

PROTECTIVE TAX ELECTIONS

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Abstract

In many instances, taxpayers can select among various available tax outcomes by simply filing (or not filing) a tax election. Oftentimes, taxpayers file tax elections on a protective basis. When a taxpayer believes that filing an election may not be necessary but files it just in case, the taxpayer files a “protective tax election.” While existing academic literature explores various aspects of tax elections, the filing of tax elections on a protective basis has not been addressed. This Article begins to fill that gap.

In some circumstances, the tax outcome that follows from making a protective tax election is not necessarily what the taxpayer intends to claim. A taxpayer might plan to claim a given tax outcome but be wary of a risk that the claim will fail. The taxpayer files a protective tax election to opt for the taxpayer’s second choice. In other words, the taxpayer uses the election to ensure that, if the taxpayer’s intended claim does fail, the alternative tax treatment imposed upon the taxpayer is more favorable than what would befall the taxpayer in the absence of the protective tax election. This Article adopts the phrase “Favorable Fallback Protective Tax Elections” to refer to protective tax elections filed under these circumstances.

The policy implications of Favorable Fallback Protective Tax Elections are numerous. The policy disadvantages of such elections include their potential to trap unwary taxpayers as well as their propensity for encouraging well-advised taxpayers to take more aggressive reporting positions. One policy advantage of such elections is the possibility that they may encourage taxpayers to reveal useful information to the IRS.

This Article explores the various uses of protective tax elections, assesses their policy advantages and disadvantages, and recommends ways to amplify their advantages and mitigate their disadvantages.

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INTRODUCTION

In many instances, taxpayers can select among various available tax outcomes by simply filing (or not filing) a tax election. Tax elections pervade the Internal Revenue Code and the Treasury regulations and arise in numerous areas of tax law including individual income taxation,¹ the taxation of business entities,² international taxation,³ and other areas.⁴

Oftentimes, taxpayers file tax elections on a protective basis. When a taxpayer believes that filing an election may not be necessary but files it just in case, the taxpayer files a “protective tax election.” In some circumstances, the taxpayer has a given tax outcome in mind that the taxpayer intends to claim, and the taxpayer files an election on a protective basis for additional assurance that the tax outcome the taxpayer has in mind is correct. This Article will adopt the phrase “Belt and Suspenders Protective Tax Elections” to refer to protective tax elections filed under these circumstances. As an example of this type of protective tax election, consider a taxpayer who intends to claim the tax outcome that follows from filing an election and is uncertain about whether a valid election was already filed.⁵ In that instance, the taxpayer might simply file a (potentially duplicative) election on a protective basis—the filing is made on a protective basis because it might be unnecessary given that a valid election may have already been filed.

In other circumstances, the tax treatment that follows from making the protective tax election will not necessarily be what the taxpayer claims. This Article will adopt the phrase “Favorable Fallback Protective Tax Elections” to refer to protective tax elections filed under these circumstances. As an example of this use of protective tax elections, a taxpayer might plan to claim a given tax outcome, but the taxpayer may be aware of some risk that their claim will fail. In some cases, filing a protective tax election could help to ensure that, if the taxpayer’s claim does fail, the alternative tax treatment imposed upon the taxpayer is more favorable than what would befall the taxpayer in the absence of the protective tax election.⁶

Congress, Treasury, or the IRS have explicitly permitted filing some tax elections on a protective basis.⁷ In the case of other tax elections, taxpayers routinely file on a protective basis despite lack of specific authorization.⁸ In the case of yet another set of tax elections, lawmakers have explicitly disallowed

¹ Available tax elections include an individual taxpayer’s election between claiming the standard deduction or itemizing deductions. *See* I.R.C. § 63(b).

² Available elections include elections that determine how business entities are classified as well as various elections that arise in the context of partnerships and corporations. *See, e.g.*, Treas. Reg. § 301.7701-2; Treas. Reg. § 1.704-3; I.R.C. § 754; I.R.C. § 338; I.R.C. § 362(e)(2)(C).

³ *See, e.g.*, I.R.C. § 1295.

⁴ For instance, various elections can also be found in the context of estate and gift taxation.

⁵ For further discussion, *see infra* Part I.B.

⁶ For examples, *see infra* Part I.C.

⁷ For example, *see infra* Part I.C.2 (protective QEF election explicitly authorized by Treasury Regulations).

⁸ For examples, *see infra* Part I.C.3 (protective TRS elections routinely made but no explicit authorization), Part I.C.1 (protective Section 1237 election not explicitly authorized by authority on which taxpayers can rely but favorable private letter ruling has been issued).

protective filings.⁹

Prior to turning to an examination of protective tax elections, it is important to note that tax elections, as a broader category, give rise to various policy implications, as discussed in existing literature.¹⁰ As noted by this literature, tax elections may exacerbate inequities by offering tax benefits to only taxpayers who have access to sufficiently sophisticated tax advice.¹¹ Consequently, the use of tax elections is problematic, especially in areas of law that affect a wide swathe of taxpayers including those without access to sophisticated advice. Whenever possible, in such contexts, the best course of action may be to avoid use of tax elections, or, if they must be used to serve some other policy goal, adopt design features that make them less likely to trap unwary taxpayers.¹²

The aim of this Article is not to analyze tax elections, in general. Rather, this Article is focused on a question that has not yet been explored by existing literature—in particular, whether the ability to file an election protectively raises any significant policy issues, assuming that the underlying tax election exists.¹³

Taking as a given that an underlying tax election is allowed, associated Belt and Suspenders Protective Tax Elections are fairly innocuous.¹⁴ However,

⁹ For example, *see infra* Part I.D.

¹⁰ *See, e.g.*, Emily Cauble, *Tax Elections: How To Live With Them If We Can't Live Without Them*, 53 SANTA CLARA L. REV. 421 (2013); Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21 (2010) [hereinafter, Field, *Choosing Tax*]; Heather M. Field, *Checking in on "Check-the-Box"* 42 LOY. L.A. L. REV. 451 (2009) [hereinafter, Field, *Check-the-Box*]; Heather M. Field, *Tax Elections & Private Bargaining*, 31 VA. TAX REV. 1 (2011) [hereinafter, Field, *Private Bargaining*]; Aubree L. Helvey & Beth Stetson, *The Doctrine of Election*, 62 TAX LAW. 333 (2008); Victoria A. Levin, *The Substantial Compliance Doctrine in Tax Law: Equity vs. Efficiency*, 40 UCLA L. REV. 1587 (1993); Orli Oren-Kolbinger, *The Error Cost of Marriage* (Aug. 1 2020), (forthcoming) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3668099 [<https://perma.cc/8884L9UA>]; Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689 (2009); Emily Satterthwaite, *Tax Elections as Screens*, 42:1 QUEEN'S LAW JOURNAL 63 (2016); George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125 (1997); Edward Yorio, *The Revocability of Federal Tax Elections*, 44 FORDHAM L. REV. 463 (1975).

¹¹ *See, e.g.*, Cauble, *supra* note 10, at 446-47; Field, *Choosing Tax*, *supra* note 10, at 3

1 (“[A]n election, while technically available to all eligible taxpayers, may be functionally available only to the wealthiest, most sophisticated group of taxpayers, who can best navigate the complexity of the election process.”); Oren-Kolbinger, *supra* note 10, at 5 (“taxpayers may be unknowingly locked into an inferior election and therefore not maximizing their tax benefits.”)

¹² *See, e.g.*, Cauble, *supra* note 10, at 451-88.

¹³ Commentators have noted the ability to file protective tax elections in particular contexts or described the mechanics of filing particular protective tax elections. For this type of discussion of protective Section 362(e)(2)(C) elections, *see, e.g.*, Thomas Hayes & David Hering, *Beware Asset Basis Reductions in Carryover-Basis Transactions*, 38 J. CORP. TAX’N 18, 20-22 (2011) (describing circumstances in which a taxpayer might make a protective Section 362(e)(2)(C) election). For this type of discussion of protective tax elections in the entity classification context, *see, e.g.*, Bishop & Kleinberger, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW* ¶ 2.04 Election Mechanics (2005). However, existing literature lacks thorough description of the various contexts in which protective tax elections arise and lacks analysis of the advantages and disadvantages of allowing protective tax elections.

¹⁴ Taking as a given that the underlying election is allowed, there does not appear to be any harm to allowing taxpayers to file a potentially duplicative election to ensure that the taxpayer

Favorable Fallback Protective Tax Elections raise potentially thornier issues and will be the focus of this Article's analysis and policy recommendations. Requiring that taxpayers file Favorable Fallback Protective Tax Elections in order to secure more beneficial alternative tax treatment puts a high premium on planning and makes it very likely that only taxpayers with access to sophisticated advice will benefit from such elections.¹⁵ At the same time, allowing taxpayers to opt into more advantageous alternative tax treatment in case their claimed tax position is unavailable may encourage well-advised taxpayers to take more aggressive reporting positions (in other words, positions where IRS challenge would have a greater likelihood of success).¹⁶ If a taxpayer can elect more beneficial backup tax treatment so that the taxpayer does not fall as far if the taxpayer's claim is successfully challenged, the taxpayer may be more likely to go out on a limb and claim a position that carries with it a higher likelihood of successful challenge.

While these facets of Favorable Fallback Protective Tax Elections are problematic, they also may offer advantages. In some circumstances, allowing their use may provide valuable information to the IRS.¹⁷ Because the election only affects a taxpayer's tax outcome if the tax outcome the taxpayer claims is unavailable, in some circumstances, the fact that the taxpayer files the election may suggest that the taxpayer concluded there was a risk that what they plan to claim may be unavailable. In addition, in some cases, taxpayers may use Favorable Fallback Protective Tax Elections to manage uncertainty, which may be a useful feature of such elections.¹⁸

Some Favorable Fallback Protective Tax Elections are subject to restrictions that could mitigate some of the policy disadvantages and amplify some of the potential advantages.¹⁹ For instance, in some cases, a taxpayer filing such an election must provide a statement justifying the tax outcome the taxpayer intends to claim and consent to an extended statute of limitations, allowing the IRS more time to examine the taxpayer's reported tax consequences.²⁰ Curiously, other,

obtains the outcome that follows from making the election and that the taxpayer, in all events, intends to claim. There may be some additional administrative cost from the IRS having to process additional election forms, but the IRS might also save time that would be spent responding to questions from taxpayers about whether a valid election was already filed. Moreover, if the underlying election is allowed, prohibiting taxpayers from filing an associated Belt and Suspenders Protective Tax Election would be impractical. If the protective tax election turns out to be duplicative of an already filed election or unnecessary because it opts for the default treatment and the IRS disallows it on the basis that it is unnecessary, then the earlier filed election or default treatment is in place, so the taxpayer still obtains the outcome the taxpayer sought. If the protective tax election turns out to be not duplicative and not merely a confirmation of the taxpayer's default treatment, then, from the IRS's standpoint, it would be indistinguishable from an election that was not filed on a protective basis. Therefore, aside from penalizing taxpayers for filing duplicative elections or elections that merely confirm their default treatment (which would seem to be an odd step to take given the inoffensive nature of such tax elections), prohibiting Belt and Suspenders Protective Tax Elections does not seem viable.

¹⁵ For further discussion, *see infra* Part II.

¹⁶ For further discussion, *see infra* Part III.

¹⁷ For further discussion, *see infra* Part IV.

¹⁸ For further discussion, *see infra* Part V.

¹⁹ For further discussion, *see infra* Part III.D.

²⁰ *See infra* Part III.D.

arguably similar Favorable Fallback Protective Tax Elections are not subject to the same restrictions.²¹

By examining Favorable Fallback Protective Tax Elections, this Article develops recommendations for restrictions on their use and considers the possibility of employing such elections in other contexts to encourage taxpayers to provide information to the IRS. In addition to helping to develop recommendations, an exploration of the use of Favorable Fallback Protective Tax Elections offers illustrations that are relevant to two existing strands of literature. First, an existing body of literature examines uncertainty in tax law, discusses the various ways in which uncertainty may affect taxpayers, and describes steps taxpayers may take to mitigate uncertainty.²² Protective tax elections represent one additional tool that taxpayers use to cope with uncertainty. A second existing strand of literature discusses circumstances when taxpayers, by taking required steps to obtain a given tax outcome, will sort themselves into different groups in a way that reveals useful information to the IRS and/or ensures that the right taxpayers obtain the specified tax treatment.²³ Favorable Fallback Protective Tax Elections offer an opportunity to consider the circumstances under which this will occur.

This Article proceeds as follows. Part I provides and categorizes various examples of protective tax elections. Parts II through V analyze the policy implications of allowing Favorable Fallback Protective Tax Elections. In particular, Part II assesses such elections' propensity for trapping unwary taxpayers. Part III describes their potential to encourage well-informed taxpayers to take more aggressive reporting positions. Part IV analyzes the possibility that making such elections available will encourage taxpayers to reveal useful information to the IRS. Part V considers whether such elections might act as a tool that taxpayers use to obtain certainty. Based upon the analysis of policy implications, Part VI offers recommendations for the use and design of Favorable Fallback Protective Tax Elections. Part VII concludes the Article.

I. EXAMPLES OF PROTECTIVE TAX ELECTIONS

Protective tax elections fall into two different categories. A protective tax election in the first category (a "Belt and Suspenders Protective Tax Election") offers a taxpayer more certainty that the tax treatment the taxpayer intends to claim is correct. As one example, imagine that filing a given election is necessary to obtain the taxpayer's desired tax treatment and imagine the taxpayer is uncertain about whether a valid election has already been filed. The taxpayer might simply

²¹ For further discussion, *see infra* Part III.D.

²² *See, e.g.*, Heather Field, *Tax Lawyers as Tax Insurance*, 60 WM. & MARY L. REV. 2111 (2019); Yehonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings*, 29 VA. TAX REV. 137 (2009); Jeffrey H. Kahn, *Hedging the IRS – A Policy Justification for Excluding Liability and Insurance Proceeds*, 26 YALE J. ON REG. 1 (2009); Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017 (2009); Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339 (2005); Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 TAX L. REV. 489 (2011).

²³ *See infra* notes 111-117 & 129- 131 and accompanying text.

file a potentially duplicative election on a protective basis.²⁴ In the case of Belt and Suspenders Protective Tax Elections, the tax treatment that follows from making the election is the tax outcome that the taxpayer intends to claim in all events. In the example given, regardless of whether the election was not duplicative (and necessary) or duplicative (and unnecessary), the taxpayer intends to claim the tax outcome that follows from having made the election.

Sometimes the tax treatment that follows from making the election will not, necessarily, be what the taxpayer claims. Protective tax elections made under these circumstances (“Favorable Fallback Protective Tax Elections”) occupy the second category. To further illustrate the use of Favorable Fallback Protective Tax Elections in general terms, imagine that certain conditions must be met for a given tax election to dictate a transaction’s tax outcome. At the time the election must be filed, imagine the taxpayer has some doubt about whether those conditions are met. In these circumstances, the taxpayer might opt to file an election on a protective basis to specify the taxpayer’s desired tax treatment in the event that the conditions are met. If the conditions are met, the election dictates the tax outcome. If the conditions are not met, the election has no effect, and the claimed tax outcome differs from what would have followed from the election had the conditions been met. Thus, unlike Belt and Suspenders Protective Tax Elections, the tax outcome claimed by the taxpayer will not necessarily be the tax outcome that follows from making the election.

