EFFECTS OF ANTI-TAX-SHELTER RULES ON NONSHELTER TAX PRACTICE

By Michael Schler

Current and proposed rules that are aimed at stopping abusive tax shelter transactions can have a significant effect on day-to-day tax practice involving normal business transactions. In some cases, the likely benefits of those rules in stopping tax shelters probably outweigh the adverse effects of the rules on nonshelter tax practice. In other cases, the rules appear to have a low potential for benefit as compared with their serious adverse effects on nonshelter tax practice.

I. Proposed Substantive Rules

A. Antiabuse Rules

An antiabuse rule provides that if a transaction is structured in a manner designed to reduce taxes in a manner unintended by Congress, the tax reduction is disallowed. Those rules are quite controversial because of their vagueness and their resulting potential to inhibit normal business transactions. As I have stated elsewhere, I believe broad statutory antiabuse rules are necessary to combat tax shelters, because specific statutory language will never be sufficient to keep ahead of creative tax planners. I also believe that tax lawyers are capable, as part of their usual job of interpreting the code, of determining in most cases whether an antiabuse rule applies to a particular ordinary business transaction. As a result, I do not believe that antiabuse rules impose an undue burden on normal tax practice or normal business transactions.

B. Economic Substance Test

An economic substance test disallows a loss if a transaction fails the specified indicia of economic substance and the tax result is unintended by Congress. Those rules are quite controversial because of their vagueness and their resulting potential to inhibit normal business transactions. As I have stated elsewhere, I believe broad statutory antiabuse rules are necessary to combat tax shelters, because specific statutory language will never be sufficient to keep ahead of creative tax planners. I also believe that tax lawyers are capable, as part of their usual job of interpreting the code, of determining in most cases whether an antiabuse rule applies to a particular ordinary business transaction. As a result, I do not believe that antiabuse rules impose an undue burden on normal tax practice or normal business transactions.

B. Economic Substance Test

An economic substance test disallows a loss if a transaction fails the specified indicia of economic substance and the tax result is unintended by Congress. That is in reality a “double trigger” for a loss disallowance and can be viewed as an antiabuse rule that comes into play only if the economic substance test is failed. I believe an economic substance test is of limited usefulness in stopping tax shelters, because it is relatively easy for tax planners to add some nontrivial level of economic substance to almost any transaction, and the court decisions are mixed in applying the economic substance test. Moreover, economic substance is by definition a test that requires projecting the likelihood of economic profit in

the future, which is an area in which tax lawyers (or nontax lawyers) have little or no expertise.

However, the potential application of an economic substance test is not commonly an issue in normal business transactions. As a result, while I believe an economic substance test would provide only limited benefit in attacking tax shelters, I likewise believe it would cause little harm to normal business transactions.

C. The Zelenak-Chirelstein Proposal

A proposal by Profs. Lawrence Zelenak and Marvin Chirelstein disallows deductions for noneconomic losses, and adds back to gross income of a taxpayer any income that is uneconomically shifted from the taxpayer to a tax-exempt party. Their proposal codifies and greatly expands on the principles of an existing tax regulation that has not generally been used to attack tax shelters. I believe this proposal would be very useful in attacking against rules would remain.

II. The Reportable Transaction Regime

A. Background

Today, if certain fee thresholds are met, a law firm or other tax adviser must keep records and make filings with the IRS for specified categories of transactions for which it provides tax advice. The categories are (1) listed transactions, (2) transactions in which the adviser requires confidentiality of the tax treatment to protect the adviser’s tax strategies, (3) transactions in which the adviser’s fee is contingent on the taxpayer achieving the desired tax benefits, (4) transactions with a gross tax loss that exceeds certain thresholds, (5) transactions with a book-tax difference that exceeds certain thresholds, and (6) transactions that involve tax credits and a short holding period for assets. The IRS has issued so-called angel lists exempting specified transactions from categories (3)-(6).

