

# CIRCULAR ARGUMENT: WHAT IS WRONG, AND RIGHT, WITH THE CIRCULAR 230 “COVERED OPINION” REGULATIONS

Steven Z. Hodaszy\*

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#### INTRODUCTION

If there is one thing that virtually all tax attorneys have in common, it is their extreme distaste for the “covered opinion” regulations under Treasury Department Circular No. 230 (“Circular 230”).<sup>1</sup> Those regulations, which are set forth in § 10.35 of Circular 230 (the “Covered Opinion Regulations”),<sup>2</sup> have been in effect since June 20, 2005,<sup>3</sup> and they apply to the provision of written tax advice by any attorney or other practitioner permitted to practice before the Internal Revenue Service (the “IRS”).<sup>4</sup> When the regulations were first published, they were met with a

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1. The Circular 230 regulations are set forth at 31 C.F.R., Subtitle A, Part 10—Practice Before the Internal Revenue Service. As described in 31 C.F.R. § 10.0 (Scope of part), Circular 230 “contains rules governing the recognition of attorneys, certified public accountants, enrolled agents, and other persons representing clients before the Internal Revenue Service,” including, *inter alia*, “rules relating to authority to practice before the Internal Revenue Service” and prescriptions of “the duties and restrictions relating to such practice.” 31 C.F.R. § 10.0 (2010).

2. 31 C.F.R. § 10.35 (2010).

3. Circular 230 § 10.35 “applies to written advice that is rendered after June 20, 2005.” 31 C.F.R. § 10.35(g) (2010).

4. Circular 230 § 10.35(a) provides that any “practitioner who provides a covered opinion shall comply with the standards of practice in” section 10.35. 31 C.F.R. § 10.35(a) (2010). A “practitioner” for this purpose is defined in Circular 230 § 10.35(b)(1) as “any individual described in § 10.2(a)(5).” 31 C.F.R. § 10.35(b)(1) (2010). Section 10.2(a)(5), in turn, defines “practitioner” as “any individual described in paragraphs (a), (b), (c), or (d) of § 10.3.” 31 C.F.R. § 10.2(a)(5) (2010). Those paragraphs relate to attorneys, certified public accountants, enrolled agents, and enrolled actuaries, respectively. 31 C.F.R.

mountain of criticism, and they have not grown more popular in the years since. The Covered Opinion Regulations have been attacked as unduly onerous, overly broad, and inimical to the provision of sound tax advice in a number of ways.

As we mark their fifth-year anniversary, we should take the occasion to reexamine the Covered Opinion Regulations and reconsider whether their benefits justify their burdens. After five years, how well do the regulations serve their intended purpose? At the same time, are the regulations' detriments indeed as great as their many critics assert? Should we discard the Covered Opinion Regulations altogether, as some have suggested, or is there some compelling need for oversight of tax opinion practice (or, at least, a portion of that practice) that militates in favor of retaining some version of the regulations? If the latter is the case, how should we improve upon the regulations, so that they fulfill their intended function without causing the harms that their critics allege? Finally, to what extent might the need for, the effectiveness of, and the required structure of the Covered Opinion Regulations change as a result of strict-liability penalty provisions that were recently added to the Internal Revenue Code (the "Code") in conjunction with the newly-codified economic substance doctrine? This Article addresses these questions.

The Covered Opinion Regulations impose extensive due diligence obligations and detailed drafting requirements on practitioners with respect to written advice on tax matters. Part I of the Article outlines these copious rules.

The regulations were promulgated in order to combat tax practitioners' support of abusive tax shelters through the delivery of unsound legal opinions, as noted in Part II. During the rise of the corporate tax shelter market in the 1990s, as described in Part III, a surprising number of tax practitioners employed dubious due diligence, analytical, and drafting techniques to prepare incomplete and misleading tax opinions which concluded that abusive shelters were legitimate. The Covered Opinion Regulations were introduced to stem these unscrupulous and harmful opinion practices.

In their current form, however, the Covered Opinion Regulations pose myriad significant, and often unnecessary, obstacles to the practice of tax law. These problems, which have been raised by tax practitioners and tax scholars alike, are discussed in Part IV of the Article. A practitioner can "opt out" of compliance with the Covered Opinion Regulations in some (though not all) cases, but the opt-out rules present problems of their own.

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§ 10.3(a)-(d) (2010). Section 10.3(a) provides that "[a]ny attorney who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service by filing with the Internal Revenue Service a written declaration that the attorney is currently qualified as an attorney and is authorized to represent the party or parties." 31 C.F.R. § 10.3(a) (2010).

In the face of these concerns, a number of commentators contend that the Covered Opinion Regulations should simply be repealed altogether. Many others support the peculiar alternative of replacing the current opt-out rules with an “opt-in” regime, under which the regulations would not apply to any practitioner unless he or she voluntarily chooses to comply. These may be simple and tempting solutions to the hassles that the current regulations pose, but I believe that both of these approaches are ultimately misguided. While they might dispense with unnecessary obstacles to the practice of tax law in general, they would also eliminate necessary impediments to the promotion of abusive tax shelters through dishonest legal opinions.

There has to be some meaningful regulation of tax shelter opinions; otherwise, experience indicates that too many practitioners will be enticed by market forces to render unsound opinions in support of illegitimate shelters. Up until now, the Covered Opinion Regulations have not only effectively deterred such opinion practices; they have actually established tax practitioners as “gatekeepers” who restrain taxpayers from engaging in abusive transactions. Unfortunately, going forward, this “gatekeeper” function might be undermined by a recently enacted strict-liability penalty for transactions without economic substance. Yet that result is not a foregone conclusion at this point; and, even if the regulations become unable to do as much in the future to encourage good taxpayer behavior, they will still remain absolutely necessary to impede bad practitioner behavior. For all of these reasons, as detailed in Part V.A, I argue that some version of the Covered Opinion Regulations must be retained.

However, the regulations’ scope must be narrowed substantially, in order to stop the regulations from intruding into routine tax practice in ways that are unwarranted and counterproductive. Perhaps the greatest criticism of the Covered Opinion Regulations is that they are grossly overbroad, applying not only to tax shelter opinions (as originally intended) but to virtually all routine, legitimate tax planning advice, as well. This problem is the worst because it magnifies the effects of all of the others. Accordingly, in Part V.B of the Article, I propose a significant and specific textual reform to the Covered Opinion Regulations that would restrict their focus to opinion practice in the tax shelter area. If this revision were adopted, the problems discussed in Part IV would cease to infect all aspects of legitimate tax counseling. Instead, the regulations would impose only warranted restrictions on unscrupulous practice in the tax shelter context.

Part V.C of the Article explains why it would be a mistake to adopt the opt-in approach advocated by many commentators, particularly if the Covered Opinion Regulations are appropriately narrowed to cover only tax shelter opinions. Part V.D argues that, for similar reasons, the current opt-out rules should be repealed once the regulations are narrowed in the way that Part V.B suggests. Granting practitioners an option to avoid compliance with rules proscribing egregious tax shelter opinion practices would be bad policy in any event, but eliminating any such option will be

critical to the continued functioning of the regulations if the new strict liability penalty for transactions lacking economic substance becomes the predominant penalty for abusive tax shelters.

Part VI is the conclusion of the Article.

#### I. THE DEFINITION OF A “COVERED OPINION” AND THE REQUIREMENTS FOR PREPARING COVERED OPINIONS.

As every member of the tax bar probably knows all too well, the Covered Opinion Regulations impose extensive, rigorous requirements for written advice (including e-mails) concerning federal tax issues arising from (1) “[a] transaction that is the same as or substantially similar to” any transaction determined by the IRS “to be a tax avoidance transaction and identified” as such in published guidance (a “Listed Transaction”),<sup>5</sup> (2) “[a]ny partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed” under the Code (a “Principal Purpose Transaction”),<sup>6</sup> or (3) “[a]ny partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed” under the Code (a “Significant Purpose Transaction”),<sup>7</sup> if the written advice concerning the Significant Purpose Transaction is (a) “a reliance opinion;”<sup>8</sup> (b) “a marketed opinion;”<sup>9</sup> (c) “subject to conditions of confidentiality;”<sup>10</sup> or (d) “subject to contractual protection.”<sup>11</sup>

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5. 31 C.F.R. § 10.35(b)(2)(i)(A) (2010).

6. 31 C.F.R. § 10.35(b)(2)(i)(B) (2010).

7. 31 C.F.R. § 10.35(b)(2)(i)(C) (2010).

8. Under Circular 230, “[w]ritten advice is a reliance opinion if the advice concludes at a confidence level of at least more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer’s favor.” 31 C.F.R. § 10.35(b)(4)(i) (2010). A “Federal tax issue” is defined under Circular 230 as “a question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes.” 31 C.F.R. § 10.35(b)(3) (2010). In turn, a federal tax issue is “significant” if the IRS “has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.” *Id.*

9. Circular 230 defines written advice to be a “marketed opinion” if the practitioner who provides the advice “knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner’s firm) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).” 31 C.F.R. § 10.35(b)(5) (2010).

10. “Written advice is subject to conditions of confidentiality if the practitioner imposes on one or more recipients of the written advice a limitation on disclosure of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that practitioner’s tax strategies, regardless of whether the limitation on disclosure is legally binding.” 31 C.F.R. § 10.35(b)(6) (2010).

Those three classes of transactions are intended collectively to capture all undertakings that may constitute abusive tax shelters. (One fundamental question is whether they in fact capture much more than that). Listed Transactions comprise the narrowest of the three groups; they are the transactions that the IRS has already identified as abusive. The other two classes are intended to include abusive transactions that the IRS has not yet discovered, but wants to stop.

In setting parameters as to what is or is not a Principal Purpose Transaction, the regulations make clear that a partnership, other entity, plan or other arrangement does not have a principal purpose of avoiding or evading federal tax “if that partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the [Code] and Congressional purpose.”<sup>12</sup> Of course, an undertaking that is not a Principal Purpose Transaction may nevertheless be a Significant Purpose Transaction. Indeed, the regulations emphasize that a “partnership, entity, plan or arrangement may have a significant purpose of avoidance or evasion even though it does not have the principal purpose of avoidance or evasion.”<sup>13</sup>

Importantly, in contrast to the principal purpose standards, the regulations do *not* say that a transaction will not be deemed to have a significant purpose of tax avoidance or evasion if its purpose is to claim tax benefits in a manner consistent with the Code and Congressional purpose.<sup>14</sup> Particularly when juxtaposed against that express limitation in the “principal purpose” definition, the absence of such a limitation in defining “significant purpose” suggests that Significant Purpose Transactions may technically include even ordinary, well-established tax minimization strategies that are intended by Congress, expressly permitted under the Code, and plainly not abusive. While nevertheless troublesome, this omission from the “significant purpose” definition is almost certainly not intended to capture ordinary tax planning in such a way. Rather, it is more likely just a result of the fact that the “significant purpose” language in the Covered Opinion Regulations tracks (almost verbatim) the broad definition of “tax shelter” in § 6662 of the Code, which imposes accuracy-related penalties on certain underpayments of tax.<sup>15</sup>

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11. Circular 230 refers to written advice as subject to contractual protection “if the taxpayer has the right to a full or partial refund of fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) if all or a part of the intended tax consequences from the matters addressed in the written advice are not sustained, or if the fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) are contingent on the taxpayer's realization of tax benefits from the transaction.” 31 C.F.R. § 10.35(b)(7) (2010).

12. 31 C.F.R. § 10.35(b)(10) (2010).

13. *Id.*

14. *See* 31 C.F.R. § 10.35(b)(2)(i)(C) (2010).

15. *Compare* 31 C.F.R. § 10.35(b)(2)(i)(C) (2010) and 31 C.F.R. § 10.35(b)(10) (2010) with I.R.C. § 6662(d)(2)(C)(ii) (2010). *See* Steven M. Weiser, *Circular 230 Compliance: A Guide For the Non-Tax Attorney*, 34 COLO. LAW. 29, 32 (2005) (noting that

Written advice that comes within any of the categories outlined above is defined in Circular 230 as a “covered opinion.”<sup>16</sup> For any written advice that constitutes a covered opinion, the Covered Opinion Regulations set forth stringent standards that the practitioner preparing the advice must meet with respect to (1) finding or assuming the relevant facts, (2) relating the applicable law to the relevant facts, (3) evaluating significant federal tax issues, in particular, and (4) reaching an overall conclusion as to the likely federal tax treatment of the transaction to which the advice relates.<sup>17</sup>

Regarding factual matters, Circular 230 requires the practitioner to “use reasonable efforts to identify and ascertain the facts . . . to determine which facts are relevant . . . [and to] consider all facts that the practitioner determines to be relevant.”<sup>18</sup> The practitioner is prohibited from “bas[ing] the opinion on any unreasonable factual assumptions,” which include any “factual assumption that the practitioner knows or should know is incorrect or incomplete.”<sup>19</sup> Nor may the practitioner base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person, including any “factual representation that the practitioner knows or should know is incorrect or incomplete.”<sup>20</sup> As a primary example of an impermissible factual assumption or the improper reliance on someone else’s factual representation, the Covered Opinion Regulations specifically provide that a practitioner may not rely on a general assumption “that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits,”<sup>21</sup> and a practitioner may not rely on a taxpayer’s representation “that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete.”<sup>22</sup> A covered opinion must identify, in separate sections, each factual assumption that the practitioner makes and each factual representation of the taxpayer on which the practitioner relies.<sup>23</sup>

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the compliance-with-Code-and-purpose exception exists under the “principal purpose” standard but not under the “significant purpose” standard).

16. 31 C.F.R. § 10.35(b)(2)(i) (2010).

17. The complete requirements for covered opinions are set forth in 31 C.F.R. § 10.35(c) (2010).

18. 31 C.F.R. § 10.35(c)(1)(i) (2010). Relevant facts that must be considered may include facts that “relate to future events if a transaction is prospective or proposed.” *Id.*

19. 31 C.F.R. § 10.35(c)(1)(ii) (2010). As described under Circular 230, “[a] factual assumption includes reliance on a projection, financial forecast or appraisal.” *Id.* Therefore, Circular 230 provides that “[i]t is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal.” *Id.*

20. 31 C.F.R. § 10.35(c)(1)(iii) (2010).

21. 31 C.F.R. § 10.35(c)(1)(ii) (2010).

22. 31 C.F.R. § 10.35(c)(1)(iii) (2010).

23. *See id.*; 31 C.F.R. § 10.35(c)(1)(ii) (2010).

Once the practitioner appropriately identifies the relevant facts, he or she must relate the applicable law to those facts.<sup>24</sup> In so doing, the practitioner not only must consider all relevant provisions of the Code and the Treasury regulations thereunder, but must also take into account any “potentially applicable judicial doctrines.”<sup>25</sup> With certain limited exceptions,<sup>26</sup> the practitioner “must not assume the favorable resolution of any significant Federal tax issue,”<sup>27</sup> and he or she may not “otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions.”<sup>28</sup> Moreover, the practitioner’s opinion “must not contain internally inconsistent legal analyses or conclusions.”<sup>29</sup>

Unless the opinion is a “limited scope opinion” as defined under Circular 230 § 10.35(c)(3)(v)(A),<sup>30</sup> and except to the extent that the practitioner permissibly relies on the legal opinion of another practitioner with respect to certain matters,<sup>31</sup> “[t]he opinion must consider all significant Federal tax issues,”<sup>32</sup> and it “must provide the practitioner’s conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant Federal tax issue” so considered.<sup>33</sup> In the text of the opinion, the practitioner must describe the reasons for his or her conclusions, “including the facts and analysis supporting the conclusions” or, alternatively, he or she must “describe the reasons that the practitioner is

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24. See 31 C.F.R. § 10.35(c)(2)(i) (2010).

25. *Id.*

26. In certain circumstances, a practitioner is permitted to deliver opinions that are limited to the consideration of fewer than all significant federal tax issues, and practitioners may also (within certain limits) rely on the legal opinions of others with respect to some significant federal tax issues. For further discussion of Limited Scope Opinions and permitted reliance on opinions of others, see *infra* notes 30-31.

27. 31 C.F.R. § 10.35(c)(2)(ii) (2010).

28. *Id.*

29. 31 C.F.R. § 10.35(c)(2)(iii) (2010).

30. Circular 230 permits a practitioner to provide written advice on a transaction that covers fewer than all significant tax issues related to the transaction (a “Limited Scope Opinion”) if (1) the taxpayer and the petitioner agree as to the scope of the opinion and (2) they agree that the taxpayer may rely on the opinion for purposes of defending against the assessment of penalties imposed by the Code only with regard to the tax issues actually addressed in the opinion. See 31 C.F.R. § 10.35(c)(3)(v)(A)(1) (2010). A Limited Scope Opinion is not permissible, however, if the transaction to which the opinion relates is a Listed Transaction or a Principal Purpose Transaction or if the opinion is otherwise a “marketed opinion.” See 31 C.F.R. § 10.35(c)(3)(v)(A)(2) (2010). Any Limited Scope Opinion must contain a legend stating that, “[w]ith respect to any significant Federal tax issues outside the limited scope of the opinion, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.” 31 C.F.R. § 10.35(e)(3)(iii) (2010).

31. In rendering his or her covered opinion, a “practitioner may rely on the opinion of another practitioner with respect to one or more significant Federal tax issues” as long as he or she “identif[ies] the other opinion and . . . the conclusions reached” therein, unless “the practitioner knows or should know that the opinion of the other practitioner should not be relied on.” 31 C.F.R. § 10.35(d)(1) (2010).

32. 31 C.F.R. § 10.35(c)(3)(i) (2010). For a description of what constitutes a “significant Federal tax issue” under Circular 230, see *supra* note 8.