This part will proceed by describing, in more detail, examples of protective tax elections. It is worth noting that the examples described below are by no means the only examples of protective tax elections.²⁵ While the remainder of this Article will focus on Favorable Fallback Protective Tax Elections, this part will also briefly provide examples of Belt and Suspenders Protective Tax Elections because they provide a useful point of contrast to help clarify the contours of elections that belong in the Favorable Fallback Protective Tax Election category.

²⁴ For further discussion, *see infra* Part I.B.

²⁵ Other examples abound. For instance, a protective entity classification election might be filed by the beneficiaries of a trust who believe it constitutes an ordinary trust but want to make a protective filing to select its classification in case it is considered to be a business entity. *See, e.g.*, Bishop & Kleinberger, *supra* note 14. As another example, in response to the 2009 financial crisis, Congress enacted Code Section 108(i) that allowed taxpayers to elect to defer cancellation of debt income (“COD income”) realized in certain circumstances. The IRS issued a revenue procedure that allowed taxpayers to file a return claiming that the reacquisition of debt did not result in COD income and, at the same time, file a protective election to defer inclusion in gross income of the COD income in the event that the IRS determined that the taxpayer had, in fact, realized COD income. Rev. Proc. 2009-37, 2009-36 I.R.B. 309. The Revenue Procedure specified that, if the taxpayer made such a protective election, the IRS could subsequently challenge the taxpayer’s failure to include in income the COD income even if the statute of limitations had expired for the year when the COD income was realized. *Id.* Protective tax elections under Section 362(e)(2)(C) are also explicitly authorized by the Treasury Regulations. *See* Treas. Reg. § 1.362-4(d). Other examples include protective elections under I.R.C. § 761(a), protective § 83(b) elections, the protective election allowed by Treas. Reg. § 1.163(j)-9(b)(2)(ii), and a number of examples in the gift and estate tax arena; just to name a few.

A. *Example of Belt and Suspenders Protective Tax Election – U.S. Tax Classification of Entity Formed Outside the United States*

As discussed above, Belt and Suspenders Protective Tax Elections are used merely to assure the taxpayer of obtaining the tax outcome that the taxpayer intends to claim in all events. As an example, consider a group of taxpayers who form a business entity outside of the United States and assume it is not a type of business entity that is required to be treated as a corporation for U.S. tax purposes.²⁶ Imagine the owners of the business entity have decided that they want to treat the entity as a corporation for U.S. tax purposes. If no election is filed with respect to the entity, then it will be treated as a partnership for U.S. tax purposes if it is not the case that all owners of the entity have limited liability.²⁷ In that case, filing an election is necessary to obtain the tax classification of corporation. By contrast, if all the owners have limited liability, then the entity will be treated as a corporation for U.S. tax purposes unless a contrary election is filed.²⁸ In that case, filing an election would not be required to obtain their desired tax treatment.

If the owners are not entirely certain about whether the law of the jurisdiction in which the entity is formed provides limited liability to all owners within the meaning of the Treasury Regulations, they may opt to file a protective tax election to treat the entity as a corporation for U.S. tax purposes.²⁹ The election is protective because it is possible that it is not necessary (if it is the case that all owners have limited liability). The ability to file protective tax elections in this context is not explicitly addressed by the Treasury Regulations, but the preamble to the Regulations regarding entity classification do state that protective entity classification elections are not prohibited.³⁰

In this example, the owners consistently intend to treat the entity as a corporation for U.S. tax purposes, and the role of the protective tax election is merely to ensure that they obtain that tax treatment. Filing the protective tax election obviates the need to make a more certain determination of what the entity's classification would be in the absence of an election, which could likely be a more costly endeavor than simply filing the election.³¹

²⁶ For a description of entities that are automatically treated as corporations, *see* Treas. Reg. §§ 301.7701-2(b)(1) & (3)-(8).

²⁷ Treas. Reg. § 301.7701-3(b)(2).

²⁸ Treas. Reg. § 301.7701-3(b)(2).

²⁹ *See, e.g.,* Field, *Check-the-Box*, *supra* note 10, at 472 (describing the use of protective entity classification elections in the context of non-U.S. entities)

³⁰ T.D. 8697, 1997-1 C.B. 215 (“protective elections are not prohibited under the regulations.”)

³¹ One alternative to allowing protective tax elections in this context would be to replace the current default rule with a clearer one. In addition to obviating the need to make protective tax elections, a clearer default treatment would have some ancillary benefits. Under the current default rule, not all potential uncertainty is cured by allowing protective tax elections. This is true, in part, because taxpayers will not file protective tax elections with respect to some non-U.S. entities, which will necessitate an eventual determination by the taxpayer and the IRS of the default treatment of those entities. Despite some potential administrative benefits to adopting a clearer default rule, leaving it murky may also offer some benefits. The fact that taxpayers file protective tax elections with respect to non-U.S. entities may increase the odds of those entities getting on the IRS's radar, for instance.

B. Example of Belt and Suspenders Protective Tax Election – Elections That Are (Potentially) Duplicative

In the example above, protective tax elections are used to address uncertainty about the default tax treatment that applies in the absence of any election at all. In some other contexts, a taxpayer may be uncertain about whether a valid election has already been filed, and, to address that uncertainty, the taxpayer may opt to file the election—perhaps for the first time (in which case it is necessary to obtain the tax treatment that the taxpayer intends to claim) or perhaps for the second time (in which case it is unnecessary). The taxpayer is uncertain about whether a filing would be the first valid filing or an unnecessary second valid filing, and, as a result, the taxpayer’s filing is made on a protective basis.

For one example, imagine taxpayers have formed a business entity and desire to treat it as an S Corporation for tax purposes. In addition to meeting various eligibility requirements,³² an election must be filed in order to treat an entity as an S Corporation, and all persons who are shareholders on the day on which the election is made must consent to the election.³³ If there is any doubt about whether an initial election has been filed or about whether it was valid, the taxpayers may opt to file an election on a protective basis to ensure that, at least going forward, the entity is treated as an S Corporation.³⁴

C. Favorable Fallback Protective Tax Elections

In the examples above involving Belt and Suspenders Protective Tax Elections, the outcome that follows from making the election is the outcome that the taxpayer intends to claim in all events. By contrast, in other contexts involving Favorable Fallback Protective Tax Elections, a taxpayer files a protective tax election that will only affect the taxpayer’s tax treatment if the tax outcome the taxpayer expects to claim is unavailable. If the taxpayer’s expected tax outcome is unavailable, the protective tax election leads to tax consequences that differ from the consequences that the taxpayer plans to claim. Thus, the outcome that follows from making the protective tax election is not the outcome that the taxpayer intends to report.

The pattern that arises in the context of a Favorable Fallback Protective Tax Election is illustrated in the table below.³⁵

³² I.R.C. § 1361.

³³ I.R.C. § 1362(a)(2).

³⁴ See, e.g., Eustice, Kuntz & Bogdanski, *Federal Income Taxation of S Corporations*, at ¶4.01 at footnote 9 (November 2021) (“At the risk of attracting the Service’s attention, a taxpayer can put any future question about the validity of an original election to rest by filing a protective election in a later year.”)

³⁵ This illustrates the pattern that arises when the default treatment that follows without the election in place is less favorable than the treatment that follows from making the election, which will not always be the case.

Table 1. Favorable Fallback Protective Tax Elections

Taxpayer's Intended Tax Outcome Most Favorable Outcome	Taxpayer's Intended Tax Outcome is Unavailable and election IS in place
	Intermediate Outcome
	Taxpayer's Intended Tax Outcome is Unavailable and election is NOT in place Least Favorable Outcome

The left-hand side of the table illustrates the tax outcome the taxpayer expects. The taxpayer is aware of some risk that the expected tax outcome may be unavailable. If that risk becomes reality, the resulting tax outcomes are shown on the right-hand side of the table. In that event, the taxpayer will fare better if the election is in place than if it is not. As a result, the taxpayer may file the election protectively to secure the taxpayer's second choice tax outcome in case the taxpayer's first choice is not available.

1. Example of Favorable Fallback Protective Tax Election – Protective Section 1237 Election

One example of a Favorable Fallback Protective Tax Election arises in the context of the sale of subdivided land. When a taxpayer sells appreciated real estate, the resulting gain generally will be classified as ordinary income if the real estate is “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,” as described by Internal Revenue Code Section 1221(a)(1).³⁶ Real estate fitting this description is often referred to as “dealer property.”³⁷ If, instead, the taxpayer holds the real estate for investment purposes, the resulting gain will be capital gain.³⁸

Whether real estate is “dealer property” is determined based on all relevant facts and circumstances bearing on whether the taxpayer held the property with the intent described in Section 1221(a)(1).³⁹ Courts will examine facts that include, but are not limited to: (1) the frequency and substantiality of sales, (2) the extent of improvements made to the property by the taxpayer, and (3) efforts by the taxpayer to advertise the property for sale.⁴⁰ Because the determination of whether sale of

³⁶ I.R.C. § 1221(a)(1).

³⁷ See, e.g., Gerald J. Robinson, *Federal Income Taxation of Real Estate* ¶ 17.13 (2019) (using the “dealer property” phrase).

³⁸ I.R.C. § 1221(a).

³⁹ See, e.g., *Biedenharn Realty Co. v. United States*, 526 F.2d 409 (5th Cir. 1976) (examining various factors including frequency and substantiality of sales, extent of improvements to the property, and solicitation and advertising efforts); *United States v. Winthrop*, 417 F.2d 905, 911 (5th Cir. 1969) (describing the facts-and-circumstances-based nature of the test).

⁴⁰ See, e.g., *Biedenharn Realty Co.*, 526 F.2d 409; *Winthrop*, 417 F.2d 905.

real estate produces ordinary income or capital gain is based on the facts and circumstances of each case, cases with similar fact patterns sometimes result in different outcomes across cases within a jurisdiction or across jurisdictions. As one court stated, “Finding ourselves engulfed in a fog of decisions with gossamer like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests, we take the route of ad hoc exploration...”⁴¹

When certain requirements are met, Internal Revenue Code Section 1237 effectively provides a safe harbor ensuring that at least some gain from sale of subdivided land will not be treated as gain from sale of dealer property.⁴² In order to qualify for this safe harbor, in addition to meeting a host of other requirements,⁴³ the taxpayer and certain other parties must not have made any substantial improvements to the land.⁴⁴ If a taxpayer does not qualify for the safe harbor because the taxpayer has made what would otherwise be considered substantial improvements to the land then, as long as the improvements fall into certain categories and as long as the taxpayer has held the land for at least 10 years, the taxpayer can make an election to treat the improvements as not substantial and still obtain the treatment afforded by the safe harbor.⁴⁵ If the taxpayer makes such an election, then the taxpayer cannot include the cost of the improvements in the basis of the land.⁴⁶

In order to illustrate the potential use of a protective Section 1237 election, consider the following example.

Example 1. Anne holds a parcel of land that Anne subdivided into five lots and improved by adding roads. Anne has held the land for at least 10 years. Setting aside the cost of adding the roads, Anne’s basis in the land would be \$110,000. The cost of adding the roads was \$20,000. Anne sells the lots for a total price of \$200,000.

In Example 1, Anne might file a return taking the position that, under the general facts and circumstances test, the parcels of land are not dealer property so that she realizes \$70,000 of capital gain, resulting from the difference between the \$200,000 selling price and a \$130,000 basis that includes the cost of adding the roads. In case this claim fails because the IRS asserts that the property is dealer property under the general facts and circumstances test, Anne might file a Section 1237 election on a protective basis. Anne would make a protective filing to preserve the ability to claim \$90,000 of capital gain under the safe harbor⁴⁷ rather than \$70,000 of

⁴¹ *Winthrop*, 417 F.2d 906.

⁴² I.R.C. § 1237. If more than five parcels from the tract of real property are sold by the taxpayer, then some portion of the gain will be treated as gain from sale of dealer property. I.R.C. § 1237(b)(1).

⁴³ For additional requirements, see I.R.C. § 1237(a).

⁴⁴ I.R.C. § 1237(a)(2).

⁴⁵ I.R.C. § 1237(b)(3). To be eligible to make this election, the improvements must consist of “the building or installation of water, sewer, or drainage facilities or roads” and the land must not have been “marketable at the prevailing local price for similar building sites without such improvement.” I.R.C. §§ 1237(b)(3)(A) & (B).

⁴⁶ I.R.C. § 1237(b)(3)(C).

⁴⁷ If the safe harbor applies, the gain is treated as capital rather than ordinary but the taxpayer’s

ordinary income.⁴⁸ Anne prefers the outcome that she originally reported (\$70,000 of capital gain) to either of the alternatives (\$90,000 of capital gain or \$70,000 of ordinary income). However, in the event that the IRS challenges her first choice, Anne might very well prefer recognizing \$90,000 of capital gain to recognizing \$70,000 of ordinary income, assuming a sufficient difference in the effective tax rate applicable to each type of income in her hands.⁴⁹ Thus, she may file this election on a protective basis to secure a more favorable second choice in case her first choice fails. This example follows the general pattern shown in Table 1 above, as illustrated in Table 2 below.

Table 2. Section 1237 Protective Tax Election

Taxpayer's intended tax outcome \$70,000 capital gain @ tax rate of 20%, results in \$14,000 in tax liability	Taxpayer's intended tax outcome is unavailable, and a protective tax election IS in place \$90,000 capital gain @tax rate of 20%, results in \$18,000 in tax liability
	Taxpayer's intended tax outcome is unavailable, and a protective tax election is NOT in place \$70,000 ordinary income @ tax rate of 37%, results in \$25,900 in tax liability

Regarding the validity of a protective Section 1237 tax election, the Treasury Regulations provide that “the rules of [S]ection 1237 are not applicable” if the real property would not have been dealer property under the general facts and circumstances test.⁵⁰ Arguably, this means that, if the property is not dealer property, a protectively filed Section 1237 election has no effect on the property's basis so that the cost of improvements can be included in basis. If, instead, it is dealer property under the facts and circumstances test, then the protectively filed Section 1237 election does take effect.

Moreover, in a letter ruling issued in 1986, the IRS concluded that a taxpayer could file a Section 1237 election protectively, to take effect only if the IRS determined that the sales of subdivided property did not qualify for capital gain

basis in the property does not include the cost of the roads.

⁴⁸ If the IRS successfully asserts that the land is dealer property and if the taxpayer has not made an effective Section 1237 election, the gain is ordinary income, but the basis of the property includes the cost of the roads.

⁴⁹ This is true in the case of the assumed tax rates shown in Table 2 below, for instance.