B. Listed Transactions

In my experience, category 1 (listed transactions), as well as categories 2, 3, and 6, are not problems in normal tax practice. Some have complained that category 1 is too broad because the category includes transactions that are “substantially similar” to listed transactions, and that test is difficult to apply. However, I believe that is not a major problem under a fair reading of virtually all the listed transactions. Consequently, the burden on normal tax practice should not be too great. At some point, however, adviser reporting for past transactions should apply only to listed transactions that were done during some reasonable period of time before the listing.

C. Tax Losses and Book/Tax Differences

Transactions with either tax losses or book-tax differences cause by far the greatest difficulties to tax advisers in normal tax practice, for several reasons:

First, an enormous number of ordinary transactions result in tax losses or book-tax differences. In addition, the reporting rules apply if anyone in the firm (even a nontax person) gives tax advice on such a transaction, and that advice is often given in practice by corporate lawyers. Regarding transactions involving book-tax differences, the reporting requirements are triggered only if someone in the firm makes a statement relating to the book-tax difference in the transaction. However, that could easily happen in a discussion between an attorney and a client. As a result, in practice, most firms assume that if they are involved in any transaction with a loss or book-tax difference, the transaction is reportable unless an exception applies.

Second, it is extremely difficult for a law firm to be sure that it has identified all of its transactions that involve tax losses or book-tax differences. Many of those transactions have only routine tax consequences, so tax lawyers may have little or no involvement in the transaction. Moreover, whether or not tax lawyers are involved, the lawyers in a law firm working on an ordinary transaction would normally have little or no interest, except for reportable transaction purposes, in whether the client happened to have a tax loss on a sale of a business asset, or whether the client would be reporting the transaction differently for book and tax purposes.

Third, the angels lists of loss transactions and book-tax differences exclude many common transactions. However, the exclusions themselves are unclear in many respects. In particular, the exclusion for loss transactions

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3Treas. reg. section 1.165-1(b). See Schier, supra note 1, at 377.

4The authors of the proposal acknowledge that it would not cover the transaction at issue in Gregory v. Helvering, 293 U.S. 465 (1935). Likewise, it would not cover the purported tax-free reorganization that was rejected by the court in Tribune Company v. Commissioner, 135 T.C. No. 8, Doc 2005-19801, 2005 TNT 187-12 (Sept. 27, 2005).

5Section 6111(a); Treas. reg. sections 301.6112-1(c), 1.6011-4; Notice 2005-22, 2005-1 C.B. 756, Doc 2005-3777, 2005 TNT 37-3.

depends on the seller having a "qualifying basis" in the
sold asset. That itself may require going back over many
years to determine all prior basis adjustments to the asset.

Fourth, the penalties for nonreporting a reportable
transaction are enormous. The penalty for not filing a
timely quarterly return reporting a nonlisted transaction
is a flat $50,000.8 The statutory scheme makes it very
difficult for that penalty to be waived.9 Also, if a report-
able transaction is overlooked, the firm will not be comply-
ing with the separate requirement to maintain a list of
reportable transactions and information about those transac-
tions. The penalty for not providing the IRS with a
complete list on request is $10,000 per day.10 There
is no statutory limit on the number of days the penalty
can apply. While this penalty can be waived at the
discretion of the IRS for reasonable cause, that is of scant
comfort to a law firm faced with the risk of a considerable
penalty if it happens to overlook a common business
transaction that has a tax loss or a book-tax difference.

Fifth, several states have adopted reporting rules that
parallel the federal rules and that require tax advisers to
make state filings similar to the federal filings. Those
states include New York, California, Illinois, and Minne-
sota, and others are likely to follow. Any federal filing by
a tax adviser will therefore require research by the
adviser as to which states might require a similar filing.
That will depend on such factors as where the taxpayer
files its own tax returns and where the adviser carries on
business. Compliance with numerous and varying state
rules will impose a significant further burden on tax
advisers, and subject advisers to the risk of further
penalties for noncompliance.

D. Conclusions

The reporting rules imposed on tax advisers for book-
tax and loss transactions impose a considerable burden
on tax advisers involved in normal business transactions.
Every law firm in the country has been required to make
an enormous effort to develop, and ensure ongoing
compliance with, procedures relating to those transac-
tions. Given the penalties for noncompliance, that effort
usually involves considerable partner time.

