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Dysfunction Junction: Reasonable Cause and Good Faith Reliance on Tax Advisors with Conflicts of Interest

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ABSTRACT

Taxpayers who underpay their taxes may be liable for accuracy-related penalties if the underpayment is attributable to negligence or the careless, reckless, or intentional disregard of rules or regulations. Understatements of tax liability resulting from participation in certain types of tax avoidance transactions are also subject to penalties. Accuracy-related penalties may be imposed even with respect to innocent mistakes if the discrepancy between a taxpayer's correct and reported tax liability is sufficiently large.

Taxpayers may, however, avoid accuracy-related penalties by relying on a reasonable cause defense. The reasonable cause defense may be satisfied by relying on professional tax advice even if the advice concludes that the taxpayer's chance of prevailing on the underlying merits is uncertain, the advice turns out to be incorrect, and the taxpayer is found liable for the underlying tax. Reliance on professional tax advice is not, however, a fail-safe escape from penalties. Courts have repeatedly held that taxpayers cannot rely on advisors "they know to be burdened with an inherent conflict of interest." But courts have not clearly articulated the circumstances under which the common law conflict of interest rule applies, making its application unpredictable and inconsistent.

A statutory conflict of interest rule now exists to prohibit taxpayers from relying on advisors who participate in the organization, management, promotion, or sale of certain tax avoidance transactions. Tax advisors who are tax return preparers may be subject to penalties, and those who provide written tax advice are potentially subject to censure, monetary penalties, suspension, or disbarment from practice before the Service for violating the covered opinion rules in Circular 230. These developments ostensibly enhance the quality of written tax advice, which would lessen the import of the common law conflict of interest rule and support its abrogation. This Article explains why

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the common law conflict of interest rule remains relevant despite these developments. This Article also proposes several regulatory changes to mitigate advisor conflicts of interest.

After an introduction in Part I, Parts II through IV offer helpful background information to provide a context for the academic discussion that occurs in the remainder of this Article. Readers familiar with the landscape of tax opinions and accuracy-related penalties may wish to skip ahead to Part V.

I. Introduction

Taxpayers may be liable for accuracy-related penalties for underpaying their federal income taxes due to negligence or the disregard of rules or regulations. Taxpayers who engage in certain types of tax avoidance transactions that result in an understatement of tax liability are also subject to accuracy-related penalties. A taxpayer who is not negligent, considers all relevant rules and regulations, and does not participate in tax avoidance transactions may nonetheless be subject to an accuracy-related penalty if the discrepancy between the taxpayer's correct and reported tax liability is sufficiently large.

Taxpayers may, however, be able to avoid accuracy-related penalties by satisfying a reasonable cause and good faith exception, which requires a showing that there is reasonable cause for the inaccuracy and that the taxpayer acted in good faith despite the inaccuracy. Before 2004, there was one reasonable cause exception for accuracy penalties imposed pursuant to section 6662.[1] When Congress enacted section 6662A in 2004, it created an additional, more stringent reasonable cause exception that applies specifically to penalties imposed under section 6662A.

Both reasonable cause exceptions generally may be satisfied by relying on a tax advisor who concludes that the taxpayer's chance of prevailing on the underlying merits is uncertain, even though the advice turns out to be incorrect, and the taxpayer is found liable for the underlying tax.[2] As the Supreme Court recognized in *United States v. Boyle*:

> When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.[3]

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[1] Section references are to the 1986 Code, as amended, unless otherwise noted.

[2] Richard M. Lipton, *Reasonable Cause and Good Faith Reliance on an Advisor Help a Son-of-BOSS Taxpayer Avoid Penalties*, 118 J. TAX'N 249, 254 (2013) (stating that "a taxpayer can prevail on penalties even if the taxpayer's case on the merits is nearly meritless").

[3] United States v. Boyle, 469 U.S. 241, 251 (1985) (citing Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769, 771 (2d Cir. 1950) (emphasis omitted)); *see also* Reg. §§ 1.6664-4(b)(1), -4(c)(2).

Boyle "recognizes that technicalities of the Code are beyond the ken of the average lay person, and that it is reasonable to rely on the advice of lawyers or accountants concerning such technicalities, even if the advice proves incorrect."[4] One reason taxpayers hire advisors is to obtain expertise that taxpayers lack regarding complex, and in many cases, uncertain tax laws.[5]

Obtaining a tax opinion is not, however, a fail-safe escape from penalties.[6] The reasonable cause exception that applies to section 6662A penalties prohibits taxpayers from relying on advisors who participate in the organization, management, promotion, or sale of the transaction (the "statutory conflict of interest rule"). The reasonable cause exception that applies to penalties imposed under section 6662 does not itself prohibit advisors with conflicts from helping taxpayers avoid penalties, but courts have repeatedly held that taxpayers "cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest" (the "common law conflict of interest rule").[7] Prohibiting reliance on a conflicted advisor presumably helps to ensure that an advisor's relationships with nonclients or the advisor's own personal interests do not cloud the advisor's judgment to the point of providing the client biased and unreliable advice.

Courts have not clearly articulated the circumstances under which the common law conflict of interest rule should apply. Consequently, application of the common law conflict of interest rule is unpredictable and inconsistent, resulting in both false positives (cases where the reasonable cause exception was applied to permit taxpayers to avoid penalties when perhaps the exception should not have applied) and false negatives (cases where the reasonable cause exception was found not to apply when perhaps it should). From a policy perspective, false positives may be better than false negatives. False negatives may hurt voluntary compliance to the extent that unpredictability and inconsistency reinforce taxpayers' perception that the tax system itself is unfairly administered. But false positives are detrimental as well because they excuse taxpayers from paying penalties that otherwise should be imposed.

This Article disproves the hypothesis that the common law conflict of interest rule could be abrogated in light of the enactment of section 6662A and the statutory conflict of interest rule as well as relatively recent enhancements

[4]Allison v. United States, 2008-1 U.S.T.C. ¶ 50,209, 101 A.F.T.R.2d 1028 (Fed. Cl. 2008).

[5]As an illustration, consider that more than 57% of individual income tax returns filed in 2011 were prepared by paid tax preparers. INTERNAL REVENUE SERV., IRS PUBLICATION 4822, TAXPAYER ATTRIBUTE FILING REPORT 2 (Jan. 2013). It is not unreasonable to think that the numbers are even higher for corporate and partnership returns. *See* IRS ADVISORY COUNCIL, SMALL BUSINESS/SELF EMPLOYED SUBGROUP REPORT 11 (Nov. 15, 2006).

[6]Reg. § 1.6664-4(b)(1) (stating that "[r]eliance on . . . the advice of a professional tax advisor . . . does not necessarily demonstrate reasonable cause and good faith").

[7]Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994); *see also* Mortensen v. Commissioner, 440 F.3d 375, 387 (6th Cir. 2006) (stating that "[i]n order for reliance on professional tax advice to be reasonable . . . the advice must generally be from a competent and independent advisor unburdened with a conflict of interest and not from promoters of the investment").

to the tax return preparer penalties under section 6694 and the covered opinion rules of Treasury Department Circular No. 230 (Circular 230). These developments ostensibly help to enhance the quality of written tax advice, which would lessen the import of the common law conflict of interest rule and support its abrogation. Several weaknesses in these statutory and regulatory rules, however, prevent them from being an effective replacement for the common law conflict of interest rule.

Part II of this Article describes the federal tax practice of rendering tax opinions and in particular, the levels of confidence typically ascribed to written opinions. Parts III and IV, respectively, provide an overview of accuracy-related penalties and describe the reasonable cause exceptions applicable to accuracy-related penalties. Readers who are familiar with the landscape of tax opinions and accuracy-related penalties may wish to skip ahead to Part V. Part V discusses the potential for advisor bias and the unpredictability of the common law conflict of interest rule that applies to accuracy-related penalties imposed under section 6662. Part VI provides a critique of section 6662A and the statutory conflict of interest rule, the tax return preparer penalties under section 6694, and the covered opinion rules of Circular 230, and concludes that each of these legislative and regulatory developments have shortcomings, creating a patchwork of provisions that stop short of creating an effective system that enhances the quality of written tax advice. Part VII of this Article recommends regulatory changes that would put the onus on tax advisors to guard against potential conflicts of interest.

II. Tax Opinion Confidence Levels

Taxpayers ordinarily seek to avoid accuracy penalties by relying on a written tax opinion from a professional advisor such as a tax lawyer or accountant.[8] A typical opinion will evaluate the available legal authorities and assess the strength of the taxpayer's reporting position using one of several commonly understood confidence levels, some of which are set forth in the Code itself or in the Treasury regulations.

Section 6662(d)(2)(B) provides a statutory exception from substantial understatement penalties with respect to non-tax shelter transactions (the "Substantial Authority Exception").[9] The exception works by reducing the amount of an understatement, and the substantial understatement penalty applies only if the amount of the understatement exceeds a minimum threshold.[10] To avoid accuracy-related penalties with respect to non-tax shelter transactions that are disclosed to the Service, taxpayers need only a reasonable

[8] Stobie Creek Invs. v. United States, 2008-2 U.S.T.C. ¶ 50,471, 102 A.F.T.R.2d 5442 (Fed. Cl. 2008) ("[T]he concept of reliance on the advice of professionals is a hallmark of the exception for reasonable cause and good faith."); David Weisbach & Brian Gale, *The Regulation of Tax Advice and Advisors*, 130 Tax Notes (TA) 1279, 1287 (Mar. 14, 2011) (stating that "[o]ne of the central benefits of obtaining an opinion is to protect against the possibility of penalties").

[9] I.R.C. § 6662(d)(2)(C) (this exception is not applicable to tax shelter transactions).

[10] § 6662(d)(2)(B).

basis for the position.[11] For non-tax shelter transactions that are not properly disclosed, a taxpayer needs to have substantial authority for the position reported on a tax return.[12] The substantial authority standard "is an objective standard" that "is less stringent than the more likely than not standard . . . but more stringent than the reasonable basis standard."[13] Thus, a lower level of confidence is acceptable if the taxpayer draws the Service's attention to the transaction.[14] "More likely than not" means a greater than 50% likelihood that the position would be upheld were it to be challenged by the Service.[15] "Reasonable basis" is defined in the regulations to mean "significantly higher than not frivolous or not patently improper."[16] "Reasonable basis" and "substantial authority" are commonly understood to mean confidence levels of 20% and 40%, respectively.[17] Even taxpayers who cannot muster a reasonable basis for the position may nevertheless be able to avoid accuracy penalties imposed by section 6662 by satisfying the reasonable cause and good faith defense, which requires no particular level of confidence for non-tax shelter transactions.[18]

The only way for taxpayers who engage in tax motivated transactions to avoid accuracy-related penalties is by satisfying the reasonable cause and good faith defense.[19] Any taxpayer who engages in a listed transaction or a reportable avoidance transaction within the meaning of section 6662A (transactions with a significant purpose of tax avoidance or evasion and certain characteristics that require them to be disclosed to the Service) qualifies for the reasonable cause defense only by having substantial authority for the position and a reasonable belief that the position was more likely than not the proper treatment at the time the return was filed.[20]

The Treasury regulations apply these same standards to corporate taxpayers who engage in tax shelters, which are transactions with a significant purpose

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[11] § 6662(d)(2)(B)(ii).

[12] § 6662(d)(2)(B)(i).

[13] Reg. § 1.6662-4(d)(2).

[14] *See Recent Proposed Statutory Changes to Return Preparer Rules of Internal Revenue Code Section 6694 and Related Issues,* N.Y. STATE BAR ASS'N TAX SECTION, Jan. 28, 2008, http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1146Report.pdf (letter discussing the recent and proposed statutory changes to tax return preparer penalties).

[15] Reg. § 1.6662-4(d)(2).

[16] Reg. § 1.6662-3(b)(3).

[17] JOINT COMM. ON TAX'N, COMPARISON OF JOINT COMM. STAFF AND TREASURY RECOMMENDATIONS RELATING TO PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE 13 (Nov. 5, 1999).

[18] I.R.C. § 6664(c).

[19] The exception in section 6662(d)(2)(B) does not apply to tax shelters. *See* I.R.C. § 6662(d)(2)(C); *supra* notes 9-12 and accompanying text. Although a taxpayer engaged in a tax shelter can no longer avoid accuracy penalties by having substantial authority or by disclosing the transaction and having a reasonable basis, those taxpayers may nonetheless qualify for the reasonable cause and good faith exception. Notice 2005-12, 2005-1 C.B. 494.

[20] § 6664(d)(3)(B), (C). *See infra* notes 64-67 and accompanying text for discussion of reportable transactions.

of tax avoidance.[21] Pursuant to this special rule, a corporate taxpayer that engages in a nonreportable transaction with a significant tax avoidance purpose and wishes to rely on the merits of the underlying position to support a reasonable cause defense has to, at a minimum, show that there is substantial authority for the taxpayer's tax treatment and that the taxpayer reasonably believes that the tax treatment was more likely than not the proper treatment at the time the return was filed (the "Legal Justification Test").[22] The reasonable belief requirement may be satisfied by reliance on a "more likely than not" tax opinion.[23] Failing to satisfy these minimum requirements will preclude a corporate taxpayer from using its legal justification to meet the reasonable cause and good faith exception.[24]

The Service has taken the position in nonbinding guidance that "noncorporate taxpayers must also satisfy the more demanding standards for the reasonable cause and good faith exception in Regulation section 1.6664-4(f) with respect to tax shelter items."[25] There is a reasonable argument that the Legal Justification Test in Regulation section 1.6664-4(f)(2) should apply to tax shelters of noncorporate taxpayers. Until December 8, 1994, corporate taxpayers could exclude understatements attributable to a tax shelter by relying on the Substantial Authority Exception.[26] Treasury adopted the Legal Justification Test in 1995 after Congress eliminated the Substantial Authority Exception for corporations.[27] Treasury interpreted Congress's repeal of the Substantial Authority Exception for corporations to mean that a harsher regime should apply to corporate tax shelters.[28] Presumably, that same rationale would extend to noncorporate taxpayers after Congress eliminated the Substantial Authority Exception in 2004 for noncorporate taxpayers engaged

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[21] Reg. § 1.6664-4(f)(2).

[22] Reg. § 1.6664-4(f)(2). After the enactment of section 6662A, this rule in effect applies only to nonreportable significant purpose transactions. *See* I.R.C. §§ 6664(d)(1), 6662A(b)(2)(B) (stating that section 6662A applies to "any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax"). Satisfying the Legal Justification Test is a necessary, though perhaps not sufficient, requirement of the reasonable cause defense. Reg. § 1.6664-4(f)(3).

[23] Reg. § 1.6664-4(f)(2)(i)(B)(2).

[24] Reg. § 1.6664-4(f)(2)(i).

[25] Internal Revenue Serv., Variable Prepaid Forward Contracts Incorporating Share Lending Arrangements UIL: 1001.00-00, 2008 WL 852615 (Feb. 6, 2008). Coordinated issue papers are not binding authority; like revenue rulings, they merely state the Service's position. Tarpot Admin. Servs. v. Commissioner, 133 T.C. 202, 224 n.18 (2009).

[26] I.R.C. § 6662(d)(2)(C) (1994).

[27] Uruguay Round Agreements Act, Pub. L. No. 103-465, § 744, 108 Stat. 4809, 5011 (1994); T.D. 8617, 1995-2 C.B. 274.

[28] *See* T.D. 8617, *supra* note 27 ("Treasury and the IRS continue to believe that the regulations, including the authority requirement, properly implement the statute and Congressional intent.").

in tax shelters.[29] But the Legal Justification Test regulations, having last been amended in 2003, do not apply to noncorporate taxpayers.[30]

Thus, all significant purpose transactions of corporate taxpayers, whether or not they are reportable, require a more likely than not confidence level to avoid penalties. In contrast, noncorporate taxpayers engaged in tax motivated transactions that are not reportable or listed transactions, and thus not subject to section 6662A penalties, can satisfy the reasonable cause and good faith defense without having any particular level of confidence.