⁵⁰ Treas. Reg. § 1.1237-1(a)(4).

treatment under the general facts and circumstances test.⁵¹ The ruling stated, “Since the [question of whether property is dealer property] is generally a question of fact a taxpayer would naturally want to make a protective election under section 1237(b)(3)(C) where substantial improvements have been made. We believe that such election is proper.”⁵²

2. *Example of Favorable Fallback Protective Tax Election – Protective QEF Election*

Another example of a Favorable Fallback Protective Tax Election arises in the context of the passive foreign investment company (“PFIC”) rules and the qualified electing fund (“QEF”) election. A U.S. person who owns stock in a non-U.S. corporation that constitutes a PFIC is subject to certain tax rules generally aimed at limiting the U.S. person’s ability to benefit from deferral of U.S. tax by delaying receipt of distributions from the PFIC and sale of their interest in the PFIC.⁵³ A non-U.S. corporation will be a PFIC in a given year if at least 75% of its gross income for the year consists of certain types of passive income or at least 50% of its assets held that year produce passive income or are held for the production of passive income, subject to some exceptions.⁵⁴ If a non-U.S. corporation is a PFIC, one of several tax regimes will be imposed upon a U.S. person who owns stock in the PFIC.⁵⁵ One possible tax regime applies only if the U.S. person has made a QEF election.⁵⁶

Imagine a shareholder would prefer the QEF tax regime to the other alternatives in the event that the corporation is a PFIC but is uncertain, at the time the election must be filed, about whether the corporation is a PFIC because of uncertainty about how it will fair under the income test or asset test.⁵⁷ In that event, the shareholder might opt to file a QEF election on a protective basis to preserve the ability to apply the QEF regime if the corporation does, indeed, turn out to be a

⁵¹ PLR 8626004. Only the taxpayer to whom the ruling was issued may rely upon it as discussed in more detail in Part V.A.

⁵² *Id.* Some language in the Treasury Regulations could be viewed as in tension with this letter ruling’s conclusion. In particular, the Treasury Regulations provide that, once made, an election under Section 1237(b)(3)(C) is generally irrevocable and binding on the taxpayer. Treas. Reg. § 1.1237-1(c)(5)(iii)(c). This could be read to suggest that a taxpayer must report the resulting gain as if the basis excluded the cost of the roads once an election has been filed. However, in the letter ruling, the IRS reasoned that, in order to become irrevocable, the election must have initially been binding, and, if the property would not have been dealer property under the general facts and circumstances test, Section 1237 does not apply at all so that the election would not have been binding in the first place. *See* PLR 8626004 (“The Income Tax Regulations recognize the fact that the election under section 1237(b)(3)(C) is binding only if the property would otherwise be considered [dealer property].”)

⁵³ *See* I.R.C. §§ 1291-1298.

⁵⁴ I.R.C. § 1297.

⁵⁵ *See* I.R.C. §§ 1291, 1293, 1296.

⁵⁶ I.R.C. § 1295(a)(1).

⁵⁷ This uncertainty may be attributable to factual uncertainty (about the entity’s income or assets) or to legal uncertainty about how the PFIC classification rules may apply in certain circumstances.

PFIC.⁵⁸ The potential tax outcomes in this example correspond to the general pattern illustrated in Table 1 above, as shown in Table 3 below.

Table 3. Protective QEF Election

Taxpayer's intended tax outcome Non-U.S. Corporation is NOT a PFIC	Taxpayer's intended tax outcome is unavailable, and a protective tax election IS in place
Most Favorable Tax Outcome	Intermediate Tax Outcome Taxpayer's intended tax outcome is unavailable, and a protective tax election is NOT in place
	Least Favorable Tax Outcome

The Treasury Regulations explicitly authorize protective QEF elections but also provide guidelines regarding when and whether they will be effective.⁵⁹ In particular, generally a QEF election must be filed by the due date for the shareholder's tax return (including extensions) for the first year to which the election is intended to apply.⁶⁰ However, the Treasury Regulations allow for taxpayers to make a QEF election later than that time and have it apply retroactively to a previous year if (1) the shareholder had a reasonable belief that the corporation was not a PFIC as of the time of the election's due date and (2) the shareholder filed a "protective statement" as of the election's due date to preserve the ability to make a late, retroactive election.⁶¹ When filing a protective statement, the shareholder must also agree to extend the statute of limitations for all the tax years to which the protective election applies.⁶² The protective statement must also describe the shareholder's basis for its reasonable belief that the corporation is not a PFIC, and the shareholder must sign the statement under penalties of perjury.⁶³ If the shareholder has not complied with these requirements, generally the shareholder cannot make a QEF election on a retroactive basis, subject to some exceptions.⁶⁴

⁵⁸ See, e.g., Bittker, Emory & Streng, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS: FORMS ¶ 15.10[4][e] (describing the availability of protective QEF elections)

⁵⁹ See *infra* notes 61-64 and accompanying text.

⁶⁰ I.R.C. § 1295(b)(2); Treas. Reg. § 1.1295-1(e)(1).

⁶¹ Treas. Reg. § 1.1295-3(a). The regulations also provide guidance regarding what constitutes reasonable belief. Treas. Reg. § 1.1295-3(d). In the case of shareholders who own small interests in the corporation, different rules apply. Treas. Reg. § 1.1295-3(e).

⁶² Treas. Reg. § 1.1295-3(b)(2).

⁶³ Treas. Reg. § 1.1295-3(c).

⁶⁴ See Treas. Reg. § 1.1295-3(f) (setting forth a procedure under which a shareholder can seek IRS consent to make the election on a retroactive basis despite not having filed the protective statement and providing requirements that must be met to obtain that consent). Also, in the case of shareholders who own small interests in the corporation, different rules apply. See Treas. Reg. § 1.1295-3(e).

3. Example of Favorable Fallback Protective Tax Election – Protective TRS Election

Another example of a Favorable Fallback Protective Tax Election is a “protective TRS election.” An entity that qualifies as a real estate investment trust (a “REIT”) can receive favorable tax treatment. Unlike a regular C corporation, a REIT is entitled to a deduction for the dividends that it pays to its shareholders, so that, by making sufficient distributions, a REIT can effectively eliminate any entity-level tax.⁶⁵ To qualify as a REIT, an entity must meet many technical requirements.⁶⁶ One such requirement provides that not more than 10% of the value of the outstanding securities of any one issuer may be held by the REIT, subject to certain exceptions.⁶⁷ This 10% restriction does not apply to stock that qualifies as a real estate asset,⁶⁸ and shares in another REIT can qualify as a real estate asset.⁶⁹ The 10% restriction also does not apply to stock in a “taxable REIT subsidiary” (a “TRS”).⁷⁰ In order to be a TRS, an entity must be a corporation, it must not be a REIT, some of its stock must be owned by a REIT, and the REIT and the TRS must have jointly filed an election to treat the corporation as a TRS.⁷¹

If a REIT (“Parent REIT”) owns a large percentage of the stock of another REIT (“Subsidiary REIT”), the failure of the Subsidiary REIT to meet one of the REIT qualification requirements could cause the Parent REIT to fail to meet the 10% restriction.⁷² To guard against this possibility, it is common practice to file a protective TRS election with respect to the Subsidiary REIT.⁷³

If the Subsidiary REIT meets all REIT qualification requirements, the protective TRS election has no effect, and the Subsidiary REIT is entitled to the favorable tax treatments afforded to REITs. If the Subsidiary REIT fails a REIT qualification test, the protective TRS election takes effect. When the TRS election takes effect, the Subsidiary REIT becomes subject to entity level tax, but its classification as a TRS protects the Parent REIT from violating the 10% restriction and potentially failing to qualify as a REIT itself. The tax outcomes in this context follow the general pattern illustrated in Table 1 as shown by Table 4 below.

⁶⁵ I.R.C. § 857.

⁶⁶ I.R.C. §§ 856, 857.

⁶⁷ I.R.C. § 856(c)(4)(B)(iv)(III).

⁶⁸ I.R.C. § 856(c)(4)(B)(iv) (“except with respect to...securities includible under subparagraph (A) [which refers to “real estate assets, cash and cash items (including receivables), and Government securities]”).

⁶⁹ I.R.C. § 856(c)(5)(B).

⁷⁰ I.R.C. § 856(c)(4)(B)(iv) (“except with respect to a taxable REIT subsidiary...”). Stock in a TRS is subject to another restriction; namely, not more than 20 percent of the value of the REIT’s assets may be represented by securities of one or more TRSs. I.R.C. § 856(c)(4)(B)(ii).

⁷¹ I.R.C. § 856(l)(1).

⁷² If the Parent REIT owns more than 10% of the stock in the Subsidiary REIT, the Parent REIT would run afoul of the 10% restriction unless the Subsidiary REIT is a REIT or the Subsidiary REIT is a TRS.

⁷³ See, e.g., Bittker, Emory & Streng, *supra* note 58, at ¶ 1.03[10][b] (discussing the use of protective TRS elections).

Table 4. Protective TRS Election

Taxpayer's intended tax outcome Parent and Subsidiary are both REITs Most Favorable Tax Outcome	Taxpayer's intended tax outcome is unavailable, and a protective tax election IS in place Subsidiary is a TRS, but Parent is a REIT
	Intermediate Tax Outcome Taxpayer's intended tax outcome is unavailable, and a protective tax election is NOT in place Neither is a REIT Least Favorable Tax Outcome

The practice of filing a protective TRS election is not explicitly authorized. However, taxpayers apparently operate under the assumption that the practice of filing protectively is effective because an entity that is a REIT cannot be treated as a TRS.⁷⁴ Thus, as long as the Subsidiary REIT meets the requirements to qualify as a REIT, the TRS election would have no effect. It would only kick in if the Subsidiary REIT failed to qualify as a REIT, and, in that event, the election would cause the Subsidiary REIT to be a TRS and protect the Parent REIT from running afoul of the 10% restriction.

D. Example of Favorable Fallback Tax Election That Is (In A Sense) Not Allowed – Section 6015(c) Election

After filing a joint return, imagine a couple divorces or legally separates. Subject to some exceptions, a member of the couple might file an election under Internal Revenue Code Section 6015(c).⁷⁵ By making such an election, an individual will be liable only for the part of any deficiency assessed by the IRS with respect to the joint return that is “properly allocable” to that individual.⁷⁶

⁷⁴ I.R.C. § 856(l)(1). *See, e.g., BNA Tax Management Portfolio 742-4th: Real Estate Investment Trusts, Detailed Analysis, F. Taxable REIT Subsidiaries* (“Note that a new protective election must be filed each year: a valid TRS election requires that the REIT making it is a REIT, and the TRS making it is a TRS; and if the subsidiary REIT qualifies as a REIT throughout a year, the election for that year will be invalid. There is no authority that specifically allows for a protective TRS election; however, if the parent REIT is a REIT for a taxable year and a subsidiary REIT turns out not to be a REIT for that year, the situation will meet the requirements for a TRS election.”)

⁷⁵ Such an election will not be valid, for instance, if assets were transferred between the individuals who filed the joint return as part of a fraudulent scheme. I.R.C. § 6015(c)(3)(A)(ii). Also, if the individual had actual knowledge of the deficiency, or any portion of the deficiency, at the time they signed the joint return, other rules apply. I.R.C. § 6015(c)(3)(C).

⁷⁶ I.R.C. §§ 6015(c)(1)-(3). For rules governing what portion of a deficiency is properly allocable to an individual, see I.R.C. § 6015(d).

When Section 6015 was initially enacted, nothing in the statute precluded taxpayers from filing such an election as soon as they were divorced. As a result, many taxpayers filed protective elections when their divorce cases were finalized to opt for the treatment provided by Section 6015(c) in the event that the IRS assessed a deficiency with respect to a previously filed joint return. As other scholars have noted, the IRS was “deluged” with such protective elections⁷⁷ and asked Congress for assistance to limit its administrative burden.⁷⁸ In response, in 2000, Congress amended the statute to provide that a Section 6015(c) election cannot be filed with respect to a return until after the IRS asserts a deficiency affecting the return.⁷⁹

The previous practice of filing elections at the time of divorce could be framed as an example of a Favorable Fallback Protective Tax Election. The election does not affect tax consequences unless the IRS assesses a deficiency. If the IRS does assess a deficiency, the election affects the taxpayer’s liability.

Finally, while the statutory change made in 2000 ends the practice of filing the election on a protective basis, the election can be filed any time between when the IRS assesses a deficiency and two years after the IRS has begun collection activities affecting the individual making the election.⁸⁰ Given that the time of divorce or legal separation is not the deadline for filing the election, losing the ability to make the election on a protective basis is not as consequential as it would be if the election did have such a deadline.⁸¹

As a useful point of contrast, recall the example shown in Table 2 in Part I.C.1 involving Section 1237. When tax law permits Anne in that hypothetical to file a protective election, she can initially report \$14,000 in tax liability and preserve an opportunity to owe \$18,000 in tax liability (rather than \$25,900) if the IRS later challenges her treatment of the property as investment property.

If she were prohibited from filing the election on a protective basis but required to make the election prior to the IRS auditing and potentially challenging her treatment of the property as investment property, then she would be forced to either: (1) not make the election, report \$14,000 in tax liability, and risk the IRS later asserting that the proper amount of tax liability is \$25,900, or (2) make the election on a non-protective basis and report \$18,000 in tax liability.

By contrast, if she was prohibited from filing the election on a protective

⁷⁷ See Stephanie Hunter McMahon, *An Empirical Study of Innocent Spouse Relief: Do Courts Implement Congress’s Legislative Intent?* 12 FLA. TAX REV. 629, 687 (2012).

⁷⁸ Robert S. Steinberg, *Three at Bats Against Joint and Several Liability: (1) Innocent Spouse, (2) The Election to Limit Liability and (3) Equitable Relief: The Treasury and Courts Begin to Interpret IRC 6015 After Enactment of the IRS Restructuring and Reform Act of 1998*, 17 J. AM. ACAD. MATRIM. LAW. 403, 407 (2001) (“The IRS had been deluged with an overwhelming number of prophylactic elections. ... Administratively, the IRS was ill prepared for the onslaught of attempted elections and asked Congress for assistance.”)

⁷⁹ I.R.C. § 6015(c)(3)(B).

⁸⁰ *Id.*

⁸¹ The later timing of the election can, nevertheless, have some consequences. When it could be filed at the time of divorce, commentators noted that divorce lawyers viewed the ability to file as a potential “bargaining chip” in divorce proceedings. See Ryan Donmoyor, *ABA Tax Section Meeting: Divorce Lawyers, Tax Lawyers Split on Election of Proportionate Liability*, 98 TAX NOTES TODAY 149-2 (August 4, 1998).

basis but allowed an opportunity to make the election after-the-fact if and when the IRS challenged her treatment of the property as investment property, then she could still, effectively, obtain the benefit of making a protective election—namely, she could report \$14,000 in tax liability, but, if the IRS challenged that outcome, make the election retroactively so as to owe \$18,000 in tax liability rather than \$25,900. In other words, the ability to wait and see and file an election late after the development of full information can serve the same function for a taxpayer as the ability to file earlier on a protective basis. Thus, because an election under Section 6015(c) can (and indeed must) be made late, after the taxpayer has full information, eliminating the ability to file on a protective basis takes away very little from taxpayers, at least from a tax perspective.⁸²

II. TRAPPING UNWARY TAXPAYERS

Favorable Fallback Protective Tax Elections give rise to numerous policy implications. One of their significant policy disadvantages is their potential to trap unwary taxpayers. Benefiting from a Favorable Fallback Protective Tax Election requires that the taxpayer declare, to the IRS, an intention to obtain a more favorable second choice tax outcome if the taxpayer's expected tax outcome fails. Requiring taxpayers to elect into obtaining a more favorable fallback position places a premium on access to information about tax law. This is true of tax elections generally.⁸³ As existing literature notes, when taxpayers can simply file an election to obtain more favorable tax treatment, well-advised taxpayers will have no reason to not file beneficial tax elections, while only taxpayers who are unaware of the existence of the election or the advantages of filing will miss out on similarly beneficial treatment.⁸⁴ Of course, the ability of parties with access to sophisticated advice to fare better than less well-advised parties is not unique to tax law. This lack of uniqueness does not make the phenomenon's existence in tax law any less concerning. Moreover, given that the tax system is often pointed to as the area of law best situated to respond to distributional concerns, traps for the unwary are arguably of particular concern in tax law.⁸⁵

The tendency to trap unwary taxpayers that is true of tax elections generally may be even more true of Favorable Fallback Protective Tax Elections. Such an election does not entail making a selection that relates to a tax position the taxpayer plans to claim but rather involves making a choice that only becomes relevant if the tax position the taxpayer plans to claim turns out to be unavailable. As a result, the potential benefits of such an election may be particularly likely to escape the notice of taxpayers without access to sophisticated tax advice.