33. 31 C.F.R. § 10.35(c)(3)(ii) (2010).



unable to reach a conclusion as to one or more issues.”<sup>34</sup> If an opinion fails to reach a conclusion at a confidence level of at least more-likely-than-not that the taxpayer will prevail on the merits with respect to one or more significant federal tax issues, the opinion must highlight that fact and must prominently state that the taxpayer cannot use the opinion to avoid the imposition of penalties arising from those issues.<sup>35</sup> When evaluating a taxpayer’s chance of success on the merits as to any significant federal tax issue addressed in the opinion, the practitioner is specifically prohibited from considering “the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.”<sup>36</sup> A practitioner may not provide a “marketed opinion” at all unless he or she is able to conclude with a confidence level of at least more-likely-than-not that the taxpayer will prevail on the merits with respect to each significant federal tax issue arising from the transaction to which the opinion relates.<sup>37</sup>

Finally, a covered opinion must include “the practitioner’s overall conclusion as to the likelihood that the Federal tax treatment [that the taxpayer is taking] of the transaction or matter that is the subject of the opinion is the proper treatment,” and the practitioner must describe in the opinion his or her “reasons for that conclusion.”<sup>38</sup> Alternatively, if a practitioner cannot reach such an overall conclusion, the opinion may generally contain a statement to that effect and, in that case, it must include an explanation “for the practitioner’s inability to reach a conclusion.”<sup>39</sup> If the opinion is a “marketed opinion,” however, failing to reach such a conclusion is not an option. For any “marketed opinion,” not only must the practitioner reach a conclusion “that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment,” he or she must do so at a confidence level of at least more-likely-than-not.<sup>40</sup>

The sanctions that may be levied against practitioners who violate the Covered Opinion Regulations are severe. “[T]he IRS has the ability to censure, disbar, or suspend a tax advisor from practice before the IRS, and may impose monetary penalties for noncompliance with [those] regulations.”<sup>41</sup> Circular 230 § 10.50 provides that the Secretary of the

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34. *Id.* “If the practitioner is unable to reach a conclusion with respect to one or more [significant federal tax] issues, the opinion must state that the practitioner is unable to reach a conclusion with respect to those issues. . . . If the practitioner fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues considered, the opinion must include the appropriate disclosure(s) required under” Circular 230. *Id.* The provisions concerning such disclosures are contained in 31 C.F.R. § 10.35(e).

35. *See* 31 C.F.R. § 10.35(c)(4) (2010), 31 C.F.R. § 10.35(e)(4) (2010).

36. 31 C.F.R. § 10.35(c)(3)(iii) (2010).

37. 31 C.F.R. § 10.35(c)(3)(iv) (2010).

38. 31 C.F.R. § 10.35(c)(4)(i) (2010).

39. *Id.*

40. 31 C.F.R. § 10.35(c)(4)(ii) (2010).

41. Weiser, *supra* note 15, at 37.

Treasury (and, by extension, the IRS, as his or her delegate) may exercise the general authority to “censure, suspend, or disbar any practitioner from practice before the [IRS] if the practitioner . . . fails to comply with any regulation” within Circular 230, including (without limitation) the Covered Opinion Regulations.<sup>42</sup> Circular 230 § 10.52 further provides that “[a] practitioner may be sanctioned . . . [for w]illfully violat[ing]” virtually any of the Circular 230 regulations,<sup>43</sup> or for violating the Covered Opinion Regulations, in particular, either “[r]ecklessly or through gross incompetence.”<sup>44</sup>

In addition to these sanctions, the American Jobs Creation Act of 2004 (the “JOBS Act”),<sup>45</sup> “permit[s] the IRS to impose monetary penalties on a tax practitioner” for violations of the Covered Opinion Regulations.<sup>46</sup> “The amount of the monetary penalty can be as much as 100 percent of the gross income derived from the conduct giving rise to the penalty. In other words, the IRS can penalize a lawyer for an amount equal to the gross fees received from the provision of the tax advice to the client.”<sup>47</sup> Furthermore, if the practitioner who provides the sanctionable advice does so on behalf of a firm (or on behalf of any other employer or other entity for which the practitioner acts as agent), and if that firm or other entity knew or reasonably should have known of the practitioner’s conduct, then the firm or other entity is also subject to the same monetary penalties.<sup>48</sup>

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42. 31 C.F.R. § 10.50(a) (2010). “Censure,” as referred to in § 10.50, “is a public reprimand.” *Id.*

43. 31 C.F.R. § 10.52(a)(1) (2010). Circular 230 § 10.52(a)(1) specifically excludes impositions of sanctions for willful violations of Circular 230 § 10.33, which sets forth aspirational (rather than mandatory) best practices for tax advisors.

44. 31 C.F.R. § 10.52(a)(2) (2010). Circular 230 § 10.52 was added as part of a substantial set of amendments to Circular 230 contained in final regulations that the Secretary adopted in December 2004 (the “December 2004 Amendments”) (*published at* 69 Fed. Reg. 75,839-45 (Dec. 20, 2004)). It is unclear whether the “willful, reckless or gross incompetence” standard established under that section sets a minimum threshold for the imposition of sanctions for violations of the Covered Opinion Regulations, or whether sanctions may be imposed for any such violation (even if the violation is not due to willfulness, recklessness or gross incompetence) pursuant to Circular 230 § 10.50. On one hand, § 10.50 obviously cannot be ignored; on the other hand, if § 10.52 does not establish such a threshold as to what constitutes sanctionable conduct, then § 10.52 would seem to be largely superfluous in light of the preexisting authority to sanction under § 10.50.

45. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

46. Linda Z. Swartz & Jean Marie Bertrand, *Circular 230 and Tax Shelters in 2008*, 857 PLI/Tax 193, 251 (Feb. 2009) (citing § 882(b) of the JOBS Act, amending 31 U.S.C. § 330(b)).

47. Weiser, *supra* note 15, at 37 (footnote omitted) (citing 31 U.S.C. § 330(b)).

48. See Swartz & Bertrand, *supra* note 46, at 251; Weiser, *supra* note 15, at 37. “[F]actors that may be relevant to determining whether a monetary penalty should appropriately be imposed on an employer include (i) the gravity of the misconduct, (ii) any history of noncompliance by the employer, (iii) preventative measures in effect prior to the misconduct’s occurrence, and (iv) any corrective measures taken by the employer after it discovers the misconduct.” Swartz & Bertrand, *supra* note 46, at 252 n.226 (citing Notice 2007-39, 2007-20 I.R.B. 1243).

When providing a Significant Purpose Transaction opinion that is either a “reliance opinion” or a “marketed opinion,” a practitioner can opt out of the requirement to follow the Covered Opinion Regulations if he or she prominently<sup>49</sup> places certain disclaimers on the opinion. Written advice concerning a Significant Purpose Transaction that otherwise comes within the definition of a “reliance opinion”<sup>50</sup> will not be treated as such for purposes of the regulations “if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.”<sup>51</sup> (Such a disclosure is referred to herein as a “Non-Reliance Disclaimer.”)

Advice that would otherwise constitute a “marketed opinion”<sup>52</sup> concerning a Significant Purpose Transaction will not be treated as such under the regulations if it prominently contains both a Non-Reliance Disclaimer and a disclosure to the effect that “[t]he advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice [and that the] taxpayer should seek advice based on the taxpayer’s particular circumstances from an independent tax advisor.”<sup>53</sup> A practitioner cannot opt out of compliance with the Covered Opinion Regulations by including a Non-Reliance Disclaimer (or by any other means) if he or she provides a Listed Transaction opinion, a Principal Purpose Transaction opinion or a Significant Purpose Transaction opinion that is either subject to conditions of confidentiality or subject to contractual protection.<sup>54</sup>

## II. THE DEVELOPMENT OF, AND PURPOSE BEHIND, CIRCULAR 230’S COVERED OPINION REGULATIONS.

Under 31 U.S.C. § 330, the Secretary of the Treasury is authorized to regulate the practice of tax representatives before the Treasury Department.<sup>55</sup> In 1966, pursuant to that grant of authority, the Secretary

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49. The standards for “prominent” disclosure are set forth in Circular 230 § 10.35(b)(8).

50. For the definition of “reliance opinion” under Circular 230, see *supra* note 8.

51. 31 C.F.R. § 10.35(b)(4)(ii) (2010).

52. For the definition of “marketed opinion” under Circular 230, see *supra* note 9.

53. 31 C.F.R. § 10.35(b)(5)(ii) (2010).

54. Provisions specifying that written advice will not be treated as a covered opinion if the appropriate disclaimers are prominently included are set forth in the definitions of “reliance opinion” and “marketed opinion” and those provisions expressly do not apply in the context of opinions concerning either Listed Transactions or Principal Purpose Transactions. See 31 C.F.R. §§ 10.35(b)(4)(ii) and 10.35(b)(5)(ii) (2010). No similar rules for excepting written advice from the scope of the “covered opinion” definition exist in the provisions governing Listed Transaction opinions or Principal Purpose Transaction opinions, nor do they exist within the provisions for opinions subject to conditions of confidentiality or to contractual protection. See 31 C.F.R. §§ 10.35(b)(2)(i)(A), 10.35(b)(2)(i)(B), 10.35(b)(6), and 10.35(b)(7) (2010).

55. Weiser, *supra* note 15, at 29 (citing 31 U.S.C. § 330).

promulgated Circular 230, at 31 C.F.R. part 10.<sup>56</sup> The general purpose of Circular 230 is to set forth rules (1) governing the authority of attorneys, certified public accountants, enrolled agents, and other persons to represent clients before IRS, (2) prescribing duties and restrictions of such persons in their practice before the IRS, and (3) providing for discipline of any such persons who violate those duties or restrictions.<sup>57</sup> Since they were originally published, the Circular 230 regulations have been amended a number of times.<sup>58</sup>

The most recent significant amendments to Circular 230 are contained in final regulations that the Secretary adopted in December 2004 (the “December 2004 Amendments”).<sup>59</sup> The December 2004 Amendments added a number of regulations that establish “aspirational standards of tax practice and . . . standards and requirements concerning the provision of tax advice.”<sup>60</sup> Among those added standards and requirements are the Covered Opinion Regulations. While those additions arguably would have exceeded the Secretary’s original regulatory authority pursuant to 31 U.S.C. § 330, the Secretary was granted specific authority to promulgate the Covered Opinion Regulations and the other December 2004 Amendments by the JOBS Act,<sup>61</sup> which President Bush signed into law in October 2004.<sup>62</sup> Section 822(b) of the JOBS Act added 31 U.S.C. § 330(d), “which provides that ‘[n]othing . . . shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice . . . which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.’”<sup>63</sup> At the time when the JOBS Act became law, Treasury had already issued proposed regulations in 2003 that largely mirrored the final December 2004 Amendments.<sup>64</sup> Thus, the JOBS Act “merely codified what the Secretary had already expressed an intention

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56. See Juan F. Vasquez, Jr. & Jaime Vasquez, *Section 10.35(B)(4)(II) of Circular 230 Is Invalid (But Just in Case It Is Valid, Please Note That You Cannot Rely on This Article to Avoid the Imposition of Penalties)*, 7 HOUS. BUS. & TAX L. J. 293, 298 (2007); Weiser, *supra* note 15, at 29.

57. 31 C.F.R. § 10.0 (2010) (Scope of part).

58. See Vasquez & Vasquez, *supra* note 56, at 298; Weiser, *supra* note 15, at 29.

59. 69 Fed. Reg. 75,839-45 (Dec. 20, 2004) (*cited in* Weiser, *supra* note 15, at 29 n.5 and Vasquez & Vasquez, *supra* note 56, at 298 n.28).

60. Weiser, *supra* note 15, at 29.

61. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 822(b), 118 Stat. 1418 (2004). The grant of such authority apparently was intended to extend only to regulations governing opinions specifically regarding tax shelters, however. See *infra* note 139 and accompanying text.

62. See Weiser, *supra* note 15, at 29; Vasquez & Vasquez, *supra* note 56, at 299-300.

63. Vasquez & Vasquez, *supra* note 56, at 300 (quoting Pub. L. No. 108-357, § 822(b), 118 Stat. 1418, 1587 (2004)).

64. Those proposed regulations were published at 68 Fed. Reg. 75,186 (proposed Dec. 30, 2003).

to do; that is, regulate the issuance of tax advice with regard to tax shelter transactions.”<sup>65</sup>

Indeed, the purpose behind the Covered Opinion Regulations and the other December 2004 Amendments is to “combat tax shelters and enhance public ‘confidence in the honesty and integrity’ of tax professionals.”<sup>66</sup> The objective of the Covered Opinion Regulations, in particular, “was to limit the use of opinion letters in tax shelter offerings.”<sup>67</sup> More specifically, the Covered Opinion Regulations “are intended to deter taxpayers from engaging in abusive transactions by limiting or eliminating their ability to avoid penalties through inappropriate reliance on a tax advisor’s advice.”<sup>68</sup> To accomplish this, the regulations seek to “make it more burdensome for tax professionals to provide written opinions that clients can use in attempting to avoid monetary penalties when their daring attempts to save tax are disallowed.”<sup>69</sup> In addition, the Covered Opinion Regulations “are aimed at preventing unscrupulous tax advisors and promoters from marketing abusive transactions to large numbers of customers . . . based on an opinion that fails to consider adequately the facts of the particular transaction.”<sup>70</sup> In this regard, the regulations are particularly concerned with discouraging tax attorneys and other tax advisors “from actively promoting aggressive tax avoidance strategies . . . to persons who are not their existing clients.”<sup>71</sup>

### III. THE TAX SHELTER MARKET AND THE PARTICIPATION OF ATTORNEYS IN ABUSIVE TAX SHELTERS, WHICH GAVE RISE TO THE COVERED OPINION REGULATIONS.

Treasury and the IRS were spurred to bolster their efforts to combat abusive transactions by the marked increase in tax shelter<sup>72</sup> activity during

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65. Weiser, *supra* note 15, at 29 (citing 68 Fed. Reg. 75,186, 75,186-87 (proposed Dec. 30, 2003)).

66. Deborah L. Paul, *New York State Bar Association Tax Section Report on Circular 230*, reprinted at 794 PLI/TAX 9, 15 (Oct.-Nov. 2007) (quoting preamble to the December 2004 Amendments).

67. Deborah H. Schenk, *The Circular 230 Amendments: Time to Throw Them Out and Start Over*, 110 TAX NOTES 1311, 1312 (Mar. 20, 2006) (citation omitted).

68. Paul, *supra* note 66, at 15.

69. Casey R. Law, *The Circular File: Dealing With the 2005 Amendments to Treasury Department Circular 230 Without Contracting Disclaimer Mania*, 76 J. KAN. B. ASS’N 24, 25 (Sept. 2007).

70. Paul, *supra* note 66, at 15.

71. Law, *supra* note 69, at 25.

72. One reason why tax shelters are so challenging to regulate is that they are difficult to define. The Code’s definition of “tax shelter” is in § 6662(d)(2)(C)(ii). That definition has been criticized as less than illuminating, because it is too broad and imprecise to provide proper guidance as to whether a particular transaction falls inside or outside of its scope. Indeed, it is possible to construe the definition as capturing a wide range of deals that it presumably was not intended to cover. The definition includes any plan or arrangement for which a “significant purpose” is the avoidance or evasion of federal income tax, and that description arguably applies to almost “anything a tax lawyer advises a client to do.” Scott

the 1990s. Although a large tax shelter market initially developed during the late 1970s and early 1980s, Congress “effectively eradicated the first wave of tax shelters” in 1986, when it passed the Code provisions that prohibit offsetting ordinary income against passive losses.<sup>73</sup> Those tax shelters, however, were targeted primarily to middle-income individuals.<sup>74</sup> Accordingly, the passive loss reforms did little to slow the growth of the market for corporate tax shelters, which flourished over the decade that followed.<sup>75</sup>

The rise of the corporate tax shelter market stemmed in part from the fact that, during the 1990s, corporate tax departments came under increasing pressure not only to perform traditional legal compliance functions, but also to become profit centers.<sup>76</sup> As corporate managements searched for evermore ways to reduce expenses, the drive to find new methods to decrease their firms’ tax liabilities garnered added attention. Simply put, “[u]nder a basic cost-benefit analysis, purchasing tax shelters made sense financially.”<sup>77</sup>

At the same time, changes in the legal and accounting industries in the 1990s increased the willingness of tax attorneys and accountants to participate in the development and promotion of corporate tax shelters.<sup>78</sup> Law firms “became more entrepreneurial, and ‘consulting’ became one of the largest parts of accounting firm practices.”<sup>79</sup> As they increased their focus on consulting, the big accounting firms became among the most active promoters of corporate tax shelters. They developed complex shelters and marketed them to literally hundreds of clients on a contingency-fee basis (the fee being based on the amount of tax saved), often making tens of millions of dollars on a single shelter.<sup>80</sup> Lawyers who refrained from participating directly in the development and marketing of tax shelters, nevertheless participated in the profits by providing opinion

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A. Schumacher, *MacNiven v. Westmoreland and Tax Advice: Using “Purposive Textualism” to Deal with Tax Shelters and Promote Legitimate Tax Advice*, 92 MARQ. L. REV. 33, 58 (2008). An often-quoted, more colloquial “tax shelter” definition was introduced by Professor Michael Graetz. Professor Graetz famously described a tax shelter as “[a] deal done by very smart people that, absent tax considerations, would be very stupid.” *Id.* at 57-58 (citation omitted). While that definition well reflects the spirit of what a tax shelter is, it too is of limited help in determining whether a particular transaction constitutes a shelter.

73. Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 83 (2006).

74. *Id.* See also Schumacher, *supra* note 72, at 55 (in contrast to current tax shelters, which “are invested in by high net-worth individuals and corporations . . . the shelters of the 1970s were invested in by thousands of individuals, including middle-class taxpayers”); CAMILLA E. WATSON & BROOKS D. BILLMAN, JR., *FEDERAL TAX PRACTICE AND PROCEDURE—CASES, MATERIALS AND PROBLEMS* 137 (2005) (discussing “mass-marketing of tax shelters to middle class Americans” in the 1970s).

75. See Rostain, *supra* note 73, at 83.

76. See *id.* at 86.

77. *Id.*

78. See Schumacher, *supra* note 72, at 53.

79. *Id.*

80. See Rostain, *supra* note 73, at 88.

letters with respect to the shelters promoted by the accountants.<sup>81</sup> “At the height of the shelter market, fees for opinion letters ran into the hundreds of thousands of dollars, with some even commanding \$1 million or more.”<sup>82</sup>

The prospect of such enormous fees made the temptation to traffic in questionable, overly-aggressive tax advice simply too great to resist for a surprisingly large number of professionals.<sup>83</sup> While earlier tax shelter activity had previously been confined largely to professionals “at the periphery” of their professions, advisors involved in the more recent shelters “worked for some of the most prestigious accounting and law firms.”<sup>84</sup> This unholy alliance between prominent attorneys and accountants produced a rapid proliferation of more sophisticated,<sup>85</sup> more potentially lucrative,<sup>86</sup> and arguably more abusive corporate tax shelters than had ever been seen before.<sup>87</sup>

The success of these dubious enterprises depended particularly on the provision of the tax attorneys’ legal opinions. Attorneys’ opinions have long been considered to be essential elements of such schemes because, up until now, they have effectively operated as insurance policies against penalties that might otherwise have been assessable under the Code against tax shelter investors if the investors’ reported losses from the shelters are disallowed.<sup>88</sup> If a taxpayer relies on an attorney’s legal opinion in taking a reporting position that ultimately results in an underpayment of tax, the opinion is generally considered to provide reasonable cause for the underpayment (provided that the opinion meets certain minimum requirements under applicable Treasury regulations), and the taxpayer’s reliance thereon is generally considered to constitute action in good faith with respect to the underpayment, for purposes of invoking the exception under § 6664(c)(1)<sup>89</sup> to the imposition of a 20% accuracy-related penalty

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81. *See id.* at 92.

