only a small group of individuals and the firm is not indicted.

1. **Increased use of criminal charges by the government.** The criminal indictments against advisers at KPMG, Ernst & Young, and Jenkens & Gilchrist, among others, sent shockwaves through the tax advising community. A number of individual advisers at each firm, as well as other shelter participants, were indicted for their roles in designing, marketing, and selling shelters.\(^{129}\) The advisers were charged with violating multiple criminal provisions in the code as well as other federal criminal law statutes. While the Jenkens & Gilchrist case is ongoing, several advisers from the KPMG and E&Y cases were convicted and imprisoned. Below we provide some background on each case, including the charges levied against the defendants and the results.

   **a. KPMG.** In 2005 federal prosecutors obtained indictments against 19 individuals in what was hailed as the largest ever criminal tax case.\(^{130}\) Initially, six tax partners at KPMG, two former KPMG employees running a tax shelter boutique, and a tax partner from Brown & Wood\(^{131}\) were indicted for their part in tax shelter design and marketing activities.\(^{132}\) Ten others were later added, bringing the total to 19.\(^{133}\) The KPMG partners worked in various tax groups within the firm, including the personal financial planning group (for wealthy individuals), the innovative strategies group (for corporate clients), and the national tax group (meant to provide support and assist in transaction design throughout KPMG’s tax groups). Federal prosecutors charged the defendants with tax shelter fraud for designing and marketing shelters\(^{134}\) for wealthy individuals to eliminate or reduce taxes owed in exchange for a percentage fee of the tax savings. Together, the shelters were alleged to have generated at least $11.2 billion in phony tax losses, along with at least $115 million in gross fees for KPMG and at least $23 million in gross fees for Brown & Wood.

   The shelters were each packaged with a pre-written opinion letter that clients could use to defend against any later challenges by the IRS.

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\(^{126}\)\(^{126}\) However, others have noted the IRS’s attempts to expand its use of the statute. See, e.g., Brian R. Lynn, “But I Don’t Sell Tax Shelters! The Expanding Reach of the Code Sec. 6700 Promoter Penalty,” 82 Taxes 39 (2004).

\(^{127}\)\(^{127}\) Or $10,000 if the return is that of a corporation. Section 6701(b)(1)-(2).

\(^{128}\) Section 6701. Notably, the taxpayer is not required to have knowledge of the understatement.

\(^{129}\) For example, individual advisers at BDO Seidman and Sidney Austin Brown & Wood were also included in the indictments.


\(^{131}\) Brown & Wood merged with Sidney Austin in 2001. The combined firm is now known only as Sidney Austin LLP.

\(^{132}\) United States v. Stein, No. 1:05-cr-00888 (S.D.N.Y.), Document 1 (KPMG indictment), Doc 2005-17997, 2005 TNT 167-12. Unless otherwise noted, the information describing the allegations and charges was taken from the original indictment.

\(^{133}\) Stein, No. 1:05-cr-00888, Document 57 (KPMG superseding indictment), Doc 2005-21082, 2005 TNT 200-14.

\(^{134}\) The shelters that the partners were charged with promoting included FLIP (Foreign Leveraged Investment Program), OPIS (Offshore Portfolio Investment Strategy), BLIPS (Bond Linked Issue Premium Structure), and SOS (Short Option Strategy), along with variations of each. For a detailed account of the shelter design and marketing activities at KPMG, see Rostain, “Travails in Tax: KPMG and the Tax-Shelter Controversy,” in Deborah L. Rhode and David Luban (eds.), Legal Ethics: Law Stories, ch. 3 (2006).
Among the statements included in the opinion letters for the FLIP and OPIS transactions were that the investment strategy was based on capital appreciation, that the client had reviewed the economics and believed it had the potential for reasonable profit, and that there was no firm and fixed plan to complete the steps constituting the shelter. The government alleged that, in fact, clients were targeted based on their large taxable gains and that the only expected benefits were the phony tax savings. Similar pre-written opinion letters were included with the other shelters. Marketing of the shelters continued even after others within the firm suggested the claimed tax benefits would not be upheld if challenged. Federal prosecutors further alleged that the indicted partners fraudulently concealed the shelters by (1) not registering them as required by law; (2) causing to be prepared tax returns that concealed the losses; (3) asserting sham attorney-client privilege claims; and (4) obstructing IRS and Senate investigations into the shelter activities.

