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# ABA Formal Opinion 346 and a New Statutory Penalty Regime

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## I. ABA Formal Opinion 346

The American Bar Association released Formal Opinion 346 in June 1981, less than one year after the Treasury Department issued proposed amendments to Circular 230.[1] The ABA later withdrew the June release, reissuing Formal Opinion 346 in January 1982.[2] In its final form, Opinion 346 promulgated ethical and disciplinary standards for lawyers rendering opinions on tax shelter investments offered to nonclients. In that way, Opinion 346 differed significantly from ABA Formal Opinion 314, which governed advice to individual clients in the preparation of tax returns.[3] When representing individual clients, the lawyer's relationship with the IRS was largely adversarial. But when providing a tax shelter opinion the lawyer knows or should know will be relied on by third persons, the lawyer, according to Opinion 346, ''functions more as an adviser than as an advocate.''[4]

The guidelines for tax lawyers in Opinion 346 responded directly to the 1980 proposed amendments to Circular 230. While officially restricted to legal opinions on tax shelter investment offerings, Opinion 346 examined the relationship between tax lawyers and the IRS in contexts that extended beyond the tax shelter marketplace. In particular, it discussed the tax lawyer as adviser versus advocate, definitional boundaries of tax shelter activity, disciplinary standards and authorities for tax lawyers, due diligence standards applicable to all transactional lawyers, and practice standards to follow when opining on the likely success or failure of aggressive tax positions. Opinion 346 also articulated eight ethical principles to guide tax lawyers. The ethical guidelines were based on various Ethical Considerations of the Model Code and thus were aspirational rather than disciplinary in nature.

### A. Opinions for 3rd Persons: Adviser vs. Advocate

Opinion 346 differentiated between the tax lawyer as advocate and adviser. When representing a client in adversarial proceedings before the IRS, the tax lawyer functioned as an advocate.[5] In rendering a tax shelter opinion to be relied on by third persons, however, the tax lawyer functioned as an adviser. Under normal circumstances, lawyers did not owe third persons special ethical considerations. But when those third persons had ''an interest in the integrity of the evaluation,'' the legal duty of the lawyer ''goes beyond the obligations a lawyer normally has to third persons.''[6] The tax lawyer's legal opinion on a tax shelter offering was ''frequently of substantial importance.'' The shelter promoter depended on the tax lawyer's opinion in marketing the shelter offering to potential investors, often using the lawyer's name and firm in connection with sales promotion efforts. Nonclient tax shelter investors relied on the lawyer's opinion in determining whether to invest in a

[1]ABA Committee on Ethics and Professional Responsibility, Formal Opinion 346 (June 1, 1981). For Treasury's 1980 proposed amendments to Circular 230, see ''Proposed Amendments, Tax Shelters; Practice Before the Internal Revenue Service,'' 45 *Fed. Reg.* 58594 (Sept. 4, 1980).

[2]ABA Comm. on Ethics and Professional Responsibility, Formal Opinion 346 (Revised) (Jan. 29, 1982).

[3]ABA Comm. on Professional Ethics, Formal Opinion 314 (Apr. 27, 1965). Over the years, the ambit of Opinion 314 had broadened to represent prevailing ethical standards ''not only for advice to clients in return preparation, but generally for lawyers in their relationship with the Internal Revenue Service.'' The Association of the Bar of the City of New York, Special Committee on the Lawyer's Role in Tax Practice, ''The Lawyer's Role in Tax Practice,'' 36 *Tax Law.* 865 (Summer 1983). For more on Opinion 314 and a detailed discussion of the reasonable basis standard, see Dennis J. Ventry Jr., ''Reasonable Basis and Ethical Standards Before 1980,'' *Tax Notes*, May 29, 2006, p. 1047.

[4]ABA Comm. on Ethics and Professional Responsibility, Op. 346, *supra* note 2.

[5]To establish the lawyer's role as advocate, Opinion 346 referred to Ethical Consideration 7-22, which stated that ''a litigant or his lawyer may, in good faith and within the framework of the law, take steps to test the correctness of a ruling of a tribunal.'' That was a particularly odd reference given that Opinion 314 stated unequivocally that the IRS was neither a judicial tribunal nor even a ''quasi-judicial institution.'' ABA Comm. on Professional Ethics, Op. 314, *supra* note 3.

[6]ABA Comm. on Ethics and Professional Responsibility, Op. 346, *supra* note 2 (citing to Ethical Consideration 7-3). Remaining citations in this paragraph are from ABA Comm. on Ethics and Professional Responsibility, Op. 346, *supra* note 2.



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proposed venture. Thus, the principles enunciated in Opinion 314 governing advice rendered to individual clients had ''little, if any, applicability.''