82. *Id.* at 94 (citations omitted).

83. *See* Schumacher, *supra* note 72, at 53.

84. *Id.* at 55.

85. *See, e.g., id.* at 53-54 (discussing newly developed corporate finance techniques, such as new financial instruments, special-purpose entities and off-shore arrangements used to facilitate corporate tax shelters).

86. *See id.* at 55 (noting that magnitude of losses claimed by investors in more recent tax shelters “dwarfs” losses generated by 1970s shelters, and citing examples).

87. *See generally* Rostain, *supra* note 73, at 88-94 (outlining “the rise of the tax shelter market” during the 1990s, providing examples of notable abusive corporate shelters of the period, and discussing the respective roles of attorneys and accountants in the development of the market); Meah Rothman Tell, *Circular 230: Beware the Jabberwock!*, 80 FLA. B. J. 39 (2006) (discussing several high-profile examples of abusive tax shelters promoted by prominent accounting firms and supported by the legal opinions of prominent law firms); Schumacher, *supra* note 72, at 53-56 (describing “the rise of mega tax shelters” and the participation of attorneys and accountants therein).

88. *See* Rostain, *supra* note 73, at 92-93; Schenk, *supra* note 67, at 1312.

89. Section 6664(c)(1) of the Code provides that “[n]o penalty shall be imposed under section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.” I.R.C. § 6664(c)(1) (2010). Treasury regulation § 1.6664-4 sets

for underpayments under § 6662<sup>90</sup> or the 75% fraud penalty under § 6663.<sup>91</sup> (Similarly, with certain exceptions, reliance on certain legal opinions can be asserted to invoke the heightened reasonable-cause-and-good-faith exception to the 20% accuracy-related penalty under § 6662A(a)<sup>92</sup> that has applied since 2004 to understatements arising from “reportable transactions”<sup>93</sup>).

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forth rules for whether the reasonable-cause-and-good-faith exception applies in particular circumstances. In general, the rules provide for a facts-and-circumstances-based determination. See Treas. Reg. § 1.6664-4(b) (2010). There are special rules, however, for determining whether the exception applies in the case of substantial understatement penalties attributable to tax shelter items of corporations. See Treas. Reg. § 1.6664-4(f) (2010). In addition to the general facts-and-circumstances test, those special rules expressly provide that that reasonable cause may be established through reliance in good faith on the opinion of a professional tax advisor, but only if that opinion meets certain minimum requirements. Treas. Reg. § 1.6664-4(f)(2) (2010).

90. Section 6662 of the Code provides, *inter alia*, for the imposition of a penalty in the amount of 20% of any portion of an underpayment of tax that is attributable to “negligence” (as defined in § 6662(c)) or a “substantial understatement of income tax” (as defined in § 6662(d)). See I.R.C. § 6662 (2010).

91. Section 6663 of the Code provides for the imposition of a penalty in the amount of 75% of any portion of an underpayment of tax that is attributable to fraud. See I.R.C. § 6663(a) (2010).

92. Section 6662A(a) of the Code provides for the imposition of a penalty in the amount of 20% of any portion of a “reportable transaction understatement.” See I.R.C. § 6662A(a) (2010). A “reportable transaction understatement” is an underpayment of tax that results from or is facilitated by a reportable transaction, as calculated according to a formula set forth in § 6662A(b). See I.R.C. § 6662A(b)(1) (2010). Under § 6664(d) of the Code, a penalty under § 6662A will not be imposed “with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.” See I.R.C. § 6664(d)(1) (2010). However, to fall within this protection, a taxpayer must meet certain requirements that make the reasonable-cause-and-good-faith exception to the § 6662A penalty somewhat more stringent than the reasonable-cause-and-good-faith exception to the § 6662 and § 6663 penalties provided by § 6664(c)(1) and the Treasury regulations thereunder. The § 6664(d) requirements include that (a) the taxpayer adequately disclosed the reportable transaction in question, (b) there was substantial authority for the taxpayer’s tax treatment of the reportable transaction, and (c) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. See I.R.C. § 6664(d)(3) (2010). The rules relating to what constitutes a “reasonable belief” in this context, including rules specifically addressing legal opinions on which reliance can and cannot be placed, are set forth in § 6664(d)(4). See I.R.C. § 6664(d)(4) (2010). Notwithstanding the general rule of § 6664(d)(1), no reasonable cause exception to the imposition of a § 6662A(a) penalty is available in the case of any portion of a reportable transaction understatement that arises from a transaction to which a § 6662(b)(6) penalty applies because the transaction lacks economic substance under the newly-codified economic substance doctrine. See I.R.C. § 6664(d)(2) (2010). For a discussion of the recent codification of the economic substance doctrine, see *infra* note 99 and accompanying text. For a discussion of the related strict liability penalty for transactions without economic substance, see *infra* notes 187-99 and accompanying text.

93. A “reportable transaction” is defined under the Code as a transaction with respect to which information must be included on a participant’s tax return because the Secretary has determined, pursuant to regulations prescribed under § 6011, that the transaction has “a potential for tax avoidance or evasion.” I.R.C. § 6707A(c)(1) (2010). In accordance with those regulations, the IRS has promulgated a list of categories of reportable transactions, as



Of course, there traditionally have been certain exceptions to the availability of legal opinions as penalty defenses, and those exceptions are likely to increase in the future. Since 2004, one exception has been that reliance on a legal opinion cannot provide a defense against imposition of the 30% penalty under § 6662A(c) that applies to understatements related to undisclosed reportable transactions.<sup>94</sup> Moreover, as discussed further below, the extent to which reliance on a legal opinion will be grounds for a reasonable-cause-and-good-faith defense against accuracy-related penalties asserted in any future tax shelter case has recently been called into some question by the March 2010 enactment of the § 6662(b)(6) strict liability penalty with respect to transactions that contravene the newly-codified economic substance doctrine.<sup>95</sup> Nevertheless, the ability to invoke reliance on a legal opinion as a part of a defense against penalties certainly has been, and potentially will continue to be,<sup>96</sup> a significant consideration for investors contemplating participation in tax shelters.

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to which a participant must disclose information on a Form 8886 filed together with the participant's return. The categories of reportable transactions are: Listed Transactions, transactions subject to conditions of confidentiality, transactions subject to contractual protections, loss transactions (*i.e.*, transactions that generate losses in excess of certain specified thresholds, which vary depending on whether the claimant of the loss is an individual, corporation or partnership), and so-called transactions of interest (which are transactions that the same as, or substantially similar to, ones that the IRS has specifically identified as having potential for tax avoidance or evasion). *See* IRS Instructions for Form 8886 (Rev. Mar. 2010) (Reportable Transaction Disclosure Statement) at 1-3.

94. Section 6662A(c) of the Code provides (or, at least, is intended to provide) for the imposition of a penalty in the amount of 30% of any portion of a reportable transaction understatement arising from a reportable transaction that the taxpayer did not adequately disclose in accordance with regulations under § 6011 (*i.e.*, a transaction that was not disclosed on a Form 8886). Specifically, § 6662A(c) provides that the 30% penalty applies "to the portion of any reportable transaction understatement with respect to which the requirement of section 6664(d)(2)(A) is not met." I.R.C. § 6662A(c) (2010). Prior to March 30, 2010, § 6664(d)(2)(A) referenced the requirement for adequate disclosure, in accordance with regulations prescribed under § 6011, of relevant facts affecting the tax treatment of an item of income. However, as a result of amendments to § 6664(d) that became effective on March 30, 2010 in connection with the codification of the economic substance doctrine, the former § 6664(d)(2)(A) was redesignated as § 6664(d)(3)(A). *Compare* I.R.C. § 6664(d)(3)(A) (as amended in 2010), *with* I.R.C. § 6664(d)(2)(A) (2009). In what was presumably a drafting oversight in connection with the March 30, 2010 amendments, the cross-reference in § 6662A(c) was not updated accordingly. Nevertheless, the context makes clear that the 30% penalty is still intended to apply to reportable transaction understatements arising from transactions that were not adequately disclosed pursuant to § 6011. (For a description of what constitutes a "reportable transaction understatement," see *supra* note 92). The penalty under § 6662A(c) is a strict liability penalty. The reasonable-cause-and-good-faith exception under § 6664(d) is expressly inapplicable in cases where the reportable transaction at issue was not adequately disclosed. *See* I.R.C. § 6664(d)(3)(A) (2010). This abolition of, *inter alia*, "penalty protection for opinion letters in connection with reportable tax shelters that are not properly disclosed and are later found to be abusive" was enacted in 2004 as part of the JOBS Act. Rostain, *supra* note 73, at 108 (citations omitted).

95. *See infra* notes 187-99 and accompanying text.

96. *See infra* text accompanying notes 194-99 (discussing potential limits in the IRS's application of § 6662(b)(6) and the corresponding potential for remaining vitality of other

To arrive at a level of comfort they needed in order to deliver opinions on the overly aggressive transactions that they were blessing, tax attorneys in the 1990s often used techniques that skirted the boundaries of sound professional judgment, if not professional ethics.<sup>97</sup> First, they adopted a hyper-textual approach to the construction and application of the tax laws. That is, they focused solely on whether the proposed tax treatment of a given transaction could technically be argued to come within the literal terms of the Code, without taking account of the legislative history or purpose of the provisions in question, and without giving effect to judicially-created anti-abuse doctrines such as the business purpose and economic substance doctrines.<sup>98</sup> (The economic substance doctrine was

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accuracy-related penalties—which have reasonable-cause-and-good-faith exceptions—in the tax shelter context).

97. Prior to the Covered Opinion Regulations under Circular 230, the only professional ethical guidance to attorneys specifically in relation to tax shelter opinions was found in the American Bar Association’s Formal Opinion 346, which was released in 1982. See A.B.A. Comm. on Ethics and Prof. Resp., Formal Op. 346 (1982). A detailed analysis of Formal Opinion 346 is beyond the scope of this article. For useful discussions of that opinion, see, e.g., David T. Moldenhauer, *Circular 230 Opinion Standards, Legal Ethics and First Amendment Limitations on the Regulation of Professional Speech by Lawyers*, 29 SEATTLE U. L. REV. 843, 868-70 (2006); David J. Moraine, *Loyalty Divided: Duties to Clients and Duties to Others—The Civil Liability of Tax Attorneys Made Possible by the Acceptance of a Duty to the System*, 63 TAX LAW. 169, 182-84 (2009). Though one may debate the theoretical superiority or inferiority of the standards set forth in Formal Opinion 346 relative to the Covered Opinion Regulations, one conclusion is inescapable: The aspirational standards in that opinion had been wholly ineffective at deterring the conduct described below.

98. See Rostain, *supra* note 73, at 94; Schumacher, *supra* note 72, at 56. The business purpose doctrine and the economic substance doctrine are among “a cluster of overlapping doctrines, dating back to the 1930s, that courts . . . developed to disallow the tax benefits of abusive transactions.” Rostain, *supra* note 73, at 84-85. (The substance-over-form and step-transaction doctrines are also in this group). “The economic substance doctrine was, if not formulated, then at least popularized by Learned Hand in the Second Circuit’s 1934 decision of *Gregory v. Helvering*.” David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 241 (1999) (citing *Gregory v. Helvering*, 69 F.2d 809 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935)). That doctrine has since “played a particularly important role in the government’s fight against corporate tax shelters.” Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 6 (2000). The doctrine’s basic premise “is that a court may deny the tax benefits achieved by a business transaction where the transaction itself lacks any economic benefit without regard to the tax benefits.” Jeffrey C. Glickman & Clark R. Calhoun, *The “States” of the Federal Common Law Tax Doctrines*, 61 TAX LAW. 1181, 1183 (2008). In one often cited case, the Tax Court explained the economic substance doctrine as follows:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purposes other than tax savings.

*ACM P’ship v. Comm’r*, 73 T.C.M. (CCH) 2189, 2215 (1989), *aff’d in part and rev’d in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999) (quoted in Glickman & Calhoun, *supra* note 98 at 1183). Thus, the doctrine dictates that a transaction will not be recognized for tax purposes if it does not provide a potential for economic gain to the taxpayer—apart from any tax considerations or consequences. See Rostain, *supra* note 73,

codified on March 30, 2010, at § 7701(o) of the Code.<sup>99</sup> Prior to that time, it was strictly a common-law doctrine.) Indeed, the attorneys' opinions often contained express qualifications such as, "in giving this opinion, we do not consider the application of the doctrines of economic substance and business purpose."<sup>100</sup>

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at 85. The economic substance doctrine consists of two "separate, but interrelated, inquiries." Bankman, *supra* note 98 at 9 (citing *ACM P'ship*, 157 F.3d at 247-48). The first inquiry is an objective test that focuses on "whether the transaction has any practical economic effects other than the creation of income tax losses." *Id.* (quoting *ACM P'ship*, 157 F.3d at 248 (quoting *Jacobson v. Comm'r*, 915 F.2d 832, 837 (2d Cir. 1990))). The second inquiry "explicitly incorporates the business purpose doctrine." Bankman, *supra* note 98 at 9. The business purpose doctrine "is the subjective inquiry into the taxpayer's intent to enter into a transaction, and a taxpayer must show that it had an independent non-tax purpose for the transaction." Glickman & Calhoun, *supra* note 98, at 1189. In other words, the business purpose doctrine asks: Does the taxpayer have a reason—other than tax avoidance—for doing the deal? In short, the transaction will be respected for tax purposes only if the answer is "yes." See Rostain, *supra* note 73, at 85. Over time, courts developed differing views as to whether both the objective and subjective tests always need to be satisfied and whether to respect transactions that satisfy only one of the tests. See Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017, 1033 (2009). These inconsistencies sparked many calls for the codification of the doctrines over the years. See Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 391 (2010). Ultimately, as discussed below, the economic substance doctrine was incorporated in the Code in March 2010. In any event, the economic substance and business purpose doctrines reflect the fundamental theory that tax deductions under the Code "should apply only to activities aimed at income generation," given that the basic aim of the Code is to "tax income minus the cost of generating it." Rostain, *supra* note 73, at 86 (citations omitted).

99. Section 7701(o) of the Code, entitled "Clarification of Economic Substance Doctrine," was added as part of the Health Care and Education Reconciliation Act of 2010, which President Obama signed into law on March 30, 2010. Section 7701(o) provides that "[i]n the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." I.R.C. § 7701(o)(1) (2010). The new Code section defines "economic substance doctrine" as the "common law doctrine under which tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." I.R.C. § 7701(o)(5)(A) (2010). The section specifically provides that the threshold question of "whether the economic substance doctrine is relevant to a transaction shall be made in the same manner" as if the new law "had never been enacted." I.R.C. § 7701(o)(5)(C) (2010). One commentator suggests that this latter provision "should mean that for the most part, the law has not changed." Monte A. Jackel, *Dawn of a New Era: Congress Codifies Economic Substance*, 129 TAX NOTES 289, 296 (Apr. 19, 2010). However, an express requirement, in all cases, that the present value of a transaction's reasonably expected pre-tax profit be "substantial" in relation to the present value of the transaction's expected net tax benefits (see I.R.C. § 7701(o)(2)(A) (2010)) is one change to the common law doctrine. Jackel, 129 TAX NOTES at 296. Moreover, because the new section does not define what constitutes a change "in a meaningful way" in a taxpayer's economic position, or what constitutes a "substantial" purpose for entering into a transaction, it is too early to tell whether those concepts introduce any significant changes to the economic substance doctrine. See *id.* Section 7701(o) applies to transactions consummated after March 30, 2010.

100. David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 362-63 (2006).

Second, the attorneys frequently relied on unsupported or unreasonable factual assumptions or factual representations.<sup>101</sup> Many times, these were general, unsubstantiated representations or assumptions that the transaction in question had a legitimate business purpose apart from tax considerations or that the transaction had the potential to produce economic profit before taking into account any tax effects. For example, an attorney's opinion would simply state something to the effect that, "in giving this opinion, we rely on your representation that there is a realistic possibility to make a pretax profit."<sup>102</sup> Other times, there would just be a blanket assumption in the opinion (without any back-up) that all statements in the offering circular for the tax shelter were correct.<sup>103</sup>

Third, the attorneys would sometimes render "partial opinions," in which they would address only some of the federal tax issues arising in a transaction. They would speak to those issues as to which they could reach a favorable conclusion, and they would simply ignore those that were problematic or inconvenient (stating, in the process, that the opinion was limited solely to the matters expressly mentioned).<sup>104</sup> Because most investors "tended to focus primarily on the opinion's conclusion that the tax benefits were allowable," they usually failed to consider the various qualifications and conditions upon which the opinions were rendered, and they were thus "misled into believing that the tax benefits were legitimate."<sup>105</sup>

It was in order to eliminate these practices, which had become so widespread and which had facilitated so many abusive tax shelters during the preceding decade, that the December 2004 Amendments to Circular 230 introduced requirements for tax advisors to consider all relevant facts and to rely only on reasonable factual assumptions and representations, to relate all relevant law (including judicial anti-abuse doctrines) to those facts, and to address all pertinent federal tax issues, when providing covered opinions.<sup>106</sup>

#### IV. THE MOST COMMON, AND MOST SIGNIFICANT, CRITICISMS OF THE COVERED OPINION REGULATIONS

When the Covered Opinion Regulations were first announced, they were met with virtual screams of protest from practicing tax attorneys and tax law scholars, and that criticism has not abated in the years since the regulations took effect.

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101. *Id.* at 362.

102. *Id.*

103. *See* WATSON & BILLMAN, *supra* note 74, at 137.

104. *See id.* at 138.

105. *Id.* at 137.

106. *See* Schizer, *supra* note 100, at 363.

A. *The Regulations are Unduly Complex*

As an initial matter, even before considering the substance of the rules that the regulations impose, the language and organization of the Covered Opinion Regulations have been disparaged as unworkably complex. Critics maintain that the regulations are unnecessarily complicated, “with numerous defined terms and overlapping standards and definitions.”<sup>107</sup> They complain that, before providing any written advice to a client, an attorney must spend an inordinate amount of time sifting through various arcane regulatory provisions to try to figure out which categories his or her opinion may come within, which exceptions or opt-out provisions may be relevant, and which requirements therefore apply to his or her project.<sup>108</sup> As a consequence, tax attorneys may actually have to spend more time deciphering the rules that govern their opinions than they spend considering the substance of the tax matters on which they are opining.<sup>109</sup> According to the critics, simply forcing tax attorneys to focus so much time and attention on the form and procedure for opinion-giving, when they should instead be thinking about “real” tax issues, may itself diminish the quality of the advice that the attorneys ultimately provide.<sup>110</sup>

B. *The Regulations Impose Prohibitive Time and Cost Burdens*

From here, things only get worse according to the regulations’ many detractors. Assume that a client asks to receive—or that an attorney determines that it would be prudent to provide—written advice with respect to a particular tax matter. If, after combing through the Covered Opinion Regulations, a practitioner concludes that his or her written advice would constitute a covered opinion (as will very often be the case<sup>111</sup>), then the regulations require the practitioner to provide a full-blown opinion that satisfies the exacting due diligence and drafting standards set forth in Circular 230 § 10.35(c).<sup>112</sup> Of course, if the advice constitutes a “reliance opinion” that relates to a Significant Purpose transaction, the practitioner can opt out of compliance with the § 10.35(c) regulations by including a prominent Non-Reliance Disclaimer in the opinion.<sup>113</sup> However, while such disclaimers have become commonplace, there are significant

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107. Schumacher, *supra* note 72, at 63.