The government obtains some benefit from the report-
ing of those transactions by tax advisers, because taxpayers
are discouraged from engaging in tax shelter transac-
tions that must be reported both by them and their
advisers. However, for most tax advisers, the vast major-
ity (if not all) of the transactions that fall in those
categories are normal business transactions, not tax shel-
ters.

Moreover, the benefit to the government from the report-
ing of those transactions is limited. For transactions
with book-tax differences, all large and midsize corpora-
tions are now required to file Schedule M-3 with their tax
returns. That schedule provides considerable information
to the IRS concerning book-tax differences and makes
adviser reporting of those differences less important to
the IRS. Also, adviser reporting of loss transactions will
have only limited effects on the tax shelter problem,
because a taxpayer can engage in a tax shelter that is not
subject to that reporting. For example, reporting applies
only to section 165 losses, not section 162 deductions.
Likewise, taxpayers may try to have a transaction fit into
a category of transaction described on an angel list.

In contrast, the reporting of listed transactions by
advisers is of great benefit to the government, because it is
difficult for taxpayers and advisers to avoid such
reporting. Moreover, the reporting of listed transactions
imposes a relatively low burden on tax advisers engaging
in normal business transactions because very few, if any,
of their transactions will be listed transactions or substan-
tially similar to a listed transaction.

The government has been very reluctant to expand the
number of listed transactions, apparently because it has
become a "badge of dishonor" to engage in a listed
transaction. However, there are numerous transactions
that the government could add to the list of listed
transactions. In fact, many transactions have not been
listed even though they have been the subject of govern-
ment litigation, adverse technical advice memoranda, or
newspaper articles.

If transactions were regularly added to the list, there
would be far less need for the reporting by advisers of
transactions giving rise to losses or book-tax differences.
It is true that the IRS might not find out about certain
transactions as quickly if that reporting was eliminated.
However, that delay should not prevent the IRS from
eventually finding out about the transactions it is con-
cerned about. The IRS could then list them and (because
of the retroactive reporting requirement for listed trans-
actions) obtain information about taxpayers who had
engaged in those transactions in the past.

Consequently, consideration should be given to the
approach of expanding the category of listed transactions
and narrowing the obligation of tax advisers to report
transactions with losses and book-tax differences. That
approach would greatly alleviate the burden now borne
by all tax advisers engaged in normal business transac-
tions. Taxpayers could continue to be required to report
their own transactions giving rise to losses and book-tax
differences. The burden of that reporting by taxpayers is
much less than the burden on tax advisers, because
taxpayers are familiar with their own book and tax
situations.

III. Tax Opinions by ‘Disqualified Tax Advisers’

A. Background

If a taxpayer engages in a reportable transaction, and a
significant purpose of that transaction is tax avoidance,
additional penalties apply to any understatement of tax.11
A taxpayer may not rely on an opinion of a "disqualified
tax adviser" to avoid those penalties.12 A disqualified tax

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8 Section 6707.
9 Sections 6707(c), 6707A(d).
10 Section 6708(a)(1).
11 Section 6662A.
12 Section 6664(d)(3)(B).
adviser is one who meets certain fee thresholds and who participates in the organization, management, promotion, or sale of the transaction. The fee thresholds are quite low, relative to fees charged by a law firm for a significant transaction.13

The fees that count against the threshold for a disqualified tax adviser include all fees earned by the adviser for advice on the transaction or for implementing the transaction, not just fees for giving tax advice.14 In addition, the person drafting the documents for a transaction is treated as participating in the organization of the transaction.15

B. Consequences

As discussed above, a reportable transaction may be a normal business transaction. Also, almost any transaction that results in tax savings might be said to have a significant purpose of tax avoidance. As a result, the rules regarding disqualified tax advisers can potentially apply to normal business transactions.

Applying those rules, if a law firm is hired to draft the documents for a transaction, and the fee for that work exceeds the threshold, the firm will be a disqualified tax adviser. Consequently, that firm will not be permitted to give a tax opinion on which the taxpayer can rely to avoid these penalties.