Although the highest level of opinion discussed in the Treasury regulations is a "more likely than not" opinion; "will" and "should" opinions are also commonly rendered.[31] Practitioners typically peg "will" opinions at about a 90% certainty that the intended tax consequences would be sustained if challenged by the Service and "should" opinions at somewhere between a 70% to 90% likelihood.[32] These confidence levels can be set forth in a hierarchy from strongest to weakest as follows: will (90% or greater confidence level); should (70%-90%); more likely than not (more than 50%); substantial authority (40%-50%); reasonable basis (20%); and not frivolous or not patently improper.[33] "Will" opinions usually are limited to straightforward legal issues because they provide assurance at almost near certainty.[34] As noted by one commentator, "[t]here is a fairly wide range of transactions in which an advisor easily reaches 'more likely than not,' and equally easily concludes that he will not get to 'will,' leaving him to think long and hard about whether he can make the jump to 'should.'"[35] More generally, it is worth emphasizing that

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[29]I.R.C. § 6662(d)(2)(C)(i) (2003), *amended by* Pub. L. No. 108-357, § 812, 118 Stat. 1418, 1577-80 (2004); *see also* Weisbach & Gale, *supra* note 8, at 1289 n.63 (noting that the reasonable cause regulations make a distinction between corporate and noncorporate taxpayers that no longer exists in the Code).

[30]T.D. 9109, 68 Fed. Reg. 75126 (Dec. 30, 2003).

[31]Reg. § 1.6662-4(d)(2); *see also* Weisbach & Gale, *supra* note 8, at 1284.

[32]Robert Rothman, *The Least Fun Part of the Job or a Tax Lawyer's Guide to Acquisition Agreements*, 55 TAX LAW. 711, 744 (2002) ("[B]y convention a 'will' opinion represents the lawyer's professional judgment that there is no risk of any other characterization."); Jasper L. Cummings, Jr., *The Range of Legal Tax Opinions, with Emphasis on the 'Should' Opinion*, 98 TAX NOTES (TA) 1125, 1129, 1132 (Feb. 19, 2003) (noting the "'will' opinion is the clean or unqualified opinion of near certainty, or as certain as things can be in the tax world," and that a "should" opinion conveys a certainty of between 70% and 90%); *see also* Weisbach & Gale, *supra* note 8, at 744 ("[B]y convention the 'should' opinion represents a professional judgment that concludes, with a fairly high degree of confidence, that certain consequences will ensue, but which acknowledges some degree of uncertainty with respect to that conclusion.").

[33]The former regulations relating to tax preparer penalties contained an additional confidence level, a "realistic possibility of success," which was defined to mean "a one in three, or greater, likelihood of being sustained on the merits." Reg. § 1.6694-2(b) (2007) (current version at Reg. § 1.6694-2(b)); *see also* ABA COMM. ON ETHICS & PROF'L RESPONSIBILITY, FORMAL OP. 85-352 (1985) (permitting a lawyer to advise a client with respect to a tax return position provided there is "some realistic possibility of success if the matter is litigated").

[34]Robert P. Rothman, *Tax Opinion Practice*, 64 TAX LAW. 301, 312 (2011) (stating that "will" opinions are "often easy to give" because they involve "no troublesome legal issues").

[35]*Id.* at 313.

the mathematical precision of these confidence levels may not be reflected in the legal authorities, which to the extent they exist, are sometimes vague and ambiguous, or even contradictory.[36]

III. Overview of Accuracy-Related Penalties

A. *Civil Tax Penalties As Tools to Promote Voluntary Compliance*

The U.S. tax system is known as a self-assessment system because taxpayers are required to calculate their tax liabilities, file their tax returns, and pay their taxes without direct intervention or enforcement by the Service.[37] The success of our self-assessment system necessarily depends on taxpayers' voluntary compliance with the legal duties imposed upon them. The Service estimates that approximately 83% of taxpayers correctly calculate and timely file and pay the taxes they owe voluntarily without compulsion from the Service.[38]

The legal and economics literatures generally accept the view that civil tax penalties are intended to promote voluntary compliance, although how penalties actually do so is subject to debate.[39] Under a deterrence theory of tax compliance, civil tax penalties encourage taxpayers to compute their taxes accurately and to make timely payment of those taxes, thereby promoting voluntarily compliance in a self-assessment system by making noncompliance more costly.[40] A deterrence theory of tax compliance posits that taxpayers will comply with the tax laws when the expected cost of noncompliance exceeds

[36] *Id.* at 311.

[37] Internal Revenue Serv., Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance 6 (Aug. 2, 2007) [hereinafter Improving Voluntary Compliance]; *see, e.g.*, Laing v. United States, 423 U.S. 161, 191 (1976) (quoting Flora v. United States, 362 U.S. 145, 176 (1960)) ("Our income tax system is primarily a self-reporting and self-assessment one. It is 'based upon voluntary assessment and payment, not upon distraint.'").

[38] *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study*, Internal Revenue Service, Jan. 6, 2012, http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study. The voluntary compliance rate, which is the amount of taxes paid voluntarily and timely, expressed as a percentage of total taxes that the Service estimates should have been paid, is estimated to be 83.1%. Improving Voluntary Compliance, *supra* note 37, at 18. The 16.9% comprises noncompliant taxpayers who do not file required returns, under-report their income, or fail to timely pay the taxes they owe. *Tax Gap Map*, Internal Revenue Service, Dec. 2011, http://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf. The 16.9% of noncompliance translates into an estimated $450.0 billion of taxes that are legally imposed but are not voluntarily and timely paid. *Id.*

[39] Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. on Legis. 111, 111-12 (2009).

[40] *Id.* at 112; *see also* Office of Tax Pol'y, Dep't of the Treasury, Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code 18 (1999) [hereinafter 1999 Report] ("The fundamental objective [of penalties] should be to foster and enhance the high degree of voluntary compliance that presently exists among the taxpaying public without undue burden or complexity.").

the cost of compliance.[41] The expected cost of noncompliance would consist of the taxes, penalties, and interest that would be owed if the taxpayer did not comply. But the cost of noncompliance must be discounted by the risk that the Service will actually detect the noncompliance.[42] For fiscal year 2012 (October 2011–September 2012), only about 1% of all individual income tax returns, 1.6% of all C corporation returns, and 17.8% of large corporate returns were audited.[43] Given the low audit rates, a deterrence model fails to justify fully the role of penalties as a mechanism to promote voluntary compliance because, economically at least, there is no incentive for taxpayers to comply.[44]

Penalties also may encourage voluntary compliance by reinforcing norms. A norms model explains taxpayers' compliance with the tax laws by reference to personal and social norms, including reciprocal cooperation and trust.[45] Under a norms model, taxpayers comply with the tax laws because they assume or perceive others to be in compliance.[46] The imposition of penalties encourages law-abiding taxpayers to remain compliant by assuring them that those who do not comply will be penalized.[47] Without the threat of penalties, otherwise compliant taxpayers may stop complying once they start to feel duped by actually paying the taxes they owe while others fail to meet their tax reporting or payment obligations.[48] Additionally, imposing penalties under a norms model is intended to punish those who fail to follow tax-compliance

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[41] Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323, 325-26 (1972).

[42] *Id.*

[43] INTERNAL REVENUE SERV., DATA BOOK, EXAMINATION COVERAGE: RECOMMENDED AND AVERAGE RECOMMENDED ADDITIONAL TAX AFTER EXAMINATION, BY TYPE AND SIZE OF RETURN, FISCAL YEAR 2012, TABLE 9A (2012). The chances of being audited increase noticeably for individuals with adjusted gross income above $1.0 million. *Id.* at 26 (Table 9b). Likewise, larger corporations have a greater chance of being audited, and almost all of the largest corporations are audited. *Id.* at 22.

[44] Consider as an example an individual who owes $10,000 of taxes and assume a penalty rate of 20% and a detection rate of 1%. Ignoring interest owed on the underpayment, the expected economic cost of noncompliance is only $120 ($10,000 in taxes and $2,000 in penalties owed if caught × 1% detection rate) whereas the cost of complying is the $10,000 of tax that is legally due. A deterrence theory says that this taxpayer will not pay the $10,000 of taxes owing because the expected cost of noncompliance is only $120.

[45] Doran, *supra* note 39, at 131.

[46] *Id.*

[47] *Id.*; *see also* INTERNAL REVENUE SERV., IRS PENALTY HANDBOOK, 20.1.1.2.1(7) (stating that "[p]enalties support voluntary compliance by assuring compliant taxpayers that tax offenders are identified and penalized").

[48] *See, e.g.*, Linda M. Beale, *Book-tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301, 371 (2004) (stating that taxpayers in a voluntary compliance system "are more likely to comply if they believe that the tax system is fairly and consistently applied across taxpayers").

norms.[49] Imposing penalties for noncompliance emphasizes the fairness of the tax system, which also encourages voluntary compliance.[50]

How penalties affect voluntary compliance is not certain because their effects have generally not been quantitatively measured.[51] Whatever the justifications for civil tax penalties or their effectiveness in promoting voluntary compliance, they are well entrenched in our federal tax system, having been a part of federal tax law since the Civil War.[52]

B. *Summary of Accuracy-Related Penalties*

By one count, there are over 130 different civil tax penalty provisions in the Code.[53] This Article is not intended to be a comprehensive discussion of all the penalty provisions. Instead, because the focus of this Article is on the reasonable cause and good faith exceptions applicable to accuracy-related penalties, this section of the Article provides a summary of the accuracy-related penalties to which the reasonable cause exceptions apply.

1. *Section 6662 Accuracy-Related Penalties*

Section 6662 imposes an accuracy-related penalty on underpayments of tax attributable to certain types of misconduct, including negligence or disregard of rules or regulations and transactions found to be lacking economic substance.[54] An accuracy-related penalty may apply even if the taxpayer is not negligent and considers all rules and regulations if there is an understatement of income tax that is sufficiently large, or in the words of the Code, "substantial." The term "understatement" generally means the excess of the correct tax liability over the liability shown on the return reduced by any rebates.[55] For corporations other than S corporations and personal holding companies, an understatement of income tax is substantial if the understatement exceeds the lesser of (1) ten percent of the tax liability required to be shown on the return for the taxable year, or if greater, $10,000, or (2) $10.0 million.[56] For all other taxpayers, an understatement is substantial if it exceeds the greater of (1) ten

[49] Doran, *supra* note 39, at 133 (stating that "the norms model assumes that certain taxpayers will not follow tax-compliance norms, and those taxpayers must be deterred by the threat of legal sanctions").

[50] In his article, Professor Doran offers a third role for tax penalties, which is to define tax compliance. *Id.*

[51] *See* 1999 REPORT, *supra* note 40, at 39 (noting that the government has insufficient data to determine the effectiveness of penalties but stating nonetheless that "the overall evidence suggests that penalties and audits have positive effects on compliance").

[52] *Id.* at 19.

[53] NAT'L TAXPAYER ADVOCATE, INTERNAL REVENUE SERV., 2008 ANNUAL REPORT TO CONGRESS, vol. 2, 7 (2008).

[54] I.R.C. § 6662(b)(1)-(3). Section 6662 applies to other types of misconduct in addition to those just mentioned. *See* § 6662(b)(4)-(5), (7). This Article does not discuss those provisions because they generally do not arise in cases analyzing the common law conflict of interest rule.

[55] § 6662(d)(2)(A).

[56] § 6662(d)(1)(B).

percent of the correct tax required to be shown on the return or (2) $5,000.[57] A penalty also applies to underpayments attributable to substantial valuation misstatements, which exist when the value or adjusted basis of property claimed on a return is 150% or more of the correct amount.[58]

The amount of the penalty is equal to 20% of the underpayment of tax.[59] The penalty rate increases to 40% of understatements attributable to gross valuation misstatements within the meaning of section 6662(h) and undisclosed noneconomic substance transactions within the meaning of section 6662(i).[60] While an underpayment may be attributable to more than one kind of misconduct, there is no stacking or accumulation of penalties. Thus, the maximum accuracy-related penalty that may be imposed is 20% (or 40% in the case of gross misconduct) even if an underpayment is attributable to more than one type of misconduct or overstatement.[61]

2. *Section 6662A Penalties on Reportable Transaction Understatements*

In 2004, as a reaction to the tax shelter heyday of the late 1990s and early 2000s, Congress enacted section 6662A to deter taxpayers from entering into tax avoidance transactions.[62] Section 6662A created a new penalty for understatements of tax attributable to (1) "any listed transaction" or (2) "any reportable transaction . . . if a significant purpose of such transaction is the avoidance or evasion of Federal income tax" (reportable avoidance transactions).[63] Participation in reportable transactions must be reported to the Service because these types of transactions are abusive or have the potential for abuse.[64] Reportable transactions include: (1) listed transactions, which are transactions that the Service has identified as abusive pursuant to section 6011; (2) transactions with contractual protection that permits the taxpayer to receive a refund of fees paid to advisors if the intended tax treatment is not sustained or where the fees are contingent on receipt of the intended tax benefits; (3) confidential transactions, which involve advisors who prohibit their clients from disclosing the tax treatment or structure to protect the confidentiality of the advisors' tax strategies;[65] (4) transactions resulting

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[57] § 6662(d)(1)(A).

[58] § 6662(e)(1)(A).

[59] §§ 6662(a), 6664(a).

[60] A gross valuation misstatement exists when the value or adjusted basis of property claimed on a return is 200% or more of the correct amount. § 6662(h)(2)(A)(i). Additionally, a 40% penalty rate applies if the correct value or adjusted basis of property is zero but some other value or adjusted basis is claimed on a return. Reg. § 1.6662-5(g).

[61] Reg. § 1.6662-2(c).

[62] STAFF OF JOINT COMM. ON TAX'N, 108TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION IN THE 108TH CONGRESS 364 (Joint Comm. Print 2005).

[63] I.R.C. § 6662A(b)(2).

[64] § 6662A(d) (referring to section 6707A(c), which refers to section 6011).

[65] A transaction is a reportable loss transaction only if the advisor is paid at least $250,000 for a corporate taxpayer or $50,000 in all other cases. Reg. § 1.6011-4(b)(3)(iii).

in large tax losses being claimed;[66] and (5) transactions of interest, which are transactions the Service has identified as potentially abusive but for which the Service lacks sufficient information to determine whether the transactions should be listed.[67]

The section 6662A penalty is calculated by multiplying the penalty rate times the base. The penalty rate is generally 20% of any reportable transaction understatement, but increases to 30% if the transaction is not disclosed.[68] Public entities have to disclose payment of the 30% penalty to the Securities and Exchange Commission.[69] Unlike the accuracy-related penalty in section 6662, which is computed based on the net amount of tax owing, the section 6662A penalty is computed based on the net increase in taxable income resulting from the difference between the proper tax treatment and the taxpayer's treatment of the item as shown on the return.[70]

IV. Reasonable Cause and Good Faith Exceptions to Accuracy-Related Penalties

A. *Background and Scope of the Reasonable Cause and Good Faith Exceptions*

Taxpayers may avoid accuracy penalties, other than those stemming from transactions lacking economic substance, by satisfying a reasonable cause and good faith exception, which requires a showing that there is reasonable cause for the inaccuracy and that the taxpayer acted in good faith despite the inaccuracy.[71] The reasonable cause and good faith exception is the only way to avoid accuracy-related penalties imposed under section 6662A, as

[66] Loss transactions that must be reported include those generating at least $2.0 million of section 165 loss for an individual in any tax year or $4.0 million in the year the transaction is entered into and the succeeding five taxable years. Reg. §§ 1.6011-4(b)(5)(i)(D), -(4)(b)(5)(ii). For corporations, the amount of loss is at least $10.0 million or at least $20.0 million over the same combination of years set forth in the previous sentence. Reg. §§ 1.6011-4(b)(5)(i)(A), -(4)(b)(5)(ii).

[67] Reg. § 1.6011-4(b).

[68] § 6662A(c). Section 6662A(c) refers to the disclosure requirement in section 6664(d)(2)(A). *Id.* Section 6664(d) has been amended since the enactment of section 6662A. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(c)(2)(A)-(C), 124 Stat. 1029, 1069-70. The disclosure requirement is now in section 6664(d)(3)(A). *Id.*

[69] I.R.C. § 6707A(e)(2)(B); Rev. Proc. 2005-51, 2005-2 C.B. 296.