108. *See, e.g.*, Paul, *supra* note 66, at 17-18.

109. *See id.* at 18; Schumacher, *supra* note 72, at 63.

110. *See* Schumacher, *supra* note 72, at 63; Paul, *supra* note 66, at 17-18.

111. This is because virtually any written tax advice has the potential to come within the broad scope of a Significant Purpose Transaction opinion.

112. *See* Weiser, *supra* note 15, at 29-30.

113. For a description of what constitutes a “reliance opinion” under Circular 230, see *supra* note 8. It is also possible to opt out of compliance with the Circular 230 § 10.35(c) regulations in the case of a “marketed opinion” that relates to a Significant Purpose transaction by including both a Non-Reliance Disclaimer and certain other disclaimers. For a description of what constitutes a “marketed opinion” under Circular 230, see *supra* note 9. For a description of the Covered Opinion Regulations’ opt-out provisions, see *supra* notes 49-54 and accompanying text.

drawbacks to them (as discussed further below).<sup>114</sup> Moreover, the possibility of opting out of compliance with § 10.35(c) does not even exist in the case of opinions related to Listed Transactions or Principal Purpose Transactions.<sup>115</sup>

The critics assert that meeting the § 10.35(c) standards greatly increases the time burden associated with providing such tax advice and, therefore, substantially increases the cost of such advice to clients.<sup>116</sup> This, in turn, strains the relationship between tax attorneys and their clients. For example, a client who wishes to receive succinct advice on a relatively routine tax planning matter will likely be upset to find that the brief e-mail response that he or she expected will instead have to be a several-page formal opinion, which will take far longer to produce and will cost far more when it finally arrives.<sup>117</sup> Such experiences may cause clients to conclude “that they cannot rely on their practitioner to offer them advice without producing a document that is formalistic and expensive.”<sup>118</sup> As a result, in at least some instances, clients may become discouraged from seeking tax counsel in the first place.<sup>119</sup>

C. *The Regulations Impede Communication between Attorneys and Clients, and Prevent Delivery of Informal or Piecemeal Advice*

In addition to increasing the cost of tax advice in many instances, some critics charge that the Covered Opinion Regulations (and particularly the § 10.35(c) requirements) impede the normal flow of communications between tax attorneys and their transactional clients because they do not reflect how advice is actually rendered during the course of a deal.<sup>120</sup> In short, the argument is that transactional advice—including tax advice—is typically requested and given piecemeal during the gestation of a deal, and the Covered Opinion Regulations make it harder to provide such advice in writing if the transaction in question is within the regulations’ wide ambit. Generally, a client’s first request for tax advice will not be a request for a comprehensive opinion addressing all tax issues in a deal, just prior to the transaction’s completion. Instead, a client usually seeks advice in many stages, beginning when he or she first “noodles” over a deal’s structure and

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114. See *infra* Part IV.F.

115. See *supra* note 54 and accompanying text.

116. See, e.g., Weiser, *supra* note 15, at 29-30; Paul, *supra* note 66, at 17; Schenk, *supra* note 67, at 1315; Vasquez & Vasquez, *supra* note 56, at 295.

117. Vasquez & Vasquez, *supra* note 56, at 316 (citing Richard M. Lipton, *Attorney Comments on Proposed Circular 230 Amendments*, 2004 TAX NOTES TODAY 48-41 (Mar. 11, 2004)).

118. Edward F. Koren, *ABA Section Members Comments on Circular 230 Regs.*, 2005 TAX NOTES TODAY 90-23 (May 11, 2005) (quoted in Vasquez & Vasquez, *supra* note 56, at 316).

119. See Schenk, *supra* note 67, at 1315; Vasquez & Vasquez, *supra* note 56, at 316.

120. See Paul, *supra* note 66, at 16, 26-31 (asserting that various examples of “informal” written tax advice should be excluded from the definition of a “covered opinion”).

continuing as different variations of the transaction are considered and as deal terms are added and deleted through negotiations.<sup>121</sup> The tax questions that arise during this long process often involve significant but discrete issues (as opposed to encompassing all tax aspects of the deal); and they usually call for response that is considered (of course), but also prompt, succinct and informal.<sup>122</sup>

The problem is that, if such a response is given in writing, and if the transaction is a Listed Transaction, a Principal Purpose Transaction or a Significant Purpose Transaction (and any deal which is not one of the first two will almost certainly be in the last category), then the brief, informal response on the discrete issue will have to meet all of the heightened due diligence and comprehensive drafting requirements of Circular 230 § 10.35(c).<sup>123</sup> This is true even if the advice is in electronic form.<sup>124</sup> As a result, “there is an increased incentive to use oral advice.”<sup>125</sup> In at least some cases, this may be worse for the client because oral advice on complex tax issues is more susceptible to misunderstanding and because the client will be left without a “record” to consult later.<sup>126</sup> Moreover, in today’s world, “advice that would in the past have been delivered orally is often transmitted by e-mail.”<sup>127</sup> “[B]ecause the sender” and recipient “need not be present at the same time[,]” attorneys and clients alike often prefer e-mails to oral communication, and e-mail has thus become one of the primary ways in which tax and other legal advice is given and received.<sup>128</sup> Of course, it is often possible to opt out of compliance with the regulations by adding a Non-Reliance Disclaimer to the message, and such disclaimers in attorneys’ e-mails have become ubiquitous. Again, however, that option does not exist in every case, and the disclaimers themselves are not without their own problems.<sup>129</sup>

*D. The Regulations Prevent Practitioners from Exercising Professional Judgment in Distinguishing between Important and Unimportant Tax Issues*

Worse yet, as some commentators have pointed out, the Covered Opinion Regulations may prevent attorneys from providing at least one

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121. *See id.* at 16.

122. *Id.* at 16, 26.

123. *See generally* 31 C.F.R. § 10.35(a) (2010), 31 C.F.R. § 10.35(b)(2)(i) (2010). *But see* 31 C.F.R. § 10.35(b)(2)(ii)(A) (2010) (containing an exception to this requirement if the advice in question constitutes preliminary advice).

124. “Electronic communications” are expressly included among the types of written advice that can be a “covered opinion” under Circular 230. *See* 31 C.F.R. § 10.35(b)(2)(i) (2010).

125. Schenk, *supra* note 67, at 1315.

126. *Id.*

127. Paul, *supra* note 66, at 26.

128. *Id.*

129. *See infra* text accompanying notes 152-56 (discussing problems with Non-Reliance Disclaimers).

particularly important component of tax advice at any price or in any form. Generally, a covered opinion must consider all “significant federal tax issues” and provide a conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each such issue.<sup>130</sup> This general rule limits a practitioner’s discretion to confine his or her counsel to the issues that he or she believes to be of true and material concern.<sup>131</sup>

For purposes of the Covered Opinion Regulations, a federal tax issue is “significant” if the IRS “has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.”<sup>132</sup> This “reasonable basis” standard captures a much broader swath of tax issues than did the standard that applied under Circular 230 prior to the December 2004 Amendments. Before those amendments, the former Circular 230 § 10.33 required tax opinions to address only those federal tax issues that were subject to “a reasonable possibility of challenge by the” IRS.<sup>133</sup> As commentator David Moldenhauer explains, the prior standard thus “allowed a practitioner to exercise professional judgment in distinguishing between those issues that raised a possibility of challenge, and thus required discussion, and those that did not.”<sup>134</sup>

“In contrast,” the current “reasonable basis standard” under Circular 230 § 10.35 “does not allow for such judgment.”<sup>135</sup> Moldenhauer notes that, while the “reasonable basis standard” may be appropriate to the evaluation of whether a reporting position is sufficient to avoid penalties, employing that standard “to define the entire range of issues to be

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130. 31 C.F.R. § 10.35(c)(3)(i) and (ii) (2010). For a description of what constitutes a “significant Federal tax issue” under Circular 230, see *supra* note 8.

131. See Moldenhauer, *supra* note 97, at 860-61. As noted above, there are two exceptions to the general rule. First, a practitioner may rely on the opinion of another practitioner with regard to some significant federal tax issues. See 31 C.F.R. § 10.35(d)(1) (2010). Also, Limited Scope Opinions are permissible in some cases. See 31 C.F.R. § 10.35(c)(3)(v)(A) (2010). For further discussion of a practitioner’s ability to rely on others’ opinions and further discussion of Limited Scope Opinions, see *supra* notes 30-31 and accompanying text.

132. 31 C.F.R. § 10.35(b)(3) (2010). The regulations do not define what constitutes a “reasonable basis for a successful challenge” in this context. Law, *supra* note 69, at 32. However, the Treasury regulations promulgated under § 6662 of the Code provide that, in the context of a defense against the imposition of an accuracy-related penalty for substantial underpayments of tax, “a ‘reasonable basis’ for a taxpayer’s position is a standard that is ‘significantly higher than not frivolous or not patently improper.’” *Id.* at 32 n.34 (quoting Treas. Reg. § 1.6662(b)(3)). Therefore, assuming that the IRS applies the “reasonable basis” standard in the same way under Circular 230, the standard “is not satisfied by a return position that is merely arguable or that is merely a colorable claim.” *Id.* (quoting Treas. Reg. § 1.6662(b)(3)); see also Moldenhauer, *supra* note 97, at 860-61.

133. Former 31 C.F.R. § 10.33(a)(4) (1984) (*quoted in* Moldenhauer, *supra* note 97, at 861).

134. Moldenhauer, *supra* note 97, at 861.

135. *Id.*



considered in an opinion requires the practitioner to identify not merely the positions that the IRS would most likely raise but rather all positions that the IRS might take that are more than merely arguable, colorable, frivolous or patently improper.”<sup>136</sup> Indeed, a practitioner “must do so even if the position has a low likelihood of success or the IRS is unlikely to raise the issue for policy or other reasons.”<sup>137</sup>

This restriction on an attorney’s ability to separate the wheat from the chaff when advising a client may seriously impede the quality of the advice, and may greatly diminish the client’s interest in receiving it. As another prominent commentator has noted, clients “do not want to read about all potentially significant tax issues. They want their advisors to serve as a filter, to tell them where the real risks are and how they can be addressed.”<sup>138</sup> Distinguishing between material concerns and theoretical or peripheral ones is a prerequisite to developing and dispensing sound legal advice. To the extent that the “reasonable basis” standard for defining “significant federal tax issues” in covered opinions prevents attorneys from engaging in that fundamental exercise, the Covered Opinion Regulations may therefore substantially diminish the value of the tax counsel that clients receive.

*E. The Regulations are Far Too Broad, and they Capture Much More than the Tax Shelter Advice that they were Intended to Regulate*

By far the most significant criticism of the Covered Opinion Regulations is that they are incredibly overbroad. The intent of the Covered Opinion Regulations is to impose rigorous requirements on legal opinions provided in connection with tax shelters, in order to prevent such opinions from being used to support abusive shelters.<sup>139</sup> As written, however, the regulations cover far more than opinions related to tax shelters. This is because the phrase “significant purpose,” as used in Circular 230 § 10.35(b)(2)(i)(C) and (b)(10), is so broad that a Significant Purpose Transaction could include virtually any matter as to which a client

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136. *Id.* (citing Treas. Reg. § 1.6662-3(b)(3) (2003)).

137. *Id.* (citation omitted).

138. James M. Peaslee, *Attorney Seeks Improvements to Circular 230 Rules*, 2005 TAX NOTES TODAY 45-14 (March 9, 2005) (quoted in Vasquez & Vasquez, *supra* note 56, at 316-17).

139. “[O]ne may argue that that the plain meaning of [§ 822 of the JOBS Act] clearly authorizes the Secretary of the Treasury to issue Circular 230 addressing written tax advice if [such advice] has ‘a potential for tax avoidance or evasion.’” Vasquez & Vasquez, *supra* note 56, at 300 (quoting Pub. L. 108-357, § 822(b), 118 Stat. 1418, 1587 (2004)). However, “one must look no further than the same tax act to discover that ‘Congress deliberately targeted its burdensome opinion standards to situations where there is a risk of shelter activity.’” *Id.* (quoting Jeffrey H. Paravano & Melinda L. Reynolds, *The New Circular 230 Regulations—Best Practices or Scarlet Letter?*, 46 TAX MGMT. MEMO 339, 340 (2005)). See also Isaac J. Roang, *To Disclaim or Not to Disclaim: IRS Circular 230 Requirements for Written Advice*, 19 GEO. LEGAL ETHICS 937, 946 (Summer 2006) (“The [Covered Opinion Regulations] were, presumably, initiated in response to a marketed tax shelter opinion problem.”).

would ever seek tax counsel.<sup>140</sup> Almost any undertaking in which a tax advisor is consulted could accurately be said to have as a significant purpose the avoidance of income tax, because the “very essence” of providing transactional tax advice is to find ways to make transactions more tax efficient.<sup>141</sup> Thus, for example, items of written advice concerning such matters as like-kind exchanges, corporate reorganizations, and choices of business entity could all be construed as covered opinions under a literal reading of the regulations’ “significant purpose” language.<sup>142</sup> In short, the “significant purpose” advice regulated under Circular 230 is not confined to counsel concerning aggressive, potentially abusive endeavors; instead, it encompasses all legitimate tax planning.<sup>143</sup>

This flaw greatly exacerbates all of the other problems with the Covered Opinion Regulations. Because the regulations apply to written advice concerning virtually every tax matter, the issues described above relate to nearly everything that any tax practitioner does. The regulations do not merely impact counsel related specifically to tax shelters (as they were meant to); rather, they impose burdens and restrictions on the provision of practically all tax advice. To fix the problems with the Covered Opinion Regulations, the first and most important step is therefore to correct their scope. The broad reach of the “significant purpose” regulations must be narrowed so that they encompass only tax shelter advice, and nothing more (as proposed in Part V.B *infra*<sup>144</sup>). Because

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140. See *supra* text accompanying notes 14-15; see also *infra* text accompanying notes 206-09.

141. See Vasquez & Vasquez, *supra* note 56, at 297; see also Swartz & Bertrand, *supra* note 46, at 257 (“it is not clear whether structuring a transaction that would otherwise occur for good business reasons in a tax-efficient manner could constitute a significant tax avoidance purpose”); Roang, *supra* note 139, at 947 (Covered Opinion Regulations “go much farther than tax shelters because almost all tax opinions have a ‘significant purpose’ to avoid taxes”).

142. See Vasquez & Vasquez, *supra* note 56, at 297; see also Paul, *supra* note 66 (providing various examples of routine tax advice that could be characterized as a having tax avoidance as a “significant purpose”).

143. The IRS has made a number of statements indicating that it will not apply the Covered Opinion Regulations in the context of transactions that are not overly aggressive. Roang, *supra* note 139, at 947; see also Vasquez & Vasquez, *supra* note 56, at 321-22 (describing various IRS statements to the effect that “the literal language of § 10.35 is not what will control”). These statements have been less than reassuring to the tax bar, however. Commentators Jeffrey H. Paravano and Melinda L. Reynolds have summed up practitioners’ response well:

Statements by government officials that tax advisors should take comfort in the fact that the Circular 230 rules will be enforced in a “reasonable” rather than a literal manner are appreciated but also create a certain amount of horror in the minds of tax practitioners who feel compelled to attempt to comply with the laws as written. If a regulation cannot or will not be enforced pursuant to its terms, the regulation should be changed.

Jeffrey H. Paravano & Melinda L. Reynolds, *The New Circular 230 Regulations—Best Practices or Scarlet Letter?*, 46 Tax Mgmt. Memo 339, 341-42 (2005) (quoted in Vasquez & Vasquez, *supra* note 56, at 322).

144. See *infra* text accompanying notes 211-14.

providing counsel on tax shelters is a decidedly small part of what tax practitioners do, this one change will make any remaining problems with the Covered Opinion Regulations far easier to deal with. It will remove those problems from the center of tax practice to the periphery.

*F. The Opt-Out Procedures and Related Non-Reliance Disclaimers  
Also Create Certain Problems*

As mentioned before, a practitioner can opt out of compliance with the due diligence and drafting requirements under Circular 230 § 10.35(c) by prominently placing a Non-Reliance Disclaimer on his or her opinion, if the opinion relates to a Significant Purpose Transaction and is a “reliance opinion.”<sup>145</sup> Opting out is also possible in the case of an opinion that relates to a Significant Purpose Transaction and is a “marketed opinion,” if the opinion contains both a Non-Reliance Disclaimer and certain additional “consumer protection” legends.<sup>146</sup> There is no ability to opt out of complying with the regulations if the opinion relates to a Listed Transaction or a Principal Purpose Transaction, or if the opinion relates to a Significant Purpose Transaction and is either “subject to conditions of confidentiality” or “subject to contractual protection.”<sup>147</sup> When the rules permit, opting out of compliance enables a practitioner to avoid the above-described problems that stem from the regulations’ due diligence and drafting requirements.

The use of Non-Reliance Disclaimers has thus become extremely widespread in tax practice. Indeed, nearly all law firms that provide any tax advice now include Non-Reliance Disclaimers on most of their written correspondence—including literally all of their e-mails—even when the correspondence has nothing to do with a tax matter.<sup>148</sup> For example, if an attorney sends you an e-mail asking if you want to grab a beer after work, you are now usually cautioned that the invitation cannot be used as a defense against the imposition of tax penalties. This absurd overuse of Non-Reliance Disclaimers has turned them into objects of ridicule.<sup>149</sup> Though the firms themselves no doubt recognize the ludicrousness of this approach, they nevertheless “prefer using these blanket disclosure procedures rather than requiring each lawyer to make a determination as to whether a particular written communication is subject to [Circular 230’s] due diligence and drafting guidelines.”<sup>150</sup> This practice has therefore

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145. See *supra* notes 49-51 and accompanying text.

146. See *supra* notes 52-53 and accompanying text.

147. See *supra* note 54 and accompanying text.

148. Weiser, *supra* note 15, at 33; Schumacher, *supra* note 72, at 62-63.

149. For a while, one internet vendor even sold t-shirts, mugs and underwear “emblazoned with the no-penalty-protection mantra.” Schumacher, *supra* note 72, at 63 (discussing the vendor Café Press, whose website is [www.cafepress.com](http://www.cafepress.com)).