As a result, if the taxpayer desires penalty protection, it must use one firm to draft the documents for the transaction and another firm to give an opinion on the tax consequences of the transaction. That is so even if the first firm is the taxpayer’s long-time outside counsel, on which the taxpayer relies for all its tax and corporate advice. Moreover, the taxpayer may have less confidence in the second firm than in the first, and the second firm may be a competitor to the first firm (and have an incentive to find fault with the first firm’s work). Those results are very illogical.

It gets even worse. Suppose the taxpayer goes to a second firm that will do nothing on the transaction except give a tax opinion. Fortunately, the mere giving of tax advice does not make the second firm a disqualified tax adviser, even if the second firm suggests “modifications” to the transaction.16 Thus, the taxpayer can rely on an opinion of the second firm for penalty protection.

However, that result presupposes that the second firm is generally satisfied with the structure of the transaction as presented to it. If the second firm suggests “material modifications to the transaction that assist the taxpayer in obtaining the anticipated tax benefits,” the second firm itself is considered to be participating in the organization of the transaction.17 If the fee threshold is satisfied for the second firm, and the second firm suggests too many changes to the transaction, the second firm thus becomes a disqualified tax adviser and the taxpayer cannot rely on the tax opinion of the second firm either. Perhaps the taxpayer will then go to a third firm, and, the taxpayer would hope, that firm will not suggest too many additional changes to the structure (or charge too much).

C. Conclusions

Those results obviously put the taxpayer, as well as the tax adviser(s), in difficult positions. The taxpayer can’t achieve penalty protection from its regular tax adviser, and perhaps not even from a second tax adviser. The first tax adviser can’t provide penalty protection on the transaction because it is the firm that did the corporate work on the transaction.

The second tax adviser is in an even more peculiar position. Assuming the fee threshold is satisfied, it can’t provide penalty protection if it suggests too many changes to the transaction. To make things worse, it is impossible to determine exactly when any suggested changes would cross the “materiality” threshold. The second adviser is thus under pressure to avoid taking any risks in that regard and to give an opinion on the transaction “as is,” as opposed to trying to improve the tax position of the taxpayer. If the second adviser thinks that some changes would improve the tax position of the taxpayer, the adviser can either (1) suggest the changes, helping the taxpayer on the merits but hurting the taxpayer on penalty protection, or (2) refrain from suggesting the changes and give the opinion nonetheless, hurting the taxpayer on the merits but helping the taxpayer on penalty protection.

It is difficult to see the tax policy behind this set of rules.

IV. Circular 230

The recent amendments to Circular 23018 have created by far the biggest current problem for a nonshelter tax practice. Those amendments affect every piece of written tax advice, including every e-mail containing tax advice, provided by every tax adviser in the country (and in some cases outside the country). Law firms engaged in normal business transactions have spent extraordinary amounts of partner, associate, and staff time to comply with those rules.

It is very doubtful that the benefit to the government from certain of those rules is worth the burden imposed on tax advisers in attempting to comply with them. It is also questionable whether the government, for the purpose of attacking tax shelters, is justified in adopting such rules.

13The threshold is $250,000 if only C corporations are involved, and $50,000 otherwise. Treas. reg. section 301.6112-1(c)(3)(i). Lower thresholds apply for listed transactions.
14Treas. reg. section 301.6112-1(c)(3)(iii).
16Id. (excluding the case in which the tax adviser’s “only involvement is rendering an opinion regarding the tax consequences of the transaction”).
17Id.
a detailed and restrictive set of rules regulating normal day-to-day tax practice. Others have made similar points.\(^{19}\)

### A. Complexity

The rules in Circular 230 are very complex. Every piece of written tax advice, including every e-mail, must be evaluated before being given to determine, among other things, whether (1) the transaction has the principal purpose of tax avoidance, (2) the transaction has a significant purpose of tax avoidance, (3) the advice will be used by the recipient to promote, market, or recommend the transaction to others, (4) the advice reaches a conclusion with which the IRS would have a reasonable basis to disagree, and (5) the advice reaches a “more likely than not” or higher level of comfort on any tax issue. The first four of those questions are very subjective and are often subject to vigorous debate among tax practitioners.