[70] § 6662A(b). The base for the section 6662A penalty is the "reportable transaction understatement," which is the sum of two different calculations. § 6662A(b)(1). The first calculation is the product of increases in taxable income due to improper treatment of an item and the highest rate of appropriate tax applicable to the taxpayer. § 6662A(b)(1)(A). The second calculation is the amount of decrease in the total amount of tax credits stemming from the taxpayer's treatment of the section 6662A item and the proper treatment of such item. § 6662A(b)(1)(B).

[71] I.R.C. § 6664(c)(2), (d)(2) (no reasonable cause exception for transactions found to lack economic substance).

well as for penalties attributable to tax shelter transactions.[72] The term "tax shelter" means "a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."[73]

The reasonable cause and good faith exception recognizes that taxpayers who undertake efforts to determine their proper tax liability should not be penalized for getting it wrong.[74] Before 2004, there was one reasonable cause exception for accuracy penalties.[75] But when Congress enacted section 6662A, it created a new, more stringent reasonable cause exception that applies specifically to penalties imposed under section 6662A.

B. *Reasonable Cause and Good Faith Exception to Section 6662A Penalties*

The heightened reasonable cause exception, which applies to penalties imposed under section 6662A relating to listed transactions and reportable avoidance transactions, is available only if three requirements are satisfied.[76] First, the taxpayer must disclose to the Service, pursuant to section 6011, the facts concerning the transaction's treatment.[77] Failing to disclose a transaction subject to section 6662A results in a strict liability penalty because the reasonable cause exception is unavailable if there is no disclosure and the reasonable cause exception is the only way to avoid the imposition of section 6662A penalties.[78] Second, there must be substantial authority for the taxpayer's treatment of the transaction, which involves an objective evaluation of the legal

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[72] § 6664(d). *See supra* notes 9-13 and accompanying text discussing the "substantial authority exception" that may be used to avoid accuracy-related penalties relating to transactions that are not tax shelters.

[73] I.R.C. § 6662(d)(2)(C)(ii).

[74] David T. Moldenhauer, *Penalty Protection Opinions and Advisor Conflicts of Interest*, 27 Akron Tax J. 55, 61 (2012).

[75] The reasonable cause and good faith exception was incorporated in section 6664 in 1989 as part of the Improved Penalty Administration and Compliance Tax Act and was made applicable to all accuracy-related penalties that existed at the time of enactment. Improved Penalty Administration and Compliance Tax Act, Pub. L. No. 101-239, § 6664, 103 Stat. 2106, 2398 (1989); *see also* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 323, 96 Stat. 324, 613-15 (repealed 1989) (providing that "[t]he Secretary may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith").

[76] § 6664(d)(3); *see supra* notes 63-67 and accompanying text for definitions of listed transactions and reportable avoidance transactions.

[77] § 6664(d)(3)(A). To satisfy the disclosure requirement, taxpayers must attach a completed Form 8886 (Reportable Transaction Disclosure Statement) to the return that reflects the transaction. Reg. § 1.6011-4(d); Notice 2005-12, *supra* note 19.

[78] H.R. Rep. No. 108-548, pt. 1, at 263-64 (2004) (stating that "[i]f the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies)").

authorities.[79] Third, the taxpayer must reasonably believe its treatment was more likely than not the correct treatment.[80] A taxpayer's reasonable belief may be founded on a more likely than not opinion from a professional advisor provided the advice is not a "disqualified opinion" and is not from a "disqualified tax advisor."[81] Disqualified opinions are those based on unreasonable factual or legal assumptions or unreasonable representations provided by the taxpayer or other individuals.[82] Disqualified opinions can also include opinions that do not identify and consider all the pertinent facts of a transaction or any other requirement that Treasury may prescribe.[83]

The Code defines the term "disqualified tax advisor" using four characteristics—any of which will cause the advisor to be a disqualified tax advisor.[84] The first situation is an advisor who derives more than $50,000 for advising a natural person or more than $250,000 in all other cases (a "material advisor") who participates in the organization, management, promotion, or sale of the transaction or is related to any person who so participates.[85] The fee thresholds are reduced to $25,000 for corporations and $10,000 for all other taxpayers who engage in listed transactions.[86] The second type of disqualified advisor is one who is directly or indirectly paid by a material advisor with respect to a transaction.[87] A disqualified advisor can also include an advisor whose fee is contingent on "all or part of the intended tax benefits from the transaction being sustained."[88] Last, a disqualified advisor is one who has a disqualifying financial interest in the transaction as posited by Treasury Department regulations.[89] Treasury has not proposed any applicable regulations.[90]

Section 6662A may apply if a transaction that is not listed at the time a return is filed reporting the consequences of the transaction later becomes

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[79] Reg. § 1.6662-4(d)(3)(i); *see* text accompanying note 13 for definition of substantial authority.

[80] § 6664(d)(3)(C).

[81] § 6664(d)(4)(B)(i). A more likely than not opinion is one concluding that the position on the return will be sustained on the merits at a likelihood of more than 50%.

[82] § 6664(d)(4)(B)(iii)(I)-(II).

[83] § 6664(d)(4)(B)(iii)(III)-(IV).

[84] § 6664(d)(4)(B)(ii).

[85] § 6664(d)(4)(B)(ii)(I). The Service issued Notice 2005-12 to provide interim guidance as to when a material advisor is considered to organize, manage, promote, or sell a transaction within the meaning of section 6664(d)(4)(B)(ii)(I). Notice 2005-12, *supra* note 19.

[86] Notice 2005-12, *supra* note 19 (stating that the fee amounts applicable to listed transactions under Regulation section 301.6112-1(c)(3)(ii) apply); *see* T.D. 9046, 2003-1 C.B. 614, prior to amendment by T.D. 9352, 2007-2 C.B. 621.

[87] § 6664(d)(4)(B)(ii)(II).

[88] § 6664(d)(4)(B)(ii)(III). Since 2008, Circular 230 has prohibited contingent fee arrangements for tax planning and advice, including the rendering of written tax advice. 31 C.F.R. § 10.27 (2011).

[89] § 6664(d)(4)(B)(ii)(IV).

[90] Notice 2005-12 provides interim guidance with respect to certain kinds of disqualifying compensation arrangements. Notice 2005-12, *supra* note 19.

listed while the statute of limitations on assessment is still open.[91] In such cases, the tax advisor could retroactively become disqualified, which would prohibit the taxpayer from relying on the reasonable cause exception applicable to section 6662A penalties.[92]

C. *Exception to Section 6662 Penalties*

The reasonable cause exception in section 6664(c) applies to transactions that are not covered by section 6662A, including: (1) nonreportable, nonsignificant purpose transactions; (2) reportable transactions, other than listed transactions, with no significant avoidance purpose; and (3) nonreportable transactions that nonetheless have a significant purpose of tax avoidance.[93] The decision of whether a taxpayer acted with reasonable cause and in good faith is made by taking into account all the relevant facts and circumstances.[94] The most important factor is the taxpayers' efforts to ensure their correct tax liability.[95] Other facts and circumstances that may be relevant in determining whether reasonable cause and good faith exist include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances as well as the taxpayer's education, knowledge, and business experience.[96] Reasonable cause requires the taxpayer to exercise "ordinary business care and prudence."[97]

What factors constitute reasonable cause is a legal question.[98] Whether those factors are present in a given case (*i.e.*, whether a taxpayer has reasonable cause for a tax underpayment) is a factual question.[99] Because it is a question of fact, a trial court's decision regarding whether or not reasonable cause exists may be reversed only if there is a "definite and firm conviction that a mistake has been committed."[100] The Service's determination regarding reasonable cause is reviewed de novo by the trial court.[101]

Like the reasonable cause exception attributable to section 6662A penalties, the section 6664(c) reasonable cause exception attributable to section

[91] *See* Reg. § 1.6011-4(e)(2)(i).

[92] Alan W. Granwell & David D. Sherwood, *Accuracy-Related and Fraud Penalties After Enactment of the American Jobs Creation Act of 2004*, FED. B.A. SEC. TAX'N REP. 19, 20 n.3 (2005).

[93] No penalty will apply even if a transaction is reportable so long as there is no significant tax avoidance purpose and the taxpayer discloses the relevant facts relating to the position and can show a reasonable basis for the position. I.R.C. § 6662(d)(2)(B)(ii).

[94] Higbee v. Commissioner, 116 T.C. 438, 448 (2001); Reg. § 1.6664-4(b)(1).

[95] Reg. § 1.6664-4(b)(1).

[96] *Id.*

[97] Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 98 (2000) (citing United States v. Boyle, 469 U.S. 241 (1985)).

[98] Am. Boat Co. v. United States, 583 F.3d 471, 483-84 (7th Cir. 2009).

[99] *Id.*

[100] *Id.* at 483 (citing Anderson v. City of Bessemer City, 470 U.S. 564, 573 (1985)).

[101] Murfam Farms, LLC *ex rel.* Murphy v. United States, 94 Fed. Cl. 235, 245 (Fed. Cl. 2010).

6662 penalties may be satisfied by relying on a tax advisor even if the advice in hindsight turns out to be incorrect and the taxpayer is found to be liable for the underlying tax. For purposes of section 6664(c), the advisor has to be competent and reliance has to be reasonable in light of the circumstances.[102] A taxpayer's education, sophistication, and business background are taken into account to determine whether reliance is reasonable.[103] The Tax Court has said that a taxpayer must satisfy the following three-part test to *possibly* avoid accuracy-related penalties under section 6662 by relying on a tax advisor: "(1) The advisor was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the advisor, and (3) the taxpayer actually relied in good faith on the advisor's judgment."[104] The regulations also require that the tax advice (1) be grounded on all relevant facts and the law that pertains to those facts and (2) not rely on unreasonable or inaccurate factual or legal assumptions or unreasonable representations.[105]

D. *A Comparison of the Two Reasonable Cause Exceptions*

The reasonable cause exception in section 6664(c) is more lenient than the section 6664(d) exception applicable to section 6662A penalties in at least three ways. First, disclosure of the transaction is not required to qualify for the section 6664(c) exception.[106] Second, except for corporate taxpayers who engage in tax shelters, taxpayers generally may satisfy the section 6664(c) reasonable cause exception without having substantial authority for the position and without believing that the position is more likely than not correct.[107] Third, unlike the more stringent reasonable cause exception in section 6664(d), which categorically prohibits reliance on conflicted advisors, section 6664(c) does not itself require taxpayers to rely on disinterested advisors.

[102] *Am. Boat*, 583 F.3d at 481; Reg. § 1.6664-4(c)(1).

[103] Reg. § 1.6664-4(c)(1).

[104] Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 98-99 (2000).

[105] Reg. § 1.6664-4(c)(1).

[106] *Compare* I.R.C. § 6664(c)(3), *with* § 6664(d)(3)(A). But even under the more lenient reasonable cause exception, failing to disclose a reportable transaction "is a strong indication that the taxpayer did not act in good faith with respect to the portion of the underpayment attributable to the reportable transaction." Reg. § 1.6664-4(d).

[107] *Compare* I.R.C. § 6664(c)(3), *with* § 6664(d)(3)(B), (C). Circular 230, however, requires the inclusion of a disclaimer that a covered opinion cannot be used for penalty protection if a more likely than not level of confidence cannot be reached. 31 C.F.R. § 10.35(e)(4)(ii) (2011). This glitch arises because the Legal Justification Test applies only to corporate taxpayers whereas the covered opinion rules do not distinguish among types of taxpayers. *See supra* notes 22-24 and accompanying text for discussion of Legal Justification Test.

V. Common Law Conflict of Interest Rule

A. *Introduction and Background*

Although the more lenient reasonable cause exception in section 6664(c) does not itself statutorily require independent advisors to avoid penalties, courts have repeatedly held that taxpayers "cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest."[108] Thus, unlike the per se prohibition that applies to section 6662A penalties, whether advice from an advisor with a conflict of interest would make reliance on the advice unreasonable under the more lenient reasonable cause exception should depend on all the facts and circumstances.[109] One of the early cases applying this common law conflict of interest rule is *Goldman v. Commissioner.*[110] In *Goldman*, an individual taxpayer claimed losses on his 1981 and 1982 tax returns.[111] The losses claimed were approximately 400% more than the amount of cash he invested in a limited partnership formed to invest in oil and gas exploration.[112] The Service disallowed the losses claimed and imposed a negligence penalty.[113] The taxpayer sought to avoid the penalty by arguing reliance on a tax advisor's evaluation of the investment.[114]

The Second Circuit acknowledged that reliance on professional advice may provide a reasonable cause defense but noted that "such reliance must be objectively reasonable."[115] Here, reliance on the advisor was not objectively reasonable because the investor knew that the advisor had an "inherent conflict of interest" due to the advisor's role as the limited partnership's sales representative.[116] The investor knew or should have known of the advisor's role because he was identified as the partnership's sales representative on the subscription agreement and the limited partnership agreement, both of which the taxpayer signed.[117]

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[108] Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994); *see also* Mortensen v. Commissioner, 440 F.3d 375, 387 (6th Cir. 2006) (stating that "[i]n order for reliance on professional tax advice to be reasonable . . . the advice must generally be from a competent and independent advisor unburdened with a conflict of interest and not from promoters of the investment").

[109] *See* Am. Boat Co. v. Commissioner, 583 F.3d 471, 483 (7th Cir. 2009) (the court, in evaluating applicability of reasonable cause exception under section 6664(c), declined to adopt a per se rule that would disqualify advice from one who implements a transaction that includes a potential tax shelter).

[110] *Goldman*, 39 F.3d at 408.

[111] *Id.* at 404.

[112] *Id.*

[113] *Id.* at 405.

[114] *Id.* at 408.

[115] *Id.*

[116] *Id.* at 404, 408.

[117] *Id.*

The rationale for the common law conflict of interest rule, though not usually articulated in the cases, is that a lawyer free of conflicts of interest is more likely to give unbiased advice to the client.[118] Prohibiting reliance on a conflicted advisor helps ensure that the lawyer's personal interests or interests to third parties do not diminish the lawyer's duty of undivided loyalty to the client.[119] Otherwise, the lawyer's judgment could become impaired such that the conflicted lawyer will either consciously or unconsciously fail "to consider, recommend or carry out an appropriate course of action for the client."[120] A lawyer with something to gain personally may be too tempted to provide a client biased and unreliable advice if necessary to further the lawyer's own personal interests.[121]

B. *Potential for Advisor Bias*

Tax planning is less of a science and more of an art. Creative advisors exploit complex and detailed tax rules to find unintended loopholes.[122] Legislative or regulatory fixes to close loopholes add more complexity to the Code.[123] Though it may seem counterintuitive, the detailed rules written by Congress and the Treasury themselves "might become the source of further

[118] See Rule 1.7 of the American Bar Association's *Model Rules of Professional Conduct*, which generally prohibits a lawyer from representing a client if "there is a significant risk that the representation . . . will be materially limited . . . by a personal interest of the lawyer." MODEL RULES OF PROF'L CONDUCT R. 1.7 (2013). Similarly, Rule 102 of the American Institute of Certified Public Accountants' (AICPA) Professional Standards requires a CPA to "maintain objectivity and integrity" and to "be free of conflicts of interest." AICPA PROF'L STANDARDS R. 102 (1988); *see also* Audrey I. Benison, *The Sophisticated Client: A Proposal for the Reconciliation of Conflicts of Interest Standards for Attorneys and Accountants*, 13 GEO. J. LEGAL ETHICS 699, 700 (2000) ("Conflicts of interest rules are designed to preserve unadulterated decision-making by prophylactically restricting conflicted representations."). The Treasury has published regulations that govern individuals who represent taxpayers before the Service in title 31, section 10 of the Code of Federal Regulations and reprinted the regulations as Treasury Department Circular No. 230 (Circular 230). Circular 230 is administered and enforced by the Office of Professional Responsibility. Circular 230 echoes the language of the ABA Model Rules regarding conflicts of interest. 31 C.F.R. § 10.29 (2011).

[119] *See* MODEL CODE OF PROF'L RESPONSIBILITY EC 5-1.

[120] MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 8 (2013).