150. Weiser, *supra* note 15, at 33.

become almost universal, despite the fact that the IRS has strongly objected to it.<sup>151</sup>

Although Non-Reliance Disclaimers have become commonplace as a way to avoid other burdens of the Covered Opinion Regulations, the disclaimers themselves have significant drawbacks. They, too, have therefore garnered much criticism.

First, and most obviously, a Non-Reliance Disclaimer prevents an opinion from being invoked as part of a reasonable-cause-and-good-faith defense to the imposition of accuracy-related penalties under § 6662 of the Code (or § 6662A(a) of the Code, in the case of disclosed reportable transactions) or fraud penalties under § 6663 of the Code.<sup>152</sup> The potential harm this causes to the opinion's recipient is self-evident and requires little elaboration. Suffice it to say that, if a tax opinion endorses a particular reporting position, and it turns out that the opinion cannot be used to defend against the assessment of penalties arising from that reporting position, the opinion will have been worthless to the client (both as "insurance" and as advice).

Second, because Non-Reliance Disclaimers have become ubiquitous, it is likely that many clients have come to view the disclaimers as meaningless boilerplate that they can simply ignore.<sup>153</sup> Of course, this is not a problem in the many instances (like the invitation for a beer) when the disclaimer should be ignored. Yet there can be a big problem if a client becomes "trained" to ignore Non-Reliance Disclaimers in formal legal opinions (or other written communications) that contain tax advice. In such cases, clients will fail to recognize the substantial limitations of the advice

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151. *Id.* at 33 (citing IRS statements reported in 2005 TAX NOTES TODAY116-4 (June 17, 2005)).

152. For a discussion of the accuracy-related penalties under § 6662, the fraud penalty under § 6663, and the reasonable-cause-and-good-faith defense to those penalties under § 6664(c)(1), see *supra* notes 89-91 and accompanying text. For a discussion of the accuracy-related penalties under § 6662A, which apply to reportable transaction understatements, and the reasonable-cause-and-good-faith defense to the § 6662A(a) penalty that is available under § 6664(d)(1) only in the case of properly disclosed reportable transactions, see *supra* notes 92-94 and accompanying text. At least one commentator has argued that a Non-Reliance Disclaimer may not actually preclude assertion of the reasonable-cause-and-good-faith defense because Treasury has not amended the regulations under § 6664 to provide that opinions that include such disclaimers cannot be used as part of such a defense. See Moldenhauer, *supra* note 97, at 858. Such an amendment to those regulations would no doubt add clarity. However, even without such a clarification, it is difficult to imagine a court concluding that reliance on an opinion is a reasonable cause for, or an act in good faith with respect to, a reporting position if the opinion itself expressly provides that it cannot be relied upon to avoid the imposition of penalties. Curiously, the commentator also asserts that, even if an opinion "fails to meet the standards for avoiding penalties under Code Section 6664," a taxpayer may be able to rely on the opinion as a defense against the negligence penalty under § 6662(b)(1) or the fraud penalty under § 6663. *Id.* It is hard to see how this can be true, given that the sole statutory basis for the reasonable-cause-and-good-faith defense to the negligence and fraud penalties (as well as to the substantial-underpayment penalty under § 6662(b)(2)) derives from § 6664(c)(1).

153. Schenk, *supra* note 67, at 1313; Paul, *supra* note 66, at 17.

they receive. Legal advice that qualifies for the reasonable-cause-and-good-faith defense against tax penalties is qualitatively different from advice that does not. Clients who do not fully appreciate when they are getting the latter, rather than the former, can be severely disadvantaged as a result.<sup>154</sup>

Third, any client who actually pays attention to the disclaimer, and who comprehends its significance, is apt to lose confidence in the advice that he or she has received—and in the practitioner who has provided it. One commentator has offered an interpretation of the typical Non-Reliance Disclaimer that is admittedly cynical, but also undeniably accurate: “Even though you have requested and paid for professional tax advice, it will be useless to you if the IRS decides to penalize you for relying on it.”<sup>155</sup> Not only will a client who adopts this interpretation be nonplussed to learn that the disclaimer renders the communication useless as penalty protection; he or she may question whether the advice contained in the communication can be trusted or relied upon for any purpose.<sup>156</sup> This is yet another way in which the Covered Opinion Regulations may have the effect of dissuading some clients from seeking tax counsel in the first place.

*G. To Address the Problems with the Non-Reliance Disclaimers, Some Commentators Have Recommended Switching to an Opt-In System in Lieu of the Opt-Out Approach*

To address these disclaimer issues—and to make it even easier to avoid the Circular 230 § 10.35(c) due diligence and drafting requirements—many commentators have proposed replacing the opt-out regime under the current regulations with an opt-in regime. This recommendation was the hallmark of the New York State Bar Association’s comments on the December 2004 Amendments,<sup>157</sup> and a great number of others have since echoed the suggestion.<sup>158</sup> Under an opt-in approach, an

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154. For one thing, if a client does not realize that a proffered communication will not provide penalty protection, he or she has no meaningful opportunity to purchase an alternative form of covered opinion that would provide such protection. For another, such misunderstandings may lead some clients to try to rely on opinions with Non-Reliance Disclaimers to avoid imposition of penalties, despite the existence of the disclaimers. See Schenk, *supra* note 67, at 1313 (“It seems entirely likely that a client faced with a substantial underpayment penalty will continue to assert that she relied on an attorney’s opinion despite a legend on the opinion.”). Unfortunately, any client who does so is likely to be in for a rude awakening.

155. Law, *supra* note 69, at 24.

156. See *id.*; see also Paul, *supra* note 66, at 17 (“[C]lients may view the banners as heavy-handed, causing them to distrust [practitioners’] advice.”); Edward F. Koren, *ABA Section Members Comments on Circular 230 Regs.*, 2005 TAX NOTES TODAY 90-23 (May 11, 2005) (quoted in Vasquez & Vasquez, *supra* note 56, at 316) (“Clients will fear . . . that they cannot rely on the practitioner’s advice due to the existence of the disclaimer language that is prominently displayed.”).

157. See Paul, *supra* note 66.

158. For but a small subset of the other opiners who have recommended an opt-in approach, see, e.g., Roang, *supra* note 139, at 949; Schizer, *supra* note 100, at 363; Schenk,

opinion would not be subject to the due diligence and drafting requirements under the Covered Opinion Regulations, no matter what the nature of the transaction to which it relates, unless the opinion expressly states that it is intended to be relied on as a defense against the imposition of penalties under the Code.<sup>159</sup> Non-Reliance Disclaimers would thus become unnecessary; they would be replaced by affirmative statements (on the relatively few opinions that meet the heightened due diligence and drafting guidelines) to the effect that the related opinions are intended to provide penalty protection. Despite its apparent popularity among some practitioners and scholars, this idea should be categorically rejected. For the reasons explained in Part V.C, allowing practitioners to “opt in” to compliance with the regulations’ due diligence and drafting requirements, is inimical to the purpose of preventing those practitioners from facilitating abusive tax shelters.

V. FIXING WHAT IS WRONG, AND KEEPING WHAT IS RIGHT, WITH THE COVERED OPINION REGULATIONS

A. *The Basic Framework of the Regulations Should Be Retained*

In response to the problems with the Covered Opinion Regulations outlined in Part IV, at least one prominent legal scholar has concluded that the regulations should be discarded altogether.<sup>160</sup> As noted above, a number of other commentators—scholars and practitioners alike—think that the regulations should be revised by replacing the current opt-out regime with an opt-in approach.<sup>161</sup> This change, too, would essentially eviscerate the regulations because it would make compliance with them merely voluntary.

Despite the real and serious concerns that the regulations raise, neither of these alternatives is acceptable, because each would leave a gaping hole in the rules that prohibit abusive tax shelters. As we have seen, tax attorneys, and the opinions they provided, were essential to the rise of the market for abusive corporate tax shelters in the 1990s.<sup>162</sup> As recent history also teaches us, efforts at self-regulation through rules of professional ethics and other aspirational best practices have been insufficient to reign in those tax practitioners who would deliver

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*supra* note 67, at 1316-18; see also Vasquez & Vasquez, *supra* note 56, at 313-14 (quoting published comments of attorneys Kenneth Horwitz, Kenneth Gideon, Arthur L. Bailey, Jerald August and Guy Maxfield).

159. Paul, *supra* note 66, at 18; Roang, *supra* note 139, at 949; Vasquez & Vasquez, *supra* note 56, at 314.

160. See generally Schenk, *supra* note 67.

161. See *supra* Part IV.G.

162. For a discussion of the involvement of tax attorneys in abusive corporate tax shelters in the 1990s, the centrality of their opinions to those enterprises, and the dubious techniques they used to prepare those opinions, see *supra* notes 76-105 and accompanying text.

incomplete, misleading or otherwise unreasonable legal opinions in order to facilitate abusive tax shelter transactions.<sup>163</sup> Regrettably, this experience demonstrates that there is a strong need for the Covered Opinion Regulations, or something akin to them, to curtail the deceitful opinion practices of tax practitioners who otherwise would be tempted to support such transactions. Regulatory efforts in this regard thus cannot simply be abandoned. If the current regulations are imperfect—and they certainly are—then we must mend them, not end them.

1. Effective Regulations Should Enlist the Aid of Practitioners in Deterring Clients from Engaging in Abusive Transactions

One obvious threshold goal of any regulations in this area should be to prevent unscrupulous tax practitioners from delivering unsound legal opinions that encourage investors to participate in abusive shelters. However, to deter abusive tax shelters effectively, a regulatory scheme must not only prohibit bad behavior by tax practitioners; it must actually enlist the aid of private practice tax attorneys in reigning in their clients.<sup>164</sup> In other words, the regulations must incent tax attorneys to dissuade or inhibit their own clients from engaging in abusive transactions.

This is true for at least two reasons. First, the IRS simply does not have adequate resources to identify and stop all abusive tax shelter activity on its own.<sup>165</sup> There is a mismatch in resources between the private tax bar and government tax attorneys that is reflected both in the low audit rate and, more generally, in the comparatively lean manner in which the government staffs all enforcement matters.<sup>166</sup> Second, and even more importantly, the government is significantly limited in its access to information. In our system of voluntary compliance, the taxpayer typically controls the flow of tax information to the government, generally reporting only what the IRS specifically requests (and usually construing those requests in the narrowest, most self-interested manner).<sup>167</sup> As a result, no matter how

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163. See, e.g., Rostain, *supra* note 73, at 93 (noting, in a discussion of attorneys' role in the rise of the 1990s corporate tax shelter market, that "[t]he general standards for tax advice in the regulations did not inhibit lawyers from providing opinions for abusive transactions; nor had the American Bar Association enunciated stricter standards."). For more about the inadequacy of professional ethics rules to curb the delivery of unsound legal opinions that facilitate abusive tax shelters, see *supra* note 97 and accompanying text.

164. See generally Schizer, *supra* note 100; see also Schumacher, *supra* note 72, at 100.

165. For a detailed discussion of the limits of the government's tax enforcement resources, and the mismatch in resources between the IRS and the private tax bar, in particular, see Schizer, *supra* note 100, at 331-45; see also Schumacher, *supra* note 72, at 100 ("The enforcement budget is insufficient for the government to ever fully win the tax shelter war.") (citations omitted).

166. Schizer, *supra* note 100, at 331.

167. *Id.* at 337 ("[Taxpayers] have the further advantage of controlling the flow of information to the government, offering only what the government requests (and, even then, typically construing the government's request in a self-interested way).").

many resources it throws at enforcement, the government often may not learn about abusive tax shelters until long after they have been completed. Many times, the government will not make the discovery until after a particular type of shelter has proliferated repeatedly throughout the market. It is therefore well recognized that “the IRS cannot solve the shelter problem without the help of the bar and tax professionals in general.”<sup>168</sup>

Even relative to other tax professionals, such as tax accountants, tax attorneys are particularly well suited to the role of policing their clients’ tax shelter activity, because of their unique understanding of the judicially-created legal doctrines that distinguish between abusive and legitimate transactions.<sup>169</sup> Judicial constructs such as the business purpose doctrine and the newly-codified economic substance doctrine<sup>170</sup> give weight and effect to the fundamental idea that the Code is intended to tax income, minus only the cost of generating such income, and that the only legitimate tax deductions are therefore those which arise from activity undertaken with an intent (and reasonable expectation) to generate income.<sup>171</sup> As noted above,<sup>172</sup> one significant contributor to the rise of the abusive corporate tax shelter market in the 1990s was an increased adherence to hyper-textual interpretations of the tax law, in which overly aggressive transactions were justified on the basis of literal readings of Code provisions, without giving any consideration to the economic substance or business purpose doctrines.<sup>173</sup>

Just as ignoring those doctrines was necessary to the completion of the abusive deals of the 1990s, anything that restricts taxpayers to endeavors which have economic substance and a good business purpose will, by definition, curtail unduly aggressive transactions. This is where the expertise of a private practice tax attorney, if properly directed, can be used

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168. Schumacher, *supra* note 72, at 100.

169. Rostain, *supra* note 73, at 82 (“Tax lawyers are especially suited to this gatekeeping role because of their expertise in the judicially created doctrines that developed to distinguish abusive tax shelters from legitimate tax planning.”); *see also id.* at 114-15 (“Tax lawyers are appropriate gatekeepers because they enjoy in-depth knowledge of cases.”).

170. On May 30, 2010, the economic substance doctrine was codified at I.R.C. § 7701(o). *See supra* note 99 and accompanying text. The economic substance doctrine was judicially created, however, and prior to § 7701(o), it was a common-law doctrine. *See supra* note 98. Although § 7701(o) introduces some new factors for testing whether a transaction has economic substance, the economic substance doctrine under the Code is likely to remain essentially similar to the common law doctrine in many, if not most, significant respects. *See Jackel, supra* note 99, at 296. Thus, the newly-codified version of the doctrine continues to incorporate the complexities nuances of the common law doctrine that often require the knowledge and experience of a seasoned tax practitioner to unpack.

171. *See Rostain, supra* note 73, at 84-86; *see also supra* note 98 (for further detail regarding the economic substance and business purpose doctrines, and the concepts underlying them).

172. *See supra* notes 97-100 and accompanying text.

173. Rostain, *supra* note 73, at 82, 114. The economic substance was originally a common law doctrine, but (as noted above) was very recently added to the Code. For a discussion of the doctrine’s codification, *see generally* Jackel, *supra* note 99.



effectively to stem the tide of abusive shelters. To accomplish this, tax shelter regulations must create strong incentives for a client to seek the attorney's "blessing" upon a tax shelter transaction, and they must create equally strong incentives for the attorney to condition his or her blessing on a reasoned determination that the transaction has both pre-tax economic substance and a legitimate non-tax business purpose.<sup>174</sup>

2. Thus Far, the Covered Opinion Regulations Have Effectively Created a Role for Tax Practitioners as "Gatekeepers" to Block Abusive Transactions

Up until now, the Covered Opinion Regulations have fostered exactly the kind of incentives described above. To create those incentives on the clients' side, the Covered Opinion Regulations tie to the Code provisions and Treasury regulations concerning penalties and defenses against penalties. The prospect of an addition to tax in the amount of 20% of any substantial underpayment<sup>175</sup> (or 20% of any reportable transaction understatement, in the case of a properly disclosed reportable transaction<sup>176</sup>) is a significant risk to be considered in the context of any aggressive transaction, and any taxpayer contemplating a tax shelter will be strongly incented to avoid such a penalty. Happily, the Code allows for a reasonable-cause-and-good faith defense against the imposition of such those penalties.<sup>177</sup> In turn, a related Treasury regulation expressly provides that—in the case of a penalty that would arise out of a corporate tax shelter—the minimum requirements for such a defense under the Code may be met by good-faith reliance on the opinion of a professional tax advisor.<sup>178</sup> Thus, a client who proposes to engage in a tax shelter has a strong incentive to obtain a legal opinion that meets those requirements.

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174. See Rostain, *supra* note 73, at 105-06. In order for such regulations to succeed, it is critical that the interests of attorney and taxpayer be aligned properly. Appeals to an attorney's professional norms or his or her duty to the system may have limited effect, but any regulatory scheme that places the lawyer's interests at odds with the client's, is ultimately doomed to failure. See Schizer, *supra* note 100, at 355-71 (discussing the need to align the interests of attorneys and clients by giving attorneys incentives and opportunities to police clients' involvement in aggressive and potentially abusive transactions).

175. See I.R.C. § 6662(b)(2) (2010).

176. See I.R.C. § 6662A(a) (2010).

177. See I.R.C. § 6664(c)(1) (2010) (providing for a reasonable-cause-and-good-faith exception to the § 6662 and § 6663 penalties); see also I.R.C. § 6664(d) (2010) (providing for a more stringent reasonable-cause-and-good-faith exception to the § 6662A(a) penalty in the case of properly disclosed reportable transactions, but expressly denying the availability of such exception to the 30% penalty under § 6662A(c) applicable in the case of undisclosed reportable transactions).

178. See Treas. Reg. § 1.6664-4(f) (2010). For further discussion of the Treas. Reg. § 1.6664-4(f) minimum requirements, see *supra* note 89. The requirements under the section 1.6664-4 regulations for opinions upon which taxpayers may rely in order to invoke the exception to the § 6662 and § 6663 penalties "are very similar, but not identical, to" the Covered Opinion Regulations. Schenk, *supra* note 67, at 1313. Additional standards as to opinions that may not be relied on to invoke the exception to the § 6662A(a) penalty (with

On the attorneys' side, the Circular 230 § 10.35(c) due diligence and drafting standards are all directed at requiring a practitioner to conclude—on the basis of a substantial factual and legal inquiry—that a tax shelter transaction has economic substance and a legitimate business purpose, before he or she delivers an opinion that can be relied upon for penalty protection. In preparing the opinion, the practitioner cannot rely on unreasonable factual assumptions or representations.<sup>179</sup> In particular, he or she cannot rely on any blanket assumption or representation that the deal in question has economic substance or a valid business purpose.<sup>180</sup> In relating the facts to relevant law, the practitioner is expressly required to consider all “potentially applicable judicial doctrines” (a requirement that is targeted particularly to consideration of the economic substance and business purpose doctrines).<sup>181</sup> In so doing, the practitioner must address all significant federal tax issues related to the transaction.<sup>182</sup> This prevents him or her from simply glossing over inconvenient obstacles (like economic substance or business purpose considerations) in a “partial” opinion of the sort that was often used in the abusive shelters of the 1990s.<sup>183</sup> Finally, to be eligible for use as penalty protection, the opinion must reach a conclusion at a confidence level of at least more-likely-than-not that the taxpayer will prevail on the merits with respect to each such significant federal tax issue.<sup>184</sup> If the opinion does not meet these basic requirements, it must contain a Non-Reliance Disclaimer, which will preclude the opinion from being usable as a defense against penalties. The sanctions against

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respect to disclosed reportable transactions) are set forth in § 6664(d). See I.R.C. § 6664(d)(4)(B) (2010).