To be clear, if the underlying election still existed but lawmakers disallowed protective filing, taxpayers lacking access to sophisticated advice might be even more severely disadvantaged. However, an alternative that avoids trapping unwary

⁸² It may be significant for non-tax reasons as discussed above in note 81.

⁸³ See *supra* note 10 and accompanying text.

⁸⁴ See *supra* note 10 and accompanying text.

⁸⁵ See, also, Emily Cauble, *Accessible Reliable Tax Advice*, 51 U. MICH. J. L. REF. 589, 592-93 (2018).

taxpayers is to bestow on all taxpayers—even those who neglect to file an election—the results that would have followed from making a Favorable Fallback Protective Tax Election.

In order to demonstrate, consider again the example in Table 2 above involving the Section 1237 election. Imagine the Section 1237 election was still available but taxpayers could not file it on a protective basis. Under that set of circumstances, at the time Anne filed her return, two options would be available to her: (1) she could file the election on a non-protective basis and report tax liability of \$18,000 or (2) she could take the position that the land was investment property under the facts and circumstances test and report tax liability of \$14,000 but risk being subject to tax liability of \$25,900 if her claim were successfully challenged. Taxpayers lacking access to sophisticated advice will be less able than taxpayers with access to such advice to accurately evaluate the risk of successful challenge. As a result, when forced to make this choice, taxpayers without access to sophisticated advice may be unlikely to make the most advantageous selection. If taxpayers can file the election protectively, then Anne can report \$14,000 in tax liability and ensure that her resulting tax liability will be only \$18,000 if her claim is successfully challenged.⁸⁶ If some taxpayers have access to sufficiently sophisticated advice to become aware of the availability of the election but not sufficiently sophisticated advice to accurately gauge the risk of successful challenge, then, for some taxpayers, eliminating the ability to file protectively might exacerbate the disadvantages stemming from a lack of access to more sophisticated advice.

However, an alternative to continuing to allow protective filing that would more effectively mitigate the harms following from a lack of access to sophisticated advice is to simply bestow on all taxpayers—even those who neglect to file an election—the results that would have followed from making a Favorable Fallback Protective Tax Election. In the context of the Section 1237 election example, for instance, Anne could report \$14,000 in tax liability and be subject to \$18,000 in tax liability if her claim was successfully challenged even if she did not file a protective tax election. I will refer to this alternative as the “Deemed Protective Tax Election Approach.” As discussed in Part VI.B below, in some contexts, such an approach may not be feasible. However, when it is feasible, it ought to be used in areas of tax law that affect a wide range of taxpayers, including those without access to sophisticated advice.

III. ENCOURAGING TAXPAYERS TO TAKE MORE AGGRESSIVE REPORTING POSITIONS

While taxpayers without access to sufficiently sophisticated advice may miss out on the benefits of filing Favorable Fallback Protective Tax Elections, taxpayers with access to such advice may be spurred on by such elections to take more aggressive reporting positions than they would without the ability to file on a protective basis. By filing a Favorable Fallback Protective Tax Election, a taxpayer ensures that, if their intended tax treatment is not available, the alternative tax

⁸⁶ This assumes she is not subject to penalties.

treatment imposed upon the taxpayer will be more favorable than it would be in the absence of the election. If the prospect of the alternative tax treatment is less daunting, the taxpayer may be more willing to take a risk by claiming a tax position that is associated with a higher likelihood of successful challenge.

A. The Concern – In Brief

To demonstrate how the availability of Favorable Fallback Protective Tax Elections could spur taxpayers on to taking more aggressive reporting positions, it is useful to have a concrete example in mind.

Example 2. Consider again the facts of Example 1 and the outcomes displayed in Table 2. In that example, if Anne sells land and reports the gain as if the property were investment property, she incurs \$14,000 in tax liability. If the IRS successfully asserts that the land is dealer property, she will be subject to tax liability of \$18,000 as a result of having filed a protective tax election (rather than tax liability of \$25,900 that would result from successful IRS challenge in the absence of an election).

Without the ability to file the election protectively, Anne would be forced to choose between: (1) reporting \$14,000 in tax liability but risking \$25,900 in the event of successful IRS challenge or (2) reporting \$18,000 in tax liability. As a result of the ability to file the election protectively, she can instead report \$14,000 in tax liability and only risk \$18,000 in the event of IRS challenge.

Without the ability to file protectively, if Anne opts to take the position that the land is investment property, reports \$14,000 in tax liability and is successfully challenged, in addition to any explicit penalties to which she may be subject, she is subject to an implicit penalty of having missed an opportunity to file the election on a non-protective basis and secure the intermediate outcome of reporting \$18,000 in tax liability. The prospect of this implicit penalty may induce some taxpayers to opt for the safer course. In particular, some taxpayers may preemptively take the position that the land is not investment property under the facts and circumstances test and file a Section 1237 election on a non-protective basis, leading to tax liability of \$18,000.

With the ability to file the election protectively, Anne can report \$14,000 in tax liability without sacrificing the opportunity to be subject to \$18,000 rather than \$25,900 if her initial characterization of the land as investment property fails. In other words, the ability to file protectively effectively eliminates the implicit penalty described above. The elimination of this implicit penalty could encourage taxpayers in Anne's position to report \$14,000 rather than play it safe and report \$18,000.

B. Point of Contrast – Late filed elections

As an alternative to filing a Favorable Fallback Protective Tax Election, a taxpayer might claim a given tax position and attempt to file a tax election that secures a more favorable alternative tax outcome later, only if the IRS challenges

the taxpayer's claimed tax position. For instance, returning to Example 2 above, Anne might report \$14,000 in tax liability and wait and see if the IRS challenges her position that the land is investment property. If the IRS does raise such a challenge, Anne might, at that time, attempt to file a Section 1237 election so that successful IRS challenge would result in tax liability of \$18,000 rather than \$25,900. Moreover, the advantage (from the Anne's point of view) or the disadvantage (from the IRS's point of view) of a wait-and-see approach is that it avoids attracting the IRS's attention unnecessarily by filing the election ahead of time on a protective basis. The ability to use a wait-and-see approach, however, is constrained by the deadlines for filing elections and by limitations on the ability to file elections after their deadlines.

The deadline for filing an election varies from election to election.⁸⁷ For many (but not all) elections, the election must be filed by the due date for the relevant tax return (sometimes including available extensions).⁸⁸ For example, the Treasury Regulations provide that the Section 1237 election must be submitted with the taxpayer's tax return for the year in which the taxpayer sells the real estate.⁸⁹ At that time, the taxpayer will not know whether the IRS will challenge the results that the taxpayer intends to claim.

As a result, the deadline for many elections precludes taxpayers from taking a wait-and-see approach.⁹⁰ A taxpayer might attempt to overcome this obstacle by filing an election after its deadline. However, limitations on filing late elections likely hinder such efforts.

When setting forth guidelines for filing late elections, the Treasury Regulations divide tax elections into two groups—regulatory elections (those with due dates prescribed by a regulation, a revenue ruling, a revenue procedure, an IRS notice, or an IRS announcement) and statutory elections (those with due dates

⁸⁷ See, also, Helvey & Stetson, *supra* note 10, at 338 (describing common deadlines for filing tax elections).

⁸⁸ Other elections have earlier or later deadlines. Entity classification elections have an earlier deadline because the effective date for such an election cannot be earlier than 75 days before it is filed. Treas. Reg. § 301.7701-3(c)(1)(iii). The Section 121(f) election is an example of an election with a later deadline. I.R.C. Section 121 allows a taxpayer to exclude from gross income up to a certain amount of gain from the sale of a principal residence, provided that various requirements are met. I.R.C. § 121. Generally, the exclusion can only apply to one sale within any given two-year period. I.R.C. § 121(b)(3). If two sales occur within a two-year period that would each qualify but for this restriction, a taxpayer can elect to not exclude the gain from one sale in order to allow for the use of the exclusion for the other sale. I.R.C. § 121(f). Because of the timing of this election, a taxpayer does not have to predict, at the time of the first sale, that a second sale will occur. The taxpayer could refrain from making the election at the time of the first sale and exclude the gain. Later within the two-year period, if there is a second sale for which the taxpayer would prefer to use the exclusion, the taxpayer is allowed to amend the earlier return to elect to include the gain for the first sale so that the taxpayer can, then, use the exclusion for the second sale. See Treas. Reg. § 1.121-4(g). Thus, using hindsight is permissible in the context of Section 121(f). Perhaps lawmakers opted to be generous in this context because of the possibility that taxpayers without access to sophisticated advice may be affected by the election.

⁸⁹ Treas. Reg. § 1.1237-1(c)(5)(iii)(b)(1).

⁹⁰ In the context of elections with later deadlines, taxpayers may be able to use a wait and see approach. For example, this is the case with the Section 121(f) example discussed above in note 88.

prescribed by statute).⁹¹ Generally, for regulatory elections and statutory elections that are due by the due date for a taxpayer's return (or the due date for the taxpayer's return with extensions), the Treasury Regulations allow taxpayers to obtain an automatic extension of time to file the election.⁹² The automatic extension of time is, in some cases, for 6 months from the election's due date and, in other cases, for 12 months from its due date.⁹³ There is no guarantee that this amount of additional time would allow a taxpayer to employ a wait-and-see approach.

For regulatory elections that are not covered by the automatic extension of time rules, a taxpayer can request a ruling from the IRS to obtain relief to file a late election.⁹⁴ However, the requirements for obtaining relief would exclude taxpayers who made a calculated decision to file late only if filing proved to be advantageous in light of later acquired information that the IRS challenged the taxpayer's reporting. In particular, to obtain relief, the taxpayer must establish that he or she acted "reasonably and in good faith" in addition to complying with other requirements.⁹⁵ The regulations specify that a taxpayer has not acted reasonably and in good faith if the taxpayer has filed a tax return that has been or could be subject to an accuracy-related penalty and the taxpayer wants to alter what they have claimed on the return and wants to file an election late in connection with the new outcome they intend to claim.⁹⁶ This would preclude taxpayers from using a wait and see approach to file a late election if the IRS challenged the results claimed by the taxpayer, at least in cases in which IRS challenge could lead to the imposition of an accuracy related penalty.⁹⁷

In addition, the regulations disallow relief for late filing if the taxpayer "was informed in all material respects of the required election and related tax consequences, but chose not to file the election."⁹⁸ Thus, a calculated decision to use a wait and see approach appears to be incompatible with obtaining relief to file a late election.

Consequently, for many elections, taxpayers cannot replicate the effects of a Favorable Fallback Protective Tax Election by delaying and making the election late. That is not invariably true. As discussed above in Part I.D, for instance, because a taxpayer makes a Section 6015(c) election after the IRS assesses a deficiency, taxpayers can (and indeed must) wait and see if a deficiency is assessed.⁹⁹ However, in the case of many elections, late filing cannot be used to

⁹¹ Treas. Reg. § 301.9100-1(b). For some tax elections, other guidelines specific to that particular election govern restrictions on late filing or preclude the possibility of obtaining relief for late filing. *See* Treas. Reg. § 301.9100-1(d)(2) ("an extension of time will not be granted...for elections that are expressly excepted from relief or where alternative relief is provided by a statute, a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin").

⁹² Treas. Reg. § 301.9100-1(b).

⁹³ Treas. Reg. § 301.9100-2.

⁹⁴ Treas. Reg. § 301.9100-3.

⁹⁵ Treas. Reg. § 301.9100-3(a).

⁹⁶ Treas. Reg. § 301.9100-3(b)(3)(i).

⁹⁷ I.R.C. § 6662 describes when accuracy related penalties will be imposed.

⁹⁸ Treas. Reg. § 301.9100-3(b)(3)(ii).

⁹⁹ Also, other elections have late filing deadlines. *See supra* note 88.

achieve the effects of a Favorable Fallback Protective Tax Election.¹⁰⁰

It is worth noting that deadlines for filing tax elections and limitations on the ability to file late elections to benefit from hindsight represent just one example of a myriad of ways in which tax law is hostile to a taxpayer's attempts to benefit from hindsight. Various judicial doctrines offer additional examples of limitations on a taxpayer's ability to leverage hindsight. As one example, imagine a taxpayer engages in a transaction using one form and attempts to claim the tax outcome that would have followed from using a different transactional form, which, in retrospect, would have produced more favorable tax consequences. In such an instance, a judicial doctrine—sometimes referred to as the “Actual Transaction Doctrine”—typically acts as a roadblock.¹⁰¹ In a similar vein, another judicial doctrine sometimes referred to as the “Non-Disavowal Doctrine” makes it difficult for a taxpayer to argue that the taxpayer's transaction should be taxed based upon its substance rather than its form.¹⁰² One explanation for this doctrine is that it is another defense against taxpayers' attempts to benefit from hindsight by reporting the outcome of a transaction based on either its form or its substance, whichever proves to be most beneficial in light of later developed information.¹⁰³

Given tax law's general hostility to taxpayers' attempts to benefit from

¹⁰⁰ Relatedly, a taxpayer might attempt to benefit from hindsight by making a given tax election by its deadline but then revoking the tax election after the fact if later developed information makes it so that the election, in retrospect, produces undesirable tax consequences. Here, limitations on the ability to revoke elections to benefit from hindsight thwart taxpayers' attempts to employ this strategy. *See, e.g.*, Helvey & Stetson, *supra* note 10 at 339 (noting that many elections cannot be revoked or can only be revoked with consent); Yorio, *supra* note 10, at 480 (“The courts have generally been antagonistic to taxpayer revocations in response to tax audits.”) Sometimes taxpayers are allowed to retroactively revise their elections but only in one direction. *See* Oren-Kolbinger *supra* note 10, at 2 (describing how married taxpayers who opt to file separately can retroactively amend their returns to opt to file jointly but not vice versa).

¹⁰¹ For additional discussion of the Actual Transaction Doctrine, *see, e.g.*, Michael E. Baillif, *The Return Consistency Rule: A Proposal for Resolving the Substance-Form Debate*, 48 TAX LAW. 289, 310-11 (1995); Emanuel S. Burstein, *The Impact of Form, and Disavowing Form, on Characterization of Sales Transactions*, 66 TAXES 220, 224 (1988); Emily Cauble, *Rethinking the Timing of Tax Decisions: Does a Taxpayer Ever Deserve a Second Chance?*, 61 CATH. U. L. REV. 1013, 1018-35 (2012); Kenneth L. Harris, *Should There Be a “Form Consistency” Requirement? Danielson Revisited*, 78 TAXES 88, 106-08 (2000); Robert Thornton Smith, *Substance and Form: A Taxpayer's Right to Assert the Priority of Substance*, 44 TAX LAW. 137, 141-43 (1990).

