

Effects of Anti-Tax Shelter Rules on Non-Shelter Tax Practice

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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 these rules in stopping tax shelters probably outweigh the adverse effects of the rules on non-shelter tax practice. In other cases, the rules appear to have a low potential for benefit as compared to their serious adverse effects on non-shelter tax practice.

I. Proposed Substantive Rules

1. Anti-abuse rules

An anti-abuse rule provides that if a transaction is structured in a manner designed to reduce taxes in a manner unintended by Congress, then the tax reduction is disallowed. These 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 anti-abuse rules are necessary in order to combat tax shelters, because specific statutory language will never be sufficient to keep ahead of creative tax planners.² I also believe that tax lawyers are capable, as part of their usual job of interpreting the Code, to determine in most cases whether an anti-abuse rule applies to a particular ordinary business transaction. As a result, I do not believe that anti-abuse rules impose an undue burden on normal tax practice or normal business transactions.

2. 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. This is in reality a “double trigger” for a loss disallowance, and can be viewed as an anti-abuse 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, since (a) it is relatively easy for tax planners to add some nontrivial level of economic substance to almost any transaction, and (b) 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.

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² Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 Tax L. Rev 325, 379-84 (2002).

On the other hand, 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.

3. The Zelenak/Chirelstein Proposal

This proposal 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.³ This proposal codifies and greatly expands on the principles of an existing tax regulation that has not generally been used to attack tax shelters.⁴ I believe this proposal would be very useful in attacking the specified categories of tax shelters, and that it would not unduly burden normal tax practice. On the other hand, there are many transactions it would not cover,⁵ and so the need for anti-abuse rules would remain.

II. The Reportable Transaction Regime

1. Background

Today, if certain fee thresholds are met, a law firm or other tax advisor must keep records and make filings with the IRS for specified categories of transactions for which it provides tax advice.⁶ The categories are (1) listed transactions, (2) transactions where the advisor requires confidentiality of the tax treatment in order to protect the advisor's tax strategies, (3) transactions where the advisor'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).⁷

³ Lawrence Zelenak and Marvin Chirelstein, *A Note on Tax Shelters*, Duke Law School Legal Studies, Research Paper No. 67 (June 2005), to be published as *Tax Shelters and the Search for a Silver Bullet*, 105 Columbia Law Review No. 6 (Oct. 2005).

⁴ Treas. reg. section 1.165-1(b). See Schler, note 2 *supra*, at 377.

⁵ The 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*, 125 T.C. No. 8 (Sept. 27, 2005).

⁶ Section 6111(a); Treas. reg. sections 301.6112-1(c), 1.6011-4; Notice 2005-22, 2005-1 Cum. Bull. 756.

⁷ Rev. Procs. 2004-65 through Rev. Proc. 2004-68, 2004-2 Cum. Bull. 965, 966, 967, 969.

2. Listed transactions and certain other transactions

In my experience, category (1) (listed transactions), as well as categories (2), (3) and (6), are not a problem 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 this test is difficult to apply. However, I believe that this is not a major problem under a fair reading of virtually all the listed transactions. In fact, because listed transactions are specified in some detail, these are the easiest transactions for tax advisors to deal with.

Another potential burden arises from listed transactions because once a transaction is listed, advisors are required to report even past transactions of the specified type. Thus, every time a new transaction is listed, each advisor must determine whether he had ever previously done such a transaction. However, since listed transactions have a very serious tax motivation, those transactions should be relatively easy for a tax advisor engaged in normal business transactions to remember. Consequently, the burden on normal tax practice should not be too great. At some point, however, advisor reporting for past transactions should only apply to listed transactions that were done during some reasonable period of time before the listing.

3. Transactions with tax losses or book/tax differences

These categories of transactions cause by far the greatest difficulties to tax advisors in normal tax practice, for a number of reasons:

(a) 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 non-tax person) gives tax advice on such a transaction, and such advice is often given in practice by corporate lawyers. As to 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, this 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.

(b) It is extremely difficult for a law firm to be sure that it has identified all its transactions that involve tax losses or book/tax differences. Many of these transactions have only routine tax consequences, and 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.