179. See 31 C.F.R. § 10.35(c)(1)(ii) and (iii). For further discussion of these requirements, see *supra* notes 18-23 and accompanying text.

180. See 31 C.F.R. § 10.35(c)(1)(ii) and (iii).

181. 31 C.F.R. § 10.35(c)(2)(i). For further discussion of these requirements, see *supra* notes 24-29 and accompanying text. At the time when the Covered Opinion Regulations were adopted, the economic substance doctrine was strictly a common law doctrine. The doctrine was just codified, at § 7701(o), on March 30, 2010. See *supra* note 99 and accompanying text. Within certain limitations, a practitioner may rely on the opinion of another practitioner with regard to some significant federal tax issues. See 31 C.F.R. § 10.35(d)(1). Limited Scope Opinions are permissible in some cases. See 31 C.F.R. § 10.35(c)(3)(v)(A). However, a Limited Scope Opinion must include a legend expressly indicating that it cannot be used for the purpose of avoiding penalties related to significant federal tax issues that are not specifically addressed in the opinion. See 31 C.F.R. § 10.35(e)(3)(iii). For further discussion of a practitioner's ability to rely on others' opinions and further discussion of Limited Scope Opinions, see *supra* notes 30-31 and accompanying text.

182. See 31 C.F.R. § 10.35(c)(3)(i). For a description of what constitutes a “significant Federal tax issue” under Circular 230, see *supra* note 8.

183. For a discussion of “partial opinions” and their use in the abusive corporate tax shelters of the 1990s, see *supra* text accompanying notes 104-05.

184. If an opinion fails to reach such a conclusion at such a confidence level with respect to any significant federal tax issue, the opinion must prominently disclose that fact and must prominently state that the taxpayer cannot use the opinion to avoid the imposition of penalties arising from such issue. 31 C.F.R. §§ 10.35(c)(4) and 10.35(e)(4). See *supra* note 35 and accompanying text.

practitioners who violate the regulations are considerable,<sup>185</sup> and the incentives to meet these due diligence and drafting standards are therefore strong.

Thus, up until now, the Covered Opinion Regulations have done something even more valuable than to prevent practitioners from delivering unreasonable legal opinions. The regulations have established the attorney as a “gatekeeper” through whom a client must pass in order to complete a tax shelter transaction.<sup>186</sup> The client desires a defense against penalties that the transaction might provoke and, at least up to this point, he or she could generally invoke such a defense through reliance on a covered opinion. In order to deliver the opinion that the client needs and wants, the attorney has to determine, *inter alia*, that the transaction has economic substance and a valid business purpose. In this way, the regulations cause attorneys to prevent (or, at least, impede) their clients from participating in abusive shelters. This, of course, is precisely what the regulations should do.

### 3. New Strict Liability Penalty for Transactions Without Economic Substance May Undermine the Covered Opinion Regulations’ Effectiveness at Creating a “Gatekeeper” Role for Tax Practitioners, but the Regulations Should Still Remain in Force

In conjunction with the recent codification of the economic substance doctrine under § 7701(o) of the Code,<sup>187</sup> Congress also added § 6662(b)(6) of the Code, which provides for a new accuracy-related penalty in the case of transactions lacking economic substance.<sup>188</sup> At the same time, Congress amended § 6664(c) of the Code to specify that there is

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185. For a description of those sanctions, see *supra* text accompanying notes 41-48.

186. See Rostain, *supra* note 73, at 82 (discussing the efficacy of using attorneys as “gatekeepers” by drawing on their expertise in interpreting and applying the economic substance and business purpose doctrines “to distinguish abusive tax shelters from legitimate tax planning”); see also Schizer, *supra* note 100, at 363 (noting, with approval, the government’s efforts, through Circular 230, rely on the tax bar “to monitor clients, and to give opinions (and thus the potential for penalty protection) only when they are deserved”); Schumacher, *supra* note 72, at 101 (“tax advisors must recognize their central role as gatekeepers and their duty to the system”).

187. See *supra* note 99 and accompanying text.

188. Section 6662(b)(6) was added to the Code (together with § 7701(o)) as part of the Health Care and Education Reconciliation Act of 2010, and became effective as of March 30, 2010. Section 6662(b)(6) provides that the 6662(a) addition to tax, which is an amount equal to 20 percent of certain underpayments of tax, applies to underpayments of tax attributable to “[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.” I.R.C. § 6662(b)(6) (2010). Under newly-enacted § 6662(i), another related addition to the Code, the addition to tax for underpayments attributable to non-economic substance transactions jumps from “20 percent” to “40 percent” of the underpayment, in the case of any transaction described in § 6662(b)(6) “with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.” I.R.C. § 6662(i)(1) and (i)(2) (2010). See Jackel, *supra* note 99, at 294 (discussing §§ 6662(b)(6) and 6662(i)).

no reasonable-cause-and-good-faith exception to the § 6662(b)(6) penalty.<sup>189</sup> Accordingly, a taxpayer cannot rely on any legal opinion—even one that meets all of the Circular 230 § 10.35(c) due diligence and drafting requirements—as a defense against imposition of the new penalty for transactions that do not have economic substance.

Given that one hallmark of an abusive tax shelter is its lack of economic substance, the new § 6662(b)(6) penalty has the potential to apply to virtually all abusive shelter transactions going forward.<sup>190</sup> Because § 6662(a) of the Code provides for the imposition of a single addition to tax for underpayments, only one § 6662(b) penalty may be imposed on a particular underpayment, “even if the underpayment is attributable to more than one kind of misconduct.”<sup>191</sup> Therefore, since the § 6662(b) penalties do not “stack,” in future tax shelter cases the IRS will have to choose between assertion of the § 6662(b)(6) penalty, on one hand, and assertion of either the § 6662(b)(2) substantial underpayment penalty or the § 6662(b)(1) negligence-or-disregard-of-rules penalty, on the other. (In the case of tax shelters that are reportable transactions, the § 6662A reportable transaction underpayment penalties are also potentially applicable.<sup>192</sup>) In view of the fact that the § 6662(b)(6) penalty is a strict liability penalty (as well as the fact that the amount of the penalty may be increased to 40% of

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189. A new § 6664(c)(2) was added to the Code, also as part of the Health Care and Education Reconciliation Act of 2010, effective as of March 30, 2010. Section 6664(c)(2) now states that § 6664(c)(1) (which provides for the reasonable-cause-and-good-faith exception to § 6662 and § 6663 penalties, generally) “shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6).” I.R.C. § 6664(c)(2) (2010). See Jackel, *supra* note 99, at 294 (discussing § 6664(c)(2)).

190. Widespread application of the § 7701(o) economic substance doctrine to tax shelters is plainly to be expected, given that “[t]he common-law economic substance doctrine mostly addresses tax-shelter-type cases.” Jeremiah Coder & Amy S. Elliot, *Some Economic Substance Guidance Likely, Officials Say*, 127 TAX NOTES 748, 749 (May 17, 2010) (quoting PricewaterhouseCoopers LLP managing director Monte Jackel). Because the § 6662(b)(6) penalty could be applied in the case of any violation of § 7701(o), that penalty is therefore at least potentially applicable in all future tax shelter cases.

191. Leandra Lederman & Stephen W. Mazza, *TAX CONTROVERSIES: PRACTICE AND PROCEDURE* 480 (3rd ed. 2009).

192. Pursuant to § 6662A(e) of the Code, both the § 6662A reportable understatement penalty and one of the § 6662(b) substantial underpayment penalties may apply in the same transaction (if the transaction is a reportable transaction). See I.R.C. § 6662A(e)(1)(B) (2010) (providing that a penalty under § 6662(a) may be applied to the excess of a § 6662(b) substantial understatement over the portion of such understatement that constitutes a reportable transaction understatement to which a § 6662A penalty has been applied). Even in the case of a reportable transaction understatement, however, the IRS has the discretion to apply one of the § 6662(b) penalties (including, of course, the new § 6662(b)(6) penalty), rather than a § 6662A penalty, to the entire understatement. See I.R.C. § 6662(b) (flush language effectively requires choice, with respect to any portion of any underpayment, of only one of a § 6662 penalty, the § 6663 penalty or a § 6662A penalty). Moreover, there is no reasonable cause exception to the imposition of a § 6662A(a) penalty in the case of any portion of a reportable transaction understatement that arises from a transaction to which a § 6662(b)(6) penalty applies because the transaction lacks economic substance. See I.R.C. § 6664(d)(2).

the related underpayment, in some cases<sup>193</sup>), the IRS would appear to have strong incentives to choose that penalty whenever possible.

To the extent that the § 6662(b)(6) penalty supplants other accuracy-related penalties with respect to tax shelters, the effectiveness of the Covered Opinion Regulations in creating a “gatekeeper” role for tax practitioners threatens to be severely undermined. If a covered opinion no longer provides insurance against the most probable accuracy-related penalty to be imposed on a tax shelter, clients will be likely no longer to view the receipt of such an opinion as a prerequisite to entering into an aggressive transaction. (This is particularly true in light of the high transaction costs that the regulations impose on such opinions). In turn, if a client no longer views a covered opinion as a necessity when investing in a tax shelter, then a practitioner’s withholding of such an opinion will no longer function as a strong impediment to the client’s participation in an abusive deal. Much of the Covered Opinion Regulations’ deterrent effect on taxpayer behavior will thus be lost.

This threatened diminution of the Covered Opinion Regulations’ effectiveness at reigning in taxpayers is plainly regrettable. However, that is not an excuse to call for the regulations to be repealed.

First, it is too early to know exactly how—and to what extent—the § 6662(b)(6) penalty will be applied in future tax shelter cases. In response to early concerns raised by tax practitioners, Treasury officials have acknowledged that there are “risks inherent in the strict liability penalty imposed by” § 6662(b)(6),<sup>194</sup> and that the lack of any reasonable cause defense to the penalty “raises issues for both taxpayers and the IRS.”<sup>195</sup>

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193. See I.R.C. § 6662(i) (2010) (providing that the addition to tax under § 6662(b)(6) increases from 20 percent to 40 percent of the underpayment, in the case of any “Nonreported Noneconomic Substance Transaction”). In contrast, § 6662A(c) provides only a 30 percent for undisclosed reportable transaction understatements. Thus, even in the context of unreported transactions, the IRS has incentive to choose the § 6662(b)(6) penalty.

194. Crystal Tandon, *Treasury Planning Guidance on Economic Substance Penalties*, 127 TAX NOTES 965 (May 31, 2010) (recounting remarks of Bob Crnkovich, senior tax counsel (partnerships) in Treasury’s Office of Tax Legislative Counsel, during a May 2010 Practising Law Institute seminar in New York concerning the codified economic substance doctrine).

195. Jeremiah Coder, *Guidance on Economic Substance to Address Uncertainty*, 127 TAX NOTES 737 (May 17, 2010) (describing statements made by Byron Christensen, Treasury deputy tax legislative counsel, during a May 2010 District of Columbia Taxation Section luncheon program). The primary risk, and chief concern raised by practitioners, is of course that the imposition of strict liability under § 6664(c) will result in the application of the § 6662(b)(6) penalty even in cases where taxpayers have attempted in good faith to follow the complex (and sometimes ambiguous) rules of the newly-codified economic substance doctrine. Attorney Bryan C. Skarlatos summarized the apprehensions of many tax advisors during a tax controversy forum sponsored by New York University that he co-chaired in June 2010. Skarlatos “called the codified doctrine amorphous and said the strict liability penalty is a ‘hammer’ waiting to drop on taxpayers despite their best efforts to follow technical tax rules.” Jeremiah Coder, *Economic Substance Guidance Will Have Limited Scope*, 127 TAX NOTES 1423, 1424 (June 28, 2010). Another issue raised by the introduction of the § 6662(b)(6) penalty is the new uncertainty as to which penalty the IRS

Treasury has indicated that the IRS will therefore establish “clear, uniform procedures on how” the § 6662(b)(6) penalty will be applied.<sup>196</sup> Whether any such procedures will ultimately be set forth in Treasury regulations or formal IRS guidance pronouncements is as yet unclear.<sup>197</sup> Predictably, because § 6664(c) clearly and unambiguously provides that there is no reasonable-cause-and-good-faith exception to the § 6662(b)(6) penalty, Treasury’s Office of Tax Legislative Counsel has emphasized that “it would be inconsistent for Treasury to issue guidance providing for a reasonable cause defense.”<sup>198</sup>

At the same time, however, Treasury has repeatedly assured practitioners that the IRS will apply § 6662(b)(6) only in “appropriate

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will apply in a given economic substance case. As Treasury deputy counsel Christensen has observed, “[a] ‘buffet of penalties’ might attach to a transaction falling under § 7701(o), so it is understandable that tax professionals will want to know what the penalty will be.” Coder, 127 TAX NOTES at 737.

196. Tandon, *supra* note 194, at 965. During a May 2010 Practising Law Institute seminar in New York concerning the codified economic substance doctrine, Bob Crnkovich, senior tax counsel (partnerships) in Treasury’s Office of Tax Legislative Counsel, stated that “[w]e clearly understand the novel nature of this strict liability penalty, and we are sensitive to it and we are considering what procedures will be put in place.” *Id.*

197. Initial indications were that a formal elucidation of such procedures could be expected, but more recent pronouncements make the possibility of such guidance appear more doubtful. Soon after § 7701(o) and § 6662(b)(6) were enacted, Treasury officials indicated that there would be forthcoming guidance as to when the § 6662(b)(6) penalty, on one hand, or another of the potentially applicable substantial underpayment penalties, on the other, will be applied to transactions that run afoul of § 7701(o). For example, during a May 2010 District of Columbia Taxation Section luncheon program, Byron Christensen, Treasury deputy tax legislative counsel, told practitioners that application of the § 6662(b)(6) strict liability penalty will be addressed in future guidance. Coder, *supra* note 195, 127 TAX NOTES at 737. Similarly, in a May 2010 Practising Law Institute seminar in New York concerning the codified economic substance doctrine, Bob Crnkovich, senior tax counsel (partnerships) in Treasury’s Office of Tax Legislative Counsel, said that “[p]ractitioners can expect economic substance guidance . . . for applying the steep penalties attached to transactions tripped up by” § 7701(o). Tandon, *supra* note 194, at 965. More recently, however, Treasury has indicated that only very limited guidance will be issued with respect to the codified economic substance doctrine, and that there may be no formal guidance regarding application of the strict liability penalty. See Coder, *supra* note 195, 127 TAX NOTES at 1423-24 (recounting comments by Treasury deputy counsel Christensen during a June 2010 tax controversy forum sponsored by New York University). On September 13, 2010, the IRS issued its first interim guidance concerning the codified economic substance doctrine and the related penalties. See Notice 2010-62; 2010-40 IRB 1 (“Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010”). Consistent with that more recent indication, Notice 2010-62 “makes no mention of whether and how the IRS would implement a uniform penalty procedure for assertions of the harsh strict liability penalty.” Amy S. Elliot, *Practitioners Blast Economic Substance Guidance*, 128 TAX NOTES 1212 (Sept. 20, 2010). Despite their disappointment with the notice, however, there are practitioners who remain hopeful that the IRS may provide further guidance that is more instructive. See *id.* at 1212-13 (quoting attorneys Cary D. Pugh and Mark Silverman).

198. Coder, *supra* note 195, 127 TAX NOTES at 737 (quoting Byron Christensen, Treasury deputy tax legislative counsel).

cases.”<sup>199</sup> Of course, Treasury and the IRS are obviously likely to conclude that the most abusive tax shelters are foremost among such “appropriate cases.” Nevertheless, to the extent that Treasury and the IRS adopt procedures that place limits on the application of the § 6662(b)(6) penalty in § 7701(o) cases, there could remain a real possibility that, for any given tax shelter, an accuracy-related penalty other than the § 6662(b)(6) penalty might be imposed. In that case, clients may continue to view the receipt of a covered opinion (which will still provide a defense against those other penalties) as a prerequisite to engaging in an aggressive deal. The “gatekeeper” function of the Covered Opinion Regulations would then remain largely intact.

Second, even if their ability to deter wrongful taxpayer behavior becomes compromised, the Covered Opinion Regulations will still remain necessary to deter bad practitioner behavior. Even if it turns out that legal opinions will no longer provide penalty protection in tax shelter cases, taxpayers (particularly corporate taxpayers) will still typically seek legal advice before entering into an aggressive transaction. Indeed, some commentators have argued that a strict liability penalty regime would increase the demand by corporate taxpayers for well-reasoned (and more conservative) advice from tax practitioners before investing in a tax shelter because, under such a regime, such taxpayers would focus more on the substance of the advice being given than simply whether a practitioner is willing to deliver any opinion that could be invoked as a penalty defense.<sup>200</sup>

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199. During a June 2010 tax controversy forum sponsored by New York University, Treasury deputy tax legislative counsel Byron Christensen “said the new section 6662(b)(6) penalty is unique because it lacks a reasonable cause defense, but he assured the audience that the penalty will be asserted only in appropriate cases. The government is interested in ensuring a proper level of oversight and a clear process for applying the penalty, he said. ‘The facts and circumstances must justify assertion of the economic substance doctrine and penalty,’ he added.” Coder, *supra* note 195, 127 TAX NOTES at 1424. Previously, during a May 2010 District of Columbia Taxation Section luncheon program, Christensen proclaimed that “government and taxpayer interests are best served by ensuring that economic substance penalties are asserted only in appropriate cases.” Coder, *supra* note 195, 127 TAX NOTES at 737. On September 14, 2010, the Large and Midsize Business Division of the IRS issued an internal examination guidance directive, which states that, “[t]o ensure consistent administration of the accuracy-related penalty imposed under section 6662(b)(6), any proposal to impose a section 6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed.” See LMSB-04-0910-024 (*reprinted at* 2010 TAX NOTES TODAY 178-47 (Sept. 14, 2010)). Presumably, this directive reflects some effort by the IRS to impose the § 6662(b)(6) penalty only in such “appropriate” cases (whichever those may be).

200. See Rostain, *supra* note 73, at 106-07. For example, the Tax Section of the New York State Bar Association has advocated for a strict liability penalty regime, contending that, in the tax shelter context, “the tax ‘dialogue’ between lawyer and client ha[s] become distorted, focusing on whether a lawyer would render an opinion rather than on the underlying merits of the transaction.” *Id.* at 107 (citing N.Y. State Bar Ass’n Tax Section, REPORT ON CORPORATE TAX SHELTERS OF NEW YORK STATE BAR ASSOCIATION TAX SECTION, at 893 (1999)). The theory underlying this argument is that “[s]trict liability neutralizes the protective effects of legal opinions, thereby putting the burden of avoiding abusive shelters squarely on taxpayers, who will be induced to seek out legal advice that is knowledgeable and conservative.” *Id.* at 106.