The defendants were charged with conspiracy to commit a number of federal crimes, including tax evasion and submission of false and fraudulent statements to the IRS. Ultimately, three defendants were convicted on multiple counts of evasion and sentenced to prison: the two former KPMG employees operating the shelter boutique and the former Brown & Wood tax attorney. However, charges were dismissed against most of the KPMG partners on constitutional grounds after federal prosecutors pressured KPMG to not pay for the partners’ legal defense fees. Nonetheless, as explored below in Part VI.B.ii, as part of its deferred prosecution agreement with the government, the firm was forced to undergo continual monitoring of its tax practice.

b. E&Y. Two years later, four former partners at E&Y were charged with various crimes for their role in the firm’s promotion and sale of tax shelters. Two additional defendants who owned and operated separate firms that helped market the structures developed by E&Y were later added to the indictment. The firm, which paid a $15 million fine in 2003 to settle civil claims, was not included in the indictment. The four partners worked in E&Y’s VIPER (Value Ideas Produce Extraordinary Results) group, later renamed SISG (Strategic Individual Solutions Group), which interacted with banks and other institutions to design, market, and implement tax strategies. The groups helped design and sell shelters to wealthy individuals for a percentage of the taxes saved.

As part of the sales and promotion efforts, the four partners created transactional documents and other materials that the government alleged contained false and fraudulent descriptions of the purchasers’ motivations for entering and exiting the transactions. For example, one partner drafted a letter to be signed by clients participating in the credit default swap transaction that falsely attributed the clients’ decision to discontinue trading activities to the September 11 attacks and possible economic repercussions. The partners also ensured that confidential materials were not retained by clients to frustrate any later challenges by the IRS. During an IRS audit of E&Y to assess promoter penalties, the four partners provided false statements to the IRS auditors about the shelters and operations of the VIPER group/SISG. In addition to their participation in the sale and marketing of the shelters, three of the partners also used the shelters to reduce their own (and other firm partners’) tax liabilities.

The defendants were charged with conspiracy to commit various offenses against the United States, including tax evasion, obstruction of the operation of the IRS, and making false statements to the IRS. The government obtained convictions of five of the defendants on conspiracy charges, four on tax evasion charges, two on obstruction of the

135Section 7201.
136Section 7206(1)-(2).
137Stein, No. 1:05-cr-00888, documents 1451, 1453, and 1459.
139United States v. Coplan, No. 1:07-cr-00453 (S.D.N.Y.), Document 1 (E&Y indictment), Doc 2007-13020, 2007 TNT 105-12. Unless otherwise noted, the information describing the allegations and charges was taken from the original indictment.
140Coplan, No. 1:07-cr-00453, Document 45 (E&Y superseding indictment).
142The fraudulent tax shelter transactions at issue included CDS (Contingent Deferred Swap), COBRA (Currency Options Bring Reward Alternatives), and PICO (Personal Investment Corporation) transactions.
143Section 7212.
144Section 7212. Charges under section 7212 were based on one partner’s direction to delete and dispose of relevant data on the COBRA transaction during the IRS’s audit, as well as another partner’s submission of false and misleading statements regarding the shelter personally used by E&Y partners.
145Section 7212. Charges under section 7212 were based on one partner’s direction to delete and dispose of relevant data on the COBRA transaction during the IRS’s audit, as well as another partner’s submission of false and misleading statements regarding the shelter personally used by E&Y partners.
IRS charges, and two on making false statements to the IRS.\textsuperscript{146} All five were sentenced to prison.

c. Jenkens & Gilchrist. The most recent of the three cases, which is still ongoing, involves criminal charges against seven individuals at three firms: former law firm Jenkens & Gilchrist,\textsuperscript{147} accounting firm BDO Seidman, and an unnamed foreign bank.\textsuperscript{148} The seven individuals were charged with defrauding the United States through designing and marketing several types of shelters.\textsuperscript{149} As in the other cases, the shelters were sold for a percentage fee based on the amount of desired tax loss and were sold along with pre-written opinion letters containing several fraudulent statements, including that there were substantial nontax business reasons for entering the transaction and that no steps were preplanned.

