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Probability, Professionalism, and Protecting Taxpayers

Bradley T. Borden
bradley.borden@brooklaw.edu

Dennis J. Ventry, Jr.

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Probability, Professionalism, and Protecting Taxpayers

DENNIS J. VENTRY, JR.* & BRADLEY T. BORDEN**

Abstract

This Article—the first in a three-part series—analyzes the affirmative and disciplinary duties imposed on tax lawyers that require them to make probability assessments about the merits of a client’s tax position or tax-favored transaction and to reflect those estimates with numerical precision. It describes how the Treasury, Congress, and the American Bar Association (often in concert, occasionally at odds) forged this obligatory standard of care over the last three decades with the shared goal of facilitating accurate advice, accurate tax returns, and compliance with the law. The resulting regulatory standard of care (which swept aside the old regime of self-regulation) assists tax lawyers in avoiding flawed methodological processes and in minimizing psychological biases and misaligned incentives that can distort professional judgment. In this way, the standard of care for tax lawyers—particularly its emphasis on improving accuracy and reducing errors by updating subjective beliefs with new, relevant information—reflects a branch of probabilistic decision theory known as Bayesian reasoning.

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*Professor of Law, UC Davis School of Law.

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I. Introduction: Tax Practice and Bayes' Theorem

Lawyers are not mathematicians. Nor are they statisticians or economists.¹ Yet they regularly make probability assessments pertaining to the outcome of pleadings, motions, hearings, litigation strategies, written and oral opinions, and business transactions. Moreover, they make these predictions in a sea of uncertainty, subject to conditions and interdependent variables largely beyond their ken or control. Even more daunting, while some lawyers render these estimates without tangible fear of negative professional implications or discipline thanks to ethical rules that tolerate debased levels of confidence (*e.g.*, not frivolous and colorable), others within the profession must meet considerably higher standards of care while risking harsher and more palpable penalties, including monetary fines, censure, suspension, and disbarment. These understandably cautious souls are known as tax lawyers.

¹With apologies to Pierre de Fermat—a French lawyer and mathematician credited with developing infinitesimal calculus through his study of “adequalities” and a pioneer in algebraic number theory (which effectively sprung forth from “Fermat’s Last Theorem”), analytic geometry, geometrical optics (including “Fermat’s Principle” pertaining to the laws of reflection and refraction), and probability theory (of which he, along with Blaise Pascal, is considered one of the “fathers”)—lawyers are more apt to possess analytical and inductive skills than aptitude in mathematical sciences.

To be sure, tax lawyers must abide by rules of conduct applicable to all attorneys. These guidelines,² broadly designed to regulate the quality of legal advice and advocacy and to align the incentives of the lawyer with her client, provide generalized standards pertaining to, for instance, due diligence and competence, communication with clients, conflicts of interest, and unreasonable fees.

In addition to these professional guidelines, tax lawyers are subject to the highly particularized, affirmative, and disciplinary practice rules promulgated by the Treasury.³ Rather than offering a vague obligation that lawyers “act with reasonable diligence and promptness in representing a client,”⁴ which reflects the basic diligence standard contained in the ABA Model Rules, the Treasury’s code of conduct provides an exhaustive guide to assist tax “practitioners”⁵ in meeting their standard of care pertaining to due diligence: exercising “diligence as to accuracy”⁶ in the preparation, approval, and filing of all documents with the Service and in determining the “correctness” of any oral or written representations made to the Service or to clients;⁷ ascertaining

²The ABA Model Rules of Professional Conduct have contained the prevailing standards of care since 1983 (last amended in February 2013 pertaining to foreign and multi-jurisdictional practice) and have been adopted in whole or in part in every domestic jurisdiction except California. See *infra* note 62. Prior codes of conduct for lawyers in the United States included the Model Code of Professional Responsibility (adopted in 1969) and the Canons of Professional Ethics (adopted in 1908), the latter of which was based primarily on the Code of Ethics promulgated in 1887 by the Alabama State Bar Association, which in turn relied on a series of published lectures delivered by George Sharswood (published in 1854), which itself was preceded by (and invoked) David Hoffman’s “fifty resolutions” described in *A COURSE OF LEGAL STUDY* (1836). For histories of these prior codes of conduct, see James M. Altman, *Considering the ABA’s 1908 Canon of Ethics*, 71 *FORDHAM L. REV.* 2395 (2003); Margaret Colgate Love, *The Revised A.B.A. Model Rules of Professional Conduct: Summary of the Work of Ethics 2000*, 15 *GEO. J. LEGAL ETHICS* 441 (2002); Susan D. Carle, *Lawyer’s Duty to Do Justice: A New Look at the History of the 1908 Canons*, 24 *LAW & SOC. INQUIRY* 1 (1999); Allison Marston, *Guiding the Profession: The 1887 Code of Ethics of the Alabama State Bar Association*, 49 *ALA. L. REV.* 471 (1998); Russell G. Pearce, *Rediscovering the Republican Origins of the Legal Ethics Codes*, 6 *GEO. J. LEGAL ETHICS* 241 (1992); Ted Schneyer, *Professionalism as Bar Politics: The Making of the Model Rules of Professional Conduct*, 14 *LAW & SOC. INQUIRY* 677 (1989); Stephen E. Kalish, *David Hoffman’s Essay on Professional Deportment and the Current Legal Ethics Debate*, 61 *NEB. L. REV.* 54 (1982); Maxwell Bloomfield, *David Hoffman and the Shaping of a Republican Legal Culture*, 38 *MD. L. REV.* 673 (1979); Edward L. Wright, *The Code of Professional Responsibility: Its History and Objectives*, 24 *ARK. L. REV.* 1 (1970).

³31 C.F.R. §§ 10.0-.93 (2014).

⁴MODEL RULES OF PROF’L CONDUCT R. 1.3 (2013), available at http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents.html.

⁵31 C.F.R. § 10.2(a)(5) (2014) (defining practitioners as any person described in section 10.3(a)-(f), including attorneys, certified public accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and registered tax return preparers).

⁶*Id.* § 10.22 (2014).

⁷*Id.* § 10.22(a) (2014).

and considering all relevant facts;⁸ relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts;⁹ never basing advice on unreasonable factual or legal assumptions,¹⁰ including “assumptions as to future events;”¹¹ and never, in evaluating the merits of a “Federal tax matter,”¹² “tak[ing] into account the possibility that a tax return will not

⁸See, e.g., *id.* § 10.33(a)(2) (2004) (urging practitioners to “[e]stablish[] the facts, determining which facts are relevant”); *id.* § 10.35(c)(1)(i) (2007) (pertaining to “covered opinions” and obligating the practitioner to “use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant. The opinion must identify and consider all facts that the practitioner determines to be relevant”); *id.* § 10.37(a)(2)(ii)-(iii) (2014) (requiring practitioners to “[r]easonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know,” and to “[u]se reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter”). At relevant points throughout the Article, we cite to former section 10.35 pertaining to the now-repealed covered opinion standards. Also, at *infra* notes 143-153 and accompanying text, we discuss the June 2014 amendments to Circular 230, which repealed section 10.35. However, we need to emphasize that notwithstanding the repeal of section 10.35, many of the former section’s requirements live on in the current Circular. In fact, the final implementing regulations state very clearly that although the Treasury removed the detailed disclosure rules pertaining to certain written opinions, “[r]obust and relevant standards for written tax advice remain appropriate because Treasury and the IRS continue to be aware of the risk for the issuance and marketing of written tax opinions to promote abusive transactions,” the precise concerns that originally animated adoption of former section 10.35 (the history of which we discuss in Part IV.B.). 79 Fed. Reg. 33,685, 33,686 (June 12, 2014). Indeed, many of the standards reflected in former section 10.35—relating applicable law and authorities to fact, avoiding conflicts of interest, basing written advice on reasonable factual and legal assumptions, including assumptions as to future events, among others—appear in other parts of Circular 230. At the end of the day, the Treasury may have repealed the over-particularized, rigid, and burdensome rules contained in section 10.35, but it replaced them with a “comprehensive, principles-based approach” that the government believes “strike[s] an appropriate balance between allowing flexibility in providing written advice, while at the same time maintaining standards that require individuals to act ethically and competently.” *Id.* at 33,687.

⁹See, e.g., 31 C.F.R. § 10.33(a)(2) (2004) (practitioner should “relat[e] the applicable law (including potentially applicable judicial doctrines) to the relevant facts” when rendering advice to taxpayer-clients); *id.* § 10.35(c)(2)(i) (2007) (in the context of covered opinions, practitioner “must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts”).

¹⁰See, e.g., *id.* § 10.33(a)(2) (2004) (expecting practitioners to evaluate “the reasonableness of any assumptions or representations . . . and arriv[e] at a conclusion supported by the law and the facts”); *id.* § 10.35(c)(1)(ii) (2007) (prohibiting “unreasonable factual assumptions” in the context of covered opinions); *id.* § 10.35(c)(1)(iii) (2007) (prohibiting “unreasonable factual representations, statements or findings of the taxpayer or any other person” in the context of covered opinions); *id.* § 10.35(c)(2)(ii) (2007) (prohibiting opinions based on “any unreasonable legal assumptions, representations, or conclusions” in the context of covered opinions); *id.* § 10.37(a)(2)(i) (2014) (requiring practitioners to base written advice “on reasonable factual and legal assumptions”).

¹¹See, e.g., *id.* § 10.37(a)(2)(i) (2014).

¹²See *id.* § 10.37(d) (2014) (providing an encompassing definition of “Federal tax matter” that “reflects the broad nature of advice rendered by Federal tax practitioners in today’s practice environment). Regulations Governing Practice Before the Internal Revenue Service, 79 Fed. Reg. 33,685, 33,688 (June 12, 2014).

be audited or that a matter will not be raised on audit.”¹³ Additional diligence duties reflected in the Treasury’s practice rules pertain to, among other things, relying in good faith on information furnished by taxpayer-clients¹⁴ or upon representations, statements, findings, agreements, or conclusions of clients or other persons,¹⁵ or on the work product or opinion of another professional.¹⁶ Tax lawyers must also abide by the practice and penalty standards under the Code and the regulations promulgated thereunder, which reflect and reinforce the Treasury’s practice rules and harmonize the tax lawyer’s standard of care with that of her taxpayer-clients.¹⁷

With respect to the Treasury’s rules providing a more affirmative and disciplinary code of conduct than the legal profession’s ethical standards, consider that while many of the lawyer’s ethical guidelines are aspirational and permissive,¹⁸ the Treasury’s standards, with only one exception,¹⁹ are mandatory.²⁰ Also consider that while the disciplinary boards of state bar associations possess authority to suspend or disbar members for professional misconduct, these bodies are “notoriously underfunded” and fail to police their members’ behavior with any consistency or enthusiasm.²¹ By comparison, the Treasury’s practice rules contain detailed provisions pertaining to prohibited behavior,²²

¹³ See, e.g., 31 C.F.R. § 10.37(a)(2)(vi) (2014); see also *id.* § 10.35(c)(3)(iii) (2007) (same, in the context of covered opinions, while also prohibiting practitioners from considering whether an “an issue will be resolved through settlement if raised” on audit).

¹⁴ See, e.g., *id.* § 10.34(d) (2011) (pertaining to tax return positions, documents, affidavits, or other submissions to the Service).

¹⁵ See, e.g., *id.* § 10.35(c)(1)(iii) (2007) (pertaining to covered opinions); *id.* § 10.37(a)(2) (iv) (2014) (pertaining to written or oral advice).

¹⁶ See, e.g., *id.* § 10.22(b) (2007); *id.* § 10.35(d)(1) (2007) (pertaining to reliance in the context of covered opinions).

¹⁷ See *infra* notes 126 and 137 and accompanying text and Parts III.A.1 and III.E.

¹⁸ See, e.g., MODEL RULES OF PROF’L CONDUCT R. 1.2(c) (2013) (pertaining to limiting the scope of the representation); *id.* R. 1.6(b) (pertaining to revealing information relating to the representation of a client); *id.* R. 1.13(c) (pertaining to “reporting out” information of organizational misconduct after failing to receive a “timely and appropriate” internal response); *id.* R. 1.14(b) (pertaining to clients with diminished capacity); *id.* R. 1.16(b) (pertaining to declining or terminating representation); *id.* R. 2.1 (pertaining to acting as “advisor” to a client); *id.* R. 3.1 (pertaining to meritorious claims and contentions); *id.* R. 3.6(b), (c) (pertaining to trial publicity); *id.* R. 3.7(b) (pertaining to lawyer as witness); *id.* R. 6.1 (pertaining to voluntary pro bono public service); *id.* R. 6.4 (pertaining to law reform activities affecting client interests); *id.* R. 8.3(c) (pertaining to reporting professional misconduct).

¹⁹ See, e.g., 31 C.F.R. § 10.33 (2004) (pertaining to “best practices for tax advisors”).

²⁰ See *id.* §§ 10.20–38 (pertaining to “duties and restrictions relating to practice before the Internal Revenue Service,” except section 10.33).

²¹ Susan P. Koniak & George M. Cohen, *Under Cloak of Settlement*, 82 VA. L. REV. 1051, 1121 (1996) (also finding that state bar disciplinary boards are “unable or reluctant to mount the effort needed to do battle with wealthy class action lawyers and powerful members of the defense bar”). ABA Model Rules 8.1 and 8.4 offer general guidelines pertaining to discipline and misconduct, but leave specific procedures and application of the rules to state bar associations. MODEL RULES OF PROF’L CONDUCT R. 8.1, 8.4 (2013).

²² See 31 C.F.R. §§ 10.51, 10.52 (2014).

penalties and other sanctions for engaging in such behavior,²³ and adversarial disciplinary proceedings for those accused of engaging in such behavior.²⁴ In addition, the Treasury's Office of Professional Responsibility (OPR) has, unlike state bar disciplinary boards, embraced its authority to regulate and prosecute all "matters related to practitioner conduct and discipline."²⁵

In providing particularized, affirmative, and disciplinary rules, the Treasury's code of conduct requires much of tax lawyers and other tax practitioners. Perhaps most importantly, the Treasury's practice rules, in conjunction with the Code and associated regulations, require tax lawyers to make rigorous probability assessments about the merits of a client's tax return position or tax-favored transaction. In fact, due to the standard of care outlined in the Treasury's practice rules and the Code, the tax lawyer's lexicon is filled with predictive terms and phrases: "more likely than not,"²⁶ "substan-

²³ See *id.* § 10.50 (2014).

²⁴ See *id.* §§ 10.60-.82 (2014).

²⁵ *Id.* § 10.1(a)(1) (2014); see also *infra* notes 89-111 and accompanying text.