### B. Defining Tax Shelter and Tax Shelter Opinion

Opinion 346 narrowed significantly Treasury's definition of tax shelter. Section 10.33(c)(3) of the proposed amendments to Circular 230 defined a tax shelter as a sale, offering, syndication, promotion, investment, or other transaction ''in which the claimed tax benefits are likely to be perceived by the taxpayer as the principal reason for his or her participation.''[7] By comparison, Opinion 346 offered a more restrictive definition, deeming a tax shelter

> an investment which has as a significant feature for federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.[8]

The ABA's definition omitted the requirement that the tax lawyer intuit intent regarding a taxpayer-investor's principal reason for participating in the tax shelter offering. Opinion 346 also contained an angel list of noncontroversial transactions. The enumerated list included municipal bonds, annuities, family trusts, qualified retirement plans, IRAs, stock option plans, securities issued in a corporate reorganization, some mineral development ventures, and real estate for which deductions were unlikely to exceed gross income from the investment in any year and for which tax credits were unlikely to exceed the tax on the income from that source in any year.

While Opinion 346 offered a more limited definition of tax shelter than the proposed Circular 230 rules, its definition of a tax shelter opinion paralleled that of the proposed amendments. Both definitions covered federal tax advice the opinion writer knew or reasonably should have known would be used in offering materials distributed to nonclients in connection with the promotion of a tax shelter.

There were also several differences between the definitions. Circular 230 covered only written advice, while Opinion 346 seemed to cover both written and oral advice (although that was likely a drafting oversight). More importantly, Opinion 346 carved out several exceptions for providing an opinion that did *not* qualify as a tax shelter opinion. Rendering advice solely to the offeror did not qualify, nor did simply reviewing the offering materials, as long as any legal work was not referred to in the offering materials or in connection with promotion efforts. Also, Opinion 346 exempted work performed by lawyers on tax shelter investments marketed to small groups of investors that relied on independent counsel for advice. Those independent advisers were similarly exempted in those situations.

### C. Disciplinary Standards

False and fraudulent opinions were prohibited. We knew that. Nevertheless, Opinion 346 spent a good deal of time reminding tax lawyers that they could be subject to discipline under the Model Rules of Professional Responsibility for rendering false opinions minimizing serious legal risks or misstating the facts or the law, either knowingly or through gross incompetence. Moreover, the lawyer could be subject to discipline for giving a false opinion that was intentionally or recklessly misleading.

In response to the Circular 230 amendments, Opinion 346 addressed the knowledge requirement for disciplining professional misconduct. Lawyers could not escape liability by pleading ignorance when they ''shut their eyes to what was plainly to be seen.''[9] Nor could they escape liability by recklessly or consciously disregarding information that strongly suggested material facts in the opinion or offering were false or misleading. That behavior equated with facilitating fraudulent activity and violated disciplinary rules.

The *mens rea* requirement under Opinion 346 necessitated more than mere negligence for a lawyer to have violated the ABA's disciplinary rules. By comparison, the proposed amendments to Circular 230 indicated that negligence could be grounds for disciplinary action. According to Opinion 346, however, culpability had to rise to the level of knowledge required to sustain a Rule 10b-5 recovery, a threshold that involved knowing or reckless conduct. Even if the lawyer lacked the knowledge required to sustain a recovery under the 10b-5 standard, he could be subject to discipline for ''gross incompetence, or indifference, inadequate preparation under the circumstances and consistent failure to perform obligations to the client.''[10]

The underlying authority to discipline misconduct also differed significantly between Opinion 346 and Circular 230. First, the ethical standards embodied in Opinion 346 were purely aspirational and restricted to attorneys. Circular 230, however, was compulsory, and it covered lawyers, CPAs, enrolled agents, and other persons representing clients before the IRS. Second, the ABA had no authority to discipline unethical or incompetent conduct of its members. Rather, state bar associations had the discretion to decide whether to regulate tax shelter opinions or to follow regulatory standards promulgated by the ABA. By comparison, Treasury had independent statutory authority to discipline unethical or incompetent conduct of its practitioners.[11] In the event of noncompliance with Circular 230 regulations, the director of practice could prosecute practitioners in disciplinary proceedings that might ultimately result in suspension or disbarment. Further, the proposed amendments to Circular 230 seemed to allow (although not explicitly) for the

[7]Proposed Amendments, *supra* note 1, at section 10.33(c)(3).

[8]ABA Comm. on Ethics and Professional Responsibility, Op. 346, *supra* note 2.

[9]*Id., citing United States v. Benjamin,* 328 F.2d 854, 863 (2d Cir. 1964).