[121] *Id.* at R. 1.7 cmt. 10 (2013) ("The lawyer's own interests should not be permitted to have an adverse effect on representation of a client. For example, if the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice.").

[122] *See* William A. Drennan, *Strict Liability and Tax Penalties*, 62 OKLA. L. REV. 1, 54 n.41 (2009) (quoting David Cay Johnston, *The Loophole Artist*, N.Y. TIMES, Dec. 21, 2003, at SM18) ("[The tax planner's] cat-and-mouse game is to work the loopholes in the system until the government finds them and draws them closed.").

[123] Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 671 (2003).

ambiguity."[124] Ambiguities in the tax law arising from its complexity make it easier for advisors to rationalize the result that the client wants.[125]

Adding to the opportunities provided by ambiguity and complexity in the tax laws, it may be impossible to know for sure whether an advisor is compromised or has simply made one or more errors in judgment in cases where advice in a tax opinion is later discovered to be incorrect because "[b]ias, by its very nature, is typically invisible."[126] It will often be impossible to tell in hindsight whether incorrect tax advice is due to the tax advisor's conscious or unconscious biases or the advisor's intentional actions.[127]

Tax advisors are subject to all sorts of biases. For example, they exhibit confirmation bias, which is the tendency to search for or interpret information that confirms one's perceptions.[128] Advisors also exhibit attachment bias, meaning they have "strong business reasons to remain in clients' good graces and are thus highly motivated" to reach the result desired by their clients.[129] The threat of familiarity posits that closer relationships are more likely to produce biases than weak or arm's length relationships.[130]

The fact that the client compensates the lawyer for the tax opinion creates the potential for compensation bias.[131] The lawyer wants to deliver the opinion that the client seeks in order to be compensated for the opinion. Additionally, a lawyer may be thinking about future opportunities to earn fees from the client through future engagements. Compensation bias can

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[124] *Id.* at 664; *see also* Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law Is Uncertain*, 27 VA. TAX REV. 241, 247-48 (2007).

[125] Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, 80 HARV. BUS. REV. 96, 99 (2002).

[126] *Id.* at 100 (discussing conflicts of interest of financial auditors).

[127] *Id.*

[128] C. Bryan Cloyd & Brian C. Spilker, *Influence of Client Preferences on Tax Professionals' Search for Judicial Precedent*, 74 ACCT. REV. 299, 303 (1999). Cloyd and Spilker used two studies to show that tax professionals conducting tax research exhibit confirmation bias. The subjects, who were given a fact pattern and the client's desired outcome, spent more time searching for cases whose outcome was consistent with client preferences than negative precedents. Moreover, because the subjects emphasized positive precedents, they felt more positive about the likelihood of success of their client's position, which then caused the subjects to more strongly recommend client preferences. The subjects in the study were tax professionals at Big 5 accounting firms, most of whom had master's degrees in taxation but only a small number of whom were also lawyers. In a different study, the authors found that confirmation bias was significantly less for law students than accounting students. C. Bryan Cloyd & Brian C. Spilker, *Confirmation Bias in Tax Information Search*, 22 J. AM. TAX'N ASS'N 60, 60 (2000).

[129] Bazerman et al., *supra* note 125, at 99.

[130] *Id.* at 100 (stating that the longer an advisor serves a client, the more biased his judgment will tend to be).

[131] Salem Fin., Inc. v. United States, 112 Fed. Cl. 543, 591 (2013) (quoting Neonatology Assocs., P.A. v. Commissioner, 299 F.3d 221, 234 n.22 (3d Cir. 2002)) (stating that "it is not immediately evident why a taxpayer should be able to take comfort in the advice of a professional promoting a tax shelter for a fee").

"nudge [advisors] to shade their views and 'draw more favorable qualitative conclusions' from their findings than they otherwise would."[132]

Because it is often impossible to determine whether an opinion was affected by advisor bias, the courts look to various factors as proxies for an advisor's lack of independence. Factors considered include the length of the relationship between the taxpayer and the advisor, the extent to which an advisor participated in the transaction, and the impact of certain fee structures.[133]

The paradigmatic example of an advisor's opinion being insufficient to avoid penalties is where the advisor or the advisor's agent is the promoter of a mass-marketed tax shelter. The case of *106 Ltd. v. Commissioner* is a good illustration.[134] 106 Ltd. was a limited partnership that Mr. Palmlund used to engage in a Son of BOSS transaction (a variation of the Bond and Option Sales Strategy) using foreign currency options at the urging of his longtime lawyer Joe Garza.[135] Palmlund ran Garza's idea by his long-time accountants at Turner & Stone and they "gave him the green light, telling him they themselves had used the same transaction" for some of their other clients.[136] Garza also told Palmlund that he had worked with Turner & Stone "on similar transactions in the past."[137] Garza delivered to Palmlund a "more likely than not" tax opinion, which Turner & Stone relied on to prepare Palmlund's tax return.[138] The Service disallowed the purported $1.0 million loss deduction generated by the Son of BOSS transaction that flowed through to Palmlund's

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[132]Christopher Tarver Robertson, *Blind Expertise*, 85 N.Y.U. L. Rev. 174, 188 (2010) (quoting Susannah L. Rose et al., *Relationships Between Authorship Contributions and Authors' Industry Financial Ties Among Oncology Clinical Trials*, 28 J. Clinical Oncology 1316, 1316 (2010)).

[133]*See, e.g.*, Stobie Creek Invs. LLC, JFW v. United States, 608 F.3d 1366, 1382-83 (Fed. Cir. 2010) (tying advisors' compensation to "sheltered gain," which along with the advisors' role in promoting and implementing transaction created an impermissible conflict of interest); Candyce Martin 1999 Irrevocable Trust v. United States, 822 F. Supp. 2d 968, 1015, 1018 (N.D. Cal. 2011) (concluding that advisors "did not have a profit motive or other monetary interest in the outcome of the transaction because those advisors were paid at an hourly rate . . . regardless of whether [the taxpayers] ultimately engaged in the transaction"); Murfam Farms, LLC *ex rel.* Murphy v. United States, 94 Fed. Cl. 235, 247 (Fed. Cl. 2010) (noting that the "conflict of interest was exacerbated by the fee structure" by which the taxpayers knew that the advisor would be paid a percentage of the loss desired); Alpha I, L.P. v. United States, 93 Fed. Cl. 280, 317 (Fed. Cl. 2010) (advisor's fees being calculated as a percentage of expected tax treatment "weighs against the taxpayer's ability to establish a defense of reasonable cause and good faith"); New Phoenix Sunrise Corp. v. Commissioner, 132 T.C. 161, 193 (2009) (holding that a conflict of interest may exist if the advisor "actively participat[es] in the development, structuring, promotion, sale, and implementation" of the transaction being opined on).

[134]106 Ltd. v. Commissioner, 136 T.C. 67 (2011), *aff'd*, 684 F.3d 84 (D.C. Cir. 2012).

[135]*Id.* at 70-71.

[136]*Id.* at 70.

[137]106 Ltd. v. Commissioner, 684 F.3d 84, 87 (D.C. Cir. 2012). In fact, "Garza 'recommended' the transaction to '[m]ore than a dozen' other clients and used a '[v]ery similar' opinion letter for each client." *Id.* at 91 (quoting trial transcript).

[138]*106 Ltd.*, 136 T.C. at 72.

personal tax return and imposed accuracy-related penalties.[139] Palmlund conceded the underlying deficiency but filed suit in the Tax Court as the partnership's tax matters partner to challenge the penalties.[140]

Both Garza and Turner & Stone were deemed to be promoters whose advice could not reasonably be relied on.[141] The Tax Court defined the term promoter broadly for purposes of applying the common law conflict of interest rule as "an advisor who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction."[142] Applying that broad definition, the Tax Court observed that:

> Garza set up the LLCs, provided a copy of the opinion letter, and coordinated the deal from start to finish. And both Garza and Turner & Stone profited from selling the transaction to numerous clients. Garza charged a flat fee for implementing it and wouldn't have been compensated at all if Palmlund decided not to go through with it. He wasn't being paid to evaluate the deal or tweak a real business deal to increase its tax advantages; he was being paid to make it happen. And Turner & Stone charged $8,000 for preparing Palmlund's tax returns—$6,500 more than usual. The extra fees were not attributable to an extraordinarily complex return . . . but, we find, were the firm's cut for helping to make the deal happen.[143]

The Tax Court recognized that the promoter definition it adopted is potentially overbroad and could reach even routine tax planning.[144] Consequently, the court limited its definition to cases "like this one" involving a "tax shelter offered to numerous parties."[145] Thus, *106 Ltd.* stands for the proposition that reliance on "an adviser who participated in structuring . . . or is otherwise related to, has an interest in, or profits from" a marketed tax shelter is unreasonable.[146]

The District of Columbia Court of Appeals affirmed the Tax Court's decision.[147] The appellate court agreed that Palmlund could not reasonably rely on the advice of Garza or Turner & Stone because "he knew or should have known that his 'advisors' were not providing independent advice and that they were in fact promoters of the tax shelter who possessed an inherent conflict of interest."[148] The court emphasized that Garza recommended

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[139] *Id.* at 73.

[140] *Id.* at 74. The Service imposed a 40% gross valuation misstatement penalty on the partnership. *Id.*

[141] *Id.* at 80-81; *106 Ltd.*, 684 F.3d at 92.

[142] *106 Ltd.*, 136 T.C. at 80 (quoting dictum in Tigers Eye Trading, LLC v. Commissioner, 97 T.C.M. (CCH) 1622, 1634, 2009 T.C.M. (RIA) ¶ 2009-121, at 908).

[143] *Id.* at 80-81.

[144] *Id.* at 80.

[145] *Id.*

[146] *Id.* at 79, *aff'd*, 684 F.3d 84 (D.C. Cir. 2012) (concluding that the taxpayer could not rely on "promoters of the transaction. The caselaw [sic] is clear on this point—promoters take the good-faith out of good-faith reliance").

[147] *106 Ltd.*, 684 F.3d at 84.

[148] *Id.* at 92.

the Son of BOSS transaction to Palmlund, that Palmlund knew that Garza was marketing the transaction to other clients, and that Turner & Stone was essentially Garza's agent.[149]

C. *Unpredictability of Common Law Conflict of Interest Rule*

Application of the common law conflict of interest rule is unpredictable and inconsistent. An examination of the cases reveals no principled basis for distinguishing between those permitting reliance on an opinion and those rejecting reliance due to the advisor's potential or actual conflicts of interest. Additionally, the current approach fails to control for hindsight bias. The determination of whether accuracy-related penalties may apply is made only after concluding that the taxpayer underreported its taxes, but it would be inappropriate if the Service and the courts were biased by the hindsight knowledge that the taxpayer's tax position had been rejected when evaluating the taxpayer's reasonable cause defense.[150] Whether the reasonable cause defense is satisfied should be evaluated in hindsight by recreating the situation the taxpayer and the advisor faced at the time the advice was rendered.[151] Yet, when decisions seem results-oriented, the effects of hindsight bias must be considered.

To illustrate the inconsistency and unpredictability of the common law conflict of interest analysis, this Part of the Article describes two cases: *Canal Corp. v. Commissioner* and *American Boat Co., LLC v. United States.*

1. *Canal*

The Tax Court in *Canal Corp. v. Commissioner* found that "Chesapeake acted unreasonably in relying on the advice of [its long-standing public accounting firm and tax return preparer] given the inherent and obvious conflict of interest."[152] The Tax Court found that the advisor "crossed the line from trusted adviser . . . to advocate" in what many believe to have been a legitimate, run-of-the-mill transaction or at least one over which reasonable minds could disagree.[153]

Canal involved the imposition of accuracy-related penalties as a result of a transaction structured as a leveraged partnership that the Tax Court

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[149] *Id.* at 91.

[150] *See* John C. Anderson et al., *The Mitigation of Hindsight Bias in Judges' Evaluation of Auditor Decisions*, 16 AUDITING: J. PRAC. & THEORY 20, 20 (1997).

[151] Am. Boat Co. v. Commissioner, 583 F.3d 471, 485 (7th Cir. 2009).

[152] Canal Corp. v. Commissioner, 135 T.C. 199, 221 (2010) (citing New Phoenix Sunrise Corp. v. Commissioner, 132 T.C. 161, 192-94 (2009)).

[153] *Canal Corp.*, 135 T.C. at 220. For critical analysis of the Tax Court's decision, see, among others, Blake D. Rubin, Andrea Macintosh Whiteway & Jon G. Finkelstein, *Tax Court Goes Overboard in Canal*, 130 TAX NOTES (TA) 185 (Jan. 10, 2011); Richard M. Lipton & Todd D. Golub, *The Tax Court Drains Canal Corporation's Leveraged Partnership Transaction*, 113 J. TAX'N 340 (2010). *See also* William P. Bowers & Patrick L. O'Daniel, *Send Not to Know for Whom the Bell Tolls*, 13 BUS. ENTITIES 4, 12 (2011) (stating that the case involved a "complicated tax issue" that "was not free from doubt").

recharacterized as a disguised sale.[154] Georgia Pacific wanted to acquire Wisconsin Tissue Mills, Inc. (WISCO) from Chesapeake Corporation, which changed its name to Canal Corporation in 2009.[155] A sale of WISCO directly to Georgia Pacific was prohibitive, however, because Chesapeake's low tax basis in WISCO would have resulted in a prohibitively large gain.[156] Consequently, Chesapeake and Georgia Pacific agreed to enter into a leveraged partnership whereby WISCO and Georgia Pacific contributed the assets constituting their tissue businesses to a newly formed limited liability company that was classified as a partnership for federal tax purposes.[157] Simultaneously, the LLC made a special cash distribution to WISCO using the proceeds of a recourse loan that Georgia Pacific guaranteed.[158]

The contribution of property to a partnership is usually not a taxable transaction.[159] But when the contribution is made in connection with a distribution from the partnership, the contribution and distribution may instead be treated as a taxable sale of assets pursuant to the so-called disguised sale rules.[160] The disguised sale rules may be avoided by satisfying the debt-financed distribution exception in Regulation section 1.707-5(b), which excepts debt-financed distributions for purposes of determining whether a partner receives money or other consideration for disguised sale purposes to the extent the distribution does not exceed the distributee partner's allocable share of partnership debt. A partner is allocated a share of partnership recourse debt to the extent that partner bears the economic risk of loss for the debt in accordance with the constructive liquidation analysis in Regulation section 1.752-2.[161] To have WISCO bear the economic risk of loss and thereby be allocated the debt, the parties agreed that WISCO would indemnify Georgia Pacific's guaranty.[162] The indemnity was recommended by Pricewaterhouse Coopers (PWC), Chesapeake's historic auditor and tax return preparer.[163] The taxpayer and the government disagreed about whether the indemnity was sufficient to allocate the LLC's debt to WISCO.[164] The Tax Court applied the anti-abuse rule in Regulation section 1.752-2(j) to disregard WISCO's indemnity agreement, concluding that "Chesapeake used the indemnity to create the appearance that WISCO bore the economic risk of loss for the LLC debt when in substance the risk was borne by [Georgia Pacific]."[165]

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[154] *Canal Corp.*, 135 T.C. at 217.
[155] *Id.* at 200 n.2, 203.
[156] *Id.*
[157] *Id.* at 203, 207.
[158] *Id.* at 207.
[159] I.R.C. § 721.
[160] I.R.C. § 707(a)(2)(B); Reg. § 1.707-3(b)(1).
[161] Reg. § 1.707-5(b).
[162] *Canal Corp.*, 135 T.C. at 204-05.
[163] *Id.* at 204.
[164] *Id.* at 212.
[165] *Id.* at 216.