In addition to the opinion letters, the defendants assisted in creating transactional documents that were meant to establish the clients’ nontax business reasons for entering the transactions. During IRS audits and civil litigation, several of the individuals were alleged to have made false statements and given false testimony under oath to try to mislead the IRS about the true nature of the shelters. Collectively, the seven defendants earned approximately $180 million in fees from their shelter activities, with Paul Daugerdas earning more than $95 million on his own. Six of the defendants were also charged with personally using specific shelters to reduce their tax liabilities.

The defendants were indicted in 2009 on charges of conspiring to commit offenses against the United States, including tax evasion\textsuperscript{150} and obstruction of the operation of the IRS.\textsuperscript{151} The case is ongoing.\textsuperscript{152}

2. Deferred prosecution and non-prosecution agreements with firms. When advisers within a firm engage in criminal activity, many other employees also suffer severe consequences through deferred prosecution agreements, including limitations on the advice that may be given and continual monitoring of their work. While these sanctions are not as extreme as those that individual advisers face, they have an enormous impact on a much larger number of individuals.

For example, in addition to the criminal case pursued against multiple individuals at KPMG and third parties, the government entered into a deferred prosecution agreement with KPMG that severely restricted the activities of the remaining tax partners and employees at the firm.\textsuperscript{153} In addition to imposing fines totaling $456 million, the agreement required KPMG advice to meet higher thresholds than the code authorities (including mandating “should” opinions for some transactions), and it implemented a third-party overseer to monitor the work of KPMG employees and ensure no criminal tax activity occurred.

Similarly, Jenkens & Gilchrist, which was already under significant pressure after its tax shelter practices were brought to light, entered into a non-prosecution agreement with the government that finalized its liability at $76 million and ultimate liquidation of the firm.\textsuperscript{154} The agreement lacked many of the specific prohibitions on conduct that appeared in KPMG’s agreement, since Jenkens & Gilchrist was already winding down, but it acted as a death knell for the firm. These agreements provide prosecutors enormous leverage against firms and often severely punish the remaining employees as well.

Most recently, in December 2010 Deutsche Bank agreed to pay more than $550 million in connection with its involvement in tax shelter fraud investigations as part of a non-prosecution agreement with the government.\textsuperscript{155} In addition to the substantial

\textsuperscript{146}Caplan, No. 1:07-cr-00453, documents 274-277, 287. One defendant, Charles Bolton, pleaded guilty to the conspiracy charges. The case against the sixth defendant, David Smith, is still open.


\textsuperscript{148}United States v. Daugerdas, No. 1:09-cr-00581, Document 1 (Jenkens & Gilchrist indictment), Dec 2009-22067, 2009 TNT 192-18. Unless otherwise noted, the information describing the allegations and charges was taken from the original indictment.

\textsuperscript{149}The shelters include the Short Sale, SOS, Swaps, COBRA, and HOMER. For a thorough explanation of the structure of contingent liability shelters, including those promoted by Paul Daugerdas at Jenkens & Gilchrist, see Karen C. Burke and Grayson M.P. McCouch, “COBRA Strikes Back: Anatomy of a Tax Shelter,” 62 Tax Law. 59 (2008).

\textsuperscript{150}Section 7201.

\textsuperscript{151}Section 7212.

\textsuperscript{152}However, in October 2010 one of the lawyers indicted, Erwin Mayer, pleaded guilty to conspiracy and tax evasion charges. He faces a potential sentence of five years on each charge.

\textsuperscript{153}KPMG deferred prosecution agreement (Aug. 26, 2005).

\textsuperscript{154}Jenkens & Gilchrist Non-Prosecution Agreement (Mar. 26, 2007).

fines, Deutsche Bank admitted criminal wrongdoing and was required to install a government-appointed independent expert to monitor its revised ethics and compliance program.