[10]*Id.*

[11]*See* 31 U.S.C. 1026 and 5 U.S.C. 301.



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prosecution of disciplinary action against a noncompliant practitioner's firm to the extent the firm was deemed complicit in the issuance of a pattern of legal opinions that failed to meet the new Circular 230 standards.

### D. Due Diligence Standards

While the disciplinary standards diverged significantly between Opinion 346 and Circular 230, the two sets of practice guidelines converged around similar themes regarding due diligence standards. In particular, both attempted to curb opinions relying on questionable factual representations of the tax shelter promoter.

Opinion 346 applied due diligence principles for tax shelter offerings contained in ABA Formal Opinion 335.[12] In so doing, it incorporated due diligence requirements familiar to all transactional attorneys. Opinion 335 established guidelines for lawyers when furnishing an assumed facts opinion in connection with the sale of unregistered securities. It recommended that while a lawyer "should make adequate preparation including inquiry into the relevant facts . . . and while he should not accept as true that which he should not reasonably believe to be true," he was not required to audit the affairs of his client or to assume, without reasonable cause, "that a client's statement of the facts cannot be relied upon."[13] If the lawyer thought that any of the alleged facts were incomplete, suspect, inconsistent, or otherwise questionable, he was required to make further inquiry. If the lawyer remained uncomfortable after further inquiry or if he failed to make those inquiries, he was not permitted to provide an opinion. Opinion 346 included the additional requirement that the lawyer must be satisfied that the material facts were accurately and completely stated in the offering materials, and that representations as to intended future activities of the shelter transaction were identified, reasonable, and complete.[14]

Regarding relating material facts to the law, Opinion 346 offered a modest requirement that lawyers correlate the law to the facts only "to the extent the facts are ascertainable when the offering materials are being circulated."[15] When addressing issues based on future activities, the lawyer was required to clearly identify the assumed facts.[16] Comparatively, the proposed Circular 230 rules provided more stringent due diligence requirements, requiring practitioners to state a conclusion as to the likely legal outcomes of each federal tax position.[17] Further, they prevented practitioners from relying on the reasonable basis standard without "fully and fairly" describing those outcomes.[18]

### E. Material Tax Issues and Likely Legal Outcome

The largest divergence between Circular 230 and Opinion 346 involved considerations of material tax issues and the rendering of an opinion on the probable outcome of asserted tax positions.

Opinion 346 required a tax lawyer to satisfy himself that he or another lawyer had considered all material tax issues. The determination of what was "material" involved a good-faith evaluation and was defined as tax aspects of the shelter transaction that could have a significant effect in sheltering income by providing deductions in excess of the income from the tax shelter in any year or tax credits that could offset tax in excess of the tax attributable to the shelter investment in any year. Once identified, the opinion should "fully and fairly" address each material tax issue for which there was a reasonable possibility of an IRS challenge. If the tax lawyer provided an opinion on only part of the tax shelter transaction, he was obligated to review all written advice to ensure that every material tax issue was adequately considered. To the extent he believed that a material tax issue covered by another tax practitioner would be challenged by the IRS, he owed an ethical duty to advise the promoter and the other practitioner and to withhold his own opinion in the event the matter was not sufficiently addressed in the offering materials.

Circular 230 took a much broader view of what constituted a material tax issue. An "important Federal tax aspect" amounted to any federal tax issue associated with the tax shelter's promotion that was "significant in relation to the total tax benefits which may be claimed from the tax shelter."[19] Despite the expansive definition, Treasury, like the ABA, permitted a practitioner to rely on the opinions of other practitioners in rendering a limited scope opinion as long as he satisfied himself that all important federal tax issues were properly considered.[20]

The most glaring difference between the two practice standards involved the tax lawyer's opinion as to the likely outcome of asserted tax positions. Opinion 314 required the lawyer "if possible" to opine on the likely outcome of each material tax issue. If the lawyer determined in good faith that he could not make a judgment as to the outcome, he was required to provide an explanation for his inability to do so. In conducting the evaluation, the lawyer was permitted to question the validity of a revenue ruling or a judicial opinion, provided he offered a complete explanation of his reasoning and fully explained the risks associated with prospective adversarial proceedings.[21] As to providing an *overall* evaluation of the realization of tax benefits, the lawyer was allowed to conclude that the significant tax benefits "probably will be realized or probably will not be realized, or that the probabilities of realization and nonrealization of the significant tax benefits are evenly divided."[22] In those "rare instances" in which the lawyer

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[12]ABA Comm. on Ethics and Professional Responsibility, Formal Opinion 335 (Feb. 2, 1974).

[13]*Id.*

[14]ABA Comm. on Ethics and Professional Responsibility, Op. 346, *supra* note 2.