Depending on the answers to those questions (and others) for any particular tax advice, (1) the tax adviser may be prohibited from giving the advice, regardless of legends or anything else, (2) the adviser may be permitted to give the advice without a legend, (3) the adviser may be permitted to give the advice, but only if it “prominently displays” the so-called nonmarketing legend, (4) the adviser may be permitted to give the advice, but only if it displays the so-called marketing legend, and (5) the taxpayer receiving the advice may or may not be able to rely on the advice for penalty protection.

As noted above, this regime applies to all written tax advice, including e-mails, given by every tax adviser. That is so despite the fact that only a very tiny fraction of all tax advice has ever related to tax shelters. That fact alone raises serious questions about the justification for the rules.

### B. Overbreadth and Ambiguity

The rules are clearly overbroad and ambiguous in many critical respects. Government officials do not dispute those points and promise to eventually fix those problems. However, in the meantime tax advisers are forced to spend considerable time in determining how the rules apply to their day-to-day tax practice. Many questions have no answers and the debates among tax advisers are endless. Tax clubs, bar associations, and e-mail discussion groups have also spent uncountable hours and days on these issues. That time is nonproductive, has nothing to do with tax shelters, and does nothing to prevent tax shelters.

The overbreadth and ambiguity in the rules also creates other significant problems. Diligent advisers who do not wish to risk a violation of Circular 230 are forced to take positions, such as putting legends on certain documents, that make no sense in order to comply with the literal requirements of the rules (or to avoid violating an ambiguous rule).

Even worse, different firms may interpret a particular rule differently. Clients may be confused because different firms giving advice to the client are adopting different policies under Circular 230. Also, particular advisers may feel forced to take positions that are less advantageous to clients — or more time-consuming for the adviser — than competitor firms are taking. Finally, different firms working on the same transaction, such as an offering that involves a disclosure document, may have to spend time negotiating among themselves over the proper position to be taken in the disclosure documents.

### C. Penalties

Tax advisers are subject to sanctions if they willfully, recklessly, or through gross incompetence violate the rules.\(^{20}\) “Gross incompetence” includes “gross indifference.”\(^{21}\) It is not clear whether those standards are violated if a tax adviser disregards a rule that literally applies to the particular situation but was probably not intended to apply. Also, given the breadth and ambiguity in the rules, and the volume of tax advice given by most tax advisers by e-mail, virtually every tax adviser is likely to inadvertently violate some technical aspect of the rules on a regular basis.

That state of affairs gives the IRS an enormous amount of discretion in deciding whom to charge with violating the rules. The result is that there is at least a theoretical risk of an IRS enforcement action for virtually every tax adviser in the country, even though the vast majority of them do not engage in tax shelters and are simply trying to give good advice to their clients.

### D. Evaluation of Specific Aspects of Circular 230

Part of the confusion and complexity in Circular 230 arises because the regulation attempts to accomplish several entirely different goals at once. The regulation can best be evaluated by separately considering several aspects of Circular 230.

1. **General standards of tax practice.** Section 10.37 of Circular 230 requires that all written tax advice meet certain general standards. For example, the advice must not be based on unreasonable factual or legal assumptions, unreasonably rely on representations from the taxpayer, or evaluate a tax issue by taking into account the likelihood of audit. In general, reputable tax practitioners have always complied with those rules, and they do not cause a problem in normal tax practice.

   In fact, in the past, most tax opinions on abusive tax shelters violated those standards. If the IRS were to seriously enforce those rules, the rest of the new rules under Circular 230 would be largely unnecessary.

2. **Special rules for listed transactions, confidential transactions, and transactions with contingent fees.**

\(^{19}\)Sec. e.g., Jeffrey H. Paravano and Melinda L. Reynolds, “The New Circular 230 Regulations — Best Practices or Scarlet Letter,” BNA Tax Mgmt. Memo., Aug. 22, 2005. (“The extreme burden these regulations put on generally compliant tax advisers and their clients suggests that the IRS, even though well-intentioned, has missed the mark here by a wide margin . . . [the regulations] seem to be in need of a significant overhaul.”)