(c) The angel lists for 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 depends upon the seller having a “qualifying basis” in the sold asset.⁸ This itself may require going back over many years of history to determine all prior basis adjustments to the asset.

(d) 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 \$50,000.⁹ The statutory scheme makes it very difficult for that penalty to be waived.¹⁰ In addition, if a reportable transaction is overlooked, the firm will not be complying with the separate requirement to maintain a list of reportable transactions and information about such transactions. The penalty for not providing the IRS with a complete list upon request is \$10,000 per day.¹¹ There is no statutory limit on the number of days the penalty can apply. While the penalty can be waived in the discretion of the IRS for reasonable cause, this is of scant comfort to a law firm faced with the risk of a very large penalty if it happens to overlook a common business transaction that has a tax loss or a book/tax difference.

(e) Several states have adopted reporting rules that parallel the federal rules, and that require tax advisors to make state filings similar to the federal filings. These states include New York, California, Illinois, and Minnesota, and others are likely to follow. Any federal filing by a tax advisor will therefore require research by the advisor as to which states might require a similar filing. This will depend on such factors as where the taxpayer files its own tax returns and where the advisor carries on business. Compliance with numerous and varying state rules will impose a significant further burden on tax advisors, and subject advisors to the risk of further penalties for noncompliance.

4. Conclusions

The reporting rules imposed on tax advisors for book/tax and loss transactions impose a considerable burden on tax advisors 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 these transactions. Given the penalties for noncompliance, this effort usually involves considerable partner time.

The government obtains some benefit from the reporting of these transactions by tax advisors, because taxpayers are discouraged from engaging in tax shelter transactions that must be reported both by them and their advisors. However, for most tax advisors,

⁸ Rev. Proc. 2004-66, 2004-2 Cum. Bull. 966, section 4.02.

⁹ Section 6707.

¹⁰ Sections 6707(c), 6707A(d).

¹¹ Section 6708(a)(1).

the vast majority (if not all) of the transactions that fall in these categories are normal business transactions, not tax shelters.

Moreover, the benefit to the government from the reporting of these transactions is limited. As to transactions with book/tax differences, all large and mid-sized corporations are now required to file Schedule M-3 with their tax returns. This Schedule provides considerable information to the IRS concerning book/tax differences and makes advisor reporting of such differences less important to the IRS. In addition, advisor 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 such reporting. For example, reporting only applies 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 advisors is of great benefit to the government, because it is difficult for taxpayers and advisors to avoid such reporting. Moreover, the reporting of listed transactions imposes a relatively low burden on tax advisors engaging in normal business transactions, since very few if any of their transactions will be listed transactions or substantially 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 government litigation, adverse technical advice memoranda, and/or newspaper articles.

If transactions were regularly added to the list, there would be far less need for the reporting by advisors 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 such reporting was eliminated. However, this delay should not prevent the IRS from eventually finding out about the transactions it is concerned about. The IRS could then list them and (because of the retroactive reporting requirement for listed transactions) 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 advisors to report transactions with losses and book/tax differences. This approach would greatly alleviate the burden now borne by all tax advisors engaged in normal business transactions. Taxpayers could continue to be required to report their own transactions giving rise to losses and book/tax differences. The burden of such reporting by taxpayers is much less than the burden on tax advisors, because taxpayers are familiar with their own book and tax situations.

III. Tax Opinions by “Disqualified Tax Advisors”

1. Background

If a taxpayer engages in a reportable transaction, and a significant purpose of the transaction is tax avoidance, then additional penalties apply to any understatement of tax.¹² A taxpayer may not rely on an opinion of a “disqualified tax advisor” to avoid these penalties.¹³ A disqualified tax advisor is an advisor who meets certain fee thresholds and who participates in the organization, management, promotion or sale of the transaction. The fee thresholds are quite low, in the context of fees charged by a law firm for a significant transaction.¹⁴

In addition, the fees that count against the threshold for a disqualified tax advisor include all fees earned by the advisor for advice on the transaction or for implementing the transaction, not only fees for giving tax advice.¹⁵ In addition, the person drafting the documents for a transaction is treated as participating in the organization of the transaction.¹⁶

2. Consequences

As discussed above, a reportable transaction may be a normal business transaction. In addition, almost any transaction that results in tax savings might be said to have a significant purpose of tax avoidance. As a result, these rules concerning disqualified tax advisors can potentially apply to normal business transactions.