[15]*Id.*

[16]*Id.*

[17]Proposed Amendments, *supra* note 1, at section 10.33(a)(1)(i).

[18]*Id.* at section 10.33(a)(1)(ii).

[19]*Id.* at section 10.33(c)(4).

[20]*Id.* at section 10.33(b)(1)-(3).

[21]ABA Comm. on Ethics and Professional Responsibility, Op. 346, *supra* note 2.

[22]*Id.*



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was prevented from providing an overall evaluation on the likely realization of tax shelter benefits, Opinion 346 required him to explain why the determination could not be made and to ensure that the offering materials fully disclosed the assumptions and risks associated with the investment. Finally, Opinion 346 permitted the lawyer to write a negative opinion if the offering materials clearly stated and prominently disclosed the negative conclusion.

Circular 230 proposed much harsher standards. It did not give the lawyer the luxury of opining only ''if possible'' on the likely outcome of each material tax issue. Nor did it countenance circumstances under which the lawyer was exempt from providing a conclusion as to likely outcomes. Rather, it prohibited all opinions that failed to reach a more likely than not conclusion that the bulk of the tax benefits flowing from the tax shelter transaction were allowable under current law.[23] Thus, Circular 230 prevented practitioners from issuing negative opinions,[24] as well as the industry standard reasonable basis opinion. And while the new Circular 230 rules permitted practitioners to disagree with the IRS under an honest-belief standard, Treasury reminded practitioners that an intentionally or recklessly misleading opinion, or one that was part of a pattern of providing incompetent opinions, would be treated as an instance of disreputable conduct and thereby punishable under Circular 230's disciplinary rules.

### F. Eight Ethical Considerations for Tax Lawyers

For lazy readers, the ABA Committee on Ethics and Professional Responsibility provided an executive ethical summary at the end of Opinion 346 (reference to which ''*must not be substituted for a review of the more complete statement of ethical standards contained in this Opinion*'').[25] Eight general principles were to guide tax lawyers issuing tax shelter opinions:

- The lawyer should establish with the promoter-client that he required access to all relevant facts before he could provide an opinion.
- The lawyer should not write an assumed facts opinion in which he took for granted the accuracy and completeness of all material facts in the offering materials or the reasonableness and completeness of representations as to future activities.
- The lawyer was required to relate the law to the facts of the offering.
- The lawyer should make a good-faith effort to inquire with the promoter that all nontax legal issues had been considered by a competent legal adviser.
- Partial opinions were discouraged but not prohibited; the lawyer should assure that all material tax issues (particularly those that might be challenged by the IRS) have been considered in the offering materials (including materials produced by other tax professionals).
- The lawyer should, when possible, provide an opinion as to the likely outcome on the merits of material tax issues addressed in the offering materials.
- The lawyer should, when possible, provide an overall evaluation of the extent to which the tax benefits in the aggregate are likely to be realized.
- The lawyer should review the offering materials to assure that they properly represent the nature and extent of the tax shelter opinion.

The ABA promulgated Opinion 346 to discourage Treasury from attempting to regulate the behavior of tax lawyers through Circular 230. The organized bar offered more modest ethical and disciplinary standards for tax practice than Treasury's proposed guidelines. Nonetheless, much progress had been made in a short period in elevating standards of tax practice and it was clear that Treasury had gotten the attention of the tax practitioner community with its proposed amendments to Circular 230. At the same time, Treasury indicated that much was left to be done.

## II. Treasury Presses for Higher Standards

Treasury remained on the offensive after the ABA issued Opinion 346. In particular, it highlighted the multiple threats posed by an unregulated tax shelter industry. Abusive tax shelters proliferated despite heightened publicity. The schemes were ''lacking economic reality,'' argued new IRS Commissioner Roscoe Egger.[26] Their promotion and use were widely publicized and highly visible, and their high profile eroded public confidence in the fairness and equity of the tax system, causing a ''decline in the level of voluntary compliance.''[27] Tax shelter returns continued to rise sharply, jumping from 217,000 in March 1981 to nearly 240,000 just four months later.[28] Moreover, tax shelter cases continued to clog both Treasury's administrative apparatus and the courts, with 11,000 cases inventoried in the IRS administrative appeals system in 1981 (more than

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[23]Proposed Amendments, *supra* note 1, at section 10.33(a)(2).