\(^{20}\)Circular 230, section 10.52. The persons in charge of a firm’s tax practice are also subject to sanctions if they do not take reasonable steps to have procedures in place to ensure compliance with the rules. Circular 230, section 10.36(a).

\(^{21}\)Circular 230, section 10.51(d).
Section 10.35 of Circular 230 contains a variety of special rules directed at listed transactions, confidential transactions, and transactions with contingent fees. Those situations do not usually arise in normal business transactions. Few, if any, objections have been raised to those rules.

3. Restrictions on the legality of tax advice. In at least one case, section 10.35 of Circular 230 simply prohibits the giving of tax advice, regardless of legends or penalty protection or anything else, even if the advice is well reasoned and turns out to have been correct. In particular, that prohibition potentially applies if the principal purpose of a transaction is tax avoidance and the transaction is not under an exception that applies when the tax benefits claimed are consistent with the statute and congressional purpose. In this situation, any tax advice on the transaction must meet a detailed set of requirements, including a requirement to discuss every relevant federal tax issue. Thus, for example, if such a transaction raises two significant issues, the tax adviser is simply not permitted to give advice to his own client on one of those issues without also fully discussing the other issue. Amazingly enough, this prohibition applies only if the tax advice is “favorable,” because there is an exception allowing negative advice.22

This restriction can affect normal nonshelter tax planning. Many transactions would not be done absent the tax benefits and thus may fail the “principal purpose” test. Moreover, it is often not completely clear whether a transaction is consistent with congressional purpose. Indeed, that is the reason an opinion may be less than a “would” opinion. Those transactions may in fact “work” for tax purposes.

Nevertheless, section 10.35 flatly prohibits the giving of favorable advice on such a transaction unless the advice discusses every issue in detail. That rule applies not only to so-called marketed opinions but also to advice given by a tax adviser entirely to his own client. The client may have reached its own conclusion concerning one or more issues, or may be willing to bear the expense only of having its tax adviser evaluate a single issue. Nevertheless, the adviser is not permitted to give favorable advice on any issue unless it gives advice on all the issues.

That rule might be justifiable in the case of an opinion that will be used by an intermediary to market the transaction. However, even then the rule might more appropriately be directed at the marketer rather than the tax adviser giving advice to the client that is the marketer.

In any event, in the case of a tax adviser giving advice to his own client, this rule seems to be a serious intrusion by the IRS into the adviser-client relationship. The only apparent justification is to protect the unsophisticated client from its own unscrupulous adviser, who was perhaps recommended to the client by a tax shelter promoter. In that case, the adviser might give favorable advice on a single issue without discussing the risks raised by other aspects of the transaction. It is not clear that the IRS should be adopting detailed rules to protect a taxpayer from its own adviser even in that situation. In any event, the rule applies to every taxpayer and every adviser, no matter how sophisticated the taxpayer. It seems inappropriate for the IRS to adopt such a broad-based prohibition.

4. Substantive requirements for opinions providing penalty protection. Section 10.35 provides elaborate rules concerning the required contents of any tax advice that is eligible to provide penalty protection to a taxpayer. The requirements are quite onerous, and most tax advisers believe that few of those opinions will ever be given. Tax advisers will not be willing to spend the time to draft those opinions, and their clients will not be willing to spend the money that their advisers will charge for them.

The substantive requirements for penalty protection is a policy issue for the IRS or Congress. Some believe that no tax opinion should ever provide penalty protection. Not going that far, I previously suggested that a taxpayer should be permitted to receive penalty protection for a tax opinion only if the opinion is attached to an original filed tax return.24

Assuming that the policy decision has been made that at least some tax opinions should provide penalty protection, the requirements of section 10.35 for penalty protection go too far. They are so detailed and technical that they appear to create unnecessary burdens on tax advisers and taxpayers, traps for the unwary, uncertainty about whether any particular opinion provides penalty protection, and risks to the tax adviser who might inadvertently fail to comply with the technical rules. The rules also greatly increase the costs to small businesses and nonwealthy individuals of obtaining penalty protection. Prior law appears to have been adequate in providing standards for opinions that provide penalty protection.25 I believe the new rules should be greatly narrowed and simplified.