Salomon Smith Barney recommended the leveraged partnership structure.[166] For an $800,000 fixed fee, PWC negotiated and structured the transaction, provided tax and accounting advice, and issued a tax opinion to Chesapeake.[167] The tax opinion concluded that the transaction should be a tax-free contribution of WISCO's assets to the newly formed LLC rather than a taxable sale.[168] Chesapeake conditioned the payment of the fee on PWC's issuance of the tax opinion by agreeing to pay PWC upon closing and conditioning the closing on the delivery of a "should" opinion.[169]

The government asserted that WISCO's transfer of assets was a disguised sale rather than a tax-free contribution, triggering a tax deficiency.[170] Chesapeake filed a petition in the Tax Court to challenge the government's asserted deficiency.[171] The government sought accuracy-related penalties in its amended answer.[172] The Tax Court sustained the deficiency and the imposition of penalties.[173]

The taxpayer claimed the reasonable cause defense to attempt to avoid the imposition of penalties.[174] But the court found that reliance on PWC's advice did not warrant the avoidance of penalties because PWC had an inherent conflict of interest.[175] The court characterized PWC's role as follows:

> We would be hard pressed to identify which of his hats Mr. Miller [the PWC lawyer who wrote and signed the tax opinion] was wearing in rendering that tax opinion. Mr. Miller not only researched and drafted the tax opinion, but he also "audited" WISCO's and the LLC's assets to make the assumptions in the tax opinion. He made legal assumptions separate from the tax assumptions in the opinion. He reviewed State law to make sure the assumptions were valid regarding whether a partnership was formed. In addition, he was intricately involved in drafting the joint venture agreement, the operating agreement and the indemnity agreement. In essence, Mr. Miller issued an opinion on a transaction he helped plan without the normal give-and-take in negotiating terms with an outside party.[176]

The decision in *Canal* is remarkable because it applies the common law conflict of interest rule in a case involving a nonmarketed tax shelter.[177] There are several facts that indicate PWC was not a promoter of a tax shelter. First,

[166] *Id.* at 203.
[167] *Id.* at 206.
[168] *Id.* at 207.
[169] *Id.* at 206.
[170] *Id.* at 209-10.
[171] *Id.* at 210.
[172] *Id.*
[173] *Id.* at 216-17, 222.
[174] *Id.* at 218.
[175] *Id.* at 220-21.
[176] *Id.* at 220-21.
[177] It is important to note that the Tax Court decided *Canal* before *106 Ltd. See supra* notes 134-149 and accompanying text for discussion of *106 Ltd.*

PWC was Chesapeake's long-time tax preparer and auditor.[178] Second, there is no evidence that the transaction in *Canal* was an off-the-shelf tax shelter that PWC marketed to its other clients. Third, the transaction in *Canal* arose as a result of Chesapeake's decision to sell WISCO's assets that no longer fit into Chesapeake's strategic plan as compared to Chesapeake selling its tissue business and then searching for a transaction to shelter gains from the asset sale.[179] Finally, much of what PWC did that troubled the court is simply ordinary transactional tax work that should not have drawn the court's wrath.

2. *American Boat*

Compare the Tax Court's decision in *Canal Corp.* with the Seventh Circuit's decision in *American Boat.*[180] The Seventh Circuit in *American Boat Co., LLC v. United States,* held that the reasonable cause exception was satisfied despite the fact that the advisor who provided the tax opinion also structured and implemented the transaction, part of which consisted of a mass-marketed tax shelter.[181] David Jump was a businessman who owned a variety of businesses.[182] In 1996, Jump's banker referred him to Erwin Mayer regarding the planning of his estate.[183] Mayer, an attorney who at the time was at the law firm Altheimer & Gray, developed an estate plan by "reorganiz[ing] Jump's operating entities into a number of limited partnerships."[184] At Mayer's recommendation, Jump engaged in a Son of BOSS transaction to offset gain triggered from the dissolution of one of Jump's entities.[185] The Service did not become aware of the 1996 transaction until after the assessment statute of limitations expired.[186]

In 1998, Jump again contacted Mayer, this time as a result of an accident caused by a towboat owned by one of Jump's companies.[187] At Mayer's recommendation, the towboat business was separated from Jump's other companies by forming American Boat Co., LLC and transferring the towboats from his other companies to the newly formed LLC.[188] For reasons not stated in the opinion, Jump engaged in another Son of BOSS transaction as part of the 1998 restructuring.[189] Mayer, who by this time had moved his practice to Jenkens & Gilchrist (J&G), provided Jump with a tax opinion supporting the

178 *Canal Corp.*, 135 T.C at 204.

179 *Id.* at 203 (stating that PWC was hired to "explore strategic alternatives for [WISCO's] tissue business").

180 Am. Boat Co. v. Commissioner, 583 F.3d 471, 483, 486 (7th Cir. 2009).

181 *Id.*

182 *Id.* at 474.

183 *Id.* The opinion does not explain the relationship, if any, between the banker and Mayer.

184 *Id.*

185 *Id.*

186 *Id.* at 475.

187 *Id.*

188 *Id.*

189 *Id.*

Son of BOSS transaction.[190] The district court disallowed the losses purportedly resulting from the 1998 transaction but allowed the taxpayer to escape a 40% gross valuation misstatement penalty, concluding that the reasonable cause and good faith defense applied.[191]

The government argued that the reasonable cause defense should not apply with respect to Mayer's advice.[192] In the government's view, advice should be "unreliable as a matter of law" whenever the advisor receives a large fee for delivering to the client huge tax benefits for relatively little economic cost.[193] In effect, the large fee and the favorable tax benefits should have put the taxpayer on notice that the advice was inherently suspect and unreliable.[194] The court dismissed this argument.[195] The fixed fee did not seem to trouble the court. In fact, it noted that "one in need of legal advice almost always has to pay something for it."[196] Additionally, although part of what Mayer did was implement a tax shelter, that fact did not make reliance on the J&G tax opinion objectively unreasonable because a "significant" amount of work was attributable to legitimate tax planning (*i.e.*, restructuring Jump's businesses).[197]

The court noted that reliance is not reasonable if the advisor is "burdened with an inherent conflict of interest about which the taxpayer knew or should have known."[198] But payment of a large fee for "a large tax benefit at minimal risk" was not sufficient to create constructive notice.[199] Additionally, Jump thought he was getting ordinary tax advice, having gone to Mayer seeking legitimate advice following the towboat accident.[200] Jump "did not know or have reason to know" that Mayer was marketing the same tax shelter to others.[201]

While the Seventh Circuit conceded that there was "merit in some of the government's arguments," it ultimately concluded that there was "no reversible error."[202] There are several favorable facts that support the court's decision. First, the advisor was paid a flat fee as opposed to a fee based on the

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[190] *Id.* at 475-76.
[191] *Id.* at 477.
[192] *Id.* at 480.
[193] *Id.* at 483.
[194] *Id.*
[195] *Id.*
[196] *Id.*
[197] *Id.*
[198] *Id.* at 481.
[199] *Id.* at 483.
[200] *Id.* at 477, 485 (stating that the district court "found that the shelter was never marketed to Jump; rather, he sought only expert legal advice, which was what he thought he was paying for").
[201] *Id.* at 477.
[202] *Id.* at 474. Whether reasonable cause exists is a question of fact and thus reversal of the trial court is appropriate only in instances of clear error. *Id.* at 483.

tax savings.[203] Second, Jump engaged in an earlier Son of BOSS transaction that the Service did not challenge.[204] Third, the advisor did not market the transaction to Jump. Instead, Jump sought Mayer's advice following the tow-boat accident.[205] Fourth, the Son of BOSS transaction was part of a larger, legitimate restructuring.[206] Finally, neither of Jump's accountants raised any issues relating to the transaction.[207] All of these facts help support the claim that Jump did not "know or have reason to know" of any conflict of interest of Mayer.[208]

3. *Reconciling* American Boat *with* Canal

Despite their factual similarities, it is difficult to provide a reasonable explanation of why the taxpayer in *American Boat* was able to rely on a tax opinion to avoid accuracy-related penalties but the taxpayer in *Canal* was not. The advisors in both cases had a prior relationship with the taxpayers and were paid large, flat fees. The advisor in *American Boat*, but not in *Canal*, recommended the transaction to the taxpayer. Both advisors planned and implemented the transactions. Ironically, had section 6662A been in effect, it would have applied to the transaction in *American Boat* because it was a listed transaction, but would not have applied in *Canal* because the leveraged partnership transaction was neither a listed transaction nor a reportable avoidance transaction. Consequently, contrary to the actual outcomes, the taxpayer in *American Boat* would have been unable to rely on the tax opinion because the advisor would have been treated as a disqualified tax advisor by organizing, planning, or implementing the transaction. But the taxpayer in *Canal* would not have been per se precluded from relying on PWC despite PWC's role in the transaction. Examining certain aspects of these two decisions, including the fee structure, the relationship between the taxpayer and the advisor, and the nature of the engagement do not sufficiently explain the inconsistency.

a. *Fee Structure*. The advisors in both *Canal* and *American Boat* were paid large, flat fees. The court in *Canal* was troubled that the fee was not based on hourly rates and questioned whether the opinion would have been of better quality if PWC were paid by the hour.[209] Yet the court in *American Boat* was not troubled by the large, flat fee.[210]

Numerous courts have addressed the impact of an advisor's compensation arrangement on the reasonable cause exception. At one end of the continuum are fees that are computed as a percentage of the tax savings recognized.

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[203] *Id.* at 484.
[204] *Id.* at 486.
[205] *Id.* at 484.
[206] *Id.* at 485.
[207] *Id.*
[208] *Id.*
[209] Canal Corp. v. Commissioner, 135 T.C. 199, 219 (2010).
[210] *Am. Boat Co.*, 583 F.3d at 483.

Circular 230 now prohibits such arrangements.[211] Similarly, courts repeatedly have found advisors whose fees are based on a percentage of the tax savings to have an impermissible conflict of interest.[212] At the other end of the continuum are fees based on an advisor's customary hourly rates. The standard criticism of hourly fees is that they may incentivize professionals to work inefficiently. Even so, these fee structures should not create an impermissible conflict of interest in the context of the reasonable cause exception.[213]

Lying on the continuum between these two extremes are fixed-fee or flat-fee arrangements where the advisor is paid a lump sum amount rather than by the hour. One criticism of fixed-fee structures is that the quality of the advice may suffer because advisors who want to boost profits will be incentivized to spend less time rendering services.[214] Despite this theoretical argument, the Seventh Circuit's decision in *American Boat* that the reasonable cause exception was satisfied despite the payment of a fixed fee indicates that fixed-fee arrangements are not per se unreasonable.[215] A fixed-fee structure necessitated by legitimate business needs (*e.g.*, a client desires a predictable amount of legal fees or wants to manage the overall amount of fees) should be susceptible to less criticism.

More troublesome are fee arrangements that are not only fixed but conditional. Advisors whose payment is contingent on the transaction closing or the delivery of an opinion with a specified level of confidence have an incentive

[211] 31 C.F.R. § 10.27(b)(1), (c) (2011) (defining a contingent fee to include a fee "that is based on a percentage of the taxes saved" and prohibiting contingent fees except, generally speaking, in controversy matters).

[212] Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1382-83 (Fed. Cir. 2010) (tying advisors' compensation to "sheltered gain," along with advisors' role in promoting and implementing transaction created impermissible conflict of interest); Murfam Farms, LLC *ex rel.* Murphy v. United States, 94 Fed. Cl. 235, 247 (Fed. Cl. 2010) (noting that the "conflict of interest was exacerbated by the fee structure" by which the taxpayers knew that advisor would be paid a percentage of the loss desired); Alpha I, L.P. v. United States, 93 Fed. Cl. 280, 317 (Fed. Cl. 2010) (advisor's fees calculated as a percentage of expected tax treatment "weighs against the taxpayer's ability to establish a defense of reasonable cause and good faith"); *see also Am. Boat Co.*, 583 F.3d at 482 (stating in dicta that "[w]hen an advisor profits considerably from his participation in the tax shelter, such as where he is compensated through a percentage of the taxes actually sheltered, a taxpayer is much less reasonable in relying on any advice the advisor may provide").

[213] Candyce Martin 1999 Irrevocable Trust v. United States, 822 F. Supp. 2d 968, 1018 (N.D. Cal. 2011) (concluding that advisors "did not have a profit motive or other monetary interest in the outcome of the transaction because those advisors were paid at an hourly rate . . . regardless of whether [the taxpayers] ultimately engaged in the transaction"); *see also* 106 Ltd. v. Commissioner, 136 T.C. 67, 79-80 (2011) (citing Countryside Ltd. P'ship. v. Commissioner, 132 T.C. 347, 352-55 (2009)) (recognizing that no conflict of interest exists when the advisor "has no stake in the transaction besides what he bills at his regular hourly rate").

[214] *See Canal Corp.*, 135 T.C. at 219 (criticizing the tax opinion delivered under a contingent fixed-fee arrangement and stating that "[t]he Court doubts that any firm would have had such a cavalier approach if the firm was being compensated solely for time devoted to rendering the opinion").

[215] *Am. Boat Co.*, 583 F.3d at 483.

to satisfy the condition to ensure they are paid at all. The Tax Court's decision in *Canal* is illustrative. The court in *Canal* found an impermissible conflict of interest where the advisor's $800,000 fixed fee was payable only if the transaction actually closed and delivery of the tax opinion was the sole condition to close.[216] The Tax Court was similarly troubled in *106 Ltd.*, a case where the advisor charged a fixed fee that was payable only if the taxpayer decided to go through with the transaction.[217]

These decisions at least suggest that one should be cautious in structuring fees to advisors that are contingent on the transaction closing. But for purposes of the heightened reasonable cause exception that applies to section 6662A penalties, an advisor who is not a material advisor will not be a disqualified advisor even if the advisor's fees are contingent on the closing of the transaction.[218] If the heightened reasonable cause exception does not prohibit such fee arrangements then arguably such arrangements should not be prohibited with respect to transactions that fall outside of section 6662A.[219]

b. *Existing Relationship between Taxpayer and Advisor.* In both *Canal* and *American Boat*, the advisor had a previous relationship with the taxpayer. PWC was Canal's historic auditor and tax return preparer. The advisor in *American Boat* had previously advised the taxpayer relating to estate planning issues. The advisor's relationship history seemed to be meaningful to the court in *American Boat* but not in *Canal* even though the relationship between PWC and Canal was more extensive and sustained. The Tax Court has emphasized that an advisor's long-standing and ongoing relationship with a client was a positive factor when evaluating an advisor's independence.[220] Perhaps this is because a long-time advisor may be more likely to create a customized transaction rather than pitch a mass-marketed tax shelter. Or perhaps a taxpayer has less reason to be suspicious and more reason to be trustful of advice from a long-term advisor. On the other hand, psychological research has shown that longer-term relationships may actually increase the potential for bias.[221]

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[216] *Canal Corp.*, 135 T.C. at 221-22.

[217] *106 Ltd.*, 136 T.C. at 80-81.

[218] Notice 2005-12, *supra* note 19 (describing contingent fee arrangements that would constitute a "disqualified compensation arrangement"); *see also* William P. Bowers & Patrick L. O'Daniel, *Send Not to Know for Whom the Bell Tolls*, 13 Bus. Entities 4, 16 (2011).

[219] *See also* 31 C.F.R. § 10.27(c)(1) (2011) (defining "contingent fee").

[220] *106 Ltd.*, 136 T.C. at 80 (citing Countryside Ltd. P'ship. v. Commissioner, 132 T.C. 347, 352-55 (2009)).

[221] *See supra* text accompanying note 130. The issue of too cozy a relationship between auditor and audit client is causing the Public Company Accounting Oversight Board (PCAOB) to reconsider mandatory firm rotation. Pub. Co. Accounting Oversight Bd., Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-006, at 2 (Aug. 16, 2011). The United States House of Representatives recently voted to prohibit the PCAOB from requiring audit firm rotation. Audit Integrity and Job Protection Act, H.R. 1564, 113th Cong. (2013).

c. *Nature of the Engagement.* The Tax Court in *Canal* was troubled by the fact that PWC negotiated and structured the transaction, provided tax and accounting advice, and rendered the tax opinion. By contrast, the Seventh Circuit in *American Boat* was indifferent to the fact that the advisor who rendered the tax opinion also recommended and implemented the transaction despite the fact that part of the transaction at issue in *American Boat* was a marketed tax shelter. There is nothing inherently suspect about an advisor who also participates in the structuring and implementation of a transaction. If, however, the taxpayer knows or has reason to know that the advisor is promoting the same or similar transaction to others, it is reasonable to expect the taxpayer to question the credibility of that advice. Reliance on advice from a promoter may be unreasonable because the economic returns derived by replicating the same transaction for multiple participants provides greater temptation for compromised judgment as compared to advisors of customized transactions.[222] Permitting reliance on advice in cases where the taxpayer neither knows nor has reason to know that the advisor was a promoter, and therefore, burdened by an inherent conflict of interest, is consistent with authorities that evaluate reasonable cause objectively from the advisee's perspective.[223] As the Tax Court intimated in *106 Ltd. v. Commissioner*, an approach that presumes that taxpayers should question the credibility of advice simply because it was provided by an advisor who also somehow participated in the transaction would be impractical and even unworkable.[224] Additionally, unlike the heightened reasonable cause exception's per se prohibition on interested advisors, reliance on advisors who also plan and implement transactions should not automatically be prohibited with respect to transactions that fall outside section 6662A.