¹⁰² For additional discussion of the Non-Disavowal Doctrine, *see, e.g.*, Baillif, *supra* note 102, at 289; Michael Baillif, *When (and Where) Does the Danielson Rule Limit Taxpayers Arguing “Substance over Form”?*, 82 J. TAX'N 362 (1995); William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form*, 70 OR. L. REV. 381 (1991); Burstein, *supra* note 101; Emily Cauble, *Reforming the Non-Disavowal Doctrine*, 35 Va. Tax Rev. 439 (2016); J. Bruce Donaldson, *When Substance-Over-Form Argument is Available to the Taxpayer*, 48 MARQ. L. REV. 41 (1964-1965); Harris, *supra* note 101; Christian A. Johnson, *The Danielson Rule: An Anodyne for the Pain of Reasoning*, 89 COLUM. L. REV. 1320 (1989); Smith, *supra* note 101.

¹⁰³ *See, e.g.*, Baillif, *supra* note 101, at 298 (“[S]ome courts ... worry that a taxpayer may decide alternatively to support or impeach a form based upon her post-transactional determination of the resultant tax liability”); Harris, *supra* note 101, at 95 (“[W]here the courts believe that the taxpayer is asserting substance as a means of post-transactional tax planning, the courts are less willing to permit the taxpayer to assert that the substance of the transaction controls.”); Smith, *supra* note 101, at 144 (listing a concern about post-transactional tax planning as one rationale for the Non-Disavowal Doctrine).

hindsight and given the specific restrictions on the ability to use hindsight in the context of tax elections, the fact that tax law allows taxpayers to make Favorable Fallback Protective Tax Elections is curious because making such an election, in a sense, allows the taxpayer to benefit from the same information taxpayers would have if they could use hindsight.¹⁰⁴ For instance, consider a taxpayer who claims that subdivided land is investment property but files an election under Section 1237 on a protective basis to secure a more favorable alternative tax outcome in the event that the IRS challenges the treatment of the land and asserts that the land is, in fact, dealer property.¹⁰⁵ If that taxpayer were precluded from filing the election on a protective basis, the taxpayer would be forced to choose between (1) taking the position that the land is investment property under the facts and circumstances test and not filing a Section 1237 election or (2) taking the more conservative position that the land is dealer property under the facts and circumstances test and filing a Section 1237 election. At the time the taxpayer made the choice, the taxpayer would not know whether the IRS would challenge the taxpayer's position that the land was investment property under the general facts and circumstances test. The ability to file on a protective basis, in effect, allows the taxpayer to harness the advantages of hindsight. The taxpayer can take the position that the property is investment property but, nevertheless, if the IRS does challenge that position, the taxpayer secures the outcome that the taxpayer would have selected had the taxpayer known

¹⁰⁴ This is true at least to a degree—although Favorable Fallback Protective Tax Elections do not allow taxpayers to benefit from hindsight to the same degree as what would occur if taxpayers could wait until all information was available before deciding whether or not to make the election at all. Allowing taxpayers to make elections after all information was available would be even more advantageous for taxpayers because some tax elections are forward-looking. They affect not just the tax consequences of events that have already transpired at the time the election is filed but also the tax consequences of future events. As an example, consider a tax election that is available under Internal Revenue Code Section 362(e)(2)(C). This election is relevant in the case of certain contributions of property by a shareholder to a corporation. It affects future tax consequences only if all the property being contributed by a shareholder to a corporation has a total basis that is more than its total value at the time of the contribution. I.R.C. § 362(e)(2). In other words, the election is only relevant when the property contributed by a shareholder has an aggregate “built-in loss.” The Treasury Regulations specifically authorize filing the election on a protective basis. A taxpayer might make such a filing protectively if, at the time the election is due, the taxpayer believes the election may be unnecessary because the taxpayer takes the view that the property he or she is contributing to a corporation does not have an aggregate built-in loss. However, in the event that the property does have an aggregate built-in loss, the taxpayer predicts that more favorable results follow if the election is in place than if it is not in place. The protective tax election safeguards the taxpayer against the possibility of discovering that, contrary to the taxpayer's estimation, the property has an aggregate built-in loss at the time of the contribution. However, if the property, surprisingly, has an aggregate built-in loss at the time of the contribution, and, also, contrary to the taxpayer's prediction, future events make it so that refraining from making the election would have led to more favorable results, the taxpayer is stuck with the less favorable results that follow from having made the election. If the taxpayer had unrestricted access to hindsight, the taxpayer could reduce his or her tax liability even further by revoking the election (or waiting to file the election later) at a time when the taxpayer had all information needed to evaluate the election's advantages and disadvantages. Thus, in cases involving forward-looking tax elections, allowing a Favorable Fallback Protective Tax Election is not the same as providing taxpayers with unfettered access to the benefits of hindsight.

¹⁰⁵ For further discussion of this example, *see supra* Part I.C.1.

that the IRS would challenge the characterization of the land as investment property.

The fact that a taxpayer must, by filing the election, declare an intention to claim a more favorable fallback position in advance of any IRS challenge likely explains tax law's openness to the use of such elections notwithstanding its hostility to taxpayers' attempts to file an election only if and when the IRS challenges the taxpayer's claimed tax position. Filing protective tax elections may be allowed based on the theory that taxpayers who file them are willing to attract IRS scrutiny and, therefore, are not likely taking very aggressive reporting positions. While taxpayers taking very aggressive positions might be deterred from filing protective tax elections in advance of IRS challenge, they would have no similar qualms about filing an election after IRS challenge. Thus, the law generally disallows the filing of elections after IRS challenge but allows advance, protective filings.

As the next part will discuss, however, the plausibility of the theory that taxpayers taking aggressive positions will be deterred from making protective filings could vary from election to election. Some protective tax elections are accompanied by features—like an extended statute of limitations and a requirement to submit a statement justifying the taxpayer's reporting position—that may make filing particularly costly for taxpayers taking aggressive reporting positions. In the context of elections with such features, the theory is more plausible than in the context of protective tax elections unaccompanied by such features. The next part will turn to a more detailed discussion of these observations.

C. Why Favorable Fallback Protective Tax Elections May Be Less Objectionable Than Elections Filed Late in Response to IRS Challenge

A taxpayer must file a Favorable Fallback Protective Tax Election ahead of time—prior to any potential IRS challenge—alerting the IRS to the taxpayer's intention to claim a favorable fallback position in the event of successful challenge. There are at least two reasons why Favorable Fallback Protective Tax Elections filed ahead of time may be less objectionable than elections filed in response to IRS challenge. First, if elections could be filed in response to IRS challenge, taxpayers could change the stakes of the game after the IRS invested resources in auditing a transaction.¹⁰⁶ The IRS might audit a taxpayer and challenge a position taken by the taxpayer, expecting that successful challenge would lead to recovering a given amount. However, if the taxpayer could later claim the tax outcome that follows from having a favorable tax election in place, the more limited recovery obtained by the IRS may be insufficient to justify the IRS's investment of resources in auditing and challenging the outcome reported by the taxpayer.¹⁰⁷ By contrast, a

¹⁰⁶ For articulation of a similar rationale in the context of the Actual Transaction Doctrine, see Burstein, *supra* note 101, at 224, quoting *Television Industries Inc. v. Comm'r* (“It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax shall be that resulting from the form of transaction taxpayers have chosen or from any other form they might have chosen, whichever is less”)

¹⁰⁷ See, also, Sheldon L. Banoff, *Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud*, 62 TAXES 942, 944 (“Approving retroactive unwindings that are tax motivated permits one to play the audit lottery: if you are audited, only then do you unwind to avoid adverse

Favorable Fallback Protective Tax Elections filed prior to audit puts the IRS on notice of what the outcome will be in the event of successful IRS challenge. Filing such an election does not entail a taxpayer switching to a different position only after the IRS has invested resources challenging the taxpayer's original position.

The second reason why Favorable Fallback Protective Tax Elections filed prior to IRS challenge may be more palatable than elections filed after the fact is that taxpayers taking very aggressive positions may be deterred from filing in advance of audit but would have no qualms about filing after the fact. To explore this possibility, consider, again, a taxpayer who sells land for a gain. Doubtless, some taxpayers who report the resulting gain as capital gain are taking very aggressive positions that likely would not withstand IRS challenge if scrutinized. Other taxpayers who report the resulting gain as capital gain are taking defensible positions—there may be some risk that their claims would be successfully challenged (particularly given the facts-and-circumstances-based nature of the test that determines whether real estate is investment property or dealer property),¹⁰⁸ but the taxpayers' positions are reasonable.

To obtain the outcome that follows from a protective tax election, a taxpayer must file the protective tax election with his or her tax return for the year in which the property is sold. If taxpayers who file the election protectively are more likely to have defensible positions, then taxpayers who secure a more favorable fallback tax outcome will tend to be those making reasonable claims.¹⁰⁹ If that is the case, then allowing filing of protective tax elections may be less problematic than allowing filing in response to audit.¹¹⁰ The next part will discuss, in more detail, whether or not taxpayers who file Favorable Fallback Protective Tax Elections are more likely to be taxpayers taking defensible positions.

tax results.”); David Hasen, *Unwinding Unwinding*, 57 EMORY L.J. 871, 935 (2008) (describing a taxpayer who attempts to unwind a transaction in response to a challenge by the IRS and stating, “Permitting taxpayers to unwind in this circumstance would allow them to contest the initial denial of favorable treatment by the government and, if unsuccessful, to obtain a second-best result through the unwind. In effect, the availability of unwind treatment makes the tax liability on an alternative, less aggressive transaction the exercise price of a put option on taking a more aggressive position.”).

¹⁰⁸ For discussion of this test, see Part I.C.1 above.

¹⁰⁹ To be clear, this would mean that, within the pool of taxpayers who would benefit from the protective tax election, taxpayers who have defensible claims may be more likely to file. In the case of some elections, some taxpayers may receive more favorable tax treatment without an election in place. Those taxpayers would refrain from making an election regardless of the strength of their initial reporting positions. For further discussion, see *infra* Part IV.

¹¹⁰ Indeed, if taxpayers are unable to file the Section 1237 election protectively, some taxpayers in Anne's position will err on the side of caution, make the election and report the results that follow from the election to lock in \$18,000 in tax liability rather than report \$14,000 and risk being subject to \$25,900. Other taxpayers will react to the uncertainty by taking their chances and reporting \$14,000. There may be nothing different about the taxpayers' transactions—they might each have an equally strong claim that the land is investment property. However, their different responses to uncertainty will prompt some to report greater tax liability than others. For further discussion of how different taxpayers respond differently to uncertainty, see, e.g., Sheldon I. Banoff, *The Use and Misuse of Anti-Abuse Rules*, 48 TAX LAW. 827, 837 (1995); Mark P. Gergen, *Reforming Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173, 196-97 (1991); Logue, *supra* note 22, at 374-75. See also Osofsky, *supra* note 22, at 503-04.

D. Will Taxpayers Who File Be More Likely to Be Taxpayers Taking Defensible Positions?

To consider whether, all else equal, taxpayers with defensible claims to the tax outcome they intend to report would be more likely to file protective tax elections than taxpayers with weaker claims, it is useful to view protective tax elections through the lens of the tax literature dealing with screening mechanisms. In various contexts, scholars have discussed whether certain steps that taxpayers must take to obtain more favorable tax outcomes can screen between taxpayers based on their level of tax motivation, their state of mind, or their propensity to comply with tax law. For instance, Professor Osofsky has analyzed whether various hurdles that taxpayers must clear in order to obtain more favorable tax outcomes tend to filter taxpayers so that taxpayers whose transactions are less significantly tax-motivated are more likely to obtain the favorable tax outcomes.¹¹¹ As Professor Osofsky observes, this could be the case if the hurdles act not only as frictions against tax planning but also as screening mechanisms because they impose less significant costs on taxpayers whose transactions are less significantly tax-motivated.¹¹² Relatedly, Professor Hayashi has examined the various facts and circumstances tests that courts apply to determine a taxpayer's intent or motive.¹¹³ Professor Hayashi argues that the best facts for a court to consider in such an analysis are facts that act as screening mechanisms—facts that would be costlier for taxpayers to create when they are attempting to disguise their state of mind than when they genuinely possess the state of mind that the fact is used to establish.¹¹⁴ As discussed in more detail below, Professor Field and Professor Satterthwaite have also discussed how the availability of certain tax elections can induce taxpayers to separate themselves into filers and non-filers in a manner that can reveal information to the IRS.¹¹⁵ Finally, Professor Raskolnikov has suggested the possibility of establishing two different tax enforcement regimes, allowing taxpayers to elect between the two regimes, and designing the features of the regimes in such a way that taxpayers who aim to game the tax system tend to opt for one regime (the “deterrence regime”) while other taxpayers tend to opt for the other regime (the “compliance regime”).¹¹⁶ While the compliance regime would carry with it lower penalties than the deterrence regime, it would be characterized by features that would be much more costly for taxpayers who seek to game the system than for other taxpayers.¹¹⁷ For instance, the compliance regime might carry with it the presumption in litigation that the IRS's position is correct unless proven otherwise by clear and convincing evidence, and taxpayers in the compliance

¹¹¹ See Leigh Osofsky, *Who's Naughty and Who's Nice? Frictions, Screening, and Tax Law Design*, 61 BUFF. L. REV. 1057 (2013).

¹¹² *Id.* At 1087 (“Frictions serve as screening mechanisms by imposing differential (and higher) costs on ...tax planners... than ...non-planners.”)

¹¹³ See Andrew Hayashi, *A Theory of Facts and Circumstances*, 69 ALA. L. REV. 289 (2017).

¹¹⁴ *Id.* at 300.

¹¹⁵ See *infra* Part IV.

¹¹⁶ See Raskolnikov, *supra* note 10, at 691-92.

¹¹⁷ *Id.*

regime might be obligated to disclose additional information to the IRS that would otherwise be protected by tax preparer privilege.¹¹⁸ Essentially, these features of the compliance regime would act as screening mechanisms to discourage taxpayers who seek to game the system from opting for the compliance regime.

In a similar vein, protective tax elections have the potential to act as screening devices if, all else equal, taxpayers are more inclined to file them when they have legitimate bases for claiming the tax outcomes they intend to report than when their intended reporting positions stand on weaker ground. A protective tax election has the potential to attract the IRS's attention and signal to the IRS that the taxpayer believes the outcome the taxpayer reports may fail (because, if the position the taxpayer reports does not fail, then the election is not necessary).¹¹⁹ The extent to which this is true may vary from election to election. Some protective tax elections are filed at a point in time when a taxpayer would have no concrete reason to believe that an election is necessary because the deadline for the election falls early in the year and the necessity of the election depends on events that happen later. In those instances, the likelihood of attracting IRS attention may be low.¹²⁰ If the taxpayer is not yet in a position to have the relevant information, the IRS may not view the protective tax election as a signal of relevant information but instead assume that the taxpayer simply files it out of an abundance of caution. By contrast, if the taxpayer files the protective tax election at a time when the taxpayer generally would be in possession of the relevant information, it might attract more IRS scrutiny. This could be true in the case of an election like the Section 1237 election that is filed at the end of the year and relates to a transaction (sale of real estate) that has already occurred so that the taxpayer would be in possession of the relevant information. The taxpayer would know, for instance, whether the taxpayer had engaged in extensive advertising efforts that could increase the risk that the IRS might challenge the taxpayer's claim that the land was investment property.