3. Criminal code provisions. Advisers are potentially subject to numerous criminal provisions under the code, as evidenced in the cases against individuals employed by KPMG, E&Y, and Jenkins & Gilchrist. These include general (and potentially far-reaching) provisions punishing evasion, avoidance, and interference with the federal tax laws, as well as more specific provisions governing the submission of false or fraudulent information and statements to the IRS. As noted above, while these provisions were in substantially the same form in 1990, federal prosecutors seem more willing to bring charges under them in recent years.

a. General provisions. Within the category of general application provisions are sections 7201 and 7212, which punish tax evasion and interference with the administration of the tax laws, respectively. These two statutes provide prosecutors with powerful tools to attack adviser misconduct.

i. Tax evasion (section 7201). First, section 7201 regulates attempts to evade or defeat any tax. The statute provides that anyone who willfully attempts in any manner to evade or defeat any tax is guilty of a felony. Notably, the statute does not restrict punishment only to those attempting to evade or defeat their own tax liability. Regardless, the general federal aiding and abetting statute provides that those that aid or abet in the commission of a federal offense may be charged as principals. On conviction, an individual is subject to a fine of up to $100,000 (or $500,000 in the case of a corporation) and a prison term of five years, or both.

In each of the indictments discussed above, individuals were charged under section 7201, and nearly every convicted defendant was found guilty of violating the statute. The success of prosecutors in charging defendants under the statute is not surprising. Once it is established that the tax laws have been violated, any adviser with the appropriate mens rea (willfulness) could seemingly be charged under section 7201. Thus, in nearly every criminal case, charges under the evasion statute are likely to be included.

ii. Obstruction of the IRS (section 7212). Second, section 7212 operates as a catchall to punish any attempt to interfere with the administration of the tax laws. It prohibits endeavoring to obstruct or impede the due administration of Title 26. Violations are punishable by a maximum fine of $5,000 or a maximum prison term of three years, or both.

Individuals in both the Jenkins & Gilchrist and E&Y cases were charged with violating the statute. Again, the potential breadth of misconduct that falls under the coverage of section 7212 gives federal prosecutors more ammunition when challenging adviser misconduct. While some activity beyond advising on illegal positions is required, one would expect the behavior necessary to be convicted under section 7212 to go hand in hand with that necessary under section 7212. That is, if an adviser is willfully attempting to assist in evasion, he is likely also willing to attempt to prevent the IRS from discovering the misconduct.

b. Information submission provisions. In addition to the more general criminal provisions in the code, additional sections of the code govern the submission of information to the IRS. These include statutes punishing the willful failure to file or supply information (section 7203), the making of false or fraudulent statements in some circumstances (section 7206), and the submission of false returns and other documents (section 7207). Significantly, the aiding and abetting statute again may be used against advisers to attach liability even when the information is not directly submitted by them.

i. Willful failure to file or submit information (section 7203). Section 7203 applies to willful failures to file returns, supply information, or pay taxes. The statute punishes any person required to keep any records or supply any information who willfully fails to do so. Any person liable under the section is guilty of a misdemeanor and subject to a maximum fine of $25,000 (or $100,000 in the case of a corporation), a maximum prison sentence of one year, or both. While the provision primarily focuses on the conduct of taxpayers, some behavior by advisers also seems to be covered, such as the list-keeping and disclosure requirements for reportable transactions.

ii. False and fraudulent statements and documents (sections 7206 and 7207). Section 7206 prohibits the making or submission of fraudulent or

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Footnote continued in next column.

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156 Section 7201.
158 Section 7212. For a detailed discussion of the use of section 7212, see Dante Marrazzo, “Practitioners — Beware the Trojan Horse: The Government Unsheathes an Old Weapon to Target Practitioners for Criminal Tax Offenses,” 13 Akron Tax J. 85 (1997).
159 For example, in the E&Y case, charges under section 7212 were based on one partner’s direction to delete and dispose of relevant data on the COBRA transaction during the IRS’s audit, as well as another partner’s submission of false and misleading statements regarding the shelter personally used by E&Y partners.
161 Section 7203.
162 See sections 6111 and 6112.
false statements in some circumstances. For example, an individual is subject to criminal penalty for (1) willfully making and subscribing any return, statement, or other document (that contains or is verified by a written declaration that it is made under the penalties of perjury) that the individual does not believe to be true and correct as to every material matter; or (2) willfully aiding or assisting in, procuring, counseling, or advising the preparation or presentation of a return, affidavit, claim, or other document that is fraudulent or false as to any material matter. Violations of section 7206 are felonies and punishable by a maximum fine of $100,000 (or $500,000 in the case of a corporation), a maximum prison term of three years, or both. Individuals in the KPMG case were charged with violating this statute.