[222] Jay A. Soled, *Tax Shelter Malpractice Cases and Their Implications for Tax Compliance*, 58 AM. U. L. REV. 267, 289 (2008) (stating that "once in place, these abusive tax shelters proved to be a cash cow because they could easily be replicated for very little costs and with tremendous revenue generation"). While an advisor of a one-off, customized deal who earns a substantial premium may be compromised, a firm is less likely to be impacted economically from a one-off transaction because it is unlikely to constitute a large percentage of total revenues. Don A. Moore et al., *Auditor Independence, Conflict of Interest, and the Unconscious Intrusion of Bias* 8 (Harvard NOM Working Paper No. 02-40, 2002).

[223] *See* 106 Ltd. v. Commissioner, 684 F.3d 84, 90 (D.C. Cir. 2012) (quoting Am. Boat Co. v. Commissioner, 583 F.3d 471, 485 (7th Cir. 2009)); *Am. Boat Co.*, 583 F.3d at 485 (stating that "the focus is on what [the taxpayer] knew or should have known at the time he obtained the opinion letter"); Candyce Martin 1999 Irrevocable Trust v. United States, 822 F. Supp. 2d 968, 1016 (N.D. Cal. 2011) (stating that "[a] taxpayer's claim of reliance upon professional advice as support for [the reasonable cause] defense is to be evaluated under an objective standard"); Reg. § 1.6664-4.

[224] *See 106 Ltd.*, 136 T.C. at 80.

VI. The Current Legislative and Regulatory Framework Is Inadequate

A. *Section 6662A Alone Is Insufficient to Police False Positives and False Negatives*

Despite the unpredictability of the common law conflict of interest rule, it should not be supplanted by the brighter-line statutory conflict of interest rule that applies to section 6662A penalties. Several deficiencies that are discussed below call into question the efficacy of the statutory conflict of interest rule.

1. *Purported Justification for the Heightened Reasonable Cause Exception*

Section 6662A is intended "to deter taxpayers from entering into tax avoidance transactions" by imposing potentially harsher penalties and a more stringent reasonable cause exception.[225] Section 6662A imposes a 30% penalty in connection with listed transactions and reportable avoidance transactions that are not disclosed, which is steeper than the usual 20% accuracy-related penalty.[226] Additionally, taxpayers are categorically prohibited from relying on interested advisors to satisfy the reasonable cause and good faith exception that applies to section 66662A penalties.[227] And no reasonable cause exception is available for taxpayers who fail to disclose transactions subject to section 6662A.[228]

Prohibiting taxpayers from relying on disqualified tax advisors seems justified with respect to marketed tax shelter opinions from promoters or their agents that have proven to be unreliable during the last tax-shelter wave.[229] Tempted by the potential fees to be earned, advisors in those kinds of situations may be more likely to reach for the desired conclusion by over-zealously interpreting existing authority, something other, more reasonable, advisors may be unwilling to do. Additionally, the more aggressive a transaction, the greater the likelihood taxpayers will be required to disclose their participation to the Service.[230] Disclosure increases the likelihood that the Service will question, and possibly, disallow the tax benefits of transactions, which heightens the mutuality of interests between a taxpayer and an advisor who marketed the transaction. The mutuality of interests between client and advisor creates a greater risk that the advisor's independence will be impaired to the extent the advisor acts more as an advocate and less as an impartial advisor.

It makes sense that opinions from tax shelter promoters would present such an unacceptable risk to the advisors' independence to be deemed

[225] H.R. Rep. No. 108-548 pt. 1, at 263 (2004).
[226] *See supra* note 68 and accompanying text.
[227] *See supra* note 80-81 and accompanying text.
[228] *See supra* note 78 and accompanying text.
[229] One need only look to the government's success at litigating tax shelter cases for confirmation that opinions have often failed to protect taxpayers from penalties.
[230] Reg. §§ 1.6011-4(a), -4(d).

statutorily unreliable.[231] But Congress and Treasury have expanded section 6662A beyond promoters to include advisors who merely draft transaction documents. As discussed below, this expansion is more difficult to justify and interferes with the typical role of tax planning advisors.[232]

2. *Section 6662A Is Under-Inclusive*

Section 6662A penalties may be imposed with respect to listed transactions and other reportable transactions with a significant tax avoidance purpose.[233] Exempting nonreportable, nonsignificant purpose transactions and reportable transactions other than listed transactions with no significant avoidance purpose from the reach of the heightened reasonable cause exception is supportable. Nonreportable, nonsignificant purpose transactions include routine, run-of-the-mill, nonsuspect transactions so the more lenient exception applies to those types of transactions. Reportable transactions are transactions that must be disclosed to the Service because they have one or more characteristics that the Service has determined are present in abusive transactions.[234] But if reportable transactions have no significant tax avoidance purpose, there would seem to be less reason to subject them to the heightened reasonable cause exception.[235]

Section 6662A may not, however, go far enough because it does not apply to nonreportable transactions that nonetheless have a significant tax avoidance purpose. For example, section 6662A would not apply to transactions like the leveraged partnership structure in *Canal* because that transaction was neither a listed nor a reportable transaction. Yet some commentators found *Canal* to be abusive.[236]

Although section 6662A is under-inclusive in the sense that there may be transactions other than listed transactions and reportable avoidance transactions that are nonetheless tax avoidance transactions, the approach Congress took likely was intentional. Had Congress not limited section 6662A to reportable transactions but instead applied it to all significant avoidance transactions whether or not they are reportable, section 6662A could sweep in legitimate transactions if "a significant purpose" is interpreted broadly to

[231] But it is not evident that opinion counsel will necessarily suffer from fewer conflicts and be more independent than promoters who help market the transactions at issue. David M. Schizer, *Enlisting the Tax Bar*, 59 Tax L. Rev. 331, 364-66 (2006).

[232] *See infra* notes 296-99 and accompanying text.

[233] I.R.C. § 6662A(b)(2).

[234] Reg. §§ 1.6011-4(a), -4(d).

[235] No accuracy penalty is imposed with regard to these types of transactions if the taxpayer discloses the relevant facts of the transaction and has reasonable basis for the position on the return. I.R.C. § 6662(d)(2)(B)(ii). Additionally, these types of transactions qualify for the more lenient reasonable cause exception that generally does not require any disclosure or minimum level of confidence in the position. I.R.C. § 6664(c).

[236] *See, e.g.*, David Michaels, Canal *Chaos: In Reality, No Substance*, 2012 Tax Notes Today 216-9 (Nov. 7, 2012); Amy S. Elliott, *Practitioners Discuss How* Canal *Crossed the Leveraged Partnership Line*, 2011 Tax Notes Today 64-2 (Apr. 4, 2011).

include any transaction with a plan to reduce tax.[237] The Code provides no guidance as to what "a significant purpose" is despite calls from professional organizations for Congress or the Service to do so.[238] Limiting the applicability of section 6662A and its more stringent reasonable cause exception to reportable transactions adds at least some dimension of predictability.

3. *Definitional Complexity in Section 6662A*

Despite the bright line that Congress drew in section 6662A by requiring reliance on disinterested advisors to avoid section 6662A penalties, it may be sub-optimal because it is paired with a vague and undefined "significant

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[237] *See* PUB. CO. ACCOUNTING OVERSIGHT BD., ETHICS AND INDEPENDENCE RULES CONCERNING INDEPENDENCE, TAX SERVICES, AND CONTINGENT FEES, PCAOB RELEASE 2005-014, at 27 (July 26, 2005) (discussing Rule 3522(b), which prohibits public accounting firms from providing nonaudit services relating to aggressive tax position transactions, which are defined to be transactions with a significant purpose of tax avoidance, and stating that the Board intends for the threshold as to what constitutes "a significant purpose" to be low); *see also* Weisbach & Gale, *supra* note 8, at 1286 (recommending that advisors may want to follow the covered opinion rules in most cases due to their uncertain scope); Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583, 624 (2006) (stating that "the use of significant tax avoidance to define the scope of covered transactions suggests that the Circular 230 standards could cover almost any transaction that provides a substantial tax benefit"); Rothman, *supra* note 34, at 334 (stating that "[a]s a practical matter, in the author's experience, most practitioners do not spend a lot of time or energy trying to figure out what significant purpose means for purposes of the Circular 230 written advice rules . . . . Instead, it is generally taken for granted that the term is so vague that we do not really know what it means and that any transaction might be considered to have a significant purpose").

[238] Both the American Bar Association and the American Institute of Certified Public Accountants have called on the Service to define more clearly, and provide guidance regarding reportable avoidance transactions. Alan R. Einhorn, *AICPA Calls for Reform of Civil Tax Penalty System*, 2009 TAX NOTES TODAY 166-76 (Aug. 31, 2009); Stuart M. Lewis, *ABA Tax Section Recommends Overhaul of Tax Penalty Regime*, 2009 TAX NOTES TODAY 75-25 (Apr. 22, 2009). The covered opinion rules of Circular 230 use both "a significant purpose" standard and "the principal purpose" standard, but only "the principal purpose" is defined. 31 C.F.R. § 10.35(b)(10) (2011) (defining "the principal purpose" for the covered opinion rules to mean a purpose that "exceeds any other purpose"). Transactions entered into without any nontax business purpose or with little or no motive for economic gain are necessarily significant purpose transactions. *See* Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 201 (D. Conn. 2004); Santa Monica Pictures, LLC v. Commissioner, 89 T.C.M (CCH) 1157, 2005 T.C.M. (RIA) ¶ 2005-104. But even a transaction supported by nontax business purposes, economic substance, or both may have a significant tax avoidance purpose. *See* 31 C.F.R. § 10.35(b)(10) (2011) (stating that "A partnership, entity, plan or arrangement may have a significant purpose of avoidance or evasion even though it does not have the principal purpose of avoidance or evasion"); Valero Energy Corp. v. United States, No. 06 C 6730, 2008 WL 4104368, at *16 (N.D. Ill. Aug. 26, 2008) (stating that section 6662(d)(2)(C) does not require that the "underlying transaction [lack] economic reality or [be] driven solely or primarily by tax-avoidance concerns"). *See generally* Nathan W. Giesselman, *A Significant Problem Defining a 'Significant Purpose' and the Significant Difficulties That Result*, 111 TAX NOTES (TA) 1119, 1130 (June 5, 2006) (suggests scrapping the significant purpose test in Circular 230, finding it unworkable).

purpose" standard. The Service may be hesitant to impose section 6662A penalties because the government bears the burden of production in any court proceeding with respect to an individual's liability for penalties.[239] The burden of production would require the government to come forward with evidence showing that the transaction is a reportable avoidance transaction, whereas the government's burden under section 6662 is a simple, mechanical one.[240] Even in cases where the government does not bear the initial burden of production, taxpayers and the government will have to contend with the definitional complexity in section 6662A from the use of the "significant purpose" language that is absent in section 6662.

Since their enactment in 2004, section 6662A penalties have only infrequently been litigated, and all the reported cases involve undisclosed listed transactions.[241] The government's burden was made easy in those cases because it did not have to contend with the significant purpose standard, which is relevant for reportable avoidance transactions, but not listed transactions.[242] All the reported cases involve listed transactions, which are transactions that are the same or substantially similar to transactions that the Service identifies in published guidance to be abusive.[243] Furthermore, the penalty is one of strict liability because the reasonable cause exception is inapplicable to transactions that are not disclosed.[244]

Of course, litigated cases do not paint the whole picture because the Service may impose section 6662A penalties that taxpayers concede or otherwise settle. Congress, in an off-Code provision, directed the Service to begin providing the congressional tax writing committees an annual report beginning no later than the end of 2010 of the penalties assessed under section 6662A.[245] Such a report may prove helpful in assessing the effectiveness of section 6662A.[246] If, on the whole, section 6662A is not enforced or is applied only to listed transactions, the common law conflict of interest rule will be of greater significance because other types of potentially abusive transactions

[239] I.R.C. § 7491(c).

[240] I.R.C. § 6662(d)(1)(A). A penalty applies under section 6662 to an understatement that is substantial, which for noncorporate taxpayers is defined to mean an understatement that exceeds the greater of (1) 10% of the correct tax required to be shown on the return or (2) $5,000. § 6662(d)(1)(A).

[241] *See, e.g.*, Soni v. Commissioner, 105 T.C.M. (CCH) 1216, 2013 T.C.M. (RIA) ¶ 2013-30; Repetto v. Commissioner, 103 T.C.M. (CCH) 1895, 2012 T.C.M. (RIA) ¶ 2012-168; Brennan v. Commissioner, 102 T.C.M. (CCH) 534, 2011 T.C.M. (RIA) ¶ 2011-276; McGehee Family Clinic v. Commissioner, 100 T.C.M. (CCH) 227, 2010 T.C.M. (RIA) ¶ 2010-202.

[242] *See* I.R.C. § 6662A(b)(2)(B).

[243] Reg. § 1.6011-4(b)(2) (defining "listed transaction").

[244] I.R.C § 6664(d)(3).

[245] Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2103, 124 Stat. 2504, 2564. An off-Code provision is one that is enacted by Congress and thus, is included in the public law but not included in the Code. *See, e.g.*, Christopher H. Hanna, *The Magic in the Tax Legislative Process*, 59 SMU L. Rev. 649, 658 (2006).

[246] The author was unable to locate these annual reports.

would, as a practical matter, be excluded from the scope of the statutory conflict of interest rule that applies to section 6662A penalties.

B. *Advisor Penalties*

Taxpayers untrained in tax law should not be held accountable for advisors' faulty legal analysis if the flaws are not apparent. The overarching question should be whether there is anything in the opinion itself or the circumstances surrounding its preparation that would alert a reasonable person that the opinion is flawed in such a way as to make reliance on the opinion unreasonable. Instead, advisors should be responsible for the quality of their legal advice. An advisor who advances untenable legal arguments could be held accountable through ethical standards, and it is reasonable for taxpayers to assume that advisers will abide by their ethical and fiduciary obligations.[247] Malpractice suits may also help to hold advisors accountable.[248]

Additionally, more attention should be given to constraining advisors through the imposition of penalties.[249] Tax return preparers are subject to penalties under section 6694 for preparing tax returns with understatements of tax liability based on a position lacking substantial authority or a reasonable basis for adequately disclosed positions.[250] Tax shelters and reportable transactions require a confidence level of more likely than not to avoid preparer penalties.[251] Importantly, the penalty may be imposed only if the preparer knew or should have known of the unreasonable return position.[252] The amount of the penalty under section 6694 is the greater of $1,000 or 50% of the tax return preparer's fees with respect to the return.[253] Even if preparer penalties may otherwise apply, a preparer may avoid penalties by satisfying a reasonable cause and good faith exception.[254] Prior to its amendment in 2007, section 6694 was largely irrelevant because the amount of the penalty was a mere $250, and no penalty would be imposed for positions with at least a realistic possibility of success.[255]

[247] *See* Klein v. United States, 94 F. Supp. 2d 838, 850 (E.D. Mich. 2000).

[248] *See* Jay A. Soled, *Tax Shelter Malpractice Cases and Their Implications for Tax Compliance*, 58 Am. U. L. Rev. 267, 284-85 (2008) (finding that malpractice litigation has been effective at curbing abusive behavior of practitioners); Weisbach & Gale, *supra* note 8, at 1295 (discussing the increase in state malpractice suits against tax advisors).