²⁶ See, e.g., I.R.C. § 6664(d)(3)(C) (pertaining to reasonable cause exception for reportable transactions); § 6694(a)(2)(C) (pertaining to an "unreasonable position" in the context of tax shelters and reportable transactions); Reg. § 1.6662-4(b)(4)(ii)(C) (pertaining to reductions in tax liability "shown on the return" for tax shelter items); Reg. § 1.6662-4(c)(3)(ii) (pertaining to tax shelter items as "tainted items" in the context of carrybacks and carryovers); Reg. § 1.6662-4(d)(2) (pertaining to the substantial authority standard); Reg. § 1.6662-4(g)(1)(i)(B) (pertaining to required authority at the time the return was filed in the context of tax shelters for noncorporate taxpayers); Reg. § 1.6662-4(g)(4)(i) (pertaining to "reasonable belief" in the context of tax shelter items for noncorporate taxpayers); Reg. § 1.6662-4(g)(5) (pertaining to "reasonable belief" for passthrough entities in the context of tax shelter items); Reg. § 1.6664-4(f)(2)(i)(B) (pertaining to the belief requirement for reasonable cause exception for corporate taxpayers in the context of tax shelter items); Reg. § 1.6694-1(a)(1) (pertaining to the standard of care to avoid penalty in the context of tax shelters); Reg. § 1.6694-1(e)(2) (pertaining to verifying information on previously filed returns); Reg. § 1.6694-2(a)(1)(i) (pertaining to the standard of care to avoid penalty in the context of tax shelters and reportable transactions); Reg. § 1.6694-2(b)(1) (pertaining to "reasonable belief" standard and its effect on avoiding penalties in the context of tax shelters and reportable transactions); Reg. § 1.6694-2(b)(2) (pertaining to permissible authorities when making more likely than not determination); Reg. § 1.6694-2(b)(3) (pertaining to avoiding penalty by virtue of a "written determination"); Reg. § 1.6694-2(b)(4) (pertaining to effect of taxpayer's jurisdiction on more likely than not determination); Reg. § 1.6694-2(b)(5) (pertaining to when the more likely than not standard must be satisfied); 31 C.F.R. § 10.35(b)(4) (2007) (pertaining to reliance opinions); 31 C.F.R. § 10.35(c)(3)(ii) (2007) (pertaining to the practitioner's conclusion as to the proper treatment of each significant federal tax issue); 31 C.F.R. § 10.35(c)(3)(iv) (2007) (pertaining to marketed opinions and the proper treatment of each significant federal tax issue); 31 C.F.R. § 10.35(c)(4)(ii) (2007) (pertaining to overall evaluation as to the proper tax treatment for marketed opinions); 31 C.F.R. § 10.35(c)(4) (2007) (pertaining to required disclosures for opinions that fail to reach a more likely than not conclusion); see also ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 346 (Revised) (1982) (requiring, in evaluating the overall merits of material tax issues pertaining to a marketed tax shelter, that tax lawyers "state that the significant tax benefits, in the aggregate, 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").

tial authority,”²⁷ “realistic possibility of success,”²⁸ “reasonable basis,”²⁹ and

²⁷ See, e.g., I.R.C. § 6662(d)(2)(B)(i) (pertaining to reduction for understatement); § 6664(d)(3)(B) (pertaining to reasonable cause exception for reportable transactions); § 6694(a)(2)(A) (pertaining to required authority for a position not to be considered an “unreasonable position”); Reg. § 1.6662-4(a) (pertaining to reductions in understatements); Reg. §§ 1.6662-4(b)(4)(ii)(A), (C) (pertaining to reductions in tax liability “shown on the return” for, respectively, non-tax shelter items and tax shelter items); Reg. §§ 1.6662-4(c)(3)(i)-(ii) (pertaining to, respectively, non-tax shelter items and tax shelter items as “tainted items” in the context of carrybacks and carryovers); Reg. § 1.6662-4(d)(2) (defining substantial authority standard, determining when and whether substantial authority exists, and discussing the effect of achieving substantial authority); Reg. § 1.6662-4(g) (pertaining to items relating to tax shelters for noncorporate taxpayers); Reg. § 1.6664-4(f)(2)(i)(A) (pertaining to the authority requirement for reasonable cause exception for corporate taxpayers in the context of tax shelters); Reg. § 1.6694-1(a)(1) (pertaining to standard of care to avoid penalty in the context of undisclosed positions); Reg. § 1.6694-2(a)(1)(ii) (pertaining to standard of care to avoid penalty in the context of undisclosed positions); Reg. § 1.6694-2(b)(1) (pertaining to the substantial authority standard in determining “more likely than not” certainty in the context of the “reasonable belief” standard to avoid penalty with respect to tax shelters and reportable transactions); Reg. § 1.6694-2(d)(3)(i) (pertaining to signing preparers and the effect of adequate disclosure on reasonable basis positions); Reg. § 1.6694-2(d)(3)(ii) (pertaining to nonsigning preparers and the effect of adequate disclosure on reasonable basis positions); Reg. § 1.6694-2(d)(3)(iii) (pertaining to requirements for rendering advice on disclosed positions without substantial authority); 31 C.F.R. § 10.34(a)(1)(i)(B), (ii)(B) (2011) (pertaining to an “unreasonable position” as described in § 6694(a)(2), which reflects a position lacking substantial authority); 31 C.F.R. § 10.35(b)(2)(ii)(E) (2007) (pertaining to advice excluded from the covered opinion standards).

²⁸ See, e.g., 31 C.F.R. § 10.35(b)(2)(ii)(E) (2007) (pertaining to advice excluded from the covered opinion standards); ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 85-352 (1985) (requiring, in advising reporting positions, that tax lawyers demonstrate a good faith belief that the position “is warranted in existing law or can be supported by a good faith argument for an extension, modification, or reversal of existing law,” and the position has “a realistic possibility of success if the matter is litigated”). As discussed in Part 4.E, until as recently as 2007, the “realistic possibility of success” standard reflected the required level of certainty for practitioners when advising return positions and transactions, at which point it was replaced with the “substantial authority” standard.

²⁹ See, e.g., I.R.C. § 6694(a)(2)(B) (pertaining to disclosed positions); § 6662(d)(2)(B)(ii)(II) (pertaining to reduction for understatement); Reg. § 1.6662-3(b)(3) (defining the reasonable basis standard); Reg. § 1.6662-4(d)(2) (pertaining to the substantial authority standard); Reg. § 1.6662-4(e)(2)(i) (pertaining to circumstances where adequate disclosure does not save certain return items); Reg. § 1.6662-4(e)(3) (pertaining to the effect of adequate disclosure for corporate taxpayers in the context of multi-party financing transactions); Reg. § 1.6694-1(a)(1) (pertaining to standard of care for disclosed positions to avoid penalty); Reg. § 1.6694-1(e)(2) (pertaining to verifying information on previously filed returns); Reg. § 1.6694-2(a)(1)(iii) (pertaining to standard of care to avoid penalty in the context of disclosed positions); Reg. §§ 1.6694-2(d)(1)-(3) (pertaining to effect of adequate disclosure of positions with a reasonable basis); 31 C.F.R. § 10.34(a)(1)(i)(A), (ii)(A) (2011); see also 31 C.F.R. § 10.35(b)(2)(ii)(E) (2007) (pertaining to advice excluded from the covered opinion standards); 31 C.F.R. § 10.35(b)(3) (2007) (pertaining to definition of “Federal tax issue”); ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 314 (1965) (stating that a lawyer, in preparing a client’s tax return, “may freely urge the statement of positions most favorable to the client just as long as there is reasonable basis for those positions”).

“not frivolous/frivolous.”³⁰ Each of these predictive levels of certainty, moreover, can be reduced to numerical probabilities with “more likely than not” reflecting more than 50% certainty,³¹ “substantial authority” ranging from 40% to 50% certainty,³² “realistic possibility of success” pegged at more than one-third likelihood,³³ “reasonable basis” extending from ten to 20%,³⁴ “not frivolous” from five to ten percent,³⁵ and “frivolous” below five percent.³⁶ At the same time, while the standard of care requires tax lawyers to render probability assessments as to the likelihood of success on the merits of a client’s reporting position or transaction (and to reduce the assessment to a numerical range), they are not the guarantors of that determination.³⁷ Indeed, they are prohibited from making such guarantees.³⁸

More than anything, the standard of care established by the Treasury’s practice rules, the Code, and relevant regulations emphasizes process and professionalism, not predictive absolutism. By focusing on *how* tax lawyers render advice, the standard of care puts advisors in the best position to make accurate and unbiased judgments about a client’s tax matters. It helps practitioners avoid flawed methodological processes, such as ignoring relevant facts, attributing too much or too little significance to certain facts or law, failing to investigate the representations and statements of other persons, or casually making factual or legal assumptions about a client’s desired tax treatment. The practice rules further improve accuracy and reduce errors by helping tax lawyers minimize potential psychological biases and misaligned incentives, such as adopting a client’s perspective as one’s own, ignoring the implications of personal financial relationships, or charging fees calculated as a percentage of taxes saved rather than work performed. In other words, and as this Article describes, the prevailing standard of care for tax lawyers and other tax practitioners aims to reduce human error caused by carelessness, incompetence, insufficient inquiry, conflicting interests, and lack of independent professional judgment.

In this way, the standard of care for tax lawyers, particularly its emphasis on improving accuracy by sharpening subjective beliefs, reflects a theory of decision-making known as Bayesian reasoning. The decision theory carrying

³⁰ See, e.g., Reg. § 1.6662-3(b)(3) (defining the reasonable basis standard); 31 C.F.R. § 10.34(b)(1), (2)(ii) (2011) (pertaining to rendering advice on documents, affidavits, and other papers); 31 C.F.R. § 10.35(b)(2)(ii)(E) (2007) (pertaining to advice excluded from covered opinion standards).

³¹ See Reg. § 1.6662-4(d)(2) (calling “more likely than not” the standard “that is met when there is a greater than 50-percent likelihood of the position being upheld”).

³² See *infra* notes 160-163 and accompanying text and Part III.A.1.

³³ See *infra* note 475 and accompanying text.

³⁴ See *infra* notes 161-162 and accompanying text.

³⁵ J. Timothy Philipps et al., *What Part of RPOS Don't You Understand?: An Update and Survey of Standards for Tax Return Positions*, 51 WASH. & LEE L. REV. 1163, 1176 (1994).

³⁶ Reg. § 1.6662-3(b)(3).

³⁷ See *infra* notes 127-129 and accompanying text.

³⁸ See *infra* notes 221-233 and accompanying text.

the name of Thomas Bayes, an 18th century English minister, provides a formally inductive and analytically rigorous way to make probability assessments about the likelihood of future events by updating existing probabilities as new, relevant information becomes available. Bayes' theorem is elegant in its simplicity—more knowledge leads to fewer errors—and is reflected in an aphorism uttered by John Maynard Keynes (himself a Bayesian probabilist) in response to criticism that he had changed his position on monetary policy during the course of the Great Depression: "When my information changes, I alter my conclusions. What do you do sir?"³⁹

Bayes, like Keynes, expressed probability as a logical and conditional relationship between hypothesis and evidence: (1) form a probabilistic belief or hypothesis about the likelihood of a future event (what Bayes called the "prior" probability or simply the "prior"); (2) update the likelihood of the probabilistic belief as new, relevant information becomes available (what Bayes called the "posterior probability" or the "posterior"); and (3) start the process anew with the posterior serving as a recalculated prior.⁴⁰ The process of learning through iterative approximation in light of new evidence and information, according to Bayesian decision theory, yields increasingly accurate predictions. Or, as statistician Nate Silver has described Bayesian reasoning, it focuses on "how we formulate probabilistic beliefs about the world when we encounter new data,"⁴¹ it brings us "*closer and closer to the truth* as we gather more evidence,"⁴² and it reduces uncertainty due to lack of knowledge.

By emphasizing the accumulation of information as a way to reduce uncertainty, Bayesian probability—also known as "subjective" or "conditional" probability—comprises a form of "epistemic" reasoning (or reasoning about knowledge and beliefs). The unifying feature of this branch of probability theory considers additional information as the pathway to acquiring additional knowledge, forming stronger beliefs, and achieving greater certainty. As reflective of epistemic reasoning, Bayes' theorem regards uncertainty as a function of the limits of our knowledge. By comparison, the other major

³⁹Paul Samuelson, *The Keynes Centenary*, in *THE COLLECTED SCIENTIFIC PAPERS OF PAUL SAMUELSON: VOLUME 5*, at 275 (Kate Crowley ed., 1986). The quotation often appears in shortened form as, "When the facts change, I change my mind. What do you do, sir?" For Keynes' thoughts on probability, see JOHN MAYNARD KEYNES, *A TREATISE ON PROBABILITY* (1921).

⁴⁰The simplest expression of Bayes' theorem states that the (posterior) probability of a hypothesis is equal to the product of (i) the prior probability of the hypothesis and (ii) the conditional probability of the new information in light of the hypothesis, divided by (iii) the probability of the new information. For Bayes' clearest explication of formulating probabilistic beliefs with the accumulation of new, relevant information, see Thomas Bayes, *An Essay Toward Solving a Problem in the Doctrine of Chances*, 53 *PHIL. TRANSACTIONS OF THE ROYAL SOCIETY OF LONDON* 370 (1763), as Communicated by Mr. Richard Price in a Letter to John Canton, M.A. and F.R.S.

⁴¹NATE SILVER, *THE SIGNAL AND THE NOISE: WHY SO MANY PREDICTIONS FAIL—BUT SOME DON'T* 241 (2012).

⁴²*Id.* at 242 (emphasis in original).

branch of probability theory, “aleatory” reasoning—more commonly called “objective” or “frequency” probability—attempts to improve certainty not by accumulating knowledge but by measuring random events.⁴³ According to “frequentists,” ascertaining the relative recurrence of randomly uncertain events through a series of repetitive trials (such as tossing dice, spinning a roulette wheel, or flipping a coin) reduces uncertainty as the frequency of an event converges on its natural probability. Thus, for frequentists, the probability that flipping an honest coin will result in heads coming up 50% of the time and tails the other 50% is not derived from the fact that the event (*i.e.*, flipping an honest coin) involves two equally likely outcomes (or, without being flippant, equipossible sides of the same coin) but instead that infinitely repetitive and random experiments derive a frequency of 50%.

Among statisticians, philosophers, and mathematicians, the popularity and application of the two paradigmatic theories over time has largely depended on two factors: one’s appetite for subjectivity (particularly Bayes’ individualistic “prior”) and the subject matter under study.⁴⁴ Bayes’ theorem is silent on how one determines the original prior probability of a hypothesis, which can lead to divergent and idiosyncratic estimates. At the same time, theorists

⁴³See, e.g., Edi Karni, *Axiomatic Foundations of Expected Utility and Subjective Probability*, in *HANDBOOK OF THE ECONOMICS OF RISK AND UNCERTAINTY: VOLUME 1*, at 3 (Mark J. Machina & W. Kip Viscusi ed., 2014) (writing that from the very beginning, “the idea of probability assumed dual meanings: the aleatory meaning, according to which probability is a theory about the relative frequency of outcomes in repeated trials; and the epistemological meaning, according to which probability is a theory of measurement of a person’s ‘degree of belief’ in the truth of propositions, or the likelihoods he assigns to events. Both the ‘objective’ and the ‘subjective’ probabilities, as these meanings are commonly called, played important roles in the developments that led to the formulation of modern theories of decision making under risk and under uncertainty and to the theory of statistics”).

⁴⁴For the last 300 years the predominant theory of probability has oscillated between the epistemic and aleatory approaches. During the 18th century and most of the 19th century, epistemic probability prevailed, while in the late 19th century the aleatory approach supplanted the epistemic approach (including Bayes’ decision theory and its variants). See, e.g., Andreas Kamlah, *The Decline of the Laplacian Theory of Probability: A Study of Stumpf, von Kries, and Meinong*, in *THE PROBABILITIES REVOLUTION: VOLUME 1*, at 91, 112 (Lorenz Krüger et al. eds., 1990) (describing the turn away from epistemic probability to aleatory probability beginning in the late 19th century). The dominance of the aleatory approach lasted until the late 1970s or early 1980s when the epistemic approach experienced a resurgence (thanks, among other factors, to advances in computing which made complex calculations under Bayes’ theorem more practical). For a discussion of Bayes’ theorem, its place in history alongside aleatory approaches to probability (particularly the frequentist approach), and its recent renaissance, see SHARON MERTSCH McGRAYNE, *THE THEORY THAT WOULD NOT DIE: HOW BAYES’ RULE CRACKED THE ENIGMA CODE, HUNTED DOWN RUSSIAN SUBMARINES, AND EMERGED TRIUMPHANT FROM TWO CENTURIES OF CONTROVERSY* (2011).

(most notably Leonard Savage⁴⁵ and his students⁴⁶) have provided methods “to furnish the missing ingredient . . . necessary to complete Bayes’ model.”⁴⁷ Moreover, Bayes’ theorem itself accounts for divergent original priors: a first prior (assuming it was not assigned 100% certainty) loses its influence as subsequent prior-to-posterior-to-prior iterations of incorporating relevant information merge toward the truth.⁴⁸

With respect to subject matter influencing the preferred decision theory, the aleatory approach augments inquiries (such as tossing dice) that seek certainty through improved measurement rather than improved judgment.⁴⁹ The epistemic approach, and particularly Bayes’ theorem, adopts a less anti-septic view of uncertainty and embraces the variable of human error, which no tool of measurement—primitive or sophisticated—can overcome.⁵⁰ Stated differently, rather than treat probability as the act of counting random events as precisely as possible, Bayesian decision theory acknowledges its inseparable link to fallible human judgment. It then incorporates the messy reality of human subjectivity into a rigorous epistemic methodology that increases accuracy in judgment.

For the subject matter under study in this Article—how the prevailing standard of care for tax lawyers facilitates accurate advice and accurate returns—Bayesian principles supply the underlying philosophy. We examine the standards that govern the professional behavior of tax lawyers, that reduce

⁴⁵ See, e.g., LEONARD J. SAVAGE, *THE FOUNDATIONS OF STATISTICS* (1954).