[24]It should be noted that the 1980 proposed amendments to Circular 230 included a ''special disclosure alternative'' that addressed the view of practitioners that it was neither unprofessional nor disreputable to issue competent negative opinions. The special disclosure provision would have allowed the practitioner to give an opinion that fell short of the more likely than not standard provided ''the risks of not obtaining tax benefits are clearly and forcefully explained in the opinion'' and the practitioner ''exercises due diligence to assure that such explanation appears in any materials used to promote the tax shelter.'' A ''clear and forceful'' explanation meant ''a highlighted statement on the first page of any offering materials, the first page of the practitioner's opinion, and at the head of any other discussion of tax aspects in the offering materials that it is 'unlikely that the bulk of the tax benefits on the basis of this tax shelter transaction is promoted are allowable under the tax law.'" Proposed Amendments, *supra* note 1, at section 10.33(c)(3), Supplementary Information.

[25]ABA Comm. on Ethics and Professional Responsibility, Op. 346, *supra* note 2. Emphasis in the original.

[26]Roscoe L. Egger Jr., ''Defusing Abusive Tax Shelters,'' *Tax Notes*, Oct. 12, 1981, p. 863.

[27]*Id.*

[28]*Id.*



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double the figure for 1980), and more than 7,000 shelter cases docketed in the U.S. Tax Court.[29]

Egger reported that the IRS was prosecuting an aggressive multiprong attack against tax shelters.[30] Its tax shelter audit program (in operation since 1973) identified and pursued potentially abusive tax shelter transactions. The newly formed Tax Shelter Group reviewed promotional and offering materials and issued rulings on new shelter schemes to apprise taxpayers, tax advisers, and promoters of the IRS's position and to explain the implications and consequences of entering into them. A new expedited review procedure for shelter cases moved the cases through the administrative process to litigation more quickly. And alterations to traditional methods of classifying returns for examination — in particular, abandoning the measure of adjusted gross income for total positive income, which summed all positive income items on a return and assigned losses a zero value — prevented high-income taxpayers from looking like low-income taxpayers because of huge artificially generated losses.

Also, Treasury continued to prod professional organizations to promulgate and adequately police standards of ethics and professional responsibility. While Treasury expressed general approval with ABA Opinion 346, it waited for similar action from other professional groups.[31] Moreover, if new ethical and disciplinary rules were not enforced by the professional organizations, Treasury said that it would investigate ways of dealing with the problem, including aggressively asserting statutory penalties or proposing additional amendments to Circular 230.[32]

While ethical standards and disciplinary rules comprised critical elements in the attack on tax shelters and overly aggressive practitioners, Treasury solicited Congress for more severe statutory penalties. Outgoing IRS Commissioner Jerome Kurtz emphasized the need for more stringent penalties. If the self-assessing federal income tax was to continue to work, Kurtz argued, it needed to provide "a financial penalty which would discourage taxpayers from playing the audit lottery."[33] A strengthened penalty structure could "deal directly with the root of the abusive tax shelter problem" by placing on the taxpayer "the burden of evaluating the real risk that the claimed tax benefit might be disallowed with the attendant penalty."[34] Moreover, higher penalties could induce tax practitioners to write more precise tax shelter opinions and prompt taxpayer-investors to read the opinions. Such a penalty structure, Kurtz noted with words that warmed the hearts of tax lawyers everywhere, might even prompt Treasury to withdraw the proposed changes to Circular 230. But the penalties had to hurt.

### III. A New Penalty Regime: ERTA and TEFRA

Beginning in 1981 Congress heeded the call for more onerous penalties. With the Economic Recovery Tax Act of 1981 (ERTA),[35] legislators shut down a large component of tax shelter activity by severely limiting the tax advantages of commodity straddles. New code section 1092 provided that losses from straddle trades could be recognized only to the extent they exceed unrealized gains on the offsetting portion of the straddle.[36] ERTA also added section 6659, imposing an ad valorem penalty on income tax underpayments attributable to substantial valuation overstatements.[37] The penalty could be waived only on a showing of reasonable basis for the valuation. ERTA also amended section 6621 to provide that interest on underpayments and overpayments of tax equaled 100 percent of the average predominant prime rate established annually.[38]

In 1982 Congress showed that it was serious about penalizing noncompliant taxpayers and their tax advisers. The Tax Equity and Fiscal Responsibility Act of 1982[39] included several antishelter penalty provisions designed to raise taxpayer compliance. The total compliance improvement package produced $27.8 billion (or 28.3 percent) of all revenue raised by TEFRA. Congress was responding to the increasingly troublesome tax gap, which had crested $95 billion in 1980.[40] Only 5 percent of the gap was attributable to tax shelter activity. But TEFRA contained many new antishelter penalties.

New section 6700 imposed penalties on tax shelter promoters.[41] The penalty was equal to the greater of $1,000 or 10 percent of the gross income derived or to be derived from activities of persons participating in the

[29] *Id.*

[30] Citations in this paragraph are from Egger, *supra* note 26, at 864-865.