[249] *See generally* Weisbach & Gale, *supra* note 8 (providing a survey of the rules regulating tax advice and tax advisors); *see also* Mark P. Gergen, *Third Party Opinions as a Tool for Enforcing Tax Law* 3 (Univ. of Penn. Law Sch. Ctr. for Tax Law & Pol'y, 2008) (stating that "[i]t is common knowledge that tax opinions and appraisals tend to be biased in favor of a taxpayer who pays for the opinion except when the opinion supplier has a substantial risk of liability to others if the opinion is erroneous").

[250] I.R.C. § 6694(a)(2)(A)-(B).

[251] § 6694(a)(2)(C).

[252] § 6694(a)(1)(B).

[253] § 6694(a).

[254] § 6694(a)(3).

[255] § 6694(a) (2006), *amended by* Pub. L. No. 110-28, § 8246(b), 121 Stat. 112, 203 (2007).

The term "tax return preparer" is defined in section 7701(a)(36) to mean any person who prepares all or substantially all of a tax return for compensation.[256] Those subject to tax return preparer penalties include practitioners who sign clients' returns and nonsigning tax return preparers, but only for advice provided "with respect to events that have occurred at the time the advice is rendered."[257] Thus, the tax return preparer penalties in section 6694 provide no deterrent effect for practitioners who provide tax planning advice regarding prospective transactions.[258] A robust debate should be had about whether tax planning advisors should be subjected to section 6694 penalties.[259]

Tax planning advisors potentially are subject to penalties other than those under section 6694. Section 6700 imposes a penalty on those who organize or sell abusive tax shelters and section 6701 imposes a penalty for aiding and abetting an understatement of tax. But both of those sections impose relatively trivial penalties of only $1,000. Section 6700(a) was amended in 2004 to impose a penalty equal to 50% of the fees of a person who organizes or participates in the sale of a transaction if that person makes a statement regarding the tax consequences of the transaction and the person knows or should have known that the statement is false or fraudulent as to a material matter. There are no reported cases imposing the stiffer penalty. Under section 6701, if the tax liability relates to a corporation, the amount of the penalty is $10,000.[260]

C. *Effect of Eliminating Circular 230 Covered Opinion Rules*

Treasury is authorized to regulate individuals who represent taxpayers before the Service.[261] Pursuant to that authority, Treasury has published regulations governing practice before the Service in title 31, section 10 of the Code of Federal Regulations, and reprinted the regulations as Circular 230.

To combat tax shelter activity that was proliferating in the late 1990s, Treasury issued an advance notice of proposed rulemaking in 2000 to seek input regarding standards of practice for advice relating to corporate tax shelters.[262] That process culminated in December 2004 when the final covered opinion rules were incorporated into Circular 230.[263] Covered opinions

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[256] I.R.C. § 7701(a)(36)(A).

[257] Reg. § 301.7701-15(b)(2)(i).

[258] Reg. § 301.7701-15(b)(2), Ex. (2).

[259] Some justify excluding advisors who engage in tax planning from section 6694 penalties based on congressional intent. *See* N.Y. State Bar Assoc., *Report on the Definition of 'Tax Return Preparer' and Other Issues Under Code Sections 6694, 6695, and 7701(a)(36)*, 2007 TAX NOTES TODAY 247-51 (Dec. 20, 2007) (positing that Congress never intended section 6694 to cover "pure advisors" who give legal advice without discussing or seeing the return and that including them within the scope of section 6694 would be unworkable).

[260] I.R.C. § 6701(b)(2).

[261] 31 U.S.C. § 330 (2006).

[262] Regulations Governing Practice Before the Internal Revenue Service, 65 Fed. Reg. 30375-01 (proposed May 11, 2000).

[263] T.D. 9165, 2005-1 C.B. 357 (promulgating Circular 230, 31 C.F.R. § 10.35 (2004)).

include written tax advice regarding abusive transactions, which for this purpose includes listed transactions and transactions with the principal purpose of tax avoidance or evasion.[264] Covered opinions also include transactions with a significant purpose of tax evasion or avoidance if, among other things, the opinion reaches a confidence level of at least more likely than not on one or more significant federal tax issues and is intended for penalty protection (*i.e.*, a reliance opinion) or "will be used or referred to by a person other than the practitioner . . . in promoting, marketing or recommending" a transaction to one or more taxpayers (*i.e.*, a marketed opinion).[265]

The covered opinion rules are unpopular among practitioners not only because of the complexity of the covered opinion definition but because of the onerous requirements imposed by the covered opinion rules in section 10.35. Section 10.35 requires practitioners to include in the opinion itself a description of all the relevant facts, all factual assumptions and factual representations relied on, the legal analysis, and an overall conclusion as to the likelihood that the advice is the proper treatment.[266] Depending on the scope of the engagement, these requirements may be unwarranted and excessive. These requirements naturally will increase the cost of legal advice for what amounts to a full-blown legal opinion, something that clients may not always want or need.

In September 2012, Treasury and the Service proposed replacing the mechanistic covered opinion rules with "streamlined standards" that would apply to all types of written advice, having concluded that the covered opinion rules were "overbroad, difficult to apply, and do not necessarily produce higher quality tax advice."[267] Revision of the rules is appropriate because the high cost of practitioner compliance far outweighs the minimal benefit to taxpayers who receive covered opinions.[268]

If finalized in their current form, the proposed regulations would eliminate the covered opinion concept, including the burdensome and formalistic requirements that turned all written advice into exhaustive legal opinions.[269] Instead, those who provide written tax advice would be required to:

> (i) Base the written advice on reasonable factual and legal assumptions (including assumptions as to future events);

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[264] 31 C.F.R. § 10.35(b)(2)(i)(A), (B) (2011).
[265] 31 C.F.R. § 10.35(b)(5).

> A Federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.

31 C.F.R. § 10.35(b)(3).
[266] 31 C.F.R. § 10.35(c).
[267] Regulations Governing Practice Before the Internal Revenue Service, 77 Fed. Reg. 57,055, 57,057 (proposed Sept. 17, 2012) (to be codified at 31 C.F.R. pt. 10).
[268] *See id.* at 57,056-57.
[269] *Id.* at 57,057.

(ii) Reasonably consider all relevant facts that the practitioner knows or should know;

(iii) Use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter;

(iv) Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable; and

(v) Not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.[270]

In evaluating compliance with these principles, the government "will apply a reasonableness standard, considering all facts and circumstances, including, but not limited to, the scope of the engagement and the type and specificity of the advice sought by the client."[271] A heightened standard of review would apply to opinions that will be used or referred to by someone other than the practitioner to promote, market, or recommend a transaction with a significant purpose of tax avoidance or evasion (*i.e.*, marketed opinions).[272]

While practitioners and professional associations generally welcome the proposed changes, it remains to be seen whether they will be more effective than the current rules in helping to depress the bad behavior of practitioners.[273] Apparently, no one has ever been disciplined under the current covered opinion rules, at least not publicly, since their adoption several years ago.[274] Eliminating the covered opinion concept in favor of standards that apply to all written advice is a good first step towards creating workable standards of conduct that may actually be enforced.[275] The current rules in section 10.35 are applicable only if the written advice is a covered opinion, which may depend on technical and vague conceptual determinations such

[270] Prop. Reg. § 10.37(a)(2), 31 C.F.R. 57,055, 57,061 (2012).

[271] Prop. Reg. § 10.37(c)(1), 31 C.F.R. 57,055, 57,062 (2012). Nearly identical language is included in current section 10.37(a), which pertains to written advice other than covered opinions. 31 C.F.R. § 10.37(a) (2011).

[272] Prop. Reg. § 10.37(c)(2), 31 C.F.R. 57,055, 57,062 (2012). Identical language is included in current section 10.37(a), which pertains to written advice other than covered opinions. 31 C.F.R. § 10.37(a).

[273] *See, e.g.*, Andrew W. Needham, *New York State Bar Association Tax Section Report on Proposed Amendments to Circular 230 Relating to Standards With Respect to Written Tax Advice*, 2012 Tax Notes Today 248-27 (Dec. 26, 2012); Rudolph R. Ramelli, *ABA Section of Taxation Comments on Proposed Reg-138367-06 Relating to Practice Before the Internal Revenue Service*, 2012 Tax Notes Today 229-26 (Nov. 28, 2012).

[274] Ramelli, *supra* note 273.

[275] *See* Regulations Governing Practice Before the Internal Revenue Service, 77 Fed. Reg. 57,055, 57,057 (proposed Sept. 17, 2012) (to be codified at 31 C.F.R. pt. 10); Prop. Reg. § 10.37(a)(1), 77 Fed. Reg. 57,055, 57,061 (2012).

as whether tax avoidance is the principal purpose or a significant purpose.[276] The preamble to the proposed regulations recognizes that "there is no direct evidence to suggest that the overly-technical and detailed requirements of current § 10.35 were responsible for, or particularly effective at, curtailing the behavior of individuals attempting to profit from promoting frivolous transactions or transactions without a reasonable basis."[277] Stripping away the complex covered opinion determinations may make enforcement easier because the government will not need to show as a threshold matter that the written advice constitutes a covered opinion. Moreover, the requirements in the proposed regulations are described in broad strokes without a lot of details.[278] For example, written advice cannot rely on unreasonable representations based on a reasonableness standard, taking into account all the facts and circumstances.[279] A potentially wider range of conduct may fit within that standard than if the standard had been written as a more specific rule.[280] The Service's Office of Professional Responsibility (OPR), which is responsible for enforcing Circular 230, could use the imprecision of the standards to the government's benefit when enforcing the provisions by broadly interpreting their requirements. On the other hand, taxpayers might use the principles-based approach to their advantage, particularly if the lack of specificity gives more discretion to practitioners.

Determining whether a principles-based approach over a rules-based approach will itself produce more ethical behavior is beyond the scope of this Article. To be sure, eliminating the complexity of the covered opinion analysis will make it easier for OPR to enforce the provisions. But the prescriptions and prohibitions, such as using reasonable efforts to ascertain the relevant facts and the prohibition against unreasonable assumptions, are essentially the same as in the current rules.[281] Whether the same standards, stripped of the covered opinion provisions and various requirements that dictated the form of the written advice, will be effective to curtail bad behavior remains to be seen.[282] Simply going from an overly detailed and formulistic approach to an overly vague one may not be the answer. At least with respect to written

[276] *See* Regulations Governing Practice Before the Internal Revenue Service, 77 Fed. Reg. at 57,056-57 (describing the effort required to determine whether written advice is a covered opinion).

[277] *Id.* at 57,057.

[278] *See supra* notes 270-72 and accompanying text for list of requirements for written advice in the proposed regulations.

[279] Prop. Reg. §§ 10.37(a)(2)(iv), (c)(1), 77 Fed. Reg. 57,055, 57,061-62 (2012).

[280] Ramelli, *supra* note 273.

[281] *Compare* Prop. Reg. §§ 10.37(a)(2), 77 Fed. Reg. 57,055, 57,061-62 (2012), *with* 31 C.F.R. §§ 10.35(c), 10.37(a) (2011).

[282] *See, e.g.*, Ramelli, *supra* note 273. The ABA, in its comments to the proposed changes to Circular 230, commended the Treasury and the Service for the proposed changes but recommended the addition of examples applying the provisions in Proposed Regulation section 10.37 to specific fact situations out of concern that the proposed changes "may not give OPR an adequate tool for addressing problematic written advice practices." *Id.*

tax advice intended for penalty protection, it may be worthwhile to have a separate set of rules that provides more specifics.

D. *Effect of High Scienter Requirements in Circular 230*

Despite the proposed elimination of the overly technical covered opinion rules, little may change as a practical matter due to the high level of scienter required to trigger sanctions under Circular 230.[283] Under both the current and proposed regulations, a practitioner may be sanctioned for violating the written advice regulations willfully, recklessly, or through gross incompetence.[284] Reckless conduct is defined as a "highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances."[285] Gross incompetence "includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client."[286] Practitioners can also be sanctioned for incompetence and disreputable conduct, which includes giving a false opinion knowingly, recklessly, or through gross incompetence, or "engaging in a pattern of providing incompetent opinions."[287] False opinions include those which

> reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts expressed in the opinion or offering material are false or misleading.[288]

The types of possible sanctions include censure, suspension or disbarment from practice before the Service, and monetary penalties.[289]

The proposed regulations do not amend the level of scienter.[290] Thus, those high scienter requirements that make enforcement of Circular 230 remote will remain if the proposed amendments are finalized. It is reasonable to suppose that the imprecision of the proposed regulations coupled with the high scienter requirements may deter OPR from enforcing the provisions at all, making the imprecise standards of conduct nothing more than mere aspirational platitudes. Reducing the level of scienter may not be justified, however. Psychological literature indicates that biased information processing is mostly

[283] Gergen, *supra* note 249, at 12.
[284] *See* 31 C.F.R. § 10.52(a) (2011); Prop. Reg. § 10.52(a), 77 Fed. Reg. 57,055, 57,062 (2012).
[285] 31 C.F.R. § 10.51(a)(13).
[286] *Id.* § 10.51(a)(13).
[287] *Id.*
[288] *Id.*
[289] *Id.* § 10.50.
[290] *See* 2012-40 I.R.B. 433.

unconscious and unintentional.[291] To the extent tax opinions are erroneous due to unconscious bias, discipline, including penalties, will not be an effective deterrent.[292]

VII. Hold Advisors Accountable for Conflicts of Interest

This Part of the Article explores possible ways to lessen the courts' reliance on the common law conflict of interest rule by bringing front-of-mind awareness to advisor conflicts of interest.

A. *Expand the Reach of Section 6662A*

Applying section 6662A and the heightened reasonable cause exception to all reportable transactions whether or not they are significant purpose transactions could eliminate the definitional complexity and under-inclusiveness of section 6662A.[293] Reportable transactions are broad categories of transactions that the Service has identified as susceptible to abuse so much so that participation in reportable transactions must be disclosed to the Service.[294] But imposing the heightened reasonable cause exception to all reportable transactions may be excessive because reportable transactions (other than listed transactions) are only potentially abusive.

On the other hand, expanding section 6662A and the heightened reasonable cause exception to all reportable transactions would be beneficial to prevent conflicts of interest from arising in the first place without requiring any substantive assessment of the advisor's behavior.[295] The heightened reasonable cause exception that applies to section 6662A penalties would be applied ex ante and involve less complex determinations ex post.

If the reach of section 6662A were expanded to all reportable transactions, scaling back the disqualified tax advisor definition would be desirable. Otherwise, a taxpayer may be precluded from relying on an advisor who

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[291] *See* Bazerman et al., *supra* note 125, at 97-98; Moore et al., *supra* note 222, at 4; Gergen, *supra* note 249, at 6-7.

[292] Bazerman et al., *supra* note 125, at 101-02.

[293] *See supra* notes 233-46 and accompanying text.

[294] *See supra* notes 64-76 and accompanying text.