⁴⁶ Three of Savage’s best-known pupils include Donald A. Berry (see, e.g., DONALD A. BERRY & DALENE K. STANGL, *BAYESIAN BIOSTATISTICS* (1996); DONALD A. BERRY & BERT FRISTEDT, *BANDIT PROBLEMS: SEQUENTIAL ALLOCATION OF EXPERIMENTS* (1985); Donald A. Berry, *A Bernoulli Two-Armed Bandit*, 43 *ANN. MATH. STATIST.* 871 (1972)), Morris De Groot (see, e.g., RICHARD M. CYERT & MORRIS H. DEGROOT, *BAYESIAN ANALYSIS AND UNCERTAINTY IN ECONOMIC THEORY* (1987); MORRIS H. DEGROOT, *OPTIMAL STATISTICAL DECISIONS* (1970)), and Roy Radner (see, e.g., ROY RADNER, *NOTES ON THE THEORY OF ECONOMIC PLANNING* (1963); ROY RADNER & JACOB MARSCHAK, *ECONOMIC THEORY OF TEAMS* (1972); Roy Radner, *Team Decision Problems*, 33 *ANN. MATH. STATIST.* 857 (1962)).

⁴⁷ Karni, *supra* note 43, at 5-6 (describing Savage’s attempt to provide the “missing link” as “infer[ring] from the decision maker’s choice behavior the prior probabilities that represent his/her beliefs and, by so doing, to provide choice-based foundations for the existence of a Bayesian prior. In Savage’s theory, new information indicates that an event that a priori is considered possible is no longer so. The application of Bayes’ rule requires that the probability of the complementary event be increased to 1, and the probabilities assigned to its subevents be increased equiproportionally”).

⁴⁸ See also SILVER, *supra* note 41, at 260 (writing that “provided . . . everyone is on the Bayesian train, even incorrect beliefs and quite wrong priors are revised toward the truth in the end”).

⁴⁹ *Id.* at 243 (stating that the aleatory approach “deemphasized the role of prediction and tried to recast uncertainty as resulting from errors of our measurement rather than the imperfections in our judgments”).

⁵⁰ *Id.* at 253 (“Essentially, the frequentist approach toward statistics seeks to wash its hands of the reason that predictions most often go wrong: human error. It views uncertainty as something intrinsic to the experiment rather than something intrinsic to our ability to understand the real world.”).

errors in judgment and deficits in knowledge, and that protect taxpayers (from making uninformed decisions due to inaccurate advice), the tax system (from revenue loss due to inaccurate returns), and tax lawyers themselves (from professional misconduct and discipline due to inaccurate advice). The tax lawyer's standard of care, like Bayesian reasoning, assists in thinking through problems more thoroughly and in "detecting when our gut-level approximations are much too crude."⁵¹ Particularly in the context of novel, aggressive, or grey-area tax positions, where tax advisors, in calculating probabilities of success or levels of certainty, might be tempted to rely on the subjective "smell test,"⁵² on trusting their gut,⁵³ or on borrowing from the science of handicapping horses,⁵⁴ the tax lawyer's standard of care offers a more analytically rigorous methodology than mere intuition. That is not to say that experience and intuition have no place in the ethical tax lawyer's mode of analysis, particularly in instances where the law offers scant guidance in ascertaining requisite levels of certainty. But it does mean that the prevailing standard of care commands tax lawyers to abide by diligent methods of investigation, independence, and self-reflection before resorting to intuitive conclusions.

The fundamental tenet of Bayes' theorem—updating one's beliefs as new, relevant information becomes available—is already embedded in the tax lawyer's affirmative and disciplinary standard of care. For example, the diligence duties briefly noted above obligate tax advisors to update probability estimates of return positions and tax-minimizing transactions.⁵⁵ The detailed requirements for determining whether a taxpayer's sought after tax treatment possesses "substantial authority"⁵⁶ provide a particularly clear example of the duty to update one's advice. These rules prompt tax advisors to make probability determinations that consider the "evaluation of authorities,"⁵⁷ the

⁵¹ *Id.* at 246.

⁵² See, e.g., Sheryl Stratton, *Circular 230 Changes Fall Short of Expectations*, 107 TAX NOTES (TA) 939, 941 (June 1, 2005) (discussing a "smell test" for whether advice falls inside or outside the covered opinion rules); Michael J. Knight, *Did the Audit Tick Ruin a Profession?*, 104 TAX NOTES (TA) 514, 515 (Aug. 2, 2004) (discussing the "smell test" in the context of evaluating whether tax advice meets, exceeds, or fails minimum thresholds of professional conduct); Frank J. Gould, *Giving Tax Advice: Some Ethical, Professional, and Legal Considerations*, 97 TAX NOTES (TA) 523, 526 (Oct. 22 2002); Brian H. Holland et al., *What Is Good Tax Practice: A Panel Discussion*, 21 N.Y.U. INST. ON FED. TAX'N 23, 38 (1963) (discussing Mortimer Caplin's, then Commissioner of the Service, lamenting how the lack of formally promulgated ethical standards specific to tax lawyers results in practitioners relying on subjective "smell tests").

⁵³ When asked by the authors what tax lawyers relied upon most in making probability assessments on grey-area tax positions, a longtime tax scholar-lawyer smiled, patted his midsection, and said, "It's all about the gut."

⁵⁴ Robert P. Rothman, *Tax Opinion Practice*, 64 TAX LAW. 301, 326 (2011) (stating that tax practitioners "like to believe (or at least like to give the impression to our clients) that what we do is different than handicapping racehorses," but concluding that making informed guesses may be the best practitioners can do in some circumstances).

⁵⁵ See *supra* notes 6-17 and accompanying text.

⁵⁶ See Reg. § 1.6662-4(d)(3).

⁵⁷ See Reg. § 1.6662-4(d)(3)(i).

“nature of the analysis,”⁵⁸ and the “types of authority”⁵⁹ that influence the likelihood of success on the merits of a position or transaction.⁶⁰ In this way, the standard of care for tax lawyers offers an even more complete method for making decisions and reducing uncertainty than Bayes’ theorem by providing a roadmap for calculating original prior probabilities (as well as subsequent posterior probabilities) pertaining to the success or failure of a client’s desired tax treatment.

In demonstrating how the prevailing standard of care for tax lawyers and other tax practitioners reduces errors and improves accuracy, we pay particularly close attention to the standards pertaining to due diligence, communicating with clients, conflicts of interest, and unreasonable fees. We discuss the development of these standards, and how the Treasury, Congress, and the American Bar Association (ABA) forged them over the last 35 years with the shared goal of facilitating accurate advice and accurate returns, a process that ultimately harmonized the standard of care for tax advisors with that for taxpayer-clients. To further illustrate the harmonization of the standards, we explore five key historical developments involving (1) due diligence as to marketed tax shelters, (2) communicating with clients as to penalties, judicial anti-abuse doctrines, covered opinions, and informed written consent to conflicts, (3) avoiding and overcoming conflicts of interest, (4) abstaining from contingent fees, and (5) due diligence as to advising return positions.

While this Article associates for the first time the tax lawyer’s standard of care with principles of probability theory—and specifically with Bayesian reasoning—it saves for two subsequent articles a more rigorous examination of the relationship. The second article in this three-part series illustrates the relationship with a hypothetical case study involving a tax advisor and her client’s tax-planning strategy (a like-kind exchange of collectibles). After describing the transaction and its interdependent sub-issues, and layering

⁵⁸ See Reg. § 1.6662-4(d)(3)(iii).

⁵⁹ See Reg. § 1.6662-4(d)(3)(iii).

⁶⁰ For another example of the updating responsibility, the prevailing standard of care requires tax professionals to revise probability assessments appropriately until, and depending on the circumstances, the date the return or claim for refund is filed, the last day of the taxable year, the date the return is signed, the date the return is prepared, the date the tax professional advised on the tax position that gave rise to an understatement of tax, or at any time the tax professional knew or should have known that the advice was no longer reliable due to developments in the law. See, e.g., Reg. § 1.6662-4(d)(3)(iv)(C) (pertaining to when substantial authority is determined); Reg. §§ 1.6662-4(g)(1)(i)(A)-(B) (pertaining to overcoming the understatement penalty for items relating to tax shelters for noncorporate taxpayers); Reg. § 1.6694-1(a)(2) (pertaining to the date a return is deemed prepared); Reg. § 1.6694-2(b)(5) (pertaining to when the more likely than not standard must be satisfied in the context of tax shelter positions); Reg. § 1.6694-2(e)(5)(iii) (pertaining to reliance on advice of others); Reg. § 1.6694-2(e)(6) (pertaining to reliance on generally accepted administrative or industry practice); Reg. § 6664(d)(4)(A)(i) (pertaining to “reasonable belief” under the reasonable cause exception for reportable transaction understatements); Reg. § 1.6664-4(f)(2)(i)(B) (pertaining to the “belief requirement” in the context of substantial understatement penalties attributable to tax shelter items of corporations).

the hypothetical with complicating factors (such as ascertaining the relevant facts and evolving law, relying on the advice of other professionals, communicating potential risks to the client, and addressing conflicts of interest), we simulate ranges of likely outcomes for the sub-issues, and derive estimates (some obtained through Bayesian reasoning) for the overall transaction's likelihood of success on the merits. Preliminary results from our analysis have prompted one reader to urge, "I hope you won't flinch from telling advisors how unlikely overall success can be, even with relatively favorable outcomes on the sub-issues."⁶¹

Meanwhile, the third and final article will aim to show how courts interpret tax advisors' reasoning and conclusions as to overall success on the merits of tax-favored transactions. We endeavor to learn how courts evaluate the behavior of tax advisors vis-à-vis the prevailing standard of care. With published misconduct cases involving tax advisors in short supply (due to settlements and arbitration clauses), we needed a proxy to investigate judicial evaluation of tax practitioner behavior. In the end, we decided to inventory and analyze all cases involving the section 6664 "reasonable cause and good faith" defense to penalties, a defense that taxpayers can establish by showing reasonable reliance on professional tax advice. It is our hope that a complete dataset involving section 6664 cases—many of which focus on the behavior of tax advisors—will illuminate what aspects of the tax advisor's standard of care courts consider most important.

Before unduly frightening tax professionals everywhere—by predicting low probabilities of success and quantifying the interrogating nature of section 6664 cases—we must first examine how the prevailing standard of care governing tax practice, with its emphasis on improved knowledge and reduced errors in judgment, helps practitioners render accurate advice while also helping taxpayers report accurate returns.

II. Regulating a Profession: Circular 230 as the (Gold) Standard of Care

Tax professionals are subject to more than one standard of care. For tax advisors who are also lawyers, the applicable standards include the ABA Model Rules of Professional Conduct (which every state except California

⁶¹This same commentator, a longtime and highly-respected member of the New York tax bar, further stated, "I hope your audiences howl with shock when you show them what can produce overall expectations of 1% or even 10%."

has adopted in whole or in part),⁶² ABA formal ethics opinions interpreting the Model Rules as applied to tax lawyers,⁶³ and Circular 230, the Treasury regulations governing federal tax practice.⁶⁴ Tax professionals who are also certified public accountants are similarly subject to the strictures of Circular 230 in addition to the practice standards promulgated by the American Institute of Certified Public Accountants (AICPA).⁶⁵ Finally, both tax lawyers and accountants must abide by the standards of care pertaining to tax return positions contained in the penalty provisions of the Code and the regulations

⁶²Members of the California State Bar are regulated by the Rules of Professional Conduct, a compilation of ethical guidelines that for most of its existence resided in the state's Business and Professions Code. See Cal. Bus. & Prof. Code §§ 6000-6243 (West 2014), *available at* <http://rules.calbar.ca.gov/Rules/RulesofProfessionalConduct/CurrentRules.aspx>. California is not alone in customizing its ethical rules governing attorneys. Many states that adopted the ABA Model Rules have enacted their own versions. New York, for instance, replaced its long-standing New York Code of Professional Responsibility in April 2009 with the New York Rules of Professional Conduct, making it the last state to abandon the traditional format of the ABA Model Code of Professional Responsibility, an architecture that the ABA itself abandoned in 1983 and that included binding disciplinary rules and nonbinding ethical considerations all arranged under canons. The (new) New York Rules of Professional Conduct largely track the structure of the ABA Model Rules but "maintain much of the language and substance" of the (old) New York Code. Roy Simon, *Comparing the New NY Rules of Professional Conduct to the NY Code of Professional Responsibility*, last accessed Oct. 13, 2014, <http://www.nysba.org/correlationchart/>.

⁶³There are three such opinions: Formal Op. 85-352, *supra* note 28; Formal Op. 346, *supra* note 26; and Formal Op. 314, *supra* note 29.

⁶⁴See 31 C.F.R. § 10 (2014). Tax law is not the only practice area subject to federal regulation. Securities lawyers face particularized practice standards under the disciplinary rules governing the professional conduct of attorneys "appearing and practicing" before the Securities and Exchange Commission (SEC). See SEC Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205 (2012); SEC Rules of Practice, 17 C.F.R. § 201.102(e) (2003).

⁶⁵For ethical standards governing CPAs, see AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CODE OF PROFESSIONAL CONDUCT (2014), *available at* <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx>; AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENTS ON STANDARDS FOR TAX SERVICES (2010), *available at* <http://www.aicpa.org/Research/Standards/Pages/default.aspx>.

promulgated thereunder, including most prominently sections 6662, 6664, and 6694.⁶⁶

While each of the above standards possesses independent moral and legal authority, Circular 230 has emerged as *the* prevailing standard for tax professionals. No other standard provides such detailed rules of behavior for tax “practitioners” nationwide, not only for lawyers and accountants, but also for enrolled agents, enrolled actuaries, enrolled retirement plan agents, and registered tax return preparers.⁶⁷ No other standard, moreover, garners as much

⁶⁶While section 6694 applies most directly to practitioners by imposing penalties on return preparers for understatements of a taxpayer-client’s tax liability, both section 6662 (pertaining to accuracy-related penalties imposed on taxpayers) and section 6664(c) (pertaining to the reasonable cause and good faith defense against penalties for taxpayers) implicate and inform practitioners’ standard of care. See I.R.C. § 6694(a)(1); see also Reg. §§ 1.6694-1, 1.6694-2, 1.6694-3. For example, practitioners can avoid imposition of penalties by showing that a position on which they advised had “substantial authority,” a level of certainty defined in Regulation section 1.6662-4(d) and explicitly cross-referenced in Regulation sections 1.6694-1(a)(1), 1.6694(a)(1)(ii), and 1.6694-2(b)(1)-(3). In the same manner, Regulation section 1.6694-2(d)(2) adopts the definition of “reasonable basis” under Regulation section 1.6662-3(b)(3), while Regulation section 1.6694-2(d)(3) adopts the definition of “adequate disclosure” under Regulation section 1.6662-4(f). For its part, taxpayers can establish the section 6664 defense to penalties by showing reasonable reliance on professional tax advice, with the reasonableness inquiry turning on whether the taxpayer’s advisor met her standard of care in rendering the advice. See Reg. § 1.6664-4(c). Throughout this Article, we discuss the overlap of the tax advisor’s standard of care with that of the taxpayer’s, with special focus on the “substantial authority” standard (see Part III.A.1) and the section 6664 defense to penalties (see Part III.E).