Section 7207 regulates the submission of fraudulent returns, statements, or other documents. It prohibits a person from willfully delivering or disclosing to the Treasury secretary any list, return, account, statement, or other document known by that person to be fraudulent or false as to any material matter. An individual is subject to a maximum fine of $10,000 (or $50,000 in the case of a corporation), a maximum prison term of one year, or both, for violations of the statute. No individuals in the cases discussed were charged with violating this provision. However, the statute serves as an effective complement to section 7203, when advisers may be punished for failure to submit specified information or for fraudulent submissions.

4. Other federal criminal law provisions. In addition to the criminal provisions in the code, other federal criminal law provisions are also available to hold advisers criminally liable for various forms of misconduct. These punish various offenses against the United States (or an agency thereof) and, again, provide a powerful arsenal for prosecuting tax violations. While additional statutes are available for various forms of misconduct, the following were used against individuals in the cases discussed above.

First, 18 U.S.C. section 371 prohibits conspiracies to commit any offense or defraud the United States or any government agency. Violations are subject to a maximum sentence of five years. In each of the cases discussed above, the individuals were charged with conspiring to commit various offenses. Because of the level of knowledge and control required, one would expect most criminal tax cases involving significant levels of evasion to involve conspiracies. Moreover, with the prosecutorial advantages of charging defendants with conspiracy (such as accomplice liability), prosecutors are likely to use the statute as frequently as possible.

Second, 18 U.S.C. section 1001 punishes material false, fraudulent, or misleading statements (or writings) made knowingly and willingly to any branch of the federal government. Violations of this provision are subject to a maximum prison term of five years. Conduct that is chargeable under 18 U.S.C. section 1001 is likely to arise in the course of an IRS audit, when advisers are typically interviewed under oath to assess potential wrongdoing. Violations of the false statements statute offer yet another device — and a much more appealing one given the ease of proof — for prosecutors to use in attacking adviser misconduct. Prosecutors thus have a vast array of civil and criminal provisions at their disposal to attack adviser misconduct with severe, life-altering punishments to use as leverage.

VII. Conclusion

What do we learn from this survey? First, be careful out there. While a gut check will always be important in maintaining an ethical practice, the rules regulating tax advisers have become like the code itself: complex and sometimes unintuitive. And the sanctions for stepping over a boundary have gone up. A detailed knowledge of these rules is now important for all tax advisers. Firms need to put in place procedures designed to ensure compliance. And advice should always be given with these questions in the background: Will it be a covered opinion, can my client rely on it, are the representations appropriate, will it be disclosed, and so on.

Second, we suspect that the substantial changes to the content and complexity of the rules governing tax advisers are a response to changes in tax practice. It might have been just a few rogues whose misbehavior has caused an overreaction by the government, but more likely, tax practice has changed for everyone because of the globalization of businesses, including law firms and accounting firms, the increased sophistication of clients and markets, and the resulting far greater opportunities for aggressive advice. We have brought these rules on ourselves.

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163Section 7206(1)-(2). Whether the falsity or fraud is with the knowledge or consent of the person authorized or required to present that return, affidavit, claim, or document is irrelevant. Section 7206 also punishes some other forms of fraudulent or false statements. See section 7206(3)-(5).

164Section 7207.

165There must be an agreement between two persons to commit an offense, and an act must be completed to effect the conspiracy. 18 U.S.C. section 371.

16618 U.S.C. section 1001. However, the section does not apply to parties to a judicial proceeding or submissions by the parties' counsel in the proceeding. 18 U.S.C. section 1001(b).
Third and finally, it seems implausible after reading this survey that the current rules are the best we can devise. They are a mishmash of new rules and old rules layered on top of one another, often without coordination. They are complex and sometimes inconsistent. The time is ripe for rethinking how tax advisers should be regulated and to devise an appropriate regime of regulation.