Such commentators believe that, “[s]ince clients would be unable to purchase penalty protection, they would seek the best legal advice, which lawyers would be motivated to provide.”<sup>201</sup>

However, while taxpayers might have greater incentive to seek “the best legal advice” before entering into a potentially abusive transaction under a strict liability regime, whether tax practitioners really would always be motivated to deliver such advice is regrettably less certain. In particular, the pro-strict-liability argument fails to consider adequately the incentives of practitioners who represent tax shelter promoters or whose financial interests are tied to the promotion of tax shelters—such as practitioners who deliver marketed opinions, opinions that are subject to conditions of confidentiality, or opinions that are subject to contractual protection. If past is prologue, such practitioners would still be tempted to deliver the kinds of unsound legal opinions that were prevalent in the abusive corporate tax shelters of the 1990s<sup>202</sup> in order to lend such transactions an “imprimatur of legitimacy.”<sup>203</sup> Even if they would no longer provide a defense against penalties imposed on abusive shelters, such legal opinions could still mislead investors into believing that those deals are legitimate.<sup>204</sup> To protect against a possible resurgence of such opinion practices, the Covered Opinion Regulations would thus remain necessary even under a strict liability penalty regime.

Accordingly, the basic framework of the Covered Opinion Regulations should remain intact, and any calls to “throw them out and start over”<sup>205</sup> should be rejected. Of course, to say that the primary structure of the Covered Opinion Regulations should be retained, is obviously not to say that the problems with the regulations should not be addressed.

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201. *Id.* at 107. On this view, such motivation on the part of the lawyers would result from a strict liability regime’s creation of “a market for well-reasoned legal advice that address[es] the legal merits of a transaction.” *Id.* Moreover, under this theory, the lawyers’ motivation would be bolstered by the fact that, because a strict liability regime motivates a taxpayer “to consult a tax advisor to obtain substantive legal guidance”, then “[i]f the lawyer’s advice turns out to be wrong on the merits, a taxpayer will have a greater likelihood of success in a subsequent malpractice action” than would be the case if the taxpayer had “obtained the lawyer’s opinion for penalty protection only.” *Id.* at 107-08.

202. For a discussion of the unsound opinions that were used in the abusive corporate tax shelters of the 1990s, such as partial opinions, opinions adopting a hyper-textual approach to statutory construction, and opinions based on unreasonable or unsupported factual representations or assumptions, see *supra* text accompanying notes 97-105.

203. Rostain, *supra* note 73, at 82.

204. See WATSON & BILLMAN, *supra* note 74, at 137-38 (describing how tax shelter investors focus on the conclusion of a legal opinion that the tax benefits are allowable, and typically assume that the opinion-giver has considered all pertinent issues and that any assumptions or qualifications in the opinion are legitimate).

205. See, e.g., Schenk, *supra* note 67.



B. *“Significant Purpose” Should Be Defined So That The Regulations Plainly Cover Only Tax Shelter Advice, and Do Not Apply to any Other Tax Advice*

First and foremost, the scope of the Covered Opinion Regulations should be narrowed so that the regulations apply only to opinions related specifically to tax shelters. The chief problem with the Covered Opinion Regulations is that they apply not only to tax shelter opinions, but also to advice concerning virtually all other tax matters. The onerous due diligence and drafting requirements of Circular 230 § 10.35(c) are necessary to curb abusive shelters. As they currently stand, however, those requirements also place unreasonable and unwarranted burdens on the provision of tax advice in connection with practically all legitimate, non-shelter-related tax planning.<sup>206</sup> As discussed above, this is because “covered opinions” under the regulations include “reliance opinions” that relate to Significant Purpose Transactions, and the “significant purpose” concept is so broad that it encompasses nearly every tax question that any tax practitioner might ever handle.<sup>207</sup> Therefore, the first order of business in fixing the Covered Opinion Regulations is to narrow the scope of what constitutes a Significant Purpose Transaction.

There is little debate that the “significant purpose” prong of the “covered opinion” definition goes much further than the tax shelter activity that the Covered Opinion Regulations were intended to regulate. Indeed, even the IRS itself has acknowledged that the current “significant purpose” phrasing is too broad.<sup>208</sup> At the same time, the IRS has thus far been reluctant to address the problem.<sup>209</sup> Presumably, this reluctance is borne out of concern that any attempt to reduce the ambit of the “significant purpose” rules may prevent the regulations from reaching potentially abusive activities that somehow escape the Listed Transaction and Principal Purpose Transaction categories.

A call simply to delete the “significant purpose” category, though tempting, is almost certainly a non-starter, because it ignores that legitimate concern. Similarly, making “significant purpose” transactions synonymous with “reportable transactions” under § 6707A of the Code, though elegant in its simplicity, would not work because the universe of reportable transactions is narrower than the universe of all tax shelters.<sup>210</sup> The

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206. For further discussion of those burdens, see *supra* Part IV.A-F.

207. See *supra* Part IV.E and text accompanying notes 14-15.

208. Swartz & Bertrand, *supra* note 46, at 257 n.240 (“An IRS official recently acknowledged that the ‘significant purpose’ definition is ‘too broad.’”) (quoting *Namorato Says Service’s Study Group to Consider Changing Circular 230 Rules*, DAILY TAX REPORT, March 6, 2006, at G-9).

209. In fact, “the IRS is on record as stating not to ‘expect to see a definition of significant purpose.’” Vasquez & Vasquez, *supra* note 56, at 297 (quoting Sheryl Stratton, *ABA Tax Section Meeting: Tax Officials Spar with Tax Bar over Circular 230*, 107 TAX NOTES 1082, 1083 (2005)).

210. A tax shelter that is not a listed transaction, a confidential transaction, a transaction with contractual protections or a so-called transaction of interest, is not a reportable

challenge, then, is this: How do we narrow the concept of what constitutes a “significant purpose” for purposes of a covered opinion, so that the regulations cease to impose on non-shelter-related advice, but so that they also continue to apply to all potentially abusive transactions?

Once again, the heart of the answer lies with the business purpose and economic substance doctrines, and with the fundamental precept that informs those doctrines. As noted above, the basic premise underlying the business purpose and economic substance doctrines is that the Code is intended to tax income, minus the cost of producing such income.<sup>211</sup> The corollary to that foundational rule, which is reflected in the two doctrines, is that the only legitimate tax deductions are those that arise from activity that was intended to—and that could reasonably have been expected to—produce pre-tax economic profit.<sup>212</sup> Framing the matter in this way provides a clear basis for distinguishing between legitimate tax planning and abusive tax shelters: A transaction is legitimate if any deductions that it creates can be expected to offset income that the transaction itself produces. In contrast, a transaction is an abusive shelter if it is intended to manufacture deductions in order to offset income that derives from other sources. The key is to introduce “significant purpose” language that identifies the latter type of transaction and differentiates it from the former.

I submit that this task could be accomplished through a relatively straightforward drafting revision to Circular 230’s “covered opinion” definition. Specifically, the current language of the “significant purpose” prong of that definition (in Circular 230 § 10.35(b)(2)(i)(C)) should be deleted in its entirety and replaced by the following definitional phrase: “*any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the creation, production or generation of losses or credits in order to reduce, or against which to offset, income from sources other than such partnership, entity, plan or arrangement.*” This phrase captures any endeavor that should be deemed abusive, based on the criteria outlined above, but it does not encompass any legitimate tax planning activity. I therefore propose that this italicized language be substituted for the current text of Circular 230 § 10.35(b)(2)(i)(C). In conjunction with this change,

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transaction if it does not generate losses above a certain multi-million-dollar threshold. See IRS Instructions for Form 8886 (Rev. Mar. 2010) (Reportable Transaction Disclosure Statement) at 1-3. The Covered Opinion Regulations should apply in the context of all tax shelter transactions, including those which fall below that high loss threshold. The Code recognizes that there are tax shelters which are not reportable transactions, and Code provisions distinguish between the two categories. See, e.g., I.R.C. § 6694(a)(2)(C) (2010) (entitled “Tax Shelters *and* Reportable Transactions”) (emphasis supplied). For further discussion of what constitutes a “reportable transaction,” see *supra* note 93.

211. For a description of the economic substance and business purpose doctrines, and the concepts underlying them, see *supra* note 98. See also *supra* note 99 (for a discussion of the economic substance doctrine as recently incorporated in the Code).

212. See Rostain, *supra* note 73, at 84-86. For further discussion of these concepts underlying the anti-abuse doctrines, see *supra* notes 98-99, 170-71 and accompanying text.

written advice that is subject to conditions of confidentiality or subject to contractual protection<sup>213</sup> should be added as a separate category of “covered opinions” under Circular 230 § 10.35(b)(2)(i). Opinions with those characteristics simply do not arise in any context other than tax shelters.

Making these revisions would appropriately narrow the scope of the Covered Opinion Regulations to written advice specifically relating to potentially abusive tax shelters.<sup>214</sup> This, in turn, would go a long way toward fixing everything else that is wrong with the regulations. Once the regulations’ ambit is appropriately confined to shelter activity, the challenges that the regulations impose with respect to such things as cost burdens, restrictions on informal advice, and the inability to distinguish between significant and insignificant tax issues, would no longer affect anything other than a (very) small subset of tax practice. A practitioner counseling on the next “son of BOSS” transaction would still have to wrestle with such concerns, but practitioners providing choice-of-entity, corporate reorganization, estate planning, or any other legitimate tax-efficient-structuring advice would not. If the requirements imposed by the regulations were imposed only on the delivery of tax shelter opinions, they would no longer be unduly onerous burdens on the provision of routine tax counsel; they would simply be necessary and reasonable restrictions on the historically over-aggressive practices of many tax advisors on potentially abusive transactions.<sup>215</sup>

### C. *Calls to Adopt an Opt-In Approach Should Be Rejected*

Once the Covered Opinion Regulations are appropriately limited to advice about tax shelters, it would be particularly nonsensical to condition the applicability of the regulations upon a practitioner’s choice to “opt in” to compliance with them. Simply put, a regulatory scheme is worthless if it depends on the voluntary consent of those whose activity is to be regulated. In such a scheme, any practitioner who wished to deliver a “partial” opinion that does not address all pertinent legal issues, an opinion based on unreasonable or unsupported factual assumptions or representations, or any of the other variations of unsound, misleading tax shelter opinions that have been used in the past to support abusive shelters, could do so with impunity. Of course, under an opt-in approach, a recipient of such an opinion would not be able to rely on the opinion as defense against penalties. The recipient may not realize this, however, because there

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213. For a discussion of what it means under Circular 230 for an opinion to be subject to conditions of confidentiality or to contractual protection, see *supra* notes 10-11.

214. In addition to the strong policy reasons for confining the Covered Opinion Regulations to tax shelter opinions, such a narrowing would bring the regulations more plainly within the limits of the Congressional grant of authority to the Secretary (under § 822 of the JOBS Act) to promulgate the regulations. See *supra* note 139 and accompanying text.

215. For an analysis weighing the burdens and benefits of the regulations when applied to tax shelter opinions (and concluding that the former outweigh the latter, thus justifying repeal of the opt-out rules in such cases), see *infra* text accompanying notes 242-53.

would be no disclaimer on the opinion to warn investors of its uselessness as penalty protection. Nor would the recipient otherwise be likely to recognize that the advice in the opinion was fundamentally defective, since the opinion would conclude (subject to arcane qualifications that many readers would simply ignore<sup>216</sup>) that the tax deductions or credits created by the shelter in question were legitimate and permissible. As a result, an opt-in regime would make it easier for unscrupulous tax shelter promoters to use such opinions to lend abusive transactions a superficial “imprimatur of legitimacy.”<sup>217</sup> For this reason, an opt-in regime is particularly ill-suited to the regulation of marketed opinions that are used to support abusive shelters.<sup>218</sup>

Moreover, if the new strict liability penalty under § 6662(b)(6) of the Code becomes the accuracy-related penalty asserted in all or most tax shelter cases,<sup>219</sup> adopting an opt-in approach would be tantamount to repealing the Covered Opinion Regulations altogether. Under a strict liability regime, the opt-in approach would render the regulations entirely unenforceable because there never would be any reason for a practitioner to “opt in” to compliance with them. The opt-in approach would require a practitioner to comply with the regulations only when he or she intends an opinion to provide penalty protection. Obviously, few (if any) practitioners would volunteer to comply when drafting a tax shelter opinion, if he or she could avoid doing so and if the opinion would never be usable as part of a reasonable cause defense against imposition of the § 6662(b)(6) strict liability penalty in any event. Since there would be no perceived downside to refraining from opting in when preparing an opinion, an opt-in approach would effectively nullify the Covered Opinion Regulations if § 6662(b)(6) becomes the IRS’s penalty of choice for abusive tax shelters.

Alternatively, to the extent that the other accuracy-related penalties remain viable possibilities in the context of tax shelters, an opt-in approach would weaken the link between tax shelter opinions and the reasonable-cause-and-good-faith defense against the imposition of such penalties arising from the shelters being opined on. Such an approach would make it easier for a practitioner to persuade a client to accept an opinion that does not offer penalty protection—even when the client has a strong interest in receiving such protection—because the practitioner would no longer have to telegraph, on the face of the opinion, the limits as to what the client is getting. This, in turn, would encourage practitioners to favor their own

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216. See WATSON & BILLMAN, *supra* note 74, at 137-38 (discussing how tax shelter investors concentrate on a legal opinion’s conclusion and assume the appropriateness of the opinion’s qualifications as to legal issues not considered or facts assumed).

217. Rostain, *supra* note 73, at 82.

218. Indeed, even the New York State Bar Association, otherwise one of the staunchest supporters of an opt-in regime, does not support the opt-in approach in the case of marketed opinions. See Paul, *supra* note 66, at 31.

219. For a discussion of § 6662(b)(6), the strict liability nature of the penalty it imposes on transactions that lack economic substance, and the penalty’s potential to undermine the “gatekeeper” effect of the Covered Opinion Regulations, see *supra* Part V.A.3.

interests (in not complying with the more exacting due diligence and drafting standards) at the expense of their clients' interests (in establishing a defense against penalties that may result from aggressive transactions). Worse yet, it would seriously erode the role of tax attorneys as "gatekeepers" who block their clients' entry into abusive deals.<sup>220</sup> Clients would still be incented to obtain penalty protection, but practitioners would be far less incented to provide it (because it would become all too easy to avoid the burdens and risks associated with preparing and delivering a covered opinion). As a result, an opt-in regime would destroy the framework that makes the Covered Opinion Regulations effective at curtailing abusive tax shelters.

Most commentators who favor an opt-in approach stress the benefits of eliminating now-ubiquitous Non-Reliance Disclaimers from practitioners' written communications.<sup>221</sup> As Professor Deborah Schenk has rightly observed, "[t]hat is a peculiarly weak reason to support the opt-in approach."<sup>222</sup> Indeed, it becomes an even weaker reason, once the Covered Opinion Regulations are revised to apply only to tax shelter advice.

Professor Schenk offers a different argument in favor of an opt-in regime. She disapproves of a reasonable cause defense to penalties in the first place,<sup>223</sup> and she particularly disagrees that legal opinions should be usable in such a defense.<sup>224</sup> In short, Professor Schenk views the defense as "a 'get-out-of-jail' option" that provides taxpayers with an undeserved escape from sanctions for violating the law. (She argues, for example, that reliance on a lawyer's advice is no better an excuse for failing to comply with the tax laws than it is for failing to comply with antitrust or securities law.<sup>225</sup>) Despite these objections, Professor Schenk nevertheless thinks that, as long as legal opinions are in fact being used as a defense against penalties, the government has a legitimate interest in what those opinions say.<sup>226</sup> In considering how to formulate (or reformulate) the Covered

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220. For a discussion of how the Covered Opinion Regulations use private practice tax attorneys as gatekeepers to impede clients from engaging in abusive deals, see *supra* Part V.A.1-2.

221. See, e.g., Paul, *supra* note 66, at 17-18; Schizer, *supra* note 100, at 363; Vasquez & Vasquez, *supra* note 56, at 313-14 (quoting published comments of attorney Kenneth Gideon).

222. Schenk, *supra* note 67, at 1316 n.22.

223. *Id.* at 1312 ("Most people support a broad reasonable cause exception to tax penalties. I am not one of them. I'd favor a strict liability penalty in many cases.")

224. *Id.* ("I am unimpressed with the argument that a taxpayer should be able to rely absolutely on a lawyer's opinion. . . . 'My lawyer told me it was OK' does not strike me as a sufficient justification for avoiding penalties for behavior Congress has chosen to penalize . . .").

225. *Id.*

226. *Id.* at 1312, 1313. Notwithstanding her opposition to using legal opinions as penalty protection, Professor Schenk takes the current interpretation of § 6664(c) of the Code—to permit reliance on an attorney's opinion for purposes of reasonable cause defense—"as a given." *Id.* at 1313.

Opinion Regulations, she therefore says that the relevant question is: "How better to carry out the appropriate Treasury goal of regulating opinions used for penalty protection?"<sup>227</sup> By framing the issue this way, Professor Schenk starts from the premise that the object of the regulations is to prevent taxpayers from avoiding penalties (and, specifically, to use legal opinions to avoid penalties) in instances when they should remain subject to those penalties.

She concludes that an opt-in system would be preferable to the opt-out approach as a way to achieve that goal.<sup>228</sup> By confining the Covered Opinion Regulations to opinions that expressly state an intention to be used as penalty protection, Professor Schenk believes that we could "eliminate much complexity engendered by the current rules" and that we could "retain the extensive rules only for penalty-protection opinions and jettison the rest."<sup>229</sup> Under this theory, complexity would be reduced because the more complicated question of which Circular 230 § 10.35(c) category an opinion falls within would be replaced by the simpler question of whether penalty protection is expressly sought.<sup>230</sup> The various challenges created by the regulations' due diligence and drafting standards would be also avoided in most cases, because those standards would apply only to the narrow universe of opinions that expressly state that they can be used as a defense against penalties.<sup>231</sup>

Professor Schenk's argument has appeal if one accepts her initial premise—*viz.*, that the purpose of the regulations ought to be to curtail the inappropriate avoidance of penalties. That premise is mistaken, however. The point of the regulations is not to curtail the underpayment of *penalties*; it is to curtail the underpayment of *tax*. The imposition of penalties is not an end in itself; rather, the threat of penalties is a means to the end of discouraging tax evasion. In one sense, permitting a reasonable cause defense against penalties may seem overly generous to noncompliant taxpayers. To that extent, Professor Schenk's observations are well taken. However, the availability of such a defense does not function merely as a gift to the undeserving. Instead, as discussed above, the possibility of such a defense—and, in particular, the express ability to use a covered opinion as part of such a defense, in the context of a corporate tax shelter—is an essential element of empowering tax attorneys to act as gatekeepers who

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227. *Id.* at 1316.