⁶⁷See 31 C.F.R. § 10.3(a)-(f) (2014). A recent U.S. Court of Appeals decision challenged the authority of the Treasury to regulate “tax return preparers” under Circular 230. See *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014) (invalidating CLE and certification requirements—which the Service had imposed in an effort to tackle widespread fraud, on hundreds of thousands of unregulated tax return preparers—on grounds that the authorizing statute provides insufficient authority). The decision, at least as currently interpreted, has no bearing on the brand of tax practice and tax advising discussed in this Article. See also Lawrence B. Gibbs, *Loving v. IRS: Treasury’s Authority to Regulate Tax Return Preparers*, 141 TAX NOTES (TA) 331, 337 (Oct. 21, 2013) (arguing that amendments in 2011 to Circular 230 covering tax return preparation by commercial preparers “are authoritative and should be upheld”); Brief for Former Commissioners of Internal Revenue as Amici Curiae Supporting Appellants, *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014) (No. 13-061), 2013 WL 1386248, at *16-17 (“In 1884, Congress empowered the Treasury to regulate the conduct of claims agents pursuing financial benefits from the government; and in 2013 the Treasury retains that authority to regulate the conduct of tax return preparers who similarly assist preparing and filing tax returns that present to the Treasury millions of claims worth billions of dollars each year.”). But see Steve R. Johnson, *Loving and Legitimacy: IRS Regulation of Tax Return Preparation*, 60 VILL. L. REV. 515 (2014) (arguing that the statute authorizing Circular 230 does not confer authority to regulate tax return preparation).

respect from tax professionals⁶⁸ or imposes such strictly enforced disciplinary rules rather than loosely enforced aspirational guidelines.⁶⁹ Furthermore, no other standard of conduct has influenced the development of the other standards as thoroughly as Circular 230,⁷⁰ or embedded its principles of accuracy and minimizing errors,⁷¹ or been adopted as the standard of care in different jurisdictions and in both state and federal courts.⁷² For more than 125 years, the Treasury has enjoyed broad authority to regulate federal tax professionals. In 1884, Congress authorized the Secretary of the Treasury to promulgate rules and regulations “governing the recognition of agents . . . representing claimants before his Department.”⁷³ Under this statutory authority,⁷⁴ the Treasury issued relatively few rules of practice until 1921,⁷⁵ when it first published Circular 230.⁷⁶ Subsequently, federal courts examining the Treasury’s ability to regulate federal tax practice found that the Treasury’s “disciplinary authority clearly extends to all practitioners before the Treasury Department”⁷⁷ and

⁶⁸As legal scholar Michael Lang writes, “When tax practitioners think of who addresses substandard behavior to their colleagues they think of the IRS Office of Professional Responsibility [which enforces Circular 230 rules] and they are right to do so.” Michael B. Lang, *Thinking About Tax Malpractice*, 32 ABA SECTION OF TAXATION NEWS QUARTERLY 1 (Fall 2012). In addition, it is safe to say that tax lawyers are more likely to follow changes in the law pertaining to due diligence standards under Circular 230 (or the Code, for that matter) than under the ABA Model Rules. Moreover, they surely are more likely to know that section 10.22 of Circular 230 contains the Treasury’s general due diligence requirements than that Model Rule 1.3 contains the ABA’s (or their state bar’s) diligence obligations.

⁶⁹See *supra* notes 18-25 and accompanying text; see also *infra* notes 86-111 and accompanying text.

⁷⁰See *infra* Part IV.

⁷¹See *infra* Parts III and IV.

⁷²See *infra* notes 74, 77-78 and accompanying text; see also Lang, *supra* note 68, at 28 (writing that “breaches of Circular 230 rules that either parallel state bar ethics rules or are designed to protect clients are likely to be treated like breaches of such state bar ethics rules,” stating by way of example that breaches of sections 10.21 and 10.22 “are likely to be allowed to be offered in court as evidence of the breach of a duty to the client”).

⁷³Act of July 7, 1884, § 3, 23 Stat. 258 (codified as 31 U.S.C. § 330, Practice before the Department).

⁷⁴See, e.g., *Falsone v. United States*, 205 F.2d 734, 741 (5th Cir. 1953) (acknowledging the Treasury’s historical authority to promulgate rules and regulations “governing recognition of attorneys and agents representing persons before the Treasury Department”); *Agran v. Shapiro*, 127 Cal. App. 2d Supp. 807, 820-21 (Super. Ct. 1954) (recognizing the longstanding authority of the Treasury to promulgate and enforce regulations pertaining to the practice of persons appearing before it).

⁷⁵See Bryan T. Camp, “Loving” *Return Preparer Regulation*, 140 TAX NOTES (TA) 457, 458 (July 29, 2013) (quoting a 1927 article authored by the Chairman of the Treasury’s Committee on Enrollment and Disbarment stating that, until 1921, “the rules governing practice were few, and applicants were enrolled without special investigation as to their character and qualifications”). Prior to 1921, the Treasury published at least three regulations governing federal tax practice: Circular 13 (Feb. 6, 1886) (pertaining to internal taxes), Circular 94, (Oct. 4, 1890) (same), and T.D. 32974 (Nov. 30, 1912) (pertaining to customs duties).

⁷⁶T.D. 38773, Circular No. 230 (Feb. 15, 1921).

⁷⁷*Poole v. United States*, 84-2 U.S.T.C. ¶ 9612, 54 A.F.T.R.2d 5536 (D.D.C. 1984).

covers “in a general way, the activities of practitioners.”⁷⁸ Moreover, Congress has repeatedly reauthorized this broad grant of authority,⁷⁹ which courts have found permits the Treasury “to judge the character, reputation, and competence of those who practice[] before it.”⁸⁰

Today, Circular 230 provides the prevailing standard of care for tax practitioners representing taxpayers “before the IRS.”⁸¹ It specifies sanctions for violating its rules.⁸² And it prescribes disciplinary proceedings for adjudicating those violations.⁸³ The Treasury broadly defines “practice before the IRS” as “all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service.”⁸⁴ Moreover, “presentations” include “preparing documents; filing documents; corresponding and communicating with the Internal Revenue Service; rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion; and representing a client at conferences, hearings and meetings.”⁸⁵

⁷⁸*Id.* at 9612, 54 A.F.T.R.2d. at 5537. For federal courts recognizing Circular 230 as the governing standard of care for federal tax practitioners, see *Banister v. U.S. Dep’t of the Treasury*, 499 Fed. App’x 668 (9th Cir. 2012); *Diaz v. Century Pac. Inv. Corp.*, 21 F.3d 1112 (9th Cir. 1994); *Owrutsky v. Brady*, 925 F.2d 1457 (4th Cir. 1991); *Silverton v. U.S. Dep’t of the Treasury*, 644 F.2d 1341 (9th Cir. 1981); *Pope v. United States*, 599 F.2d 1383 (5th Cir. 1979); *Harary v. Blumenthal*, 555 F.2d 1113 (2d Cir. 1977); *Falsone*, 205 F.2d 734; *Ryan, LLC v. Lew*, 934 F. Supp. 2d 159 (D.D.C. 2013) (“Simply stated, Circular 230 delineates who may practice before the Service, the standards and restrictions such persons must follow, and the sanctions imposed for violations of such standards and restrictions.”); *United States v. Tomlinson*, 2013-2 U.S.T.C. ¶ 50,414, 111 A.F.T.R.2d 2431 (D. Kan. 2013); *Loving v. IRS*, 917 F. Supp. 2d 67, 71 (D.D.C. 2013); *Legel v. U.S. Dep’t of the Treasury*, 2011 U.S. Dist. LEXIS 136257 (S.D. Fl. 2011); *Banister v. U.S. Dep’t of the Treasury*, 2012-2 U.S.T.C. ¶ 50,680, 110 A.F.T.R.2d 6794 (N.D. Cal. 2011); *Daniels v. United States*, 2006-1 USTC ¶ 50,310, 97 A.F.T.R.2d 2280 (N.D. Ga. 2006); *Jordan v. United States*, 2005 U.S. Dist. LEXIS 32076 (D. Conn. 2005); *Sicignano v. United States*, 127 F. Supp. 2d 325 (D. Conn. 2001); *Inst. of Certified Practitioners v. Bentsen*, 874 F. Supp. 1370 (N.D. Ga. 1994). For state courts recognizing Circular 230 as the standard of care for tax practitioners, see *N.Y. State Ass’n of Enrolled Agents, Inc. v. N.Y. State Dep’t of Taxation and Fin.*, 29 Misc. 3d 332, 333-38 (N.Y. Sup. Ct. 2010); *Estate of Heinz*, 2006 N.Y. Misc. LEXIS 4230, at *2 (Surrogate’s Ct. of N.Y., New York Cnty. 2006); *Carberry v. State Bd. of Accountancy*, 28 Cal. App. 4th 770, 790 (Cal. Ct. App. 1994); *N.Y. State Soc. of Enrolled Agents v. N.Y. State Div. of Tax Appeals*, 161 A.D.2d 1, 7 (N.Y. App. Div. 1990); *Agran*, 127 Cal. App. 2d Supp., at 820-21.

⁷⁹*See, e.g.*, H.R. Rep. No. 82-2518, at 13 (1953); H.R. Rep. No. 89-1141, at 3 (1965) (“In imposing admission requirements on prospective practitioners, the Internal Revenue Service is acting under authority of the Act of July 7, 1884.”).

⁸⁰*Poole*, 84-2 U.S.T.C. at 9612, 54 A.F.T.R.2d at 5537.

⁸¹*See* 31 C.F.R. §§ 10.20-.38 (2014).

⁸²*See id.* §§ 10.50-.53 (2014).

⁸³*See id.* §§ 10.60-.82 (2014).

⁸⁴*Id.* § 10.2(a)(4) (2014).

⁸⁵*Id.*

Substantively, Circular 230 articulates affirmative obligations for practitioners and proscribes behavior that violates those obligations⁸⁶ (or that otherwise demonstrates “incompetence and disreputable conduct”)⁸⁷ with the force of sanctions that include censure, monetary penalties, suspension, and disbarment.⁸⁸ The Treasury’s Office of Professional Responsibility (OPR) handles “matters related to practitioner conduct and . . . discipline”⁸⁹ with the OPR Director initiating disciplinary proceedings under section 10.60. The Director also has the authority to undertake “expedited proceedings” against practitioners under section 10.82 by suspending them from practice based on final prior adjudications in other judicial or administrative proceedings.⁹⁰

Since 1998,⁹¹ the Treasury has periodically published in the Internal Revenue Bulletin a list of disciplinary actions taken against practitioners.⁹² The description of the action taken typically includes the disciplined practitioner’s name, address, professional designation, a brief description of the disciplinary sanction, and effective dates of sanction.⁹³ As of February 24, 2014, the Treasury had published 72 such announcements describing disciplinary actions against more than 2,500 practitioners.⁹⁴ While the vast majority of disciplinary dispositions involve “expedited proceedings” under section 10.82,⁹⁵ the published descriptions of practitioner misconduct include a wide range of violations under Circular 230, including section 10.20 (information

⁸⁶ See *id.* § 10.52 (2014).

⁸⁷ *Id.* § 10.51 (2014).

⁸⁸ See *id.* § 10.50 (2014).

⁸⁹ *Id.* § 10.1(a)(1) (2014).

⁹⁰ See *id.* § 10.82 (2014). While the majority of these prior proceedings involve suspension or revocation of a professional license, they also include convictions of tax crimes, court sanctions relating to a taxpayer’s liability or the practitioner’s personal tax liability, and crimes “involving dishonesty or breach of trust, or any felony involving conduct that renders the practitioner unfit to practice before the [Internal Revenue Service].” See *Circular 230 Disciplinary Proceedings*, IRS, Aug. 20, 2014, <http://www.irs.gov/Tax-Professionals/Enrolled-Agents/Circular-230-Disciplinary-Proceedings>.

⁹¹ See 1998-06 I.R.B. 1 (Feb. 9, 1998).

⁹² See 31 C.F.R. § 10.80 (2014).

⁹³ Sanctions are published when (1) an Administrative Law Judge or the Secretary’s delegate on appeal issues a final agency decision (discussed *infra* at notes 103-104 and accompanying text), (2) OPR resolves a disciplinary matter with a signed “consent to sanction” by which the practitioner admits to violating one or more Circular 230 provisions, or (3) OPR issues “a decision in an expedited proceeding for suspension.” See *Circular 230 Disciplinary Proceedings*, *supra* note 90.

⁹⁴ For IRBs containing OPR “Announcements of Disciplinary Actions,” see *Disciplinary Sanctions - IRB*, IRS, updated Sept. 2, 2014, <http://www.irs.gov/portal/site/irsportal/menuitem.143f806b5568dcd501db6ba54251a0a0/?vgnnextoid=8272cd489f916310VgnVCM100000351f0a0aRCRD&vgnnextchannel=9a9246d964264310VgnVCM1000004e0d010aRCRD>.

⁹⁵ See *supra* note 90 and accompanying text.

to be furnished to the Service),⁹⁶ section 10.22 (diligence as to accuracy),⁹⁷ section 10.29 (conflicting interests),⁹⁸ section 10.30 (solicitation),⁹⁹ section 10.33 (tax shelter opinions, effective from 1984 to 2004, recodified as “Best practices” in 2004),¹⁰⁰ section 10.34 (standards for advising tax return positions and for preparing or signing returns),¹⁰¹ and section 10.51 (disreputable conduct).¹⁰²

In 2007, the OPR also began publishing final agency decisions on disciplinary proceedings, which include unappealed ALJ decisions, decisions of the designated appellate authority, and decisions of federal district courts and circuit courts.¹⁰³ As of February 24, 2014, the Treasury had published decisions in 106 proceedings involving 70 practitioners. These published decisions contain the usual trappings of judicial opinions, including statements of fact, fact to law analysis, discussion, and conclusion. Compared to the short, periodic summaries of disciplinary sanctions discussed above, these decisions allow for broader observations on the Treasury’s disciplinary authority, on the public purposes of Circular 230, and ultimately, on federal tax practitioners’ professional responsibilities.¹⁰⁴

The agency decisions recognize that federal agencies have long had the authority and power “to regulate those who practice before them,” a power

⁹⁶ See, e.g., Announcement 2012-08, 2012-07 I.R.B. 373-75; Announcement 2008-52, 2008-22 I.R.B. 1040-41.

⁹⁷ See, e.g., Announcement 2011-44, 2011-33 I.R.B. 166-67; Announcement 2011-41, 2011-28 I.R.B. 50-51; Announcement 2011-24, 2011-12 I.R.B. 571; Announcement 2010-53, 2010-36 I.R.B. 324; Announcement 2010-51, 2010-33 I.R.B. 264; Announcement 2009-75, 2009-42 I.R.B. 538; Announcement 2009-68, 2009-38 I.R.B. 390; Announcement 2009-65, 2009-36 I.R.B. 320; Announcement 2009-46, 2009-21 I.R.B. 1043; Announcement 2008-77, 2008-33 I.R.B. 396; Announcement 2008-52, 2008-22 I.R.B. 1041, 1046, 1050.

⁹⁸ See, e.g., Announcement 2012-33, 2012-35 I.R.B. 327.

⁹⁹ See, e.g., Announcement 2008-52, 2008-22 I.R.B. 1046.

¹⁰⁰ See, e.g., Announcement 2010-43, 2010-27 I.R.B. 44.

¹⁰¹ See, e.g., Announcement 2010-53, 2010-36 I.R.B. 324; Announcement 2008-52, 2008-22 I.R.B. 1050.

¹⁰² See, e.g., Announcement 2010-53, 2010-36 I.R.B. 324; Announcement 2010-51, 2010-33 I.R.B. 263-64; Announcement 2010-43, 2010-27 I.R.B. 44; Announcement 2009-75, 2009-42 I.R.B. 538, 540-41; Announcement 2009-68, 2009-38 I.R.B. 390; Announcement 2008-52, 2008-22 I.R.B. 1041.

¹⁰³ For final agency decisions, see *Final Agency Decisions*, IRS, Aug. 21, 2014, <http://www.irs.gov/Tax-Professionals/Enrolled-Actuaries/Final-Agency-Decisions>.