Applying these 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 advisor. Consequently, that firm will not be permitted to give a tax opinion upon 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. This is so even if the first firm is the long-time outside counsel to the taxpayer, 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

¹² Section 6662A.

¹³ Section 6664(d)(3)(B).

¹⁴ The 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.

¹⁵ Treas. reg. section 301.6112-1(c)(3)(iii).

¹⁶ Notice 2005-12, 2005-1 Cum. Bull. 494, Section 3(a).

the second firm may be a competitor to the first firm (and have an incentive to find fault with the first firm's work). These results are very illogical.

This 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 advisor, even if the second firm suggests "modifications" to the transaction.¹⁷ Thus, the taxpayer can rely on an opinion of the second firm for penalty protection.

However, this 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.¹⁸ 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 advisor 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 hopefully the third firm will not suggest too many additional changes to the structure (or charge too much).

3. Conclusions

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

The second tax advisor is in an even more peculiar position. Assuming the fee threshold is satisfied, it cannot 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 advisor is thus under pressure to avoid taking any risks in this 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 advisor thinks that some changes would improve the tax position of the taxpayer, the advisor 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.

¹⁷ *Id.* (excluding the case where the tax advisor's "only involvement is rendering an opinion regarding the tax consequences of the transaction").

¹⁸ *Id.*

IV. Circular 230

The recent amendments to Circular 230¹⁹ have created by far the biggest current problem for a non-shelter tax practice. Those amendments affect every piece of written tax advice, including every email containing tax advice, provided by every tax advisor 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 in attempting to comply with these rules.

It is very doubtful that the benefit to the government from certain of these rules is worth the burden imposed on tax advisors in attempting to comply with those rules. It is also questionable whether the government, for the purpose of attacking tax shelters, is justified in adopting such a detailed and restrictive set of rules regulating normal day-to-day tax practice. Others have made similar points.²⁰

1. Complexity

The rules in Circular 230 are very complex. Every piece of written tax advice, including every email, 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 these questions are very subjective and often subject to vigorous debate among tax practitioners.

Depending on the answers to these questions (and others) for any particular tax advice, (1) the tax advisor may be prohibited from giving the advice, regardless of legends or anything else, (2) the advisor may be permitted to give the advice without a legend, (3) the advisor may be permitted to give the advice, but only if it “prominently displays” the so called “nonmarketing legend”, (4) the advisor may be permitted to give

¹⁹ TD 9165 (December 2004). Circular 230 is based on the authority of the Treasury to regulate practice before the IRS. See 31 U.S.C. section 330(a)(1). The American Jobs Creation Act of 2004 added 31 U.S.C. section 330(d), authorizing the Secretary of the Treasury to impose standards for tax advice relating to transactions having the potential for tax avoidance or evasion. Circular 230 appears at 31 CFR Part 10.

²⁰ See, e.g., Jeffrey H. Paravano and Melinda L. Reynolds, *The New Circular 230 Regulations--Best Practices or Scarlet Letter*, Tax Mngmt Memo., Aug. 22, 2005 (“The extreme burden these regulations put on generally compliant tax advisors 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.”)

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 emails, given by every tax advisor. This is so notwithstanding the fact that only a very tiny fraction of all tax advice has ever related to tax shelters. This fact alone raises serious questions about the justification for the rules.

2. Overbreadth and ambiguity

The rules are indisputably overbroad and ambiguous in many critical respects. Government officials do not dispute these points, and promise to eventually fix these problems. However, in the meantime, tax advisors 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 advisors are endless. Tax clubs, bar associations and email discussion groups have also spent uncountable hours and days on these issues. This 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 advisors 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 in a different manner. This means that clients may be confused because different firms giving advice to the client are adopting different policies under Circular 230. In addition, particular advisors may feel forced to take positions that are less advantageous to clients, or more time-consuming for the advisor, 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.