5. The legending requirement. Clearly the most complex and burdensome requirement of Circular 230 is the legending requirement. Section 10.35 requires that most tax advice that is not eligible for penalty protection (as described above) contain a legend that it is not eligible for penalty protection.

In fact, there are two legends: the “nonmarketing legend” and the “marketing legend.” The proper legend depends on whether the particular tax advice meets the definition of being “marketed” advice. For all advice, the legend must state that the advice was not written or

Illustrating the complexity of the rules, advice meets the definition of negative advice only if it is “very” negative. If the advice says, “you’ll probably lose, but taking the position would not be frivolous,” the advice is not considered negative and is subject to the rules in the text.22

See, e.g., Cottage Savings Assoc. v. Comm’n, 499 U.S. 554 (1991), in which the Supreme Court allowed a loss on a pool of depreciated mortgages exchanged for another similar pool, when the only reason for the exchange was to recognize the loss.
intended to be used, and cannot be used, to avoid tax penalties. For marketed advice, the legend must also state that the advice was written to support the promotion or marketing of the transaction, and that the taxpayer should consult an independent tax adviser to seek advice based on its own particular circumstances.

The difficulties with the legending requirement are too numerous to describe in any detail here.\(^\text{26}\) Most fundamentally, the rules are very vague and complex and subject to numerous exceptions (and exceptions to exceptions). Considerable time is needed to determine whether a legend, and which legend, applies to any particular advice.

The problems with the legending requirement are greatly exacerbated by the unclear scope of the definition of “marketing.” That is quite a fundamental problem, because that definition is critical to the entire structure of the regulations. Numerous rules apply to marketing but not to nonmarketing opinions.

Another critical problem is that the definition of marketing, even when it is clear, is extremely broad. That results in the literal requirement of a marketing legend in numerous situations in which the legend makes no sense at all and was probably not intended. For example, the marketing legend (“consult an independent tax advisor”) applies to written advice given by a lawyer to her own client, when the client will rely on the advice to orally recommend the transaction to a third party but will not forward the written advice to the third party.

In some cases, the marketing legend may literally even be required in situations in which it could create a risk of securities law liability on the tax adviser or the taxpayer that would not have otherwise existed. For example, the required statement that the tax opinion “was written to support the promotion or marketing” of the transaction might have that effect. Nevertheless, tax advisers risk sanctions if they “willfully” fail to comply with these rules.

The application of the legending requirements to e-mails is particularly burdensome. E-mails containing tax advice are sent innumerable times a day by tax lawyers, and many such e-mails are also sent by nontax lawyers in a law firm. But, under the rules, each of those e-mails must be evaluated to determine whether a legend is required, and if so, which one. Many large law firms have “solved” that problem by automatically adding the “nonmarketing” legend at the end of every e-mail, at least for e-mails sent by tax lawyers.

That solution still leaves several problems. The tax lawyer must still evaluate each e-mail giving tax advice to determine whether the marketing legend is appropriate, in which case a manual substitution is necessary. The tax lawyer who does not manually remove the legend will be including the legend on personal e-mails such as invitations to dinner and so forth, which looks quite ridiculous. The nontax lawyer must remember to add the appropriate legend to any e-mail giving tax advice. One common illustration of the latter problem is when a tax lawyer forwards an e-mail giving tax advice to a nontax lawyer within the firm, not including the legend because the e-mail is not going to a client, and then the nontax lawyer forwards the e-mail to a client and forgets to add a legend.

Some firms have attempted to solve the e-mail legending problem by adding a legend at the end of every e-mail leaving the firm, regardless of whether it contains tax advice. In that way, the IRS can never claim that a required legend was not included on an e-mail. Of course, that means that the legend is included on probably a hundred times as many e-mails as is legally necessary, including innumerable e-mails having nothing whatever to do with tax, or with law, solely to avoid the omission of a required legend under Circular 230. Surely there is something wrong with a tax regulation that has driven many major law firms to that “solution.”