The ability of a protective tax election to perform a screening function also depends on what taxpayers must do to file the election. Some, but not all, protective tax elections have one or both of two design features that may tend to make filing them more costly for taxpayers with weaker claims.¹²¹ The first such feature is that some protective tax elections trigger an extended statute of limitations.¹²² Giving

¹¹⁸ *Id.*

¹¹⁹ The possibility that a protective tax election could attract IRS scrutiny is frequently mentioned by commentators as a downside for taxpayers of making the election. *See, e.g.,* Eustice, Kuntz & Bogdanski, *Federal Income Taxation of S Corporations*, at ¶4.01 at footnote 9 (November 2020)

¹²⁰ The protective TRS may provide an example. *See infra* text accompanying note 136.

¹²¹ In a similar vein, Professor Logue has argued that requiring taxpayers to disclose the fact that they have obtained tax indemnity insurance might deter taxpayers from obtaining tax indemnity insurance for particularly aggressive tax positions. *See* Logue, *supra* note 22 at 402.

¹²² This is true in the case of the protective QEF election. *See supra* note 62 and accompanying text. It was also true in the case of a protective Section 108(i) election. *See supra* note 25. It is likely that the reason for requiring the extended statute of limitations in these examples is to give the IRS a fair chance to evaluate new tax consequences being claimed retroactively for years that might be getting close to beyond the statute of limitations. Thus, the extension of the statute of limitations may not be designed with the potential screening benefit in mind. Nonetheless, it could serve that function.

the IRS more time to examine the results claimed by the taxpayer is presumably a less desirable prospect for a taxpayer who has taken a position that is more vulnerable to IRS challenge. The second such feature is that, in some contexts, taxpayers are required to include with the protective tax election a statement justifying the taxpayer's reporting position.¹²³ This feature would make the protective tax election a better screening device because taxpayers with weak positions will be resistant to the idea of providing the IRS with any more information than necessary. This feature would also provide the IRS with useful information to decide which, if any, of the taxpayers who do file protective tax elections ought to be subject to closer examination.¹²⁴

One way to conceptualize the potential for a protective tax election to perform a screening function is to consider how filing an election affects the odds that a taxpayer will be audited and the odds that the IRS, upon audit, will detect that something about the taxpayer's claimed tax position is amiss. Assume that, when filing an election, the taxpayer must agree to an extended statute of limitations and must submit a statement justifying the taxpayer's reporting position. These requirements will allow the IRS to be savvier about which taxpayers it audits from the group of taxpayers who have filed elections and also about which issues to examine when it does decide to audit a taxpayer from that group. By contrast, decisions about which taxpayers to audit and which issues to examine in the case of taxpayers who have not filed an election with the associated disclosures will be, comparatively, more random. As a result, assuming the IRS audits roughly the same percentage of taxpayers from the group that files the election as from the group that does not file the election, taxpayers taking weak reporting positions may find filing particularly costly. They may fare better if they attempt to hide out in the pool of taxpayers where decisions about which taxpayers to audit and which issues to examine are less calculated and, thus, less likely to be driven by the fact that the taxpayer's claimed tax position is weak.¹²⁵

In summary, taxpayers who file Favorable Fallback Protective Tax Elections may tend to be taxpayers taking defensible positions rather than very aggressive positions. This is true, at least, if a protective tax election possesses features that some, but not all, protective tax elections have already. These features include an extended statute of limitations for the IRS to examine the results reported by the taxpayer who files a protective tax election and a requirement that the taxpayer filing the protective tax election include a statement justifying their initial

¹²³ This is true in the case of the protective QEF election. *See supra* note 63 and accompanying text.

¹²⁴ Relatedly, Professor Blank has discussed the phenomenon of "overdisclosure"—taxpayers who report non-abusive transactions in response to requirements to disclose certain, potentially abusive transactions. Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Transaction*, 56 UCLA L. REV. 1629 (2009). He describes how various measures (such as requiring taxpayers to submit non-tax documentation related to the transactions that they disclose) can discourage overdisclosure by making disclosure more costly and also can provide the IRS with information necessary to sort the transactions that are disclosed between abusive and non-abusive transactions. *Id.* at 1686-88.

¹²⁵ *See* Appendix for further discussion.

reporting position.¹²⁶ Allowing taxpayers to file elections accompanied by such features could be conceptualized as akin to various instances in which tax law subjects taxpayers to lower explicit tax penalties if taxpayers have provided advance disclosure.¹²⁷ As discussed above, the results of filing a Favorable Fallback Protective Tax Election could be framed as a reduction in an implicit penalty imposed upon a taxpayer.¹²⁸ Thus, allowing the filing of such elections could be described as a regime that subjects taxpayers to lower implicit penalties in exchange for advance disclosure.

IV. ENCOURAGING TAXPAYERS TO REVEAL USEFUL INFORMATION TO THE IRS

On the one hand, as discussed above, there are a number of potential disadvantages to allowing Favorable Fallback Protective Tax Elections. First, at least compared to a Deemed Protective Tax Election Approach, such elections may trap unwary taxpayers. Second, permitting Favorable Fallback Protective Tax Elections may encourage taxpayers to take more aggressive reporting positions, particularly if the elections are not accompanied by the design features described above—namely, the requirements that the taxpayer consents to an extended statute of limitations and submits a statement justifying the taxpayer's reporting position. On the other hand, permitting Favorable Fallback Protective Tax Elections may also offer advantages. One potential advantage is that the availability of such elections may induce taxpayers to reveal information to the IRS. In particular, in some contexts, the fact that a taxpayer has or has not filed a Favorable Fallback Protective Tax Election could provide an indication to the IRS of the taxpayer's assessment of the strength of his or her reporting position.

Other scholars have noted that some tax elections can have an information revealing effect. For instance, Professor Field has noted that some tax elections that must be made in order to obtain favorable tax results can induce taxpayers to reveal information about themselves that might otherwise be unavailable to the IRS.¹²⁹ Professor Satterthwaite has explored in depth the possibility that tax elections may provide information to taxing authorities, arguing that the election to itemize deductions rather than claim the standard deduction may reveal useful information about various taxpayer characteristics.¹³⁰ Finally, as discussed above, Professor Raskolnikov has suggested the possibility of providing taxpayers with the ability to elect between different tax enforcement regimes as a means to encourage taxpayers to reveal information about their attitudes towards tax compliance.¹³¹

The fact that a taxpayer has made (or has not made) a Favorable Fallback Protective Tax Election also may reveal potentially useful information to the IRS.

¹²⁶ See *supra* notes 121-124 and accompanying text.

¹²⁷ For additional discussion of a context in which taxpayers who fail to provide advance disclosure will be subject to additional explicit penalties, see, e.g., Blank, *supra* note 124, at 1637-39.

¹²⁸ See *supra* Part III.A.

¹²⁹ See, Field, *Choosing Tax*, *supra* note 10, at 63.

¹³⁰ Satterthwaite, *supra* note 10.

¹³¹ See *supra* notes 116-118 and accompanying text.

If a taxpayer claims that a transaction produces a given tax outcome but files a protective tax election that will only affect the taxpayer's tax consequences if the transaction's tax outcome differs from what the taxpayer claims, the filing of the election suggests that the taxpayer is aware of a risk that the taxpayer's claim may fail. As suggested above in Part III, at least if protective tax elections include features that make filing them particularly costly for taxpayers taking indefensible positions, it could well be the case that the taxpayers who tend to file protective tax elections are not, in fact, the worst offenders. Instead, those who file Favorable Fallback Protective Tax Elections may tend to be taxpayers taking positions that are defensible but associated with some risk of being incorrect. By contrast, taxpayers taking positions that are very certain to be correct as well as taxpayers taking very aggressive positions may tend to not file.

The features described above—namely an extended period of time for the IRS to examine the claimed tax consequences and a requirement that the taxpayer provide a statement justifying the position claimed by the taxpayer—may discourage taxpayers taking very aggressive positions from joining the group that files protective tax elections. Furthermore, these features, by making it so that filing the election is not entirely costless, may reduce the likelihood that taxpayers taking positions that are almost certainly correct simply file the election anyway.¹³²

Even if protective tax elections are accompanied by these features, however, a fair amount of distracting noise will mix with potentially useful information. In particular, with these features, it may well be the case that the taxpayers who file a protective tax election tend to be taxpayers taking defensible, yet somewhat risky positions, who would benefit from the result of filing an election if their claim is challenged or otherwise becomes unavailable.¹³³ However, this leaves a number of different taxpayers in the non-filing group. In particular, the non-filing group could include (1) taxpayers taking aggressive positions who avoided filing the protective tax election so as to not attract IRS attention, (2) taxpayers who did not file the protective tax election simply because, even if their original claim fails so that making the election would affect their tax consequences, they would fare better

¹³² Along similar lines, Professor Blank has discussed the phenomenon of “overdisclosure”—taxpayers who report non-abusive transactions in response to requirements to disclose certain, potentially abusive transactions. Blank, *supra* note 124. He describes how various measures (such as requiring taxpayers to submit non-tax documentation related to the transactions that they disclose) can discourage over-disclosure by making disclosure more costly. *Id.* at 1686-88.

¹³³ When protective tax elections were allowed under Section 6015(c), it is possible that this separation into different groups would have worked out differently. For additional discussion of this election, *see supra* Part I.D. If a member of a divorcing couple thought that filing the election would attract IRS attention but, at the same time, thought that they would not be liable for any significant part of any deficiency, then the possibility of attracting IRS attention might not have discouraged filing. A second reason protective filings in this context may not have provided very clear signals is that taxpayers, by not filing on a protective basis, would not lose the ability to file later after the IRS assessed a deficiency. This might create less of an impetus to file on a protective basis even if a taxpayer feared there may be weaknesses in previously filed returns. A third reason to suspect that protective filings may not have been very informative in this context is that the decision to file may often have been driven by non-tax strategic considerations. Some commentators noted that divorce lawyers viewed the ability to file the election as a “bargaining chip” in the divorce proceedings. *See supra* note 81.

under the default rule (the taxpayers in this group may be taking very aggressive positions, defensible but somewhat risky positions, or positions that have virtually no chance of being successfully challenged), (3) taxpayers who would benefit from the election if their positions were challenged but who are taking positions that have a very low chance of being successfully challenged so that a protective tax election is simply unnecessary, and (4) taxpayers who did not receive sophisticated tax advice.

In some cases, it may be a straightforward exercise for the IRS to distinguish taxpayers in the second group from the other groups. In particular, for protective tax elections that are due with a tax return and that affect the tax consequences of only transactions that are already completed as of that time, the IRS can determine if the taxpayer would fare better under the default rule than with the election in place so that the taxpayer is a member of the second group. However, distinguishing among taxpayers within that group may be difficult. Moreover, distinguishing taxpayers in the second group from the other groups becomes more difficult in the case of an election that affects the tax consequences of future events.¹³⁴ Without knowing a taxpayer's prediction about future events, it will be difficult for the IRS to discern whether the taxpayer would have concluded that the outcome that follows under the default rule is more favorable than the outcome that follows from making the election.¹³⁵ Without this information, the IRS cannot discern whether the taxpayer is in the second group.

The deadline for filing a protective tax election will also affect how informative it is. Some tax elections must be filed quite early in time, before the taxpayer would possess the information needed to assess the riskiness of the position the taxpayer expects to take. In the case of those elections, filing on a protective basis may not reveal useful information because the taxpayer does not have useful information to reveal. The protective TRS election described above in Part I.C.3 offers a potential example. A taxpayer generally must file such an election within the first two and a half months of each year because the election cannot be effective earlier than two and half months before it is filed.¹³⁶ Typically, the taxpayer would file the election to guard against the possibility that income earned by a Subsidiary REIT (or some other occurrence) over the coming year could cause it to fail to qualify as a REIT. At the time the election is filed, not even

¹³⁴ An example of a forward-looking election with respect to which protective tax elections are authorized is Section 362(e)(2)(C). For further discussion of this election, *see supra* note 104. For discussion of how tax elections are often forward looking so that evaluating whether an election is beneficial requires predictions about the future, *see, e.g.,* Field, *Choosing Tax*, *supra* note 10, at 27.

¹³⁵ One thing that would cut down on the number of non-filers in group 2 would be to establish a penalty default rule (that is a rule that most taxpayers do not want) so that fewer taxpayers fall in this group. However, using a penalty default rule would have significant downsides in the context of a tax election that does not exclusively affect taxpayers with access to sophisticated advice. For additional discussion of the use of penalty default rules in the tax election context, *see, e.g.,* Cauble, *supra* note 10, at 459; Field, *Choosing Tax*, *supra* note 10, at 67 (“a penalty default rule generally provides undesirable tax treatment to those taxpayers who, for whatever reason, fail to act. This could disadvantage less knowledgeable and less sophisticated taxpayers who might not know which choice to make (or even know that there is a choice to make).”); Field, *Private Bargaining*, *supra* note 10, at 67-68.

¹³⁶ Form 8875 instructions.

the taxpayer is in possession of this information (although the taxpayer may have made informed projections). Therefore, the fact that the election is filed may not provide very useful information to the IRS about the likelihood that the Subsidiary REIT qualifies as a REIT. This might, in part, explain why filing them is such common practice—if they provide little useful information to the IRS then they may carry with them little perceived risk of attracting IRS attention (particularly, in chicken or egg fashion, given that they are so commonly filed).

In summary, the availability of protective tax elections may, in some cases, induce taxpayers to provide useful information to the IRS. However, there are limits on the usefulness of the information, and the usefulness of the information will likely vary a great deal from election to election. The availability of a protective tax election could be the most informative under the following conditions: (1) the election arises in a context where most taxpayers have access to sophisticated advice, (2) the election must be filed at the time of a tax return and affects only the tax consequences for the prior year, (3) for all taxpayers, the results of making the election would be more favorable than the results of not making the election in the event that the taxpayer's initial reporting position is challenged (in other words, the election is accompanied by a penalty default rule), (4) filing the election on a protective basis results in an extension of the statute of limitations for examining the taxpayer's initial reporting position, and (5) the taxpayer must include, with the election, a statement justifying the taxpayer's initial reporting position.

Considering a hypothetical protective tax election can help to illustrate a situation in which these conditions would all hold true. Under current law, if a real estate investment trust (a "REIT") sells real estate that is dealer property, the gain will be subject to entity-level tax at a rate of 100%.¹³⁷ If, instead, the REIT sells real estate that is investment property, generally it would be exempt from entity-level tax.¹³⁸ Imagine a hypothetical protective election that a REIT could file that would result in gain from dealer property being subject, instead, to an entity-level tax at a rate of 40%, for example. With such a hypothetical election, a REIT could file a return for the year in which real estate was sold that took the position that the real estate was investment property under the facts and circumstances test, and the REIT could file the protective election with the return so that, if this position were successfully challenged, the gain would be subject to a tax rate of 40% (instead of the 100% tax rate that would apply absent the protective tax election). For the protective tax election to be effective, however, assume the REIT would have to agree to an extension of the statute of limitations for the year in which the property was sold, and the REIT would have to submit a statement justifying its position that the property was investment property.

This hypothetical example satisfies all five conditions noted above. If a REIT does file the election, it likely suggests that its position that the real estate was investment property was risky but defensible. If a REIT does not file the election with respect to a sale of real estate, then likely either it is taking an

¹³⁷ I.R.C. § 857(b)(6). This 100% tax will not apply when various safe harbor requirements are met. I.R.C. § 857(b)(6).