[31] Treasury criticized some aspects of Opinion 346, particularly its endorsement of negative opinions. *See, e.g.*, R. Eliot Rosen, "Tax Section Meeting Discusses Shelter Opinion Rules, TEFRA," *Tax Notes*, Aug. 16, 1982, p. 701 (citing Peter J. Wallison, General counsel of the Treasury Department, arguing that a negative opinion, despite its negative conclusion, could mislead investors that relied on the presence of the legal opinion, could be used as insurance against the imposition of penalties, and could injure third-party investors); Jerome Kurtz, "Notes to a New Commissioner of Internal Revenue," *Tax Notes*, June 1, 1981, p. 1195, at 1197 (praising Circular 230 and its more likely than not standard for opinion writers).

[32] Egger, *supra* note 26, at 866.

[33] Kurtz, *supra* note 31, at 1197.

[34] *Id.*

[35] P.L. 97-34.

[36] Section 1092, added by P.L. 97-34, section 501(a), Aug. 13, 1981, 95 Stat. 323.

[37] Section 6659, added by P.L. 97-34, Title VII, section 722(a)(1), Aug. 13, 1981, 95 Stat. 341. Section 6659 was subsequently repealed by P.L. 101-239, Title VII, section 7721(c)(2), Dec. 19, 1989, 103 Stat. 2399.

[38] Section 6621(c), amended by P.L. 97-34, Title VII, section 711(a)-(c), Aug. 13, 1981, 95 Stat. 340.

[39] P.L. 97-248.

[40] John André LeDuc, "The Legislative Response of the 97th Congress to Tax Shelters, the Audit Lottery, and Other Forms of Intentional or Reckless Noncompliance," *Tax Notes*, Jan. 31, 1983, p. 363, at 364.

[41] Added by P.L. 97-248, Title III, section 320(a), Sept. 3, 1982, 96 Stat. 611. For a discussion of the significance of section 6700, see D. French Slaughter III, "The Empire Strikes Back: Injunctions of Abusive Tax Shelters After TEFRA," 3 *Va. Tax Rev.* 1 (Summer 1983).



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organization or sale of an investment plan or arrangement who made or furnished a statement regarding the availability of tax benefits the person knew or had reason to know was false or fraudulent. The ''reason to know'' standard could be established by objective evidence, but it did not include a duty of inquiry. Section 6700 also levied a penalty on any person who, in connection with the organization or sale of an investment plan or arrangement, made or furnished a gross valuation overstatement. The penalty could be waived only on a showing of good faith and a reasonable basis for the valuation.

The statutory definition of promoter — ''*any* person organizing or assisting'' — was expansive and it potentially applied to salespersons and brokers whose only participation in a shelter offering may have involved furnishing the prospectus containing a gross valuation overstatement.[42] While the definition of promoter may have been too large, the financial penalty was surely too small. The profit margin was so high for most tax shelters that the 10 percent penalty, ''even if paid by promoters and salesmen, would not diminish the attractiveness of promoting such shelters.''[43]

The pecuniary loss associated with violating section 6700 by itself may not have provided sufficient deterrence to noncompliant promoters. But it represented a significant component of an aggressive suite of penalty provisions designed to alter the behavior of all the actors in the tax shelter marketplace, including brokerage houses that marketed tax shelters, accountants who reviewed balance sheets, lawyers who rendered legal opinions in connection with the promotion of abusive tax shelters, and promoters who sold and marketed the products.

The selling side of the tax shelter industry represented just half the equation; someone had to buy them. Section 6661 imposed a penalty on shelter investors for substantial understatements of tax, defined as understatements in excess of the greater of $5,000 ($10,000 for corporations) or 10 percent of the tax owed.[44] The stated purpose of the new penalty was to create a downside risk for taxpayers who took aggressive tax return positions.[45] The penalty could be avoided if the return position was supported by substantial authority.[46] Substantial authority included court opinions, Treasury regulations, revenue rulings, revenue procedures, and similar administrative pronouncements, but it excluded law review articles, opinion letters, private letter rulings or determination letters, and technical advice memorandums issued to or concerning a third party.[47] If the return position was not supported by substantial authority, the taxpayer could still avoid the penalty by adequately disclosing relevant facts associated with the return position.[48] Harsher rules applied if the return position related to a tax shelter. In those circumstances, the taxpayer could avoid the penalty only if he had substantial authority *and* reasonably believed that the return treatment was more likely than not correct when he took the position.[49] The IRS was also authorized to waive the penalty on a showing of good faith and reasonable cause. Therefore, a taxpayer could avoid the penalty by showing that he believed correctly that he had a reasonable basis for his position but incorrectly that he was more likely than not to prevail. However, a taxpayer could not avoid the penalty if he knew that although he had a reasonable basis for his position, he *only* had a reasonable basis without substantial authority.[50]