¹⁰⁴ For additional analyses of these decisions and what they say about OPR’s “thought process as it enforces Circular 230 professional standards,” see generally Jeremiah Codner, *Circular 230 and Due Process*, 135 TAX NOTES (TA) 538 (Apr. 30, 2012); Jeremiah Codner, *OPR’s Role in Guiding Practitioner Sanctions*, 134 TAX NOTES (TA) 1347 (Mar. 12, 2012); Jeremiah Codner, *Strong Headwinds for Those Facing Circular 230 Discipline*, 131 TAX NOTES (TA) 539 (May 9, 2011).

that the Treasury wields through Circular 230.¹⁰⁵ They further recognize that practicing before the Service “is a privilege,” and “one cannot partake of that privilege without also taking on the responsibilities of complying with the regulations that govern such practice.”¹⁰⁶ These duties include obligations to taxpayer-clients, to the general public, and to the tax system. Circular 230 provides “rules and regulations relating to a practitioner’s activities as a taxpayer representative, as an adviser to taxpayers and relating to the practitioner’s conduct of his or her own tax and other affairs.”¹⁰⁷ As such, the Treasury’s practice rules “are designed to protect the Department and the public from persons unfit to practice before the IRS.”¹⁰⁸ In meeting this “fitness to practice” standard, practitioners must conduct themselves as persons with “‘special skills’ with regard to taxation” who “occup[y] a place of public trust”¹⁰⁹ and on whom “the IRS relies heavily . . . to perform their tasks diligently and responsibly.”¹¹⁰ “Breaches of professional responsibility by authorized practitioners,” these decisions observe, “jeopardize the achievement of the objectives of our tax laws and can inflict great damage on the public perception of fairness.”¹¹¹

The affirmative duties delineated in Circular 230 assist tax practitioners in fulfilling their professional responsibility to render accurate advice, which, in

¹⁰⁵ Director, Office of Prof’l Responsibility v. Baldwin, No. 2010-08, slip op. at 5 (2010); *see also* Director, Office of Prof’l Responsibility v. Dwayne H. Coston, No. 2010-19, slip op. at 7 (2011); Director, Office of Prof’l Responsibility v. C. Wesley Craft, No. 2010-12, slip op. at 9 (2011); Director, Office of Prof’l Responsibility v. Donald A. Navatsyk, No. 2010-03, slip op. at 7 (2010); Director, Office of Prof’l Responsibility v. James E. Barr, No. 2009-09, slip op. at 5 (2010). Like the decisions from federal courts, *see supra* note 78 and accompanying text, the agency decisions adopt a broad interpretation of what it means to practice “before the Internal Revenue Service.” *See, e.g.,* Director, Office of Prof’l Responsibility v. Philip G. Panitz, No. 2006-25, slip op. at 2 (2009) (finding jurisdiction over a practitioner because he had practiced as a tax attorney for 20 years (including the years at issue) and thus “engaged in practice before the Service within the purview” of Circular 230 and “bound” by its rules and regulations); Director, Office of Prof’l Responsibility v. Leonard Fein, No. 2006-33, slip op. at 4 (2008) (subjecting a practitioner to the strictures of Circular 230 based on the fact that he was a CPA and that he had represented taxpayers before the Service earlier in his career); Director, Office of Prof’l Responsibility v. Joseph R. Banister, No. 2003-02, slip op. at 25-26 (2004) (finding that “with regard to oral and written representations made to either the Treasury or to a client in connection with any matter administered by the Internal Revenue Service, each attorney, certified public accountant, enrolled agent and enrolled actuary is required to exercise due diligence in determining the correctness of such statements”).

¹⁰⁶ *Baldwin*, No. 2010-08 at 6; *Coston*, No. 2010-19 at 9; *Craft*, No. 2010-12 at 13; *Navatsyk*, No. 2010-03 at 9; *Barr*, No. 2009-09 at 7.

¹⁰⁷ *Banister*, No. 2003-02 at 15.

¹⁰⁸ *Baldwin*, No. 2003-02 at 5. For more on the “fitness to practice” standard, *see* Director, Office of Prof’l Responsibility v. Edgar H. Gee, Jr., No. 2009-31, slip op. at 38 (2011); *Coston*, No. 2010-19 at 9; *Craft*, No. 2010-12 at 13; Director, Office of Prof’l Responsibility v. Donald J. Petrillo, No. 2009-21, slip op. at 10 (2010); *Navatsyk*, No. 2010-03 at 9; *Barr*, No. 2009-09 at 6.

¹⁰⁹ *Gee*, No. 2009-31 at 39.

¹¹⁰ *Id.*

¹¹¹ *Id.*

turn, informs accurate returns and facilitates compliance with the law. The standard of care contained in Circular 230 explicitly aims to reduce human error caused by carelessness, incompetence, lack of inquiry or communication, conflicting interests (including personal interests), lack of independent professional judgment, and otherwise flawed or biased practices or misaligned incentives. Consider a few examples of the most salient duties under Circular 230:

- The standards pertaining to *due diligence* require advisors to, among other things, investigate facts, to remain informed and abreast of the law, to evaluate all federal tax issues associated with a taxpayer-client's position or transaction, to track courts' use of anti-abuse regulations and doctrines as well as how the deployment of such doctrines varies across jurisdictions and venues, to know the government's litigating position and strategy with respect to material tax issues and tax avoidance transactions, and at the end of the day, to articulate a conclusion as to the likelihood of success on the merits not just for each material tax issue comprising a transaction but also for the overall transaction.¹¹²
- The standards for *communicating* with taxpayer-clients assist practitioners in reducing errors by helping them understand a client's purposes, goals, and motives in planning a transaction, taking a filing position, investing in litigation, or considering controverted issues. In so doing, the standards help practitioners become familiar with their clients' affairs, assist in meeting not just the above-noted due diligence standard but also in satisfying the informed consent requirement under the conflicting interests rules (see immediately below), and in reducing the likelihood of biased probability assessments associated with failing to learn or understand a client's risk profile or underlying motives in seeking tax reduction. The communication requirement also keeps taxpayer-clients informed of their options by, among other things, advising them of penalties that might apply to certain reporting positions and ways to avoid penalties through disclosure.¹¹³
- For yet another example of Circular 230 helping practitioners and their clients reduce errors, consider the standard for avoiding *conflicts of interest*. This omnipresent standard forces practitioners to evaluate (and then reevaluate regularly) whether relationships, responsibilities, pecuniary incentives, fee structures, or other potential biases and misaligned incentives might adversely affect representation of a taxpayer-client or compromise the advisor's ability to render independent professional advice. The standard also requires practitioners to communicate any conflicts with taxpayer-clients, to discuss the potential implications of

¹¹² See *infra* Part III.A.

¹¹³ See *infra* Part III.B.

the conflicts, and to receive informed consent confirmed in writing to continue representation.¹¹⁴

- Finally, Circular 230 rules further assist practitioners in rendering accurate advice by prohibiting *unconscionable fees* and by severely restricting *contingent fees*. Both kinds of fee arrangements can cloud professional judgment and result in biased, conflicted assessments of a reporting position or transaction's likelihood of success on the merits. Moreover, contingent fees exploit the "audit lottery" by encouraging taxpayer-clients to take overaggressive positions for which their tax advisor earns a fee only if the position avoids detection.¹¹⁵

In emphasizing accurate advice and accurate returns, Circular 230's standard of care protects taxpayers, tax advisors, and the tax system. Taxpayer-clients can make more informed decisions about what to put on their returns, which protects them from having a return position challenged by the Service, litigated in court, invalidated on the merits, and subject to interest charges and penalties (with the latter levy often imposed by both federal and state tax authorities). For their part, tax advisors benefit by not subjecting taxpayer-clients to undue risk and liability, which, in addition to upholding the ethical axiom of "do no harm," protects the advisor from avoiding charges of professional misconduct (and in defending against such charges).¹¹⁶ Moreover, by fortifying its strictures of accurate advice with the palpable threat of disciplinary proceedings and sanctions, Circular 230 further protects tax professionals from losing clients to less ethical advisors. By the same token, accurate advice and accurate returns protect the tax system by raising compliance among taxpayers at all income levels and by bolstering fairness, both real and perceived, under the tax laws.

III. Building an Über Standard: Circular 230, the Code, and the ABA Model Rules

This Part examines more closely how the standards of care in Circular 230 aim to improve the accuracy of tax advisors' judgment and advice. It evaluates, in particular, the rules pertaining to due diligence, communication, conflicting interests, and unconscionable and contingent fees. In discussing these rules, we evaluate complementary and overlapping standards of care contained in the Code and its underlying regulations, especially the rules reflected in sections 6662, 6664, and 6694. Furthermore, we highlight specific ABA Model Rules of Professional Conduct, both for their relevance to tax lawyers and their influence on the development of the Treasury's rules and regulations. Meanwhile, we deemphasize (without ignoring) the

¹¹⁴ See *infra* Part III.C.

¹¹⁵ See *infra* Part III.D.

¹¹⁶ See Kip Dellinger, *Beware Conflicts of Interest*, 139 TAX NOTES (TA) 533, 535 (Apr. 29, 2013) (extending the universal ethical principle to tax practice: "The same requirement applies to the tax professional as to the doctor: Do no harm.").

persuasiveness of the three ABA formal opinions pertaining to tax practice due to their outmoded standards (including, for example, the obsolete “realistic possibility of success” standard for advising reporting positions in Opinion 85-352 or the corrupted “reasonable basis” standard for return preparation in Opinion 314) as well as their comparative lack of authority vis-à-vis the other standards. In addition, while we discuss the tax lawyer’s duties in turn, we are careful to illustrate how the standards overlap and inform each other; for example, we have already seen how obligations under the communication standard are part and parcel of the diligence and conflicts standard as well as how restrictions on unconscionable and contingent fees reinforce the conflicting interests standard.

We conclude this Part with a discussion of the taxpayer’s defense to statutory penalties. We demonstrate that taxpayers wishing to establish reasonable reliance on the advice of a tax professional to overcome penalties must show that the advice itself was reasonable, a requirement that effectively turns the tax advisor’s standard of care into the taxpayer’s standard of care. More pointedly, taxpayer-clients are on the hook for professional advice that falls below the standard of care.

A. *The Standard for Due Diligence and Competence*

The Treasury, through Circular 230, has long required tax practitioners to exercise a high degree of due diligence. As importantly, it has recognized that accurate returns are the byproduct of diligent and accurate advice. Indeed, the Circular’s general due diligence standard contained in section 10.22 governs “diligence as to accuracy.”¹¹⁷ Virtually unchanged since 1966,¹¹⁸ the standard obligates practitioners to exercise due diligence in the preparation, approval, and filing of all documents with the Service, and to determine the “correctness” of any oral or written representations made by the practitioner to the Treasury as well as to the practitioner’s taxpayer-clients.¹¹⁹

Additional and more particularized due diligence requirements are sprinkled throughout the Circular. The practitioner must not base her advice on unreasonable factual or legal assumptions,¹²⁰ including “assumptions as to future events.”¹²¹ Prohibited assumptions encompass those that the prac-

¹¹⁷ 31 C.F.R. § 10.22 (2007).

¹¹⁸ See 31 Fed. Reg. 10,773, 10,776 (Aug. 13, 1966).

¹¹⁹ 31 C.F.R. § 10.22(a) (2007).

¹²⁰ See *id.* § 10.33(a)(2) (2004) (expecting the practitioner to evaluate “the reasonableness of any assumptions or representations . . . and arriv[e] at a conclusion supported by the law and the facts”); *id.* § 10.37(a)(2)(i) (2014) (requiring practitioners to “[b]ase the written advice on reasonable factual and legal assumptions”); *id.* § 10.35(c)(1)(ii) (2007) (prohibiting “unreasonable factual assumptions” in the context of covered opinions); *id.* § 10.35(c)(1)(iii) (2007) (prohibiting “unreasonable factual representations, statements or findings of the taxpayer or any other person” in the context of covered opinions); *id.* § 10.35(c)(2)(ii) (2007) (prohibiting opinions based on “any unreasonable legal assumptions, representations, or conclusions”).

¹²¹ *Id.* § 10.37(a)(2)(i) (2014).

itioner “knows or should know [are] incorrect or incomplete,”¹²² such as assumptions as to the business purpose or pretax profit potential of a transaction or the accuracy of valuations, projections, appraisals, and financial forecasts. In addition, the practitioner must ascertain and consider all relevant facts,¹²³ relate the applicable law—including potentially applicable judicial doctrines—to the relevant facts,¹²⁴ and never, in evaluating the merits of a tax position or transaction, “take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.”¹²⁵ The Code and

¹²² *Id.* § 10.35(c)(1)(ii) (2007).

¹²³ *See id.* § 10.37(a)(2)(ii) & (iii) (2014) (practitioner must “[r]easonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know” and “[u]se reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter”); *id.* § 10.33(a)(2) (2004) (practitioner should “[e]stablish[] the facts” and “determin[e] which facts are relevant”); *id.* § 10.35(c)(1)(i) (2007) (pertaining to “covered opinions” and obligating the practitioner to “use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant. The opinion must identify and consider all facts that the practitioner determines to be relevant”); *see also* ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 346 (1982) (stating the lawyer “should . . . make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in any material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry.”).

¹²⁴ *See* 31 C.F.R. § 10.37(a)(2)(v) (2014) (practitioner must “[r]elate applicable law and authorities to facts”); *id.* § 10.33(a)(2) (2004) (practitioner should “relat[e] the applicable law (including potentially applicable judicial doctrines) to the relevant facts”); *id.* § 10.35(c)(2)(i) (2007) (practitioner “must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts” in the context of covered opinions); *see also* ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 346 (1982) (in the context of tax shelter opinions, “the lawyer should relate the law to the actual facts to the extent the facts are ascertainable when the offering materials are being circulated”).

¹²⁵ 31 C.F.R. § 10.37(a)(2)(vi) (2014); *see also id.* § 10.35(c)(3)(iii) (2007) (same, in the context of covered opinions, while also prohibiting practitioners from considering whether an “an issue will be resolved through settlement if raised” on audit).

Treasury regulations reflect and reinforce these requirements, particularly in sections 6662, 6664, and 6694.¹²⁶

In heeding Circular 230's due diligence duties when rendering advice on the merits of federal tax issues, a practitioner may reasonably rely in good faith and without verification on information furnished by taxpayer-clients.¹²⁷ In this way, tax advisors are not the absolute guarantors of their advice. Also, they may reasonably rely on representations, statements, findings, agreements, or conclusions of taxpayer-clients or other persons,¹²⁸ as well as on the work product or opinion of another professional.¹²⁹ However, in relying on others, the practitioner must take "proper account of the nature of the relationship" between herself and the person on whom she is relying (a requirement that imports a concern for avoiding conflicts into the due diligence standard)¹³⁰ and must not "ignore the implications of information furnished to, or actually known by, the practitioner."¹³¹

¹²⁶For no "unreasonable factual or legal assumptions," see I.R.C. § 6664(d)(4)(B)(iii)(I) (pertaining to disqualified opinions) and Reg. § 1.6664-4(c)(1)(ii) (pertaining to reliance on opinion or advice of a tax professional). For ascertaining and considering all relevant facts, see I.R.C. § 6662(d)(2)(B)(ii)(I) (pertaining to adequate disclosure in the context of reduction for understatements); § 6662(i)(2) (pertaining to nondisclosed noneconomic substance transactions); I.R.C. § 6664(d)(3) (pertaining to adequate disclosure in the context of reasonable cause exception for reportable transaction understatements); § 6664(d)(4) (pertaining to disqualified opinions in the context of reasonable reliance on the advice of a tax professional); Reg. § 1.6662-4(d)(2) (pertaining to the substantial authority standard). For relating the applicable law, including potentially applicable judicial doctrines, to the relevant facts, see § 6662(b)(6) (pertaining to underpayment penalties "by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law"); I.R.C. § 7701(o) (pertaining to the codification of the economic substance doctrine); § 6664(c)(2), (d)(2) (prohibiting reasonable cause and good faith defense to penalties in the context of underpayments attributable to noneconomic substance transactions). For prohibition on accounting for the chance that a return will not be audited, that an issue will not be raised on audit, or that an issue, if raised, will be resolved through settlement, see § 6664(d)(4)(A)(ii) (pertaining to "reasonable belief" and reasonable cause exception in the context of reportable transactions); Reg. § 1.6662-4(d)(2) (pertaining to the substantial authority standard and the reasonable basis standard); Reg. § 1.6662-4(g)(4)(i) (pertaining to "reasonable belief" in the context of tax shelter items for noncorporate taxpayers); Reg. § 1.6664-4(f)(2)(i)(B) (pertaining to "reasonable belief" and the reasonable cause and good faith defense to penalties in the context of tax shelter items for corporations); Reg. § 1.6694-1(e)(1) (pertaining to the "verification of information furnished by the taxpayer or other party"); Reg. § 1.6694-2(b)(1) (pertaining to the "reasonable to believe that the position would more likely than not be sustained on its merits" requirement for avoiding penalties due to advising on tax shelters).

¹²⁷See 31 C.E.R. § 10.34(d) (2011) (pertaining to advising clients on taking positions on tax returns, documents, affidavits, or other submissions to the Service, or in preparing or signing tax returns); *id.* § 10.37(b) (2014) (pertaining to requirements for written advice).

¹²⁸See *id.* § 10.37(a)(2)(iv) (2014); *id.* § 10.35(c)(1)(iii) (2007); *id.* § 10.35(c)(2)(ii) (2007).

¹²⁹See *id.* § 10.22(b) (2007) (so long as the practitioner "used reasonable care in engaging, supervising, training, and evaluating the person"); *id.* § 10.35(d)(1) (2007) (pertaining to covered opinions).

¹³⁰*Id.* § 10.22(b) (2007).