¹³⁸ Because a REIT is entitled to a deduction for dividends that it pays, by making sufficient distributions, it can eliminate entity-level tax. I.R.C. § 857

aggressive position when it asserts that the real estate is investment property so that the extended statute of limitations and requirement to submit a statement justifying its position were onerous or it is taking a very safe position so that filing the election was unnecessary. Because a tax rate of 40% would always be preferable to a tax rate of 100%, non-filing would not be explained by the taxpayer having a preference for the default treatment that follows in the absence of an election. Assuming that all REITs have access to sophisticated advice, lack of filing is also not attributable to a failure to evaluate the advantages and disadvantages of filing the election.

To be clear, I am not proposing the adoption of this particular election,¹³⁹ but rather using it as an illustration of the circumstances under which a protective tax election has the potential to reveal information, with a minimum amount of noise, to the IRS. If a taxpayer filed the election with respect to a particular sale, the taxpayer would tend to be taking a defensible but somewhat risky position that the real estate was investment property. Moreover, if a taxpayer taking a very aggressive position filed the election, the extended statute of limitations and the information statement supplied by the taxpayer would provide the IRS with a greater opportunity to discover this fact. If a taxpayer does not file an election with respect to a particular sale, then likely either the taxpayer's position that the real estate was investment property is very aggressive or stands on very strong ground¹⁴⁰—the picture is not clouded by the possibility that the taxpayer may have preferred the default treatment or simply failed to consider the possibility of filing an election.

Moving away from the specific example involving REITs, more generally, a protective tax election approach might be used in other contexts when the tax treatment that follows if the taxpayer's position is incorrect is particularly harsh. If lawmakers allow taxpayers to file protective tax elections to secure more favorable alternative treatment as long as they include a statement justifying their initial reporting positions and agree to an extended statute of limitations, the availability of the election may cause taxpayers to reveal useful information to the IRS. This is true at least if most of the taxpayers affected by the election have access to sophisticated tax advice.

V. PROVIDING TAXPAYERS WITH A DEGREE OF CERTAINTY

Favorable Fallback Protective Tax Elections are a technique that taxpayers use to manage uncertainty. Various other available mechanisms for coping with uncertainty that taxpayers have at their disposal include private letter rulings, tax indemnity insurance, and tax opinions. In some contexts, some of these other options may be entirely nonexistent or, practically speaking, unavailable. In such cases, Favorable Fallback Protective Tax Elections may help to fill a void. This Part

¹³⁹ In this context, if the REIT is aware of a risk that property will be “dealer property,” it might hold the property through a taxable REIT subsidiary (a TRS) to subject it to tax at the corporate tax rate rather than at a rate of 100% as another mechanism for mitigating the uncertainty.

¹⁴⁰ In this particular context, a safe harbor will provide some taxpayers with certainty that the 100% tax will not apply. See I.R.C. § 857(b)(6).

will proceed by discussing each of these other options, in turn, to highlight the gaps that might be filled by Favorable Fallback Protective Tax Elections. Also, as this Part will discuss, a consideration of these other options for obtaining certainty strengthens the case for imposing upon Favorable Fallback Protective Tax Elections the requirements mentioned above—namely, an extended statute of limitations and a requirement that taxpayers filing such elections supply a statement of justification for their initial reporting position.

A. *Private Letter Rulings*

If a taxpayer is uncertain about the tax consequences of a planned transaction because available legal authority does not supply a clear answer, in some cases, the taxpayer can request a private letter ruling from the IRS.¹⁴¹ To request a private letter ruling, the taxpayer must prepare a request that describes all of the relevant facts, applicable legal authority, and the ruling the taxpayer seeks.¹⁴² In addition, the taxpayer must pay a user fee.¹⁴³ The user fee is generally designed to cover the cost to the IRS of considering and issuing a ruling,¹⁴⁴ and, thus, the fee varies by type of request.¹⁴⁵ However, because the user fee also varies based on other factors—such as the income of the taxpayer—it may not fully cover the cost of the request in all cases.¹⁴⁶

The IRS will not rule on some topics.¹⁴⁷ Notably, the IRS generally will not issue rulings on topics where the taxpayer's uncertainty stems from the fact that resulting tax consequences are governed by a standard so that the tax outcome turns on the facts of each particular case.¹⁴⁸ Many of the protective tax elections described above occupy areas of law that fit this description. For instance, a standard governs the question of whether real estate is dealer property or investment property—the context in which the protective Section 1237 election arises.¹⁴⁹ Indeed, the IRS specifically includes the question of whether property is dealer property on its list of topics on which it ordinarily will not issue letter rulings.¹⁵⁰

If a taxpayer obtains a letter ruling, the taxpayer generally can rely upon it, provided that the taxpayer accurately and completely disclosed the relevant facts in the ruling request.¹⁵¹ Thus, the taxpayer can proceed with a transaction with a fairly high degree of certainty that its tax treatment will be what the taxpayer expects and

¹⁴¹ See Rev. Proc. 2021-1, 2021-1 I.R.B. 1.

¹⁴² *Id.* at Section 7 (setting forth general instructions for requesting letter rulings).

¹⁴³ *Id.* at Appendix A (listing the user fees for various types of letter ruling requests).

¹⁴⁴ See, e.g., Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance and Retroactivity in the 21st Century: A View From Within*, 46 DUQ. L. REV. 323, 347 (2008) (“The fees are based on calculations of the actual cost to the Service of preparing the rulings.... with discounted fees for lower income taxpayers.”).

¹⁴⁵ See Rev. Proc. 2021-1, 2021-1 I.R.B. 1 at Appendix A.

¹⁴⁶ For further discussion, see, e.g., Emily Cauble, *Questions the IRS Will Not Answer*, 97 IND. L.J. 523 (2022).

¹⁴⁷ See, e.g., Rev. Proc. 2021-3, 2021-1 I.R.B. 140, Section 3.

¹⁴⁸ For further discussion, see, e.g., Cauble, *supra* note 146.

¹⁴⁹ For further discussion, see *supra* Part I.C.1.

¹⁵⁰ Rev. Proc. 2021-3, 2021-1 I.R.B. 140 at Section 4.02(5).

¹⁵¹ See Treas. Reg. § 601.201(l)(5).

intends to claim. Only the taxpayer who obtains a letter ruling may rely upon it.¹⁵² However, issued letter rulings are published in anonymized form so other taxpayers may look to a letter ruling as an indication of the IRS's likely position on the issues covered by the ruling.¹⁵³

B. Tax Indemnity Insurance

In some cases, taxpayers who plan to engage in a transaction with uncertain tax consequences will obtain tax indemnity insurance.¹⁵⁴ The taxpayer receives a payout under the policy if the IRS successfully challenges the results that the taxpayer claims.¹⁵⁵ Functionally, such insurance is only available to taxpayers with significant resources as the policies are specifically negotiated and cover transactions with high amounts of potential tax liability at stake.¹⁵⁶

At one time, the Treasury Department had issued temporary regulations that would have required taxpayers to disclose to the IRS when they had obtained such insurance.¹⁵⁷ Ultimately, the disclosure requirements were not included in the final regulations.¹⁵⁸ Insurance companies criticized the temporary regulations, arguing, in part, that disclosure was unnecessary.¹⁵⁹ In particular, the insurance companies asserted that their own rigorous processes for vetting transactions to assess the risk of successful IRS challenge in order to properly price the policies made it unlikely that policies would be issued to insure tax positions that were excessively aggressive (or that, if such policies were issued, the premium charged by the insurance companies would adequately deter taxpayers because it would take into account the high degree of risk).¹⁶⁰ Other scholars have expressed skepticism about this argument, observing that insurance companies may take into account the chance of the IRS detecting an aggressive position when evaluating the overall risk and determining the premium charged for the policy.¹⁶¹ Thus, if the risk of detection is low, an insurance company might still insure a quite aggressive tax position without charging a premium that would deter taxpayers from proceeding with the transaction and obtaining the policy.¹⁶²

¹⁵² See Treas. Reg. § 601.201(l)(1) (“A taxpayer may not rely on an advance ruling issued to another taxpayer.”).

¹⁵³ See, e.g., Rachele Y. Holmes, *Forcing Cooperation: A Strategy for Improving Tax Compliance*, 79 U. CIN. L. REV. 1415, 1427 (2011) (noting that the publication of letter rulings in redacted form provides “helpful guidance” to other taxpayers).

¹⁵⁴ For further discussion, see, e.g., Field, *supra* note 22, at 2126-29; Kahn, *supra* note 22, at 7-9; Logue, *supra* note 22.

¹⁵⁵ See, e.g., Field, *supra* note 22, at 2128; Logue, *supra* note 22, at 388.

¹⁵⁶ See, e.g., Logue, *supra* note 22, at 387.

¹⁵⁷ For discussion of this history, see, e.g., Kahn, *supra* note 22, at 9; Logue, *supra* note 22 at 401-02.

¹⁵⁸ See, e.g., Logue, *supra* note 22, at 401. Treas. Reg. § 1.6011-4.

¹⁵⁹ See, e.g., Logue, *supra* note 22, at 401.

¹⁶⁰ See *id.* at 401-02.

¹⁶¹ See *id.*

¹⁶² See *id.*

C. Tax Opinions

Taxpayers with sufficient resources often resort to legal advice as a means of coping with uncertainty. In some cases, taxpayers obtain a formal tax opinion from an attorney that expresses, at a specified level of confidence, the attorney's assessment of the likelihood that a given transaction will produce a particular tax outcome.¹⁶³ In some cases, obtaining a tax opinion may reduce the likelihood that penalties will be imposed upon the taxpayer if the outcome claimed by the taxpayer is successfully challenged, although protection from penalties is not guaranteed.¹⁶⁴ Finally, while a number of obstacles stand in the taxpayer's way, in some instances legal advice that misses the mark may form the basis for a malpractice claim by the taxpayer.¹⁶⁵

D. Implication for Favorable Fallback Protective Tax Elections

Comparing Favorable Fallback Protective Tax Elections with the other options described above bolsters the case for imposing upon such elections various requirements that discourage taxpayers from making use of them when they are taking excessively aggressive reporting positions. Other scholars have proposed requiring disclosure of tax indemnity insurance based on concerns that, without such a disclosure requirement, the availability of insurance may encourage taxpayers to take unjustifiably aggressive tax positions.¹⁶⁶

Arguably, this concern may have even more force in the context of Favorable Fallback Protective Tax Elections. In the case of tax indemnity insurance, the vetting role played by insurance companies may, to a degree, guard against using policies to cover reporting positions that would be particularly vulnerable to successful IRS challenge.¹⁶⁷ Indeed, this rationale has been offered as an explanation for not requiring disclosure of the use of tax indemnity insurance to the IRS.¹⁶⁸ While there are good reasons to be skeptical about this argument even in the context of tax indemnity insurance,¹⁶⁹ this argument is a non-starter in the case of Favorable Fallback Protective Tax Elections where no similar rationale for lack of disclosure exists.

Of course, because Favorable Fallback Protective Tax Elections are filed with the IRS, disclosure is, to a degree, required. However, filing such an election does not invite scrutiny to the same degree as a letter ruling request, for instance, where the IRS is asked to specifically consider the facts of a given transaction. Unless the protective tax election must be accompanied by additional information, in some instances, the IRS might not even be able to readily identify an election that is filed to secure a more favorable fallback tax outcome. To increase the odds that the taxpayer's disclosure can attract IRS attention in a meaningful way, the additional

¹⁶³ For further discussion, *see, e.g.*, Field, *supra* note 22, at 2122-24.

¹⁶⁴ *See id.* at 2124.

¹⁶⁵ *See id.* at 2126, 2141-53.

¹⁶⁶ *See supra* Part V.B.

¹⁶⁷ *See supra* Part V.B.

¹⁶⁸ *See supra* Part V.B.

¹⁶⁹ *See supra* Part V.B.

requirements discussed above—namely, an extended statute of limitations and the required inclusion of a statement of justification for the taxpayer’s initial reporting position—ought to be imposed.

A comparison with the other options for mitigating uncertainty also shows that, in some cases, Favorable Fallback Protective Tax Elections have the potential to supplement these other available mechanisms. As noted above, the IRS will not issue letter rulings addressing numerous questions. When the IRS does not rule on a given topic, it loses an opportunity to acquire information about taxpayers’ uncertainty.¹⁷⁰ In some cases, a taxpayer might turn to a Favorable Fallback Protective Tax Election as an alternative to seeking a ruling. Such an election provides the taxpayer with some assurance (albeit to a lesser degree than a ruling).¹⁷¹ Unlike with tax indemnity insurance or tax opinions, the use of such elections allows the IRS to acquire information about the taxpayer’s uncertainty regarding his or her tax treatment. The IRS would acquire more valuable information if lawmakers required taxpayers to supplement protective tax elections with statements that explained and justified their initial reporting positions. Moreover, the IRS may be able to act upon the information provided by such elections in a way that does not necessarily require the same amount of IRS resources needed to issue a letter ruling that will be published in anonymized form.

VI. RECOMMENDATIONS

As discussed above in Parts II and III, offering taxpayers the opportunity to file Favorable Fallback Protective Tax Elections has a number of drawbacks. First, the ability to file such elections may encourage well-advised taxpayers to take more aggressive reporting positions. To guard against this possibility, lawmakers should require that a taxpayer filing such an election must consent to an extended statute of limitations and must include a statement justifying the taxpayer’s reporting position.

Second, requiring that taxpayers file protective tax elections to secure more favorable alternative tax treatment may trap unwary taxpayers. Furthermore, a requirement that a taxpayer submit a statement justifying the taxpayer’s initial reporting position—a safeguard necessary to guard against the possibility that such elections will encourage taxpayers to take aggressive reporting positions—could further exacerbate the extent to which such elections are functionally out of the reach of taxpayers who lack access to sophisticated tax advice.

Together, these policy considerations point towards taking a different approach to tax elections depending on whether they affect only taxpayers with access to sophisticated advice or, instead, affect a wide variety of taxpayers including those who lack access to sophisticated advice. In the case of elections in the first category, carefully designed Favorable Fallback Protective Tax Elections may, in some cases,

¹⁷⁰ See, e.g., Korb *supra* note 144, at 344 (“the rulings program constitutes a source of valuable information to the Service”).

¹⁷¹ For one thing, unlike a letter ruling, such an election does not assure the taxpayer that the tax consequences of a transaction will be what the taxpayer expects—it merely secures better alternative tax treatment in the event that the consequences are not what the taxpayer expects.

be a useful tool. In the case of the second category, when possible, a Deemed Protective Tax Election Approach ought to be employed instead. Each of these recommendations is discussed, in turn, below.

A. When an Election Affects Only Taxpayers with Access to Sophisticated Advice

In an area of law that affects only taxpayers with access to sophisticated advice, Favorable Fallback Protective Tax Elections may be a useful supplement to other mechanisms used by taxpayers for obtaining certainty. If made available, such elections should be accompanied by safeguards like an extended statute of limitations and a requirement that the taxpayer submit a statement justifying the taxpayer's reporting position. If a taxpayer being wrong about a claimed tax outcome results in harsh alternative tax treatment, allowing the taxpayer to file a protective tax election to secure more favorable alternative tax treatment may serve a useful purpose. Assuming taxpayers who file such an election tend to be those taking defensible positions, the availability of the election can help to better focus the penalty implicit in the harsh alternative tax treatment upon taxpayers who are taking more aggressive positions. Similar to the notion that advance disclosure, in various contexts, may allow taxpayers to fare better when it comes to explicit penalties, a Favorable Fallback Protective Tax Election can operate as a device that ties lower implicit tax penalties to advance disclosure.¹⁷²

B. When a Wide Range of Taxpayers Are Involved

If an election arises in an area of law that affects a wide range of taxpayers, including those without access to sophisticated advice, when possible, lawmakers ought to bestow on all taxpayers—even those who neglect to file an election—the results that would have followed from making a Favorable Fallback Protective Tax Election. I will refer to this alternative as the “Deemed Protective Tax Election Approach.”