New section 6661 also contained the first statutory definition of the term ''tax shelter.'' Congress described the transaction as a partnership, other entity, plan, or

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[42]Emphasis added. For criticism of the broad definition of promoter, see NYSBA Tax Section, Committee on Unreported Income, ''Comments on the Tax Compliance Act of 1982'' (1982), at 15 (finding it ''inappropriate . . . to make every person who participates in the organization or sale of a tax shelter responsible for the accuracy of the valuations on which the shelter is based''); LeDuc, *supra* note 40, at 372 (noting that ''while it may be appropriate to penalize the promoter for an unknowing gross valuation overstatement because of his managerial role, it would be unfair to penalize a mere salesman not only because he has no professional expertise to allow him to discern the overvaluation but because he lacks the managerial authority to prevent the overstatement''). *But see* Le Duc, *supra* note 40, at 372 (''The ability of the IRS to discourage professionals and brokerage houses from assisting abusive tax shelters through the imposition of this penalty may be more effective in curtailing the organization and sale of tax shelters than the direct assessment of this penalty on the promoters themselves'').

[43]LeDuc, *supra* note 40, at 373.

[44]Added by P.L. 97-248, Title III, section 323(a), Sept. 3, 1982, 96 Stat. 613. Repealed by P.L. 101-239, Title VII, section 7721(c)(2), Dec. 19, 1989, 103 Stat. 2399. The 1989 legislation also

**(Footnote continued in next column.)**

replaced section 6661 with section 6662, the accuracy-related penalty provision. *See* P.L. 101-239, Title VII, section 7721(a), Dec. 19, 1989, 103 Stat. 2395.

[45]Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, 97th Congress, 2d Session (Washington: Government Printing Office, 1982), at 216.

[46]Section 6661(b)(2).

[47]Committee reports on section 6661 indicated that the ''substantial authority'' standard was to ''be less stringent than a 'more likely than not' standard and more stringent than a 'reasonable basis' standard.'' It was anticipated that the new standard would require a taxpayer to ''have stronger support for a position than a mere 'reasonable basis' (a reasonable basis being one that is arguable, but fairly unlikely to prevail in court upon a complete review of the relevant facts and authority).'' U.S. Congress, H.R. Conf. Rep. No. 760, 97th Congress, 2d Session (Washington: Government Printing Office, 1982), at 575.

[48]Section 6661(b)(2)(B)(ii). An adequately disclosed relevant item was defined somewhat tautologically as ''any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.''

[49]Section 6661(b)(2)(C)(i)(II). Reasonable belief resembled the traditional objective standard associated with the query, ''Was the belief that of a reasonable man?'' Under that standard, a taxpayer could not argue, for instance, that he lacked sufficient sophistication or ordinary intelligence to understand the transaction or that he failed to investigate the tax status of a tax-motivated transaction.

[50]Earlier drafts of section 6661 would have imposed a strict liability standard on the taxpayer who met the substantial understatement threshold. *See* LeDuc, *supra* note 40, at 378.



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arrangement the principal purpose of which is the evasion or avoidance of federal income tax.[51] The principal purpose test required that the IRS intuit taxpayer intent for undertaking specific transactions, similar to the requirement under proposed amendments to Circular 230. Not surprisingly, the parallel definition underwent criticism similar to that levied against the tax shelter definition in Circular 230: It was unnecessarily broad[52] and required the government to divine motive.[53]

While perhaps considered unfriendly by overly aggressive taxpayers, the new statutory definition of tax shelters was designed to limit the advantages of playing the audit lottery. The taxpayer was allowed to present evidence that his investment was not a tax shelter, and he could avoid the penalty if he fully disclosed relevant facts or had substantial authority for his position. The investor penalty was intended to make otherwise aggressive taxpayers think before they acted.

TEFRA's antishelter provisions contained many additional penalties. Those included:

- new section 6701, imposing a penalty on any person who aides, assists, procures, or advises on a tax return or related document used in connection with a material tax matter that results in an understatement of tax for another person;[54]
- new section 7408, permitting the IRS to enjoin promoters of abusive tax shelters;[55]
- amended section 6621, providing that the interest rate on tax deficiencies was to be determined semiannually (rather than annually) and based on the average prime rate;[56]
- new section 6622, providing that the interest on deficiencies was to be compounded daily;[57] and
- increases to various fines for criminal offenses under the code.[58]

Those antishelter provisions gave Treasury what it had been asking for: a penalty structure that complemented its administrative and regulatory efforts against tax shelters.