¹³¹*Id.* § 10.34(d) (2011).

Reliance on the advice of others is further qualified if the practitioner “knows or reasonably should know that the opinion of the other person should not be relied on,”¹³² that the person “is not competent or lacks the necessary qualifications to provide the advice,”¹³³ that the person has a disqualifying conflict of interest,¹³⁴ or that the advice provided is incorrect, incomplete, inconsistent, or untrue.¹³⁵ In these instances, the practitioner must investigate the accuracy of the information on which she is relying (a requirement that imports a concern for communicating with clients into the due diligence standard).¹³⁶ The Code contains standards pertaining to reasonable reliance on others that complement and reinforce the standards contained in Circular 230.¹³⁷

Two additional due diligence obligations under Circular 230 deserve mention. First, the practice rules hold tax advisors to a “reasonable practitioner standard” that is explicitly cognizant of the heightened risks to diligent and independent professional judgment when rendering opinions to nonclient,

¹³² *Id.* § 10.37(b)(1) (2014); *id.* § 10.35(d)(1) (2007).

¹³³ *Id.* § 10.37(b)(2) (2014).

¹³⁴ *See id.* § 10.37(b)(3) (2014).

¹³⁵ *See id.* § 10.34(d) (2011) (prohibiting reliance on information furnished by clients that “appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete”); *id.* § 10.35(c)(1)(iii) (2007) (prohibiting reliance on advice that is “incorrect or incomplete”); ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 346 (1982) (prohibiting tax lawyers, in rendering opinions on marketed tax shelters, from “accepting as true the facts which the promoter tells him, when the lawyer should know that a further inquiry would disclose that these facts are untrue”).

¹³⁶ *See* 31 C.F.R. § 10.34(d) (2011) (requiring practitioners to “make reasonable inquiries” in relying on the advice of others).

¹³⁷ *See, e.g.*, I.R.C. § 6664(d)(4)(B)(iii)(II) (pertaining to disqualified opinions in the context of reasonable reliance on the advice of a tax professional); Reg. § 1.6664-4(c)(1) (pertaining to professional advice that might qualify the taxpayer for the reasonable cause and good faith defense to penalties); Reg. § 1.6694-1(e)(1) (pertaining to verification of information furnished by the taxpayer or other party and stating that while the practitioner “is not required to audit, examine or review books and records, business operations, documents, or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party,” she “may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer” and “must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete”); Reg. § 1.6694-1(e)(2) (pertaining to verification of information on previously filed returns); Reg. § 1.6694-2(b)(1) (pertaining to whether the practitioner reasonably believed “that [the] position would more likely than not be sustained on its merits” in the context of advising on a tax shelter or reportable transaction); Reg. § 1.6694-2(d)(2) (pertaining to the exception for adequate disclosure of positions with a reasonable basis that otherwise failed to meet the substantial authority standard); Reg. § 1.6694-2(e)(5) (pertaining to demonstrating “reasonable cause and good faith”).

third-party, taxpayer investors.¹³⁸ Reflecting the Treasury's longstanding concern over the effect of marketed opinions on both the quality of professional advice and on taxpayer compliance,¹³⁹ Circular 230 warns of "additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances" when proffering written opinions "the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing, or recommending" tax shelter transactions.¹⁴⁰ Second, Circular 230 mandates that all firms with federal tax practices institute "procedures to ensure compliance" with its requirements, a mandate that the Treasury recently expanded to include not just covered opinions, tax returns, and other submissions, but also all written tax advice.¹⁴¹ In similar fashion, Circular 230 urges firms offering federal tax advice to taxpayer-clients or preparing or assisting in submitting materials to the Service to "take reasonable steps to ensure" that their procedures are "consistent with the best practices set forth" in the practice regulations.¹⁴²

Before completing our discussion of due diligence under Circular 230 with an analysis of the "substantial authority" standard governing both practitioners (in rendering advice) and taxpayers (in reflecting advice on returns), we highlight the effect of recently finalized amendments to Circular 230 on the

¹³⁸ See 31 C.F.R. § 10.37(c) (2014) (describing the standard for significant purpose transactions); *see also* Regulations Governing Practice Before the Internal Revenue Service, 79 Fed. Reg. 33,685, 33,694, 33,688 (June 12, 2014) (explaining the standard of review to determine whether practitioners satisfy the written advice standards when they know or have reason to know that "the written advice will be used in promoting, marketing, or recommending an investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Code").

¹³⁹ *See infra* Part IV.A.

¹⁴⁰ 31 C.F.R. § 10.37(c)(2) (2014); *see also* 79 Fed. Reg. at 33,686 (in explaining the repeal of detailed rules governing covered opinions, the Treasury emphasized, "Robust and relevant standards for written tax advice remain appropriate because the Treasury and the IRS continue to be aware of the risk for the issuance and marketing of written tax opinions to promote abusive transactions"); § 10.35(c)(3)(iv) (2007) (requiring practitioners to reach "more likely than not" certainty on all federal tax issues when providing a marketed opinion); § 10.35(c)(4)(ii) (2007) (requiring practitioners to reach "more likely than not" certainty on the overall conclusion of the transaction that is the subject matter of a marketed opinion); § 10.35(e)(2) (2007) (requiring the practitioner to prominently disclose that the opinion was written to support the promotion of transaction(s) reflected in the opinion and, furthermore, that the taxpayer should seek independent advice from a tax advisor as to the merits of the transaction).

¹⁴¹ See 34 C.F.R. § 10.36 (2014); *see also* 79 Fed. Reg. at 33,689-90 (explaining the recent expansion of section 10.36 and concluding that "[t]he procedures to ensure compliance have produced great success in encouraging firms to self-regulate without the burden often associated with a rigid one-size-fits-all approach").

¹⁴² 31 C.F.R. § 10.33(b) (2004).

prevailing diligence standard.¹⁴³ The final regulations eliminate “the complex rules”¹⁴⁴ governing “covered opinions” in former section 10.35, which, according to the Treasury, “increased the burden on practitioners and clients, without necessarily increasing the quality of the tax advice that the client received.”¹⁴⁵ Revised section 10.37 subjects all written tax advice to the same, principles-based standard¹⁴⁶ that “complement[s] the best practices of § 10.33 and the due diligence requirements in § 10.22.”¹⁴⁷ It also expressly maintains the spirit of former section 10.35, which reflected the government’s long-standing effort to discourage practitioners from rendering opinions for use by nonclient, third-party, taxpayer investors.¹⁴⁸ In addition, the final regulations add for the first time a section pertaining explicitly to “competence.”¹⁴⁹ New section 10.35 obligates practitioners, in language very closely resembling the competency standard in ABA Model Rule 1.1,¹⁵⁰ to provide “the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged.”¹⁵¹ Finally, and as noted above,¹⁵² amended section 10.36 significantly broadens the responsibility of practitioners and firms to institute “procedures to ensure compliance” by including compliance with all provisions in Subparts A (Rules Governing Authority to Practice), B (Duties and Restrictions Relating to Practice Before the Internal

¹⁴³ See Regulations Governing Practice Before the Internal Revenue Service, 79 Fed. Reg. 33,685 (June 12, 2014). In addition to enhancing and streamlining diligence standards under Circular 230, the final regulations revised the category of violations subject to expedited proceedings (reflected in section 10.82) as well as the oversight and disciplinary obligations of the IRS Office of Professional Responsibility (reflected in section 10.1(a)(1)). See *id.* at 33,691-92.

¹⁴⁴ 79 Fed. Reg. at 33,685.

¹⁴⁵ *Id.* at 33,686.

¹⁴⁶ See *id.* at 33,687 (stating that “the comprehensive, principles-based approach of these amendments is more straightforward, simpler, and can be applied to all written tax advice in a less burdensome manner. Overall, the Treasury and the IRS have determined that these written advice rules strike an appropriate balance between allowing flexibility in providing written advice, while at the same time maintaining standards that require individuals to act ethically and competently”); Regulations Governing Practice Before the Internal Revenue Service, 77 Fed. Reg. 57,055, 57,057 (Sept. 17, 2012) (to be codified at 31 C.F.R. pt. 10) (explaining that the proposed regulations “streamline the existing rules for written tax advice by . . . applying one standard” that outlines “basic principles to which all practitioners must adhere when rendering written advice”).

¹⁴⁷ 77 Fed. Reg. at 57,058.

¹⁴⁸ See *supra* notes 138-140 and accompanying text.

¹⁴⁹ Previously, while a practitioner could be sanctioned for “incompetent conduct” under 31 C.F.R. § 10.51, no provision of Circular 230 expressly required that practitioners exercise competence.

¹⁵⁰ MODEL CODE OF PROF’L CONDUCT R. 1.1 (stating in its entirety, “A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.”).

¹⁵¹ 31 C.F.R. § 10.35(a) (2014).

¹⁵² See *supra* notes 141-142 and accompanying text.

Revenue Service), and C (Sanctions for Violation of the Regulations) of the Circular.¹⁵³

1. *Establishing “Substantial Authority”: Harmonizing the Diligence Standard for Tax Advisors and Taxpayers*

The “substantial authority” standard, reflected in Circular 230 and the Code, obligates tax practitioners¹⁵⁴ and taxpayers¹⁵⁵ to achieve a level of certainty before, respectively, advising (nonshelter) tax positions and reporting those positions on returns.¹⁵⁶ Failure to achieve substantial authority for a position can subject a practitioner to discipline under Circular 230¹⁵⁷ and practitioners as well as taxpayers to penalty under the Code.¹⁵⁸ In this way, the substantial authority standard harmonizes the standard of care for tax advisors with that for taxpayer-clients. It makes fulfillment of the taxpayer’s standard of care rise and fall on the integrity and substance of the advice received from her tax professional. Stated differently, by satisfying the “substantial authority” standard under Circular 230 and the Code, the practitioner also satisfies her taxpayer-client’s obligations under the Code and, furthermore, preserves her taxpayer-client’s “reasonable cause and good faith” defense in the event the Service asserts penalties on a challenged position.¹⁵⁹ Conversely, by failing her own “substantial authority” obligations, the practitioner also fails to satisfy her taxpayer-client’s obligations, invalidates her client’s reasonable

¹⁵³ See Regulations Governing Practice Before the Internal Revenue Service, 79 Fed. Reg. 33,685, 33,689-90 (June 14, 2014) (to be codified at 31 C.F.R. pt. 10).

¹⁵⁴ See I.R.C. §§ 6694(a)(1)-(2) (subjecting practitioners to penalty for advising or preparing “unreasonable positions,” defined as positions lacking “substantial authority,” that they knew or reasonably should have known were reflected on the return); Reg. § 1.6694-1(a)(1) (subjecting practitioners to penalty for advising or preparing “unreasonable positions”); Reg. § 1.6694-2(a)(1)(ii) (same); 31 C.F.R. § 10.34(a)(1)(i)(B) (2011) (prohibiting a practitioner from signing a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that “is an unreasonable position,” defined in section 6694(a)(2)(A) of the Code as a position lacking substantial authority); 31 C.F.R. § 10.34(a)(1)(ii)(B) (2011) (prohibiting a practitioner from advising a client to take a position or prepare a portion of a return for refund containing a position that “is an unreasonable position”).

¹⁵⁵ See I.R.C. § 6662(d)(2)(B)(i) (pertaining to reducing underpayments and potential penalties for portions of underpayments that possess substantial authority); Reg. § 1.6662-4(a) (same); Reg. §§ 1.6662-4(d)(2) to (d)(3) (defining substantial authority standard, determining when and whether substantial authority exists, and discussing the effect of achieving substantial authority).

¹⁵⁶ The standards of care pertaining to advising and reporting tax shelter items are more stringent and discussed at *infra* note 176.

¹⁵⁷ See 31 C.F.R. § 10.50 (2014) (pertaining to the Treasury’s authority to censure, suspend, or disbar practitioners for violations of Circular 230); *id.* § 10.51 (pertaining to “incompetent and disreputable conduct”); *id.* § 10.52 (pertaining to violations subject to sanction).

¹⁵⁸ See I.R.C. § 6694(a) (pertaining to the penalty for understating a taxpayer’s tax liability); § 6662(a) (pertaining to the imposition of penalties for accuracy-related underpayments of tax).

¹⁵⁹ For discussion of the reasonable cause and good faith defense to penalties, see *infra* Part III.E.

cause and good faith defense to penalties, and unreasonably exposes her client to unnecessary risk and liability, which, in turn, exposes the practitioner to charges of professional misconduct. The stakes are high. Fortunately, the substantial authority standard has developed into a highly particularized set of due diligence rules that assists practitioners in rendering accurate advice and in facilitating accurate return positions.

Current law defines "substantial authority" as an "objective" standard that can be reduced to objective levels of certainty. The Code defines "substantial authority" as "less stringent than the more likely than not standard" (the latter of which reflects more than 50% certainty in a position's likelihood of success on the merits), "but more stringent than the reasonable basis standard"¹⁶⁰ (reflecting ten to 20% certainty),¹⁶¹ or a level of support that, although arguable, is "fairly unlikely to prevail in court upon a complete review of the relevant facts and authority."¹⁶² Under this definition, while it is possible for a practitioner to reach "substantial authority" for a tax item or position at low levels of confidence, most practitioners would peg the requisite level of certainty at substantially closer to 50% than between ten to 20%.¹⁶³ Under no circumstances may a practitioner consider the possibility that a return will not be audited (or that an item will not be raised on audit) in determining whether a tax position or transaction possesses either substantial authority or reasonable basis.¹⁶⁴ In other words, the position or transaction must be evaluated on its merits, as if it were litigated to a final conclusion in a court of law.

In determining whether substantial authority exists, practitioners and taxpayers must demonstrate that the "weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment."¹⁶⁵ It is possible for more than one interpretation of a par-

¹⁶⁰ Reg. § 1.6662-4(d)(2).

¹⁶¹ Sheldon I. Banoff, *Dealing with the "Authorities": Determining Valid Legal Authority in Advising Clients, Rendering Opinions, Preparing Tax Returns and Avoiding Penalties*, 66 TAXES 1072, 1128 (1988); see also Reg. § 1.6662-3(b)(3) (defining "reasonable basis" as "a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim."); STAFF OF J. COMM. ON TAXATION, 106TH. CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS) 152 (1999) ("reasonable basis" as at least 20% certainty).

¹⁶² H.R. REP. NO. 97-760, at 575 (1982) (Conf. Rep.).

¹⁶³ In fact, some authorities state that the level of certainty to achieve substantial authority "should approach" 51% and can extend only as low as 45%. IRS, EXEC. TASK FORCE, REPORT ON CIVIL TAX PENALTIES, ch. 8, at 43-44 (1989). *Comparison of Joint Committee Staff and Treasury Recommendations Relating to Penalty and Interest Provisions of the Internal Revenue Code: Hearing Before the H. Subcomm. on Oversight of the H. Comm. On Ways & Means*, 106th Cong. 14 (1999) (pegging the lower range of substantial authority at 40%); Philipps et al., *supra* note 35, at 1193 ("around 40 percent").

¹⁶⁴ See Reg. § 1.6662-4(d)(2).

¹⁶⁵ Reg. § 1.6662-4(d)(3)(i).

ticular tax position to possess substantial authority,¹⁶⁶ but the weight of favorable authority for each interpretation must “substantially” outweigh contrary or unfavorable authority. Also, the substantial authority standard is an objective standard such that a taxpayer’s subjective belief that there is substantial authority for the tax treatment of an item “is not relevant in determining whether there is substantial authority for that treatment.”¹⁶⁷

In conducting the substantial authority analysis, tax practitioners must understand that the weight accorded particular authorities should reflect their “relevance and persuasiveness” as well as the “type of document providing the authority.”¹⁶⁸ An authority that is “materially distinguishable” on its facts from the sought after tax treatment, for example, or that “merely states a conclusion” rather than “cogently relating the applicable law to pertinent facts” is neither relevant nor persuasive.¹⁶⁹ Similarly, a revenue ruling is accorded more weight than a private letter ruling as is recently published guidance versus older guidance.¹⁷⁰ The regulations account for the possibility that a position can possess substantial authority in the absence of recognized authorities¹⁷¹ so long as it is supported “by a well-reasoned construction of the applicable statutory provision.”¹⁷² Furthermore, there is no substantial authority for positions or transactions found lacking in economic substance.¹⁷³ Finally, the determination of whether a particular tax treatment possesses substantial authority is considered at the time the return containing the item is filed or “on the last day of the taxable year” relating to the return. This requirement

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ Reg. § 1.6662-4(d)(3)(ii).