3. Penalties

Tax advisors are subject to sanctions if they willfully, recklessly or through gross incompetence violate the rules.²¹ “Gross incompetence” includes “gross indifference”.²² It is not clear whether these standards are violated if a tax advisor disregards a rule that literally applies to the particular situation but was probably not intended to apply. In addition, given the breadth and ambiguity in the rules, and the volume of tax advice given

²¹ 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).

²² Circular 230, section 10.51(l).

by most tax advisors by email and otherwise, virtually every tax advisor is likely to inadvertently violate some technical aspect of the rules on a regular basis.

This 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 as to virtually every tax advisor 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.

4. 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.

a. *General standards of tax practice.* Section 10.37 of Circular 230 requires that all written tax advice meet certain general standards. For example, such 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 these 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 these standards. If the IRS were to seriously enforce these rules, the rest of the new rules under Circular 230 would be largely unnecessary.

b. *Special rules for listed transactions, confidential transactions and transactions with contingent fees.* Section 10.35 of Circular 230 contains a variety of special rules directed at listed transactions, confidential transactions, and transactions with contingent fees. These situations do not normally arise in normal business transactions. Few if any objections have been raised to these rules.

c. *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, this 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 advisor 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 only applies if the tax advice is “favorable”, since there is an exception allowing negative advice.²³

This restriction can affect normal non-shelter 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, this is the reason that an opinion may be less than a "would" opinion. These transactions may in fact “work” for tax purposes.²⁴

Nevertheless, section 10.35 flatly prohibits the giving of favorable advice on such a transaction unless the advice discusses every issue in detail. This 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 only be willing to bear the expense of having its tax adviser evaluate a single issue. Nevertheless, the advisor is not permitted to give favorable advice on any issue unless it gives advice on all the issues.

This 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 advisor giving advice to the client that is the marketer.

In any event, in the case of a tax advisor giving advice to his own client, this rule seems to be a serious intrusion by the IRS into the advisor-client relationship. The only apparent justification is to protect the unsophisticated client from its own unscrupulous advisor, who was perhaps recommended to the client by a tax shelter promoter. In that case, the advisor 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 advisor even in that situation. In any event, the rule applies to every taxpayer and every advisor, no matter how sophisticated the taxpayer. It seems inappropriate for the IRS to adopt such a broad-based prohibition.

d. *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 advisors believe that few of these opinions will ever be given. Tax advisors

²³ Illustrating the complexity of the rules, advice meets the definition of negative advice only if it is “very” negative. If the advice states “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.

²⁴ See, e.g., *Cottage Savings Assoc. v Comm’r*, 499 U.S. 554 (1991), in which the Supreme Court allowed a loss on a pool of depreciated mortgages exchanged for another similar pool, where the only reason for the exchange was to recognize the loss.

will not be willing to spend the time to draft these opinions, and their clients will not be willing to spend the money that their advisors will charge for these opinions.

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 this 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.²⁵

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 advisors and taxpayers, traps for the unwary, uncertainty about whether any particular opinion provides penalty protection, and risks to the tax advisor who might inadvertently fail to comply with the technical rules. The rules also greatly increase the costs to small business and nonwealthy individuals of obtaining penalty protection. Prior law appears to have been adequate in providing standards for opinions that provide penalty protection.²⁶ I believe these new rules should be greatly narrowed and simplified.

e. *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 upon 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 intended to be used, and cannot be used, to avoid tax penalties. In addition, for marketed advice, the legend must state that the advice was written to support the promotion or marketing of the transaction, and that the taxpayer should consult an independent tax advisor to seek advice based on its own particular circumstances.

The difficulties with the legending requirement are too numerous to describe in any detail here.²⁷ Most fundamentally, the rules are very vague and complex and subject

²⁵ Schler, note 2 *supra*, at 371-72.

²⁶ *See, e.g., Long Term Capital Holdings LP v United States*, No. 04-5687 (2d Cir., Sept. 27, 2005) (upholding tax penalties on taxpayer that received favorable tax opinion, in part on ground that opinion was based on assumptions that taxpayer knew to be false).