[295] Professor Samuel Issacharoff classifies regulatory responses to conflicts of interest between principals and agents, including lawyers and their clients, into three categories: (1) substantive regulations, (2) liability rules, or (3) procedural regulations. Samuel Issacharoff, *Legal Responses to Conflicts of Interest*, *in* CONFLICTS OF INTEREST: CHALLENGES AND SOLUTIONS IN BUSINESS, LAW, MEDICINE, AND PUBLIC POL'Y, 189, 191-200 (Don A. Moore, Daylian M. Cain, George Loewenstein & Max H. Bazerman eds., 2005). Substantive regulations are rules that are applied ex ante to "regulate the substantive range of choices available to [a lawyer]" by prohibiting specific substantive decisions. *Id.* at 191. Like substantive regulations, liability rules are intended to prohibit behavior but liability rules are applied ex post. *Id.* at 192. Liability rules include civil and criminal penalties. The third category is procedural regulations, which are enforced ex ante by restricting the role of the lawyer to remove obvious conflicts of interest. Professor Issacharoff declares there to be "something distinct . . . about conflicts of interest that makes them relatively immune to substantive or liability based regimes," and finds procedural regulations superior to the other classes of legal responses. *Id.* at 201.

engages in routine tax planning. The reasonable cause exception that applies to section 6662A is restrictive in the sense that a taxpayer seeking to show a reasonable belief that the tax treatment is more likely than not correct by relying on professional advice must seek out an advisor who is not a disqualified tax advisor within the meaning of section 6664(d)(4)(B)(ii). The term disqualified tax advisor is defined in the Code to include a material advisor who "participates in the organization, management, promotion, or sale of the transaction. . . ."[296] Pending the issuance of regulations, the Service has issued interim guidance that defines the meaning of a disqualified tax advisor very broadly.[297] For example, a material advisor participates in the organization of a transaction if the advisor "devises, creates, investigates or initiates the transaction or tax strategy" or "performs acts relating to the development or establishment of the transaction," including the preparation of documents that "establish the structure used in connection with the transaction. . . ."[298] The legislative history supports the Service's interpretation of the statute. In particular, the House Report accompanying the enactment of section 6662A provides that:

> A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[299]

Advisors are disqualified only if they are "material advisors," which are those earning at least $50,000 for advice provided to individuals and $250,000 for all other taxpayers.[300] For listed transactions, the dollar thresholds are reduced to $10,000 for individuals and $25,000 for other taxpayers.[301] These dollar thresholds could be used to filter the transactions subject to section 6662A even if the provision were expanded to all reportable transactions.

B. *Conflicts of Interest in Circular 230*

Neither the current nor proposed provisions of Circular 230 provide sufficient guidance regarding either a practitioner's conflict of interest or the potential effect such a conflict may have on advice provided to a taxpayer. The covered opinion rules of Circular 230 require covered opinions to disclose referral agreements between the practitioner and a promoter and

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[296] I.R.C. § 6664(d)(4)(B)(ii)(I).
[297] Notice 2005-12, *supra* note 19.
[298] *Id.*
[299] H.R. Rep. No. 108-548, pt. 1, at 265 (2004).
[300] I.R.C. §§ 6111(b)(1)(B), 6664(d)(4)(B)(ii)(I).
[301] Reg. § 301.6111-3(b)(3)(i)(B).

compensation arrangements between the practitioner and any person with respect to promoting, marketing, or recommending the plan that is the subject of the opinion.[302] The proposed regulations, however, do not incorporate these conflict of interest disclosures.

Beyond disclosures of conflicts solely due to compensation arrangements or referral agreements, Treasury and the Service should delineate the sorts of conflicting interests that cause concern. Consideration should be given to providing specific factors that should be taken into account to determine whether an impermissible conflict exists. The Tax Court in *Countryside Ltd. Partnership v. Commissioner* clarified that a tax advisor is not a promoter of a tax shelter within the meaning of the tax practitioner privilege in section 7525 when all of the following circumstances exist:

- The advisor has a long-standing and ongoing relationship with the client;
- The advisor does not give unsolicited advice;
- The advice is a regular part of the advisor's practice (*i.e.*, it is routine advice);
- The advisor does not use generic prototypes that would indicate canned transactions;
- The advisor is paid by the hour and does not receive fixed fees or fees that are a percentage of tax savings; and
- The advisor has no stake in the transaction besides what he bills at his regular hourly rate.[303]

The *Countryside* factors could be used as a way to draw boundaries regarding the types of permissible and prohibited relationships. These factors should not, however, be adopted in their entirety without further reflection. As discussed elsewhere, psychological research has shown that longer-term relationships may actually increase the potential for bias.[304] If that is the case, the fact that an advisor has a long-standing and ongoing relationship with the client may be a risk factor rather than a guideline indicating no significant conflict of interest. Additionally, the larger the financial gain may be more important than whether the advisor is paid by the hour versus on a flat-fee basis. In addition to providing greater guidance for advisors, including more specific conflict of interest provisions in Circular 230 may provide a mechanism for enforcement against a noncomplying advisor, though the high scienter requirements in Circular 230 could be a barrier.[305]

[302] 31 C.F.R. § 10.35(e)(1) (2011).

[303] 106 Ltd. v. Commissioner, 136 T.C. 67, 80 (2011) (citing Countryside Ltd. P'ship. v. Commissioner, 132 T.C. 347, 352-55 (2009)).

[304] *See* Bazerman et al., *supra* note 125 and accompanying text; *see also* U.S. INSTITUTE OF MED., COMM. ON CONFLICT OF INTEREST IN MED. RESEARCH, EDUC., AND PRACTICE, CONFLICT OF INTEREST IN MEDICAL RESEARCH, EDUCATION, AND PRACTICE 24 (Bernard Lo & Marilyn J. Field, eds., 2009).

[305] *See supra* notes 283-92 and accompanying text.

Finally, section 10.29(b)(3) of Circular 230, which is carried over in the proposed regulations, requires practitioners to obtain their clients' written informed consent if there is a significant risk that the representation will be materially limited by a personal interest of the practitioner.[306] One weakness of the required disclosure is that it does not require that the client be informed of the consequences of the conflict. Advisors should be required to identify, evaluate, and address in writing threats to independence, particularly if written advice will be used for penalty protection. They should also be required to disclose the effects a conflict could have on the efficacy of any advice provided, including the risk that an advisor's conflict of interest may prevent the client from relying on professional advice for penalty protection.[307] Requiring practitioners to disclose potential conflicts may make them more aware of their potential for bias and even deter them from situations that create potential conflicts of interest.[308]

C. *Elevate Objectivity over Advocacy*

Lawyers represent clients in a variety of roles, including as advocates who "zealously assert[] the client's position under the rules of the adversary system."[309] Indeed, the traditional approach to legal ethics contemplates lawyers acting as advocates "to help the client win by creatively arguing that the client has complied with law or has a stronger case than the opposing

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[306] There has been at least one reported case of OPR sanctioning a lawyer for not disclosing conflicts with respect to the lawyer's "multiple adverse representations" and personal interests. IR-News Rel. 2012-63, 2012 WL 6554676, at *1 (June 22, 2012). The lawyer wrote tax opinions for several prospective participants of a benefit plan under section 419A while also representing the promoter of the plan. *Id.* The lawyer consented to censure, which means that his name, city and state of practice, and disciplinary sanction are published in the Internal Revenue Bulletin. *Id.*; *see also* Announcement 2012-33, 2012-35 I.R.B. 327.

[307] Proposed section 10.29(c) of Circular 230 provided that:

> A practitioner may not represent a party in his or her practice before the Internal Revenue Service if the representation of the party may be materially limited by the practitioner's own interests, unless the practitioner reasonably believes the representation will not be adversely affected and the client consents after the practitioner has fully disclosed the potential conflict, including disclosure of the implications of the potential conflict and the risks involved.

DEP'T OF THE TREASURY, NOTICE OF PROPOSED RULEMAKING AND NOTICE OF PUBLIC HEARING. But this proposal was not ultimately adopted. *See* T.D. 9011, 2002-33 I.R.B. 356.

[308] *See* Christopher Tarver Robertson, *Biased Advice*, 60 EMORY L.J. 653, 680 (2011).

[309] MODEL RULES OF PROF'L CONDUCT: PREAMBLE AND SCOPE (2013). Though the professional standards that govern CPAs are generally outside the scope of this Article, see AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, INTERPRETATION 102-6 (2011) (requiring a CPA to maintain objectivity even when performing tax engagements that involve acting as an advocate).

party."[310] A lawyer may also act as an advisor.[311] Whereas an advocate typically deals with already established facts, the legal advisor helps shape the facts by advising as to conduct that has yet to occur. In contrast to a zealous advocate whose job is to make the strongest legal arguments possible in favor of the client, the goal of a legal advisor is "to accurately predict" the outcome of an assumed set of facts.[312] To provide an accurate "opinion as to what the ultimate decisions of the court would be as to the applicable law," a legal advisor should objectively determine the applicable law and impartially apply the law to the anticipated facts.[313]

Lawyers providing tax opinions should not use the creative lawyering often valued in traditional advocacy.[314] Too often lawyers see their role as helping clients get what they want and finding a loophole to do it as opposed to advising their clients as to the likely consequences of future conduct and the concomitant risks. *The Restatement of Law Governing Lawyers* provides that "a lawyer's duty to third-party-opinion recipients 'is to provide a fair and objective opinion.'"[315] Tax opinions technically are not third-party opinions to the extent they are not provided to third parties but are only for the client's benefit. But because the consequences of transactions opined on affect the tax system more generally, it may be helpful to analogize tax opinions to third-party legal opinions.

Treasury and the Service should consider adding a provision to Circular 230 to emphasize the need for advisors providing tax advice to be objective and impartial. While such an approach is perhaps implicit in the provisions that prohibit unreasonable legal assumptions and that require a more likely than not opinion, it is worth making explicit the obligation to engage in objective, detached legal analysis. One approach would be to expressly require an evaluation of all relevant authorities, including contrary authorities, to determine whether sufficient authority exists to justify the opinion

[310] Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1, 26 (2005).

[311] MODEL RULES OF PROF'L CONDUCT, *supra* note 309. A lawyer who promotes illegal tax shelters may be acting outside of the roles of both advisor and advocate in an altogether different category that David Luban has termed "the Lawyer as Absolver" or the "Lawyer as Indulgence Seller." David Luban, *Liberalism, Torture, and the Ticking Bomb, in* THE TORTURE DEBATE IN AMERICA 35, 70-71 (Karen J. Greenberg ed., 2006).

[312] Schwarcz, *supra* note 310, at 27.

[313] Richard W. Jennings, *The Corporate Lawyer's Responsibilities and Liabilities in Pending Legal Opinions*, 30 BUS. LAW. 73, 75 (1975).

[314] Schwarcz, *supra* note 310, at 27 (stating that "[t]echnical accuracy must be valued more than creativity, and indeed creativity that undermines accuracy must be eschewed").

[315] *Id.* at 48 (quoting RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §95 cmt. c (2000)).

being rendered.[316] Another approach would be to add a more general statement to clarify that an advisor issuing penalty protection tax opinions has a duty to be impartial and objective.[317]

Critics may argue that a rule emphasizing the advisor's independent role will have no practical effect because such a provision is not readily enforceable in the absence of any clear demarcation between advocacy and independence. Nonetheless, incorporating a provision into Circular 230 would stress the tax advisors' independent role, and could also be referred to by advisors to keep at bay overly aggressive clients. These "normative benefit[s] . . . could be substantial, notwithstanding potential difficulties relating to enforcement."[318]

D. *Evaluate Reasonable Cause from the Taxpayer's Perspective*

Tax advice used to satisfy either reasonable cause exception must (1) be grounded on all relevant facts and the law that pertains to those facts, and (2) not rely on unreasonable or inaccurate factual or legal assumptions or unreasonable representations.[319] These requirements are better suited for inclusion in Circular 230, which regulates the conduct of advisors who practice before the Service. A taxpayer's reasonable cause defense should not be made to depend on variables that are outside the taxpayer's actual or constructive knowledge.[320] Conditioning a taxpayer's reasonable cause defense on the legal assumptions underlying the advice being reasonable is inappropriate unless the taxpayer knows or should know that the legal assumptions are unrea-

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[316] *See* Reg. § 1.6662-4(d)(3)(i) (regulation addressing whether substantial authority exists). The regulation provides that: "There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section." Reg. § 1.6662-4(d)(3)(i).

[317] *See* H.K. Woolf, Access to Justice, Final Report to the Lord Chancellor on the Civil Justice System in England and Wales (July 1996), *available at* http://webarchive.nationalarchives.gov.uk/+/http://www.dca.gov.uk/civil/final/sec3c.htm. The report recommended reforms to the English Civil Procedure Rules. One reform requires that expert witnesses be impartial and that their duty to the court override their duty to their clients. Additionally, experts would be required to include a statement in their reports declaring their understanding that their "primary duty is to the court, both in preparing his report and in giving evidence." *Id.*

[318] Steven Feola & Richard A. Alcorn, *Expert Witness Advocacy: Changing Its Culture*, 45 Ariz. Att'y 24, 28 (2009).

[319] I.R.C. § 6664(d)(4)(B)(iii) (reasonable cause exception applicable to section 6662A penalties); Reg. § 1.6664-4(c)(1) (for more lenient reasonable cause exception).

[320] As the ABA Section of Taxation aptly said in its comments to the most recent amendments to Circular 230, "taxpayers [should] not be held responsible for practice standard shortcomings in their advisors' work that they did not know of, or have reason to know of." Am. Bar Ass'n. Section of Taxation, Comments on Proposed Reg-138367-06 Relating to Practice Before the Internal Revenue Service (Nov. 27, 2012), *reprinted in* 2012 Tax Notes Today 229-26 (Nov. 28, 2012).

sonable. Similarly, ensuring that the advisor is provided with necessary and accurate information should be the responsibility of advisors to ask the right questions to solicit the necessary information rather than conditioning the taxpayer's reasonable cause defense on whether the taxpayer provided necessary and accurate information to the advisor.[321]

E. *Referrals to OPR Where Reasonable Cause Exception Not Met*

Opinion writers should be referred to OPR if a deficiency is sustained and penalties are imposed on a taxpayer who relied on professional advice. The imposition of a deficiency means that the advice underlying the opinion turned out to be incorrect. While OPR should not second-guess the underlying analysis except to the extent it bears on the advisor's competence, the imposition of penalties means that the taxpayer could not show that reliance on the advice obtained was reasonable cause for the inaccuracy and that the taxpayer acted in good faith by relying on the advice despite the inaccuracy. OPR should, in hindsight, determine whether the advisor complied with the advisor's professional obligations as described in Circular 230. Appropriate areas of inquiry could include determining whether the professional was competent, whether any impermissible conflicts of interest existed that may have affected the advisor's ability to give objective advice, and the sufficiency of due diligence conducted given the nature of the relationship with the client, the client's sophistication, and all other facts and circumstances.

F. *Penalties*

As discussed in Part VI.B., the current penalty regime is insufficient to deter tax planning advisors. For liability rules to effectively deter lawyer behavior, however, the risk of potential future punishment has to outweigh the certainty of present benefits.[322] As Professor Issacharoff notes, lawyers "may tend to overdiscount the likelihood of eventual punishment, thus undermining the deterrent function of the prescribed penalty."[323] But the real threat of penalties is one way to align the interests of advisors to their clients' interests. Putting real teeth into advisor penalties is imperative, particularly because reliance only on Circular 230 or other professional standards and ethics to police advisors are unlikely to be successful.[324]

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[321] *See* Rawls Trading LP et al. v. Commissioner, 104 T.C.M. (CCH) 732, 740, 2012 T.C.M. (RIA) ¶ 2012-340, at 2460 (quoting Longoria v. Commissioner, 98 T.C.M. (CCH) 11, 2009 T.C.M. (RIA) ¶ 2009-162 for the proposition that it is the advisor's job to solicit the necessary information from the taxpayer).

[322] Issacharoff, *supra* note 295, at 194.

[323] *Id.*

[324] N.Y. State Bar Assoc. Tax Section, Report on Corporate Tax Shelters (Apr. 23, 1999), *reprinted in* 1999 Tax Notes Today 82-29 (Apr. 29, 1999) (stating that "[b]ecause . . . the application of standards of practice to individual cases inevitably involves difficult questions of judgment, we do not believe that the corporate tax shelter phenomenon can readily be addressed simply through enforcing professional standards and ethics more vigorously").

VIII. Conclusion

Taxpayers may avoid accuracy-related penalties by relying on professional tax advice to satisfy the reasonable cause defense. Reliance on professional tax advice is not, however, a fail-safe escape from penalties. Courts have repeatedly held that taxpayers "cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest." But courts have not clearly articulated the circumstances under which the common law conflict of interest rule applies, making its application unpredictable and inconsistent. Despite the statutory conflict of interest rule in section 6662(d) that applies to section 6662A penalties, tax return preparer penalties, and the covered opinion rules in Circular 230, the common law conflict of interest rule remains relevant due to several deficiencies. In addition to highlighting the deficiencies in these statutory and legislative provisions, this Article explores analytical approaches with the potential to lessen the courts' reliance on the common law conflict of interest rule by bringing front-of-mind awareness to advisor conflicts of interest.