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ These authorities include provisions of the Code; proposed, temporary, and final regulations; revenue rulings and revenue procedures; court cases; congressional intent as reflected in committee reports; the Joint Committee on Taxation’s “Blue Book” explanations of tax legislation; and private letter rulings, technical advice memoranda, general counsel memoranda, notices, announcements, and other administrative pronouncements. See Reg. § 1.6662-4(d)(3)(iii).

¹⁷² Reg. § 1.6662-4(d)(3)(ii).

¹⁷³ See, e.g., *Fidelity Int’l Currency Advisor A Fund LLC v. United States*, 747 F. Supp. 2d 49, 240 (D. Mass. 2010) (finding no substantial authority “where the transactions lack economic substance or must be recharacterized under the step transaction doctrine”); *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636, 706 n.64 (2008) (holding that where taxpayers’ “transactions lack economic substance, or must be disregarded pursuant to the step transaction doctrine, plaintiffs cannot contend successfully that substantial authority supported the tax treatment claimed based on the form of their transactions rather than their substance”); *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 204-05 (D. Conn. 2004) (holding that for a transaction lacking economic substance, a taxpayer cannot cite authority, much less substantial authority, to support the claimed tax benefits). Nor can the taxpayer establish a reasonable cause and good faith defense against penalties for underpayments (or portions of underpayments) attributable to positions or transactions lacking economic substance (as defined in section 7701(o)) or “any similar rule of law” (I.R.C. § 6662(b)(6)). See I.R.C. § 6664(c)(1)-(2) (pertaining to general underpayments); see also I.R.C. § 6664(d)(2) (pertaining to reportable transaction underpayments).

not only obligates a practitioner to keep her substantial authority analysis up to date; it also explicitly reflects Bayesian principles, which hold that constantly updating one's beliefs as new, relevant information becomes available improves judgment, increases accuracy, and reduces uncertainty.¹⁷⁴

In the event a practitioner cannot marshal substantial authority for a position, she can still avoid penalties or discipline for both herself and her taxpayer-client. If she demonstrates a "reasonable basis" for the desired tax treatment and adequately discloses the relevant facts of the position at the time of filing, the position will be treated as if it otherwise met the substantial authority standard.¹⁷⁵ Underpayments of tax attributable to tax shelter items are subject to more stringent rules.¹⁷⁶ Finally, and as noted above,¹⁷⁷ failure to achieve substantial authority for a position or to meet the reasonable basis or adequate disclosure exception can subject taxpayer-clients to penalty (under the Code) and practitioners to both penalty (under the Code) and discipline (under Circular 230). While both parties can avail themselves of a statutory

¹⁷⁴Reg. § 1.6662-4(d)(3)(iv)(C).

¹⁷⁵See I.R.C. § 6662(d)(2)(B)(ii)(II); see also I.R.C. § 6694(a)(1)(A)-(B); I.R.C. § 6694(a)(2)(A)-(B); Reg. § 1.6662-4(a); Reg. § 1.6662-4(b)(4)(ii)(B); Reg. §§ 1.6694-2(a)(1)(ii)-(iii); Reg. §§ 1.6662-4(e), -4(f) (pertaining to the effect and form of adequate disclosure); Reg. § 1.6694-2(d)(1) (pertaining to the exception for adequate disclosure of positions possessing reasonable basis).

¹⁷⁶Understatements of tax attributable to tax shelter items are subject to a standard of care that exceeds the "substantial authority or reasonable basis/adequate disclosure" standard. For instance, section 6662(d)(2)(C) holds that establishing substantial authority or adequate disclosure with a reasonable basis for tax shelters and tax shelter items (defined in section 6662(d)(2)(C)(ii)) will generally not qualify for a reduction in the understatement of tax (nor any corresponding penalty). Regulation sections 1.6662-4(e)(2)(ii) and 1.6662-4(g)(1)(iii) underscore that disclosure is irrelevant for all taxpayers (individual or corporate) with respect to understatements due to tax shelters and shelter items (referring to Regulation sections 1.6662-4(g)(2) and (g)(3)). An individual taxpayer can still rebut an underpayment pertaining to tax shelter items if she can demonstrate both substantial authority for the item and that she "reasonably believed at the time the return was filed that the tax treatment of that item was more likely than not the proper treatment" (in other words, that the tax treatment currently possesses at least substantial authority *and* that it possessed more likely than not certainty at the time of filing). Reg. §§ 1.6662-4(g)(1)(i)(A), -4(g)(1)(i)(B); see also Reg. § 1.6662-4(g)(4). The same exception applies to practitioners attempting to establish substantial authority for tax shelter items and reportable transactions; that is, they can avoid penalty under section 6694 for an otherwise "unreasonable position" upon showing it was "reasonable to believe that the position would more likely than not be sustained on its merits" (I.R.C. § 6694(a)(2)(C)), with the determination being satisfied on the date the return was prepared or advised (Reg. § 1.6694-2(b)(5)). See generally Reg. § 1.6694-2(b). Corporate taxpayers are not so lucky; they must include all tax shelter items in computing the amount of an understatement. See Reg. § 1.6662-4(g)(1)(ii)(A). The reasonable cause and good faith defense to understatement penalties may nonetheless still be available to corporations with underpayments attributable to tax shelter items to the extent they meet the requirements in Regulation section 1.6664-4(f). See *infra* note 246.

¹⁷⁷See *supra* notes 157-158 and accompanying text.

defense to penalties based on reasonable cause and good faith,¹⁷⁸ the taxpayer's defense is tied to her advisor's behavior.¹⁷⁹ In demonstrating reasonable reliance on the advice of a tax professional—the primary method for establishing a taxpayer's reasonable cause and good faith—the taxpayer must prove that the advice itself was reasonable, the same advice on which the taxpayer may have relied in reporting the position that the Service subsequently disallowed for failing to meet the substantial authority standard and on which it assessed penalties. Part III.E explores in more detail the reasonable cause and good faith defense to penalties for taxpayers and how a taxpayer's defense is linked to the quality of her tax professional's advice.

B. *The Standard for Communicating with Taxpayer-Clients*

The tax professional's duty to communicate with taxpayer-clients requires having actual conversations with clients, including discussions of the purpose, terms, and expectation of the engagement; dialogue concerning relevant facts, assumptions, representations, and future events; and frank discussions about the consequences of reporting specific positions on returns, including the application of potential penalties, the effect of disclosure, and reliance on professional advice. These conversations make both the tax advisor and her client more knowledgeable: the tax advisor as to pertinent facts and expectations, and the client as to making informed decisions. Moreover, talking with clients assists the tax advisor in meeting her affirmative communication obligations and in fulfilling her other professional obligations, including those pertaining to due diligence, avoiding and overcoming conflicts, and eschewing unconscionable and contingent fees.

Circular 230 contains a general communication obligation requiring practitioners to communicate “clearly with the client regarding the terms of the engagement,” including the “expected purpose and use of the advice” and “a clear understanding . . . regarding the form and scope of the advice or assistance to be rendered.”¹⁸⁰ The ABA Model Rules contain similarly vague communication requirements,¹⁸¹ supplemented with the general instruction that lawyers sufficiently discuss matters “to the extent reasonably necessary to

¹⁷⁸For practitioners, see I.R.C. § 6694(a)(3) (pertaining to practitioner's “reasonable cause exception” to penalties where it “is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith”); Reg. § 1.6694-2(e) (2014) (same). For taxpayers, see I.R.C. § 6664(c)(1) (pertaining to taxpayer's “reasonable cause exception” to penalties where “it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion”); Reg. § 1.6664-4 (same).

¹⁷⁹See Reg. § 1.6664-4(c) (pertaining to reliance on a tax advisor's opinion or advice); see also *infra* Part III.E.

¹⁸⁰31 C.F.R. § 10.33(a)(1) (2004).

¹⁸¹See, e.g., MODEL RULES OF PROF'L CONDUCT R. 1.4(a)(2)-(5) (1983) (pertaining to “the means by which the client's objectives are to be accomplished,” keeping the client “reasonably informed about the status of the matter,” and “promptly comply[ing] with reasonable requests for information”).

permit the client to make informed decisions regarding the representation¹⁸² and to ensure that clients possess “sufficient information to participate intelligently in decisions concerning the objectives of the representation and the means by which they are to be pursued.”¹⁸³ These communication principles assist tax lawyers in acting in the best interests of their clients.¹⁸⁴ But for guidance specific to tax practice, the tax lawyer must consult Circular 230, relevant sections of the Code, and ABA Formal Opinion 85-352.

Part of the tax lawyer’s duty of communication involves providing accurate information to taxpayer-clients. She must ensure the “correctness” of all representations made to clients,¹⁸⁵ which is also part of her due diligence obligation. She must advise taxpayers on “the import of the conclusions reached”¹⁸⁶ as well as on the potential consequences of taking certain positions or engaging in certain transactions,¹⁸⁷ including any penalties “reasonably likely to apply.”¹⁸⁸ With respect to potential penalties, the tax lawyer must inform the taxpayer of opportunities “to avoid any such penalties by disclosure, if relevant, and of the requirements of adequate disclosure.”¹⁸⁹ She should also advise her taxpayer-client on the likelihood of avoiding penalties if the taxpayer “acts in reliance on [her] advice,”¹⁹⁰ a duty that prompts the tax lawyer to discuss with her clients the reasonable cause and good faith defense to penalties contained in section 6664(c).¹⁹¹ The duty to inform on penalties further includes discussing the application of penalties to any position or transaction

¹⁸² *Id.* R. 1.4(b) (1983).

¹⁸³ *Id.* R. 1.4 cmt. 5 (1983).

¹⁸⁴ *See id.* R. 1.4 cmt. 5 (1983) (stating that the “guiding principle” in communicating with clients is to “fulfill reasonable client expectations for information consistent with the duty to act in the client’s best interests”).

¹⁸⁵ 31 C.F.R. § 10.22(a)(3) (2007).

¹⁸⁶ *Id.* § 10.33(a)(3) (2004).

¹⁸⁷ *See* ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 85-352 (1985) (instructing tax lawyers to inform clients of “potential penalties and other legal consequences should the client take the position advised”). While Opinion 85-352 requires tax lawyers to communicate potential risks to clients (particularly those associated with penalties), the ABA Model Rules offer lawyers a permissive communication standard pertaining to adverse eventualities of alternative courses of action. *See, e.g.*, MODEL RULES OF PROF’L CONDUCT R. 2.1 cmt. 5 (stating that a lawyer *may* advise clients “when a lawyer knows that a client proposes a course of action that is likely to result in substantial adverse legal consequences to the client,” particularly if “the client’s course of action is related to the representation”).

¹⁸⁸ 31 C.F.R. § 10.34(c)(1) (2011).

¹⁸⁹ *Id.* § 10.34(c)(2) (2011); *see also* ABA Comm. on Prof’l Responsibility, Formal Op. 85-352 (stating the “lawyer should counsel the client as to whether the position is likely to be sustained by a court if challenged by the IRS, as well as of the potential penalty consequence to the client if the position is taken on the return without disclosure”).

¹⁹⁰ 31 C.F.R. § 10.33(a)(3) (2004).

¹⁹¹ For a detailed discussion of this defense, *see infra* Part III.E.

found lacking in economic substance or that fails “to meet the requirements of any similar rule of law.”¹⁹²

In addition to providing accurate information *to* taxpayer-clients, the tax advisor’s duty of communication requires her to solicit and receive accurate information *from* her clients. Indeed, in relying on information provided by clients, tax professionals “must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.”¹⁹³ Moreover, the advisor must query clients (and others) as to the “relevant facts” in evaluating and advising on a federal tax issue.¹⁹⁴ She must also ask questions and make determinations as to the reasonableness of any factual or legal assumptions,¹⁹⁵ including assumptions pertaining to future events.¹⁹⁶ These communication requirements also assist the tax advisor in fulfilling her duties of due diligence.

Finally, and as we will examine in Parts III.C and IV.B, the practitioner’s duty to communicate very prominently includes the duty to have conversations with clients regarding potential and existing conflicts of interest. In fact, communicating conflicts to taxpayer-clients is so integral to the practitioner–taxpayer relationship that the default rule under Circular 230 prohibits practitioners from representing taxpayers in the presence of a conflict, which the Circular broadly defines to include “responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.”¹⁹⁷ Indeed, the only way for practitioners to overcome a conflict under the practice regulations involves discussing the implications of the conflict with all affected clients and, furthermore, receiving from all affected clients informed consent, confirmed in writing, that explicitly waives the conflict and permits continued representation.¹⁹⁸

C. *The Standard for Avoiding and Overcoming Conflicting Interests*

The tax professional’s standard of care governing conflicts focuses on the adverse effects of misaligned incentives. Distorted incentives can cloud

¹⁹²I.R.C. § 6662(b)(6) (2012). The phrase “or failing to meet the requirements of any similar rule of law” in section 6662(b)(6) refers to other judicial anti-abuse doctrines, including the substance over form, sham transaction, and business purpose doctrines. *See also* I.R.C. § 7701(o) (pertaining to the codified economic substance doctrine); 31 C.F.R. § 10.33(a)(3) (2004) (requiring practitioners to advise taxpayers on “the import of the conclusions reached,” which would include the economic substance doctrine and related anti-abuse doctrines).

¹⁹³*See* 31 C.F.R. § 10.34(d) (2011).

¹⁹⁴*See id.* § 10.33(a)(2) (2004) (pertaining to best practices in establishing the facts); *id.* § 10.37(a)(2)(ii)-(iii) (2014) (pertaining to all written advice); I.R.C. § 6664(d)(4)(B)(iii)(III) (2012) (pertaining to “disqualified opinions” in the context of reasonable reliance on the advice of a tax professional); Reg. § 1.6662-4(d)(2) (pertaining to analyzing and establishing substantial authority).

¹⁹⁵*See supra* note 120.

¹⁹⁶*See supra* note 121.

¹⁹⁷31 C.F.R. § 10.29(a)(2) (2014).

¹⁹⁸*Id.* § 10.29(b)(3) (2014).

judgment, poison the independence of advice, produce inaccurate and incorrect advice, fail to put the taxpayer-client in the best position to make informed decisions, and sabotage the taxpayer's ability to assert a successful defense to penalties based on reasonable reliance on an advisor's opinion. Indeed, the conflicts standard touches all the other standards of care governing tax practice examined in this Article, including due diligence, communication, and unconscionable and contingent fees.

Circular 230 prohibits a practitioner from representing "conflicting interests." The rules define this category broadly as direct adversity between two or more clients¹⁹⁹ or the existence of a significant risk that the representation of one or more clients "will be materially limited by the practitioner's responsibilities to another client, a former client or third person, or by a personal interest of the practitioner."²⁰⁰ The rules also permit the practitioner to overcome the existence of a conflict if she "reasonably believes" the conflict will not prevent her from providing "competent and diligent representation,"²⁰¹ if the representation is not otherwise prohibited by law,²⁰² and if each affected taxpayer-client gives informed consent confirmed in writing after full disclosure of the conflict and its potential implications.²⁰³ Importantly, the effect of the conjunctive requirements for overcoming conflicts renders irrelevant the practitioner's subjective reasonableness assessment (as to whether she can continue representing a client) without her client's informed and written consent.

These rules should sound familiar to lawyers. They mirror ABA Model Rule 1.7 pertaining to current and concurrent conflicts.²⁰⁴ As detailed in Part IV.C, the Treasury finalized changes in July 2002 to its longstanding²⁰⁵ conflicting interests standard contained in Circular 230, only a few months after the ABA finalized and adopted revisions to its own conflicts standard. The complementarity of the standards was purposeful, with the Treasury stating at the time that its rules had been "modified from the proposed regulations to

¹⁹⁹ *See id.* § 10.29(a)(1) (2014).

²⁰⁰ *Id.* § 10.29(a)(2) (2014).

²⁰¹ *Id.* § 10.29(b)(1) (2014).

²⁰² *See id.* § 10.29(b)(2) (2014).

²⁰³ *See id.* § 10.29(b)(3) (2014).

²⁰⁴ *See* MODEL RULES OF PROF'L CONDUCT R. 1.7(a), (b)(1), (b)(2), (b)(4) (2002).