As an example of the Deemed Protective Tax Election Approach, consider a taxpayer who sells land and files a tax return reporting the gain as capital gain, resulting in tax liability of \$14,000. Imagine the IRS challenges that characterization and successfully asserts that the land is dealer property. Imagine the taxpayer has not filed a protective Section 1237 election. If the taxpayer had filed a protective Section 1237 election, the IRS's challenge would result in tax liability of \$18,000, but, without the election, the IRS's challenge results in tax liability of \$25,900.¹⁷³ Under the Deemed Protective Tax Election approach, even though the taxpayer did not file the election, the IRS would impose tax liability of \$18,000. Essentially, the taxpayer obtains the tax outcome that the taxpayer would have obtained had the taxpayer considered the possibility of a protective tax election at the time the taxpayer filed his or her return for the year when the property was sold.

¹⁷² For further discussion, *see supra* notes 127-128 and accompanying text.

¹⁷³ For further discussion of this example, *see supra* Part I.C.1.

In some contexts, the Deemed Protective Tax Election Approach might not be feasible. Some elections affect multiple taxpayers, and, while the outcome with the election in place might be more favorable for one of the taxpayers, the outcome without the election in place might be more favorable for another taxpayer. In that case, there may be no practical way for the IRS to impose upon the taxpayers what they likely would have agreed to if they had considered the possibility of a protective tax election themselves.¹⁷⁴

The Deemed Protective Tax Election Approach is likely also not feasible for tax elections that affect tax consequences over multiple years.¹⁷⁵ When assessing tax consequences for the first year that is affected by the election, it is not practical for the IRS to select, for the taxpayer, the most favorable choice because that determination depends upon a prediction about events in future years.¹⁷⁶

Nevertheless, in some contexts, a Deemed Protective Tax Election Approach is feasible because an election may affect only one taxpayer (or affect multiple taxpayers whose interests are aligned) and affect tax consequences for only one year. Furthermore, analogies to the Deemed Protective Tax Election Approach already exist in tax law. As one example, sometimes when the results of events not panning out the way a taxpayer anticipated would otherwise be particularly harsh, various relief provisions soften the taxpayer's landing. For instance, because the failure to meet certain requirements to qualify as a real estate investment trust (a "REIT") can have very harsh consequences, in some cases, taxpayers can benefit from various relief provisions that make the consequences less dire.¹⁷⁷

As a second example, sometimes, simply because of various features of a taxpayer's tax profile, there happens to be a small difference between the tax outcome that a taxpayer claims and the tax outcome that would befall the taxpayer if the IRS challenges that outcome. For instance, for some taxpayers, the effective tax rate that applies to ordinary income may be close to the effective tax rate that applies to capital gain so that a challenge of the taxpayer's claim that an asset is a capital asset may impose little additional tax liability.

¹⁷⁴ While it may be feasible to determine that the parties would have wanted the outcome that reduces their aggregate tax liability, it will not be feasible for the IRS to determine how the parties would have split the resulting tax savings and to get them to that result if they do not make the election themselves. Having the taxpayers jointly agree to a given tax outcome also has the virtue of ensuring that the taxpayers take consistent positions. *See, e.g.,* Field, *Private Bargaining*, *supra* note 10, at 44 ("Joint elections also force all of the relevant taxpayers to make affirmative commitments to consistent tax treatment, thereby increasing compliance and minimizing whipsaw...").

¹⁷⁵ One example that arises in the context of protective tax elections is Section 362(e)(2)(C). Whether or not this election is made affects a shareholder's basis in stock of a corporation and a corporation's basis in some of its assets. Thus, it affects the tax treatment of the shareholder's sale of stock, the tax treatment of the corporation's sale of certain assets, and, if the assets are subject to depreciation, the tax treatment of the corporation for each year that it holds the assets.

¹⁷⁶ For similar reasons, it can be difficult for lawmakers to select a default rule to accompany such an election that would tend to reliably match (or not match) what taxpayers would prefer. *See* Field, *Private Bargaining*, *supra* note 10, at 55.

¹⁷⁷ *See, e.g.,* I.R.C. §§ 856(c)(4) and (c)(7). For additional discussion of such relief provisions, *see* Andrew Blair-Stanek, *Tax in the Cathedral: Property Rules, Liability Rules, and Tax*, 99 VA. L. REV. 1169 (2013); Leigh Osofsky & Kathleen Delaney Thomas, *The Surprising Significance of De Minimis Tax Rules*, 78 WASH. & LEE L. REV. 773, 797-98 (2021).

As a third example, for some taxpayers in the case of some elections, the treatment that follows from having *not* made the election is more favorable than the treatment associated with having made the election. As an example, consider the Section 1237 election. Imagine the facts are identical to those of Anne whose tax outcomes are shown in Table 2 above except that the cost of installing the roads was \$50,000 rather than \$20,000. In that case, if she successfully reports the results of the transaction as if the land were investment property under the general facts and circumstances test, she incurs \$8,000 in tax liability.¹⁷⁸ If her characterization is challenged and tax liability is assessed as if the land were dealer property under the facts and circumstances test, the resulting tax liability would be lower if a protective tax election were *not* in place than if a protective tax election were in place. In particular, without a protective tax election, she incurs \$14,800 in tax liability, compared to \$18,000 with a protective tax election.¹⁷⁹

Even if lawmakers disallowed filing Section 1237 elections on a protective basis, a taxpayer in her position could characterize the land as investment property without sacrificing an opportunity to secure a better second choice tax outcome if that characterization failed. This is true because, for a taxpayer in this position, the better second choice tax outcome is the outcome that follows by default if the election has not been made. A Deemed Protective Tax Election Approach could be seen as simply another example of this phenomenon that would provide to taxpayers that same advantage regardless of whether they benefit more from the default treatment or the treatment that follows from having an election in place.

One downside to a Deemed Protective Tax Election Approach (as compared to requiring that taxpayers file protective tax elections to get the benefits of a Favorable Fallback Protective Tax Election) is that it sacrifices the potential screening and information revealing advantages of Favorable Fallback Protective Tax Elections. In particular, as described above, when taxpayers are required to file protective tax elections in order to secure a more favorable fallback position, it may be that taxpayers who file are more likely to have defensible positions. Taxpayers taking aggressive positions may be deterred from filing and, thus, subject to a greater amount of additional tax if their claims are successfully challenged. Also as described above, to some degree, the filing of protective tax elections may provide useful information to the IRS. For those reasons, in the case of elections that affect—exclusively or almost exclusively—taxpayers with access to sophisticated advice, retaining the requirement to file protective tax elections may be a sensible approach. However, outside of that context, it is arguably preferable to use a Deemed Protective Tax Election Approach when feasible to do so. While such an approach may sacrifice the implicit penalty of the additional tax revenue imposed upon taxpayers taking aggressive positions who might have been deterred from filing Favorable Fallback Protective Tax Elections, that lost implicit penalty could

¹⁷⁸ \$8,000 is the result of applying a 20% tax rate to a gain of \$40,000 (the difference between a \$200,000 selling price and a \$160,000 basis that includes the cost of the roads).

¹⁷⁹ \$14,800 is the result of applying a 37% tax rate to a gain of \$40,000 (the difference between a \$200,000 selling price and a \$160,000 basis that includes the cost of the roads). \$18,000 is the result of applying a 20% tax rate to a gain of \$90,000 (the difference between a \$200,000 selling price and a \$110,000 basis that does not include the cost of the roads).

be offset by increasing the explicit penalty imposed upon taxpayers who take indefensible positions.

CONCLUSION

In an area of tax law that affects a wide array of taxpayers, including those without access to sophisticated tax advice, tax elections have the potential to trap unwary taxpayers. This is at least as true in the case of Favorable Fallback Protective Tax Elections as it is in the case of tax elections generally. Indeed, it may be even more true in this context given that effectively using such an election requires planning not for what the taxpayer expects to happen but for what might happen. As a result, the best course of action is likely to make use of the Deemed Protective Tax Election Approach in the case of elections affecting a wide range of taxpayers.

In areas of law that tend to affect only taxpayers with access to sophisticated advice, lawmakers might consider a different approach. In particular, allowing Favorable Fallback Protective Tax Elections, in this context, may not be all bad, at least if the elections are accompanied by safeguards. These safeguards include an extended statute of limitations and a requirement for the taxpayer to submit a statement justifying the taxpayer's initial reporting position.

APPENDIX

In order to consider whether the ability to file a protective tax election could act as a screening device, imagine that, if the IRS successfully challenged the taxpayer's initial reporting position, the taxpayer would be subject to additional tax liability of \$100 if the taxpayer had not filed a protective tax election but \$50 if the taxpayer had filed such an election.

The expected additional tax liability resulting from filing the election could be expressed as:¹⁸⁰

$$\$50 \times P_{ADF} \times P_{SF} \text{ where}$$

P_{ADF} = the probability that the IRS will audit the taxpayer's return and detect that something is amiss if the taxpayer files the election

P_{SF} = the probability that an IRS challenge would be successful if the taxpayer files the election

The expected additional tax liability resulting from *not* filing the election could be expressed as:

$$\$100 \times P_{ADNF} \times P_{SNF} \text{ where}$$

P_{ADNF} = the probability that the IRS will audit the taxpayer's return and detect that something is amiss if the taxpayer does not file the election

P_{SNF} = the probability that an IRS challenge would be successful if the taxpayer does not file the election

Assume the taxpayer will not file if the expected additional tax liability resulting from filing is more than the expected additional tax liability resulting from not filing. In other words, the taxpayer will not file if:

$$\$50 \times P_{ADF} \times P_{SF} > \$100 \times P_{ADNF} \times P_{SNF}$$

The probability that an IRS challenge would be successful should be the same regardless of whether the taxpayer files the election or not. In other words, $P_{SF} = P_{SNF}$

As a result, the equation above could be simplified and rearranged as:

¹⁸⁰ For a similar approach, *see, e.g.*, Raskolnikov, *supra* note 10, at 716-17. Under Professor Raskolnikov's proposal, the probability of detection and the probability of successful IRS challenge varied depending upon which regime a taxpayer elected. *See Id.* By contrast, with protective tax elections that include the specified requirements, making or not making the election affects the probability of audit and the probability of detection.

$$P_{ADF} > 2 \times P_{ADNF}$$

In other words, a taxpayer will opt to not file if the probability that the IRS will audit the taxpayer's return and detect that something is amiss upon audit is twice as great (or more) if an election is in place than if it is not.

The prediction that taxpayers who file the election will tend to be those taking defensible rather than very aggressive positions is consistent with the above equation if it is the case that (1) the probability of audit if the election is filed exceeds the probability of audit if the election is not filed in the case of taxpayers taking aggressive positions by the same or a wider margin than in the case of taxpayers taking defensible positions (or, more precisely, that is predicted to be the case by taxpayers) and (2) the same is true in the case of the probability of the IRS detecting that something is amiss on audit.

Each of these two conditions could plausibly be true if filing the election triggers an extended statute of limitations and a requirement that the taxpayer submit a statement justifying his or her initial reporting position. As to the first condition, assuming the IRS audits tax election filers and tax election non-filers at roughly the same rate, taxpayers might expect that the requirement to submit a statement and the extended statute of limitations would allow the IRS to be savvier about which taxpayers it selects to audit from the group that have filed elections and disproportionately audit those with weaker claims while the IRS's decisions about who to audit from the group of tax election non-filers may be more random. Thus, for a taxpayer taking an aggressive position, filing an election may increase the taxpayer's perceived probability of audit by a wider margin than for a taxpayer taking a defensible position.

As to the second condition, if a taxpayer is taking a very defensible position, the probability of the IRS detecting that something is amiss may not increase by much if the taxpayer submits a filing that contains more information about the taxpayer's reporting position. (In other words, requiring a taxpayer to provide more information does not increase by much the odds of the IRS detecting that something is amiss when there is nothing particularly amiss to detect.) As the taxpayer's position becomes more aggressive, the difference grows between the probability that the IRS detects that something is amiss if the taxpayer files an election with the required statement and the probability that the same occurs if the taxpayer has not made such an election.

The discussion above assumes that the IRS would audit (and that taxpayers would predict that the IRS would audit) the two groups at roughly the same rate, rather than audit tax election non-filers more frequently to try to make use of the prediction that taxpayers taking aggressive positions would tend to not file. Auditing non-tax election filers at a higher rate could induce taxpayers taking aggressive positions to shift into the group that file the election. At first glance, it may seem that, if the IRS does not make use of the prediction that taxpayers taking very aggressive positions may tend to not file election by auditing this group of taxpayers at a higher rate, it will sacrifice any administrative benefit flowing from taxpayers separating themselves into tax election filers and non-filers. Nevertheless, the separation can still be useful in two respects. First, it helps to

ensure that the implicit penalty tends to be imposed on taxpayers taking very aggressive positions rather than defensible positions. Second, it is possible that the separation of taxpayers into different pools may make the probability of detecting that something is amiss when the IRS audits even a tax election non-filer higher than it would otherwise be.

The discussion above also assumes that a protective filed tax election will be effective even in the case of taxpayers taking very aggressive positions. If this does not hold true, then the availability of the election can even more effectively act as a screen. In other words, it is possible that, in the case of a very aggressive position, even if the election was filed the additional tax liability imposed upon the taxpayer. In that case, for a taxpayer taking a very aggressive position, the equation becomes:

$$\$100 \times P_{ADF} \times P_{SF} > \$100 \times P_{ADNF} \times P_{SNF}$$

Which can be simplified to:

$$P_{ADF} > P_{ADNF}$$

Such a taxpayer would be deterred from filing as long as that the probability of audit and detection that something is amiss if the election is filed exceeds the probability of the same occurring without filing the election by any amount.

By contrast, assuming that the effects of the election are recognized if a taxpayer was taking a defensible position, such a taxpayer would be deterred from filing only if:

$$P_{ADF} > 2 \times P_{ADNF}$$

Under those conditions, the election could act as an even more effective screening device in that non-filing would be more likely for taxpayers taking aggressive positions than for taxpayers taking defensible positions.¹⁸¹

¹⁸¹ A similar result could occur if a taxpayer taking a very aggressive position would be subject to a penalty and the penalty was, for some reason, not proportionate to the additional tax liability assessed. For instance, assume the additional tax liability taking into account a penalty would be \$75 if the election was filed and \$125 if it was not filed in the case of a taxpayer taking an aggressive position. Assume that, for a taxpayer taking a defensible position, the additional tax liability is \$50 (if filed) and \$100 (if not filed) and there is no penalty. In that case, the taxpayer taking an aggressive position does not file as long as $P_{ADF} > 1.67 \times P_{ADNF}$. By contrast, the taxpayer taking a defensible position does not file as long as $P_{ADF} > 2 \times P_{ADNF}$.