²⁷ *See, e.g., Paravano and Reynolds*, note 20 *supra*; Letter dated October 19, 2005 to Michael Desmond and Cono R. Namorato from several practitioners (including the author of this article).

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". This is quite a fundamental problem, since 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. This results in the literal requirement of a marketing legend in numerous situations where 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, where 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 where it could create a risk of securities law liability on the tax advisor 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 this effect. Nevertheless, tax advisors risk sanctions if they "willfully" fail to comply with these rules.

The application of the legending requirements to emails is particularly burdensome. Emails that contain tax advice are sent innumerable times a day by tax lawyers, and many such emails are also sent by nontax lawyers in a law firm. Yet under the rules, each of these emails must be evaluated to determine whether a legend is required, and if so, which one. Many large law firms have "solved" this problem by automatically adding the "nonmarketing" legend at the end of every email, at least for emails sent by tax lawyers.

This solution still leaves several problems. The tax lawyer must still evaluate each email 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 emails such as invitations to dinner, etc., which looks quite ridiculous. The nontax lawyer must remember to add the appropriate legend to any email giving tax advice. One common illustration of the latter problem is when a tax lawyer sends an email giving tax advice to a nontax lawyer within the firm, not including the legend because the email is not going to a client, and then the nontax lawyer forwards the email to a client and forgets to add a legend.

Some firms have attempted to solve the email legending problem by adding a legend at the end of every email leaving the firm, regardless of who sends the email and regardless of whether it contains tax advice. In that way, the IRS can never claim that a required legend was not included on an email. Of course, this means that the legend is included on probably a hundred times as many emails as is legally necessary, including

innumerable emails 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 this “solution”.

In addition, even this solution is not perfect, because of the requirement for different legends on marketing and nonmarketing advice. Firms using this approach attempt to comply with this requirement by combining the two legends into one. To make matters worse, this 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 advisors have spent time debating such questions as whether the legend must be above the signature in an email, or may be below the signature, and whether a legend must be added to an email that merely forwards an underlying email that itself contains a legend.

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

Dealing with the legending requirement has taken up vast amounts of time of tax advisors. In addition, it has taken up very large amounts of time of the technology departments in every law firm, since every firm has had to adopt some procedure for automatic legending of emails. Blackberries have created their own unique set of technological challenges (and the lengthy tax legends contained on emails have made it very difficult to read emails on a Blackberry screen).

In evaluating the legend requirements, it must be emphasized that these 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 advice for penalty protection.²⁸ The theory appears to be that if

²⁸ In fact, the IRS has not yet even adopted the substantive rules. It has announced that it will adopt rules stating that a taxpayer will not be able to rely on legended tax advice for penalty protection. *See* T.D. 9165 (Dec. 2004). However, it is illogical for the substantive rules to be described in Circular 230, in the guise of a legending requirement, and for regulations under the Code to adopt those rules as a substantive matter solely by cross-reference to Circular 230. It would be far more logical for the substantive rules to be adopted directly in regulations under the Code, and for Circular 230 simply to require legending when those substantive rules apply to deny penalty protection.

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 such taxpayers from entering into a tax shelter.

However, as to the legending of emails, I am not aware of any reported situation where any taxpayer ever claimed penalty protection for advice contained in an email. 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 email, let alone claim penalty protection on the basis of the email.

Even as to the legending of more formal advice, it is not at all clear that this 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, since such a rule would receive wide publicity. The legending requirement will have no effect on these taxpayers. As to other taxpayers, it seems unlikely that many of them that 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 this.

In any event, the legending rule adopted by the IRS appears greatly out of proportion to the tax shelter problem it is aimed at. At most, the IRS might be justified in requiring a tax advisor to provide a single written notice to each taxpayer (with receipt acknowledged by the taxpayer in writing) informing the taxpayer that the advisor'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 and how many times the taxpayer has previously received the same legend.

5. 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. These rules should be substantially revised to reduce the burden on normal tax practice.