228. *Id.*

229. *Id.*

230. *Id.* ("Under an opt-in approach, only one decision would need to be made: Is penalty protection sought or not?").

231. *Id.* (noting that, under an opt-in approach, only an opinion that "states that it is intended to be relied on" would be subject to the Covered Opinion Requirements, and describing how, in other cases, practitioners would not have to be concerned with "fine gradations" in the regulations, such as whether a given transaction is a Principal Purpose Transaction or a Significant Purpose Transaction).

impede clients from engaging in abusive shelters.<sup>232</sup> Because enlisting the aid of the private tax bar in that way is critical to stemming the tide of such transactions,<sup>233</sup> the regulations should be written to cover as wide a swath of tax shelter opinions as possible.<sup>234</sup> For this reason, moving to an opt-in approach would be exactly the wrong direction to go.

D. *After the Regulations are Narrowed to Apply Only to Tax Shelter Advice, the Opt-Out System Should Also Be Done Away With*

The reasons for rejecting an opt-in approach also militate in favor of doing away with the opt-out system. A regulatory scheme is of little utility to the extent that it allows those whose activity is meant to be regulated to choose not to be regulated. The primary need for allowing practitioners to “opt out” under the current system is to enable them to navigate around some of the burdens that the Covered Opinion Regulations can otherwise impose on the provision of legitimate tax planning advice, given that a “significant purpose” of almost any such advice is to avoid the payment of tax. If the suggestions in Part V.B are adopted and “significant purpose” is defined to refer exclusively to tax shelters, that need falls away. Once the Covered Opinion Regulations apply only to tax shelter advice (as they should), they will cease to affect the legitimate tax-efficient-structuring work on which the vast majority of tax practitioners focus the vast majority of their efforts, and the lion’s share of the burdens associated with the regulations will thus disappear on their own (without the need to invoke any “opt-out”). In this beautiful world, the only remaining role for an opt-out provision would be to allow practitioners to escape the purview of the regulations specifically when providing tax shelter advice. In virtually all cases, that is a bad idea.

First, if the new § 6662(b)(6) strict liability penalty were to replace the other accuracy-related penalties in the context of tax shelters,<sup>235</sup> and if the Covered Opinion Regulations were appropriately restricted to tax shelter opinions, the opt-out rules would completely vitiate the regulations. In a strict liability penalty environment, retaining the opt-out regime would effectively reduce the regulations to a nullity, for much the same reason that

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232. For a discussion of the Treasury regulation expressly providing that good-faith reliance on the opinion of a professional tax advisor may establish the minimum requirements for the reasonable cause exception to the substantial underpayment penalty attributable to tax shelter items of corporations, see *supra* notes 89, 178 and accompanying text.

233. See Schizer, *supra* note 100, at 331-45, 355-71.

234. This obviously does not mean that the regulations should not also be narrowed so that they cover only advice concerning tax shelters, and not advice related to legitimate tax planning. See *supra* Part V.B.

235. For a discussion of the new strict liability penalty under § 6662(b)(6) of transactions that lack economic substance under § 7701(o), and how the penalty may affect the Covered Opinion Regulations, see *supra* Part V.A.3.

enacting an opt-in rule would.<sup>236</sup> Simply put, the regulations would become wholly ineffective because practitioners would almost always choose to opt out of compliance with them.

Under the opt-out rules, the only requisite for opting out of compliance with the Covered Opinion Regulations when delivering a reliance opinion for a Significant Purpose Transaction is to include a Non-Reliance Disclaimer prominently in the opinion.<sup>237</sup> Thus, the only consequence of opting out is that the recipient is restricted from invoking the opinion as part of a reasonable cause defense against accuracy-related penalties that the IRS may assert against the transaction. Obviously, that restriction becomes irrelevant if the accuracy-related penalty that would most likely apply is a strict liability penalty for which there is no reasonable cause defense. In such a case, the recipient would lose nothing by living with the disclaimer and, thus, there would be no practical reason for the practitioner to choose to comply with the regulations when he or she could instead opt out and avoid the costs and burdens of compliance. (It is presumably for this reason, for example, that the current regulations do not permit practitioners to opt out when delivering opinions regarding transactions to which the strict liability penalty under § 6662A(c) may potentially apply.<sup>238</sup>)

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236. For a discussion of the incompatibility of an opt-in rule with the Covered Opinion Regulations under a strict liability penalty regime, see *supra* text accompanying note 219.

237. See 31 C.F.R. § 10.35(b)(4)(ii) (2010). For an outline of the opt-out rules pertaining to reliance opinions for Significant Purpose Transactions, see *supra* text accompanying notes 49-51. For a description of what constitutes a “reliance opinion” under Circular 230, see *supra* note 8.

238. Section 6662A(c) provides for a penalty in the amount of 30% of a reportable transaction understatement in the case of an undisclosed reportable transaction. See I.R.C. § 6662A(c) (2010). Under § 6664(d), there is no reasonable-cause-and-good-faith exception to the § 6662A(c) penalty. See I.R.C. § 6664(d)(3)(A) (2010). (The intent to prevent application of the reasonable cause exception in the case of undisclosed reportable transactions remains clear, despite a drafting oversight in connection with March 30, 2010 amendments to § 6664(d), as a result of which § 6662A(c) erroneously cross-references § 6664(d)(2)(A) rather than § 6664(d)(3)(A). For an explanation as to this drafting error and the intended interplay between §§ 6662A(c) and 6664(d)(3)(A), see *supra* note 94.) The § 6662A(c) accuracy-related penalty for undisclosed reportable transactions is thus a strict liability penalty. Reportable transactions include Listed Transactions, transactions subject to conditions of confidentiality, transactions subject to contractual protections, loss transactions (*i.e.*, transactions that generate losses in excess of certain specified thresholds) and transactions of interest (which are the same as, or substantially similar to, Listed Transactions). See IRS Instructions for Form 8886 (Rev. Mar. 2010) (Reportable Transaction Disclosure Statement) at 1-3. Correspondingly, there is no permission to opt out of compliance with the Covered Opinion Regulations when drafting an opinion related to a Listed Transaction, a Significant Purpose Transaction that is subject to conditions of confidentiality, a Significant Purpose Transaction that is subject to contractual protections, or a Principal Purpose Transaction. (It is reasonable to assume that any transaction that is “reportable” by virtue of being a significant loss transaction would most likely be a Principal Purpose Transaction under Circular 230 § 10.35(b)(2)(i)(B).) See generally 31 C.F.R. § 10.35(b)(2)(i) (2010); see also *supra* note 54 and accompanying text (discussing categories of opinions to which the opt-out rules do not apply). Thus, the Covered Opinion



Similarly, to opt out of compliance when issuing a marketed opinion for a Significant Purpose Transaction, the only additional requirements are to include additional disclaimers stating that the opinion is being used to market the transaction and that investors should consult their own tax advisors.<sup>239</sup> If a marketed opinion regarding a tax shelter would not be available as a defense against imposition of the § 6662(b)(6) penalty in any event, the need to include those added disclaimers would most likely be insufficient to dissuade the drafter from opting out of compliance with the regulations.

Ultimately, if the § 6662(b)(6) penalty turns out to be the penalty applied in all or most future tax shelter cases,<sup>240</sup> there will be virtually no disincentive for a practitioner to opt out of compliance with the Covered Opinion Regulations when preparing a tax shelter opinion that would otherwise constitute a reliance opinion or a marketed opinion concerning a Significant Purpose Transaction. If the opt-out rules remain in place, then most (if not all) such opinions will contain irrelevant Non-Reliance Disclaimers, and the regulations will therefore be technically inapplicable to those opinions (because they will not constitute “covered opinions” under Circular 230). In this way, the Covered Opinion Regulations will become almost completely enervated. To prevent this, if § 6662(b)(6) becomes the predominant accuracy-related penalty applied to abusive tax shelters, the opt-out rules must be repealed.<sup>241</sup>

Moreover, even assuming that other accuracy-related penalties (to which legal opinions can provide a defense) will retain some vitality in the context of future tax shelters, it would still be a bad idea to retain the current opt-out regime if the Covered Opinion Regulations are narrowed to cover only tax shelter opinions.

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Regulations already restrict the opt-out rules from applying with respect to the delivery of an opinion concerning any type of transaction as to which a strict liability penalty under § 6662A(c) could apply. Section 6662A(c) was the only accuracy-related penalty as to which there was no reasonable-cause-and-good-faith exception under § 6664 at the time when the Covered Opinion Regulations were authorized and promulgated. (The JOBS Act both authorized the Covered Opinion Regulations and enacted §§ 6662A(c) and 6664(d) in 2004.) For further discussion of the § 6662A(c) penalty and the strict liability status of that of that penalty under § 6664(d), see *supra* note 94 and accompanying text. For a discussion of what constitutes a “reportable transaction” under the Code, see *supra* note 93 and accompanying text.

239. See 31 C.F.R. § 10.35(b)(5)(ii)(B), (C) (2010). For a discussion of the complete requirements for “opting out” in the context of a marketed opinion, including the Non-Reliance Disclaimer and the consumer-protections legends that are needed, see *supra* notes 49-53 and accompanying text. For a description of what constitutes a “marketed opinion” under Circular 230, see *supra* note 9.

240. For a discussion of this possibility, see *supra* Part V.A.3.

241. Cf. Jeremiah Coder, *Alexander Addresses Determination of Economic Substance Relevance*, 127 TAX NOTES 1076, 1077 (June 7, 2010) (recounting observation of attorney Bryan C. Skarlatos that “legal opinions are no longer protection, with the introduction of a strict liability penalty applied to transactions that lack economic substance” and statement by Karen Gilbreath Sowell of Ernst & Young LLP that “[a]s a result of the [economic substance] statute, best practices in opinion writing will have to evolve”).

It would be an especially bad idea in the context of marketed opinions. Although the rules currently allow for Non-Reliance Disclaimers to appear in marketed opinions,<sup>242</sup> it is difficult to understand the rationale for that. None of the justifications that one might invoke in connection with some other forms of advice would appear to apply in the case of marketed opinions. For example, there cannot be any concern about undue restrictions on the provision of informal or piecemeal advice to a client,<sup>243</sup> because marketed opinions, by their very nature, are formal opinions intended to influence the investment decisions of non-clients. Nor should there be any worry about a restriction on the ability of practitioners to distinguish between important and unimportant tax issues.<sup>244</sup> In fact, just the opposite is true. In the context of marketed opinions, there is a particular need to regulate against the use of misleading “partial” opinions that simply ignore problematic tax questions in order to convey a false sense that the shelter being marketed is legitimate. A requirement to cover all significant federal tax issues is thus especially apt in that case. Finally, there is absolutely no justification for concern about cost burdens in the case of marketed opinions. They are, after all, essentially nothing other than advertisements for (often dubious) financial products.

These same analyses apply equally well to opinions regarding transactions that are subject to conditions of confidentiality or are subject to contractual protection.<sup>245</sup> In addition, as noted above, such transactions (if not properly disclosed and later found to be abusive) are subject to a strict liability penalty under § 6662A(c).<sup>246</sup> For all of these reasons, there should be no option to opt out of compliance with the Covered Opinion Regulations when providing those categories of opinions, either. (And, indeed, no such option currently exists.)

The remaining question is whether there is any place for an opt-out provision in the case of other sorts of Listed Transaction opinions, Principal Purpose Transaction opinions, or Significant Purpose Transaction opinions. (Just to be clear, the last category refers strictly to transactions that meet the narrow tax-shelter-specific “significant purpose” definition advocated in Part V.B above.) Are there ever good reasons for allowing practitioners to opt out of the Covered Opinion Regulations when providing any types of tax shelter advice?

One particularly bad reason for doing so would be to alleviate cost burdens. Keep in mind that we are now talking about a transaction cost to be borne by those who are investigating the boundaries of the most aggressive strategies they can pursue to avoid or evade taxes. Such clients deserve thoughtful, professional advice, but they do not deserve much

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242. See 31 C.F.R. § 10.35(b)(5)(ii)(A) (2010).

243. See *supra* Part IV.C.

244. See *supra* Part IV.D.

245. For a discussion of what it means under Circular 230 for an opinion to be subject to conditions of confidentiality or to contractual protection, see *supra* notes 10-11.

246. See *supra* note 238 and accompanying text.

sympathy when it comes to matters of expense. Attorney Casey R. Law has summarized this issue particularly well:

[A]ssisting a client in taking an aggressive (*i.e.* legally dubious) tax-saving position is a legally and ethically serious matter; in advising such a client, it is (even apart from Circular 230) a very good idea for an attorney to engage in the diligent preparation and careful analysis required for “covered opinions”; and . . . any client who could potentially benefit from such advice has both the financial ability and the moral obligation to pay for it in proportion to the attorney’s labor and risk.<sup>247</sup>

Compromising the cohesion and effectiveness of the Covered Opinion Regulations by allowing practitioners to opt out of complying with them when dispensing tax shelter advice should not be countenanced on the ground that covered opinions are expensive.

A more legitimate concern is whether the Covered Opinion Regulations prevent practitioners from providing informal advice from which clients would benefit, or whether they otherwise impede the normal flow of communications between attorneys and clients, in the context of tax shelters.<sup>248</sup> The short answer is that they do not. Informal communications (such as increasingly prevalent e-mails) and piecemeal items of advice throughout the gestation of a deal are plainly essential to the provision of sound transactional counsel (tax-related or otherwise). However, such advice is almost always already excepted from the “covered opinion” definition under the exclusion for preliminary advice pursuant to Circular 230 § 10.35(b)(2)(ii)(A). That section (the “Preliminary Advice Exclusion”) provides that “[a] covered opinion does not include . . . [w]ritten advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements of” Circular 230 § 10.35.<sup>249</sup>

The New York State Bar Association has argued that at least some instances of informal or piecemeal advice may not come within the Preliminary Advice Exclusion because, at the time the advice is provided, “there may be no expectation . . . that formal advice on the topic would be expected.”<sup>250</sup> That assertion seems peculiar, particularly in the context of advice concerning corporate tax shelters. There are extremely few, if any, corporate transactional engagements in which the practitioner’s advice consists solely of informal communications and piecemeal snippets. A formal, comprehensive opinion of counsel is almost always a prerequisite to the completion of a complex or significant corporate transaction. Thus, the

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247. Law, *supra* note 69, at 33-34.

248. For a discussion of concerns that the Covered Opinion Regulations prevent informal advice and impede communications between practitioners and clients, see *supra* Part IV.C.

249. 31 C.F.R. § 10.35(b)(2)(ii)(A) (2010).

250. Paul, *supra* note 66, at 27.

New York State Bar Association's contention does not comport with the realities of corporate law practice and is particularly out of place in a discussion of advice concerning corporate tax shelters. (The same is most likely also true in the case of personal deals done by high-net-worth individuals.) Accordingly, the only time when ultimate formal advice on a tax shelter should not reasonably be expected is if a proposed transaction is never consummated. In such a case, the entire question is moot, because there are no tax underpayments (and therefore no substantial underpayment penalties from which to be protected) stemming from deals that are never done. In the spirit of clarity and completeness, however, Treasury should consider amending Circular 230 § 10.35(b)(2)(ii)(A) to state that advice on proposed transactions that are never completed also comes within the scope of the Preliminary Advice Exception. In any event, protecting the normal flow of informal communication and piecemeal advice does not require or justify allowing practitioners to opt out of compliance with the Covered Opinion Regulations when providing counsel concerning tax shelters.

Next, there is once again the question of having to cover all significant federal tax issues.<sup>251</sup> Although the problem of "partial opinions" is particularly acute in the case of marketed opinions and opinions that are either subject to contractual protection or subject to conditions of confidentiality, the potential for misusing partial opinions to imbue an aura of legitimacy on an abusive transaction is not confined to those areas. The most effective means by which to combat this problem is to enforce the requirement to cover all significant federal tax issues in the context of all tax shelter advice (other than advice that comes within the Preliminary Advice Exception discussed above).

This is not to suggest that the concerns inherent in limiting a practitioner's ability to distinguish between important and unimportant issues are not real or significant. As discussed above,<sup>252</sup> this rule places substantial burdens on both practitioners and clients, and, for this reason, it is imperative that the rule not be applied in anything other than the tax shelter context. In the specific case of tax shelters, however, the trade-offs between the regulation's burdens and its deterrent effects are unfortunately justified by historical experience. As Professor Scott Schumacher has stated, "[t]he tax shelter boom and related problems could not have occurred without lawyers and accountants. Thus, if tax professionals and taxpayers are stymied by the government's actions in this area, we have ourselves primarily to blame."<sup>253</sup> Tax practitioners should not be able to opt out of the Covered Opinion Regulations to avoid covering all significant federal tax issues when advising on tax shelters.

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251. This requirement for covered opinions is set forth in 31 C.F.R. § 10.35(c)(3)(i) (2010). For a description of what constitutes a "significant Federal tax issue" under Circular 230, see *supra* note 8.

252. See *supra* Part IV.D.

253. Schumacher, *supra* note 72, at 100-01 (citations omitted).

For all of these reasons, after the Covered Opinion Regulations are revised to apply only to tax shelter advice, the ability to opt out of compliance with the regulations should be removed.

## VI. CONCLUSION

Though some members of the tax bar may suspect otherwise, the Covered Opinion Regulations did not emerge as part of a nefarious plot to wreak havoc on the practice of tax law. Rather, the regulations are an unfortunately necessary response to the egregious behavior of tax practitioners whose unsound legal opinions facilitated the rise of abusive corporate tax shelters in the 1990s. The regulations have been effective at curbing abusive shelter activity because they have both proscribed those unscrupulous opinion practices and created incentives that cause practitioners to dissuade their clients from investing in unduly aggressive transactions. It is too bad that the new strict liability penalty for non-economic-substance transactions may reduce the future effectiveness of those incentives that directly encourage good taxpayer behavior. Even if that occurs, however, the Covered Opinion Regulations will remain needed to discourage the bad practitioner behavior that gave rise to their promulgation in the first place.

Despite their effectiveness and the importance of their role, the Covered Opinion Regulations are not without substantial flaws. In an effort to ensure the Covered Opinion Regulations apply to advice concerning all potentially abusive transactions, the regulations were written so broadly that they unnecessarily impose on virtually all tax advice—even routine advice concerning plainly legitimate tax planning. This has created a number of burdens on the provision of sound tax counsel outside the shelter context, which has disadvantaged practitioner and client alike. To remedy those problems, the scope of the Covered Opinion Regulations must be realigned so that the regulations cover all tax shelter advice, but no other tax advice. This Article recommends a specific revision to the definition of a “covered opinion” under the regulations, to accomplish this. If that revision is made, and if the opt-out rules (and the misguided “opt-in” alternative to those rules) are discarded as well, then the regulations will continue to function as an important tool to combat abusive shelter activity without adversely affecting the rest of tax practice.