## IV. Adding Arrows to the Antishelter Quiver

By providing the IRS with penalty provisions that packed some punch, Congress expanded the attack on tax shelters. Importantly, TEFRA primarily went after investors rather than advisers. Under that strategy, ''it is the clients who police their lawyers rather than the lawyers who are asked to police their clients.''[59] The investor-focused approach differed from either Opinion 346 or the proposed amendments to Circular 230, both of which attempted to regulate tax shelters by regulating the conduct of tax advisers. But TEFRA's provisions were not exclusively investor-oriented. Indeed, they affected all facets of the tax shelter industry. In the words of one knowledgeable commentator, TEFRA ''cut across the whole spectrum of tax shelters'' with provisions that reduced ''the incentive of promoters to promote, professionals to assist, and investors to invest in tax shelters of all types.''[60] Promoters faced a new penalty, as well as the threat of being enjoined from doing business. Return preparers were disincentivized from engaging in a race to produce the lowest tax liability, because the calculation now had to account for risks associated with noncompliance and overly aggressive positions. Taxpayers could no longer rely on the advice of counsel or hide behind legal opinions. And tax lawyers had to be more precise in writing opinions to remain competitive in a professional marketplace with elevated standards and to avoid successful malpractice claims. Gresham's law gasped for air.

The new penalty structure also indirectly enhanced existing ethical and disciplinary guidelines. ABA Opinion 346 required tax lawyers to describe the risks of litigation, which, in the presence of TEFRA, included investor penalties and the satisfaction or nonsatisfaction of the more likely than not standard, as well promoter penalties that could attach in the event of litigation. Arguably, TEFRA also relieved pressure on the IRS to adopt the proposed Circular 230 amendments. The substantial understatement penalty in section 6661 reduced the need for Treasury regulations prohibiting negative opinions; a negative opinion would cast doubt on the investor's reasonable belief in the correctness of his reporting position and make the avoidance of underpayment penalties extremely difficult. Some commentators even suggested that the new penalties created strong

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[51]Section 6661(b)(2)(C)(ii).

[52]*See* LeDuc, *supra* note 40, at 376 (quoting John Nolan of the ABA Section of Taxation arguing that the definition ''is so broad that it could be interpreted to cover virtually any action by any taxpayer, business or non-business, in seeking to minimize tax liability,'' including many legitimate, congressionally mandated transactions).

[53]For a good discussion of the criticism and debate surrounding motivational standards versus objective standards, see LeDuc, *supra* note 40, at 376.

[54]Added by P.L. 97-248, Title III, section 324(a), Sept. 3, 1982, 96 Stat. 615.

[55]Added by P.L. 97-248, Title III, section 321(a), Sept. 3, 1982, 96 Stat. 612. Commentators noted that the availability of injunctive relief would help ''prevent high profit tax shelters from prospering despite the promoter penalty. A willingness to pay the 10 percent penalty will not insure the ability of a promoter to continue his business because the IRS may always resort to a prospective injunction.'' LeDuc, *supra* note 40, at 374. For a detailed discussion of the significance of section 7408, see Slaughter, *supra* note 41.

[56]Amended by P.L. 97-248, Title III, section 345(a), Sept. 3, 1982, 96 Stat. 636.

[57]Added by P.L. 97-248, Title III, section 344(a), Sept. 3, 1982, 96 Stat. 635.

[58]Section 7201, attempt to evade or defeat tax (amended by P.L. 97-248, Title III, section 329(a), Sept. 3, 1982, 96 Stat. 618);

**(Footnote continued in next column.)**

section 7203, willful failure to supply return, supply information, or pay tax (amended by P.L. 97-248, Title III, section 327, 329(b), Sept. 3, 1982, 96 Stat. 617, 618); section 7206, fraud and false statements (amended by P.L. 97-248, Title III, section 329(c), Sept. 3, 1982, 96 Stat. 618); and section 7207, fraudulent returns, statements, or other documents (amended by P.L. 97-248, Title III, section 329(d), Sept. 3, 1982, 96 Stat. 619).

[59]LeDuc, *supra* note 40, at 381.

[60]*Id.* at 389. At the time of that observation, LeDuc was counsel for the Senate Finance Committee and had participated actively in the legislative process that produced TEFRA.



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enough incentives for taxpayers to police tax advisers, thereby eliminating any need for Treasury to regulate tax advisers directly with Circular 230 or otherwise. Hopes that Treasury would withdraw Circular 230, however, were quickly dashed.

*In the next installment of Policy and Practice:* We Weren't Kidding: Circular 230 Is Here to Stay.


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