Also, even that solution is not perfect because of the requirement for different legends on marketing and nonmarketing advice. Firms using that approach attempt to comply with the requirement by combining the two legends into one. To make matters worse, the combination of legends is not specifically sanctioned by the regulations.

Yet another layer of difficulty is provided by the rule that the legend on tax advice must be “prominently disclosed.” Highly compensated tax advisers have spent time debating such questions as whether the legend must be above the signature in an e-mail, or may be below the signature, and whether a legend must be added to an e-mail that merely forwards an underlying e-mail that itself contains a legend.

Similarly, if a firm automatically adds a legend at the end of every e-mail leaving the firm, the legend is normally added by the firm’s “gateway,” and that generally requires as a technological matter that the legend be at the very bottom of the e-mail. That may be at the end of a long string of e-mails, with the tax advice being in the “top” e-mail. There is no guidance on whether that satisfies the requirement of “prominent disclosure.”

Dealing with the legending requirement has taken up vast amounts of tax advisers’ time. It has also taken up very large amounts of time of the technology departments in every law firm, because every firm has had to adopt some procedure for automatic legending of e-mails. BlackBerrys have created their own unique set of technological challenges (and the lengthy tax legends contained in e-mails have made it very difficult to read e-mails on a BlackBerry screen).

In evaluating the legend requirements, it must be emphasized that those rules are not substantive rules limiting the ability of taxpayers to rely on tax advice to avoid penalties. Rather, they are entirely a matter of “consumer protection.” The IRS has the authority to write substantive regulations stating when a taxpayer may or may not rely on tax advice to avoid penalties. The legend included on the tax advice merely informs taxpayers about the substantive rules, and protects them from the incorrect belief that they can rely on the tax

\(^\text{26}\) See, e.g., Paravano and Reynolds, supra note 19; letter dated October 19, 2005, to Michael Desmond and Cono R. Namorato from several practitioners (including the author of this article), Tax Notes, Nov. 7, 2005, p. 836.
advice for penalty protection. The theory appears to be that if the taxpayer is made aware of the substantive no-penalty-protection rule, the taxpayer will be less likely to enter into a tax shelter.

It is possible that unsophisticated taxpayers might receive tax advice and (absent the legend) be unaware that it could not be relied on for penalty protection. Moreover, the legend might in theory discourage those taxpayers from entering into a tax shelter.

However, as to the legending of e-mails, I am not aware of any reported situation in which any taxpayer ever claimed penalty protection for advice contained in an e-mail. In fact, it is difficult to believe that a taxpayer would ever enter into a tax shelter on the basis of informal advice such as an e-mail, let alone claim penalty protection on the basis of the e-mail.

Even as to the legending of more formal advice, it is not at all clear that the requirement will in reality have any material effect on tax shelters. Many taxpayers would know about a substantive no-penalty-protection rule even without the legend, because such a rule would receive wide publicity. The legending requirement will have no effect on those taxpayers. As to other taxpayers, it seems unlikely that many of them would otherwise enter into a tax shelter would be discouraged from doing so solely on the basis of the required legend. Tax shelter promoters deserve more credit than that.

In any event, the legending rule adopted by the IRS appears greatly out of proportion to the tax shelter problem it is targeting. At most, the IRS might be justified in requiring a tax adviser to provide a single written notice to each taxpayer (with receipt acknowledged by the taxpayer in writing) informing the taxpayer that the adviser’s tax advice generally does not provide penalty protection. Instead, the legend must now be added to virtually every piece of written advice sent to every taxpayer, no matter how sophisticated the taxpayer or how many times the taxpayer has previously received the same legend.

E. Conclusions

The rules in section 10.35 of Circular 230, particularly the legending rules, are complex, vague, and difficult and time-consuming to apply. They have placed a large burden on normal tax practice. The burden appears to be greater than the benefit to the fisc, to taxpayers, or to the tax system. Those rules should be substantially revised to reduce the burden on normal tax practice.