²⁰⁵ The preceding standard had remained unaltered for decades and provided a broad prohibition forbidding practitioners from representing conflicting interests "except by express consent of all directly interested parties after full disclosure has been made." Practice Before the Internal Revenue Service, 31 Fed. Reg. 10,773, 10,776 (Aug. 13, 1966).

conform more closely with the approach of the recently revised Model Rule 1.7 of the ABA Rules of Professional Conduct.”²⁰⁶

Circular 230 reminds practitioners elsewhere throughout the rules of the dangers posed by conflicting interests. Section 10.22 pertaining to “reliance on others,” requires practitioners to “tak[e] proper account of the nature of the relationship between the practitioner and the person” when relying on the work product of another professional.²⁰⁷ For another example, section 10.37 permits practitioners to rely on the advice of another person unless the practitioner “knows or reasonably should know that the opinion of the other person should not be relied on.”²⁰⁸ Unreasonable reliance includes disqualifying conflicts of interests²⁰⁹ as well as a concern over the competence of the other practitioner,²¹⁰ that the opinion does not account for all relevant facts and circumstances,²¹¹ or that it relies on “incorrect, incomplete, or inconsistent” representations or assumptions (the origins of which might themselves involve a conflict).²¹²

Finally, the Treasury’s concern over conflicts is perhaps most clearly reflected in its longstanding campaign against marketed shelters (the history of which is described in Part IV.A). Experience has shown that practitioners who provide advice and opinions to promoters of marketed shelters often fail to establish legitimate attorney–client or practitioner–client relationships with taxpayer-investors. They get paid by the promoter rather than by the client (usually from a large, flat fee paid directly to the promoter that gets divided among the shelter professionals); they receive all facts and information pertaining to the transaction from the promoter rather than from the client (including purported business purpose, pretax profit potential, and investment motive); and they assume (and often write) the representations for taxpayer-investors without ever speaking to them. At the end of the day, these practitioners are pawns of the promoter, getting paid to endorse a shelter’s tax benefits rather than to provide independent advice on the federal tax issues implicated by the shelter.

Thus, to discourage practitioners from legitimizing marketed shelter products, Circular 230 holds them to a strict “reasonable practitioner standard”

²⁰⁶Regulations Governing Practice Before the Internal Revenue Service, 67 Fed. Reg. 48,760, 48,764 (July 26, 2002). The ABA’s Model Rules of Professional Conduct, much like Circular 230, reinforce a general aversion to conflicting interests in its other standards of care. *See, e.g.*, MODEL RULES OF PROF’L CONDUCT R. 2.1 (1983) (pertaining to lawyer as advisor and obliging the lawyer to “exercise independent professional judgment and render candid advice”). For the development of the complementary conflicts standards in the Model Rules and Circular 230, see *infra* Part IV.C.

²⁰⁷31 C.F.R. § 10.22(b) (2007).

²⁰⁸*Id.* § 10.37(b), (b)(1) (2014). This recently amended provision in 31 C.F.R. § 10.37 preserves the reliance standard as reflected in 31 C.F.R. § 10.35(d)(1) (2007).

²⁰⁹*See id.* § 10.37(b)(3) (2014).

²¹⁰*See id.* § 10.37(b)(2) (2014).

²¹¹*See id.* § 10.37(b) (2014).

²¹²*See id.* § 10.37(a)(3) (2014).

when they “know or have reason to know” that their opinions will be used “in promoting, marketing or recommending” shelter transactions.²¹³ The elevated standard of care in these situations reflects Treasury’s heightened concern over “the additional risk caused by the practitioner’s lack of knowledge of the taxpayer’s particular circumstances,” including the risk that these kind of opinions are more often tailored to sell prepackaged products rather than to provide independent, customized professional advice.²¹⁴ Similar concerns that conflicting interests taint the independence of a practitioner’s advice permeate the rules governing a taxpayer’s ability to reasonably rely on the advice of a tax professional in defending against penalties,²¹⁵ court opinions denouncing taxpayers’ reliance on advice from conflicted advisors as inherently unreasonable,²¹⁶ and the former covered opinion standards.²¹⁷

D. *The Standard for Unconscionable and Contingent Fees*

Like the standards governing conflicting interests, the practice rules pertaining to fees address concerns over misaligned incentives and allegiances. Unlike the conflicting interest rules, the standards for fees consider not just the behavior of tax practitioners but also of taxpayer-clients. Thus, the standard for unconscionable and contingent fees aims to minimize biases and inaccuracies in professional judgment, the fleecing of taxpayer-clients, exploitation of the audit lottery, and noncompliance with the tax law.

The Treasury’s regulations prohibit a practitioner from charging an “unconscionable” fee in connection with any federal tax matter.²¹⁸ While the Circular does not define “unconscionable,” the assumption has always been that the Treasury is concerned about situations where the size of a practitioner’s fee is disproportionate to the amount and quality of work performed for a

²¹³ *Id.* § 10.37(c)(1)-(2) (2014).

²¹⁴ *Id.* § 10.37(c)(2) (2014).

²¹⁵ See I.R.C. § 6664(d)(4)(B)(ii)(I)-(IV) (pertaining to “disqualified tax advisors,” defined as a practitioner who, among other things, “participates in the organization, management, promotion, or sale of the transaction,” is “compensated directly or indirectly by a material advisor with respect to the transaction,” “has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained,” or “has a disqualifying financial interest with respect to the transaction”); see also Reg. § 1.6664-4(f)(3) (pertaining to the effect of advice subject to conditions of confidentiality on a taxpayer’s ability to establish reasonable reliance on the advice of a tax professional).

²¹⁶ See *infra* note 254 and accompanying text.

²¹⁷ See, e.g., 31 C.F.R. § 10.35(b)(5) (2007) (pertaining to marketed opinions); *id.* § 10.35(b)(6) (2007) (pertaining to conditions of confidentiality that restrict a taxpayer-investor’s ability to seek tax advice independent of the conclusions reached in a covered opinion); *id.* § 10.35(b)(7) (2007) (pertaining to contractual protections in the event a shelter’s intended tax benefits are not fully achieved); *id.* § 10.35(e)(1)(i)-(ii) (2007) (pertaining to required disclosures due to arrangements between practitioners and promoters calling for referral fees and fee-sharing arrangements); *id.* § 10.35(e)(2) (2007) (requiring practitioners to prominently disclose that certain opinions form part of the marketing materials designed to sell transactions and that taxpayer-investors should seek independent professional advice as to the opinions’ conclusions).

²¹⁸ *Id.* § 10.27(a) (2014).

taxpayer-client. For example, charging 25 different clients \$100,000 each for a noncustomized legal opinion (that is, one not tailored to the unique circumstances of each individual client) pertaining to the merits of a structured transaction and on which the practitioner expended a grand total of 100 hours would be considered an “unconscionable” fee. Such a fee decouples the relationship between professional services and cost of services to such an attenuated extent that the fee bears almost no relation to the work performed. In the same manner, the ABA Model Rules forbid lawyers from charging or collecting an “unreasonable” fee,²¹⁹ with the primary reasonableness factor involving “the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly.”²²⁰

In addition to avoiding unconscionable fees, tax practitioners are restricted in their use of contingent fees. The government defines “contingent fee” as any fee based on whether or not a position reflected on a tax return or other filing “avoids challenge” by the Service or is ultimately sustained; a fee based on a percentage of taxes saved or refunds received; or fee arrangements where the practitioner must reimburse the taxpayer a portion of her fee in the event the Service challenges or fails to sustain a position or other filing.²²¹ Circular 230 generally bans practitioners from charging clients this category of fees for services rendered in connection with any federal tax matter.²²² Meanwhile, courts routinely criticize and invalidate tax positions in which tax professionals base fees on a percentage of promised tax benefits or on the success or

²¹⁹MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (1983).

²²⁰*Id.* R. 1.5(a)(1). To a certain extent, the Treasury's attention to the relationship between fees and work product can be viewed not just as a way to regulate tax practitioners but also taxpayers. For instance, the rules pertaining to professional opinions used to market tax shelters are designed to discourage the use of such opinions as well as to warn taxpayers of their risks and limitations. They also put taxpayers on notice that these opinions are on the government's radar and that if a taxpayer seeks and receives such an opinion, it is reasonable for the government to assume that she is merely paying for a get-out-of-jail-free card or an outsized tax benefit rather than an independent professional analysis of the pertinent federal tax issues. *See, e.g.*, 31 C.F.R. § 10.37(c)(2) (2014) (pertaining to opinions the practitioner knows or should know will be used to promote, market, or recommend tax shelters); 31 C.F.R. § 10.35(b) (4) (2007) (pertaining to reliance opinions); 31 C.F.R. § 10.35(b)(5) (2007) (pertaining to marketed opinions) (2007). In the same way, receiving a tax benefit that appears “too good to be true” under the circumstances,” say, by paying a fee totaling a fraction of tax savings, can be indicative of a taxpayer's negligence as can “failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return.” *See* Reg. § 1.6662-3(b)(1)(i)-(ii).

²²¹*See* § 10.27(c)(1) (2014).

²²²*See* § 10.27(b)(1) (2014).

failure of receiving such benefits.²²³ According to courts, when tax advisors have “a financial stake in the outcome”²²⁴ by “tying compensation to the sheltered gain,”²²⁵ the tax advisor is “not being paid to evaluate a deal or to tweak it”²²⁶ but “to make the transaction happen.”²²⁷

At the same time, the practice rules permit contingent fees in limited circumstances: for services related to original tax returns as well as to amended returns or timely filed claims for refund,²²⁸ a claim for credit or refund “solely in connection with the determination of statutory interest or penalties,”²²⁹ and any judicial proceeding involving the federal tax laws.²³⁰ In other words, the Treasury allows contingent fee arrangements for matters and submissions that have a high probability of being examined, while it restricts contingent fees for matters and submissions that are likely to avoid detection. For more than 20 years, and as discussed in Part IV.D, the Treasury has argued that contingent fees “undermine voluntary compliance by encouraging return positions that exploit the audit selection process”²³¹ and that encourage practitioners to render increasingly aggressive advice. Moreover, the contingency of the fee structure insulates taxpayer-clients from excessive risk; if the position goes undetected, they win the audit lottery, while if the position gets flagged, challenged, or disallowed, they either pay no fee or they get reimbursed

²²³ See, e.g., 106 *Ltd. v. Commissioner*, 684 F.3d 84, 87 (D.C. Cir. 2012) (criticizing lawyer who “guaranteed” the transaction, promising to pay litigation costs if the shelter were challenged and to refund his fee if the shelter were invalidated”); *Blum v. Commissioner*, 103 T.C.M. (CCH) 1099, 2012 T.C.M. (RIA) ¶ 12,016 at 7 (criticizing accounting firm for basing its fee structure “on the complexity of its role and the value of the services provided [which the court found to be promised tax savings], rather than time spent” or independent and professional advice); 106 *Ltd. v. Commissioner*, 136 T.C. 67, 81 (2011) (criticizing accounting firm for basing its fees not on the complexity of the tax returns it prepared but on the basis of “the firm’s cut for helping to make the deal happen,” and taking the lawyer to task for not advising his client on “a real business deal to increase its tax advantages” but instead “being paid to make it happen”); *Canal Corp. v. Commissioner*, 135 T.C. 199, 220-21 (2010) (criticizing practitioner for rendering an opinion on a transaction that “he helped plan without the normal give-and-take in negotiating terms with an outside party,” also criticizing accounting firm for charging exorbitant flat fee for opinion “payable and contingent on the closing of the joint venture transaction” such that the purportedly independent advice looked “more like a quid pro quo arrangement than a true tax advisory opinion,” and concluding that taxpayer “essentially bought an insurance policy as to the taxability of the transaction” and that the accounting firm “crossed over the line from trusted adviser for prior accounting purposes to advocate for a position with no authority that was based on an opinion with a high price tag”).

²²⁴ *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1382 (Fed. Cir. 2012).

²²⁵ *Id.*

²²⁶ *Rawls Trading L.P. v. Commissioner*, 104 T.C.M. (CCH) 732, 2012 T.C.M. (RIA) ¶ 12,340, at 33.

²²⁷ *Id.*

²²⁸ 31 C.F.R. § 10.27(b)(2)(i)-(ii) (2014).

²²⁹ *Id.* § 10.27(b)(3) (2014).

²³⁰ *Id.* § 10.27(b)(4) (2014).

²³¹ Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 57 Fed. Reg. 46,356-01 (proposed Oct. 8, 1992).

prepaid fees.²³² The Treasury prefers that practitioners and their taxpayer-clients report return positions based on the merits rather than on the probability of detection, a practice that increases compliance through accurate advice and accurate returns.²³³

E. The Taxpayer's Defense to Penalties: Where the Tax Advisor's Standard Becomes the Taxpayer's Standard

In much the same way that the taxpayer's ability to meet the substantial authority standard for return positions hinges on her tax advisor's analysis, her ability to defend against penalties can depend on the integrity and independence of her tax professional's advice. Because of this relationship, analyzing the section 6664 "reasonable cause and good faith" defense to accuracy-related penalties requires accounting for the behavior of the taxpayer's advisor and, in particular, whether the advisor met or fell below the standard of care respecting diligence, communication, avoiding and overcoming conflicts, and eschewing unconscionable and contingent fees.

To be sure, part of determining whether the taxpayer deserves penalty abatement under section 6664 involves examining the *taxpayer's* behavior. The statute requires the taxpayer to possess reasonable cause for the underpayment of tax and that she acted in good faith.²³⁴ The analysis evaluates the "extent of the taxpayer's effort to assess [her] proper tax liability,"²³⁵ an inquiry that includes determining whether the taxpayer withheld relevant information from her tax advisor or provided false or misleading information,²³⁶ as well as whether she knew or should have known that her advisor "lacked knowledge in the relevant aspects of Federal tax law."²³⁷ In assessing whether the taxpayer's reliance on the advice of a tax professional was reasonable, the analysis accounts for the taxpayer's "education, sophistication, and business

²³² *Id.*

²³³ Both Circular 230 and the Code discourage exploitation of the audit lottery in additional ways. *See supra* notes 125-126 and accompanying text (discussing the prohibition on practitioners with respect to accounting for the audit lottery when evaluating the chances of success on the merits of a transaction or a reporting position).

²³⁴ *See* I.R.C. § 6664(c)(1); Reg. § 1.6664-4(a).

²³⁵ Reg. § 1.6664-4(b)(1).

²³⁶ Reg. § 1.6664-4(c)(1)(i) (querying whether "the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item," including "an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner").

²³⁷ Reg. § 1.6664-4(c)(1).

experience,”²³⁸ with more sophisticated taxpayers being held to a higher standard in assessing their proper tax liability than less sophisticated taxpayers.²³⁹

If the taxpayer meets these minimum thresholds of due care—that is, not actively concealing information, providing false information, or knowingly engaging an incompetent tax advisor—the reasonable cause and good faith inquiry shifts focus from the taxpayer to the tax advisor.²⁴⁰ Indeed, as courts have long recognized, “the concept of reliance on the advice of professionals is a hallmark of the exception for reasonable cause and good faith.”²⁴¹ The practitioner’s advice—which “does not have to be in any particular form” and can be oral or written²⁴²—must itself be reasonable, with the reasonableness inquiry turning on whether the practitioner met her professional standard

²³⁸ Reg. § 1.6664-4(c)(1).

²³⁹ See, e.g., *Crispin v. Commissioner*, 708 F.3d 507, 518-20 (3d Cir. 2013), *cert. denied*, 134 S. Ct. 784 (2013) (in denying reasonable cause and good faith defense to penalties, stating taxpayer’s “experience, knowledge, and education” as a former CPA and chief financial officer also strongly suggest enough familiarity with tax matters that he should be expected to have understood the warnings” in his law firm’s legal opinion); *Fidelity Int’l Currency Advisor A Fund LLC v. United States*, 747 F. Supp. 2d. 49, 213 (D. Mass. 2010) (in denying reasonable cause and good faith defense to penalties, finding taxpayers “highly sophisticated . . . with considerable business experience” and that they “knew or reasonably should have known that the legal advice they received . . . was not independent, and that the firms had an inherent conflict of interest”); *Longino v. Commissioner*, 105 T.C.M. (CCH) 1491, 1507, 2013 T.C.M. (RIA) ¶ 2013-80, at 69 (in denying reasonable cause/good faith defense to penalties, finding taxpayer “is a licensed attorney who has been practicing law for decades, yet he failed to comply with established law governing the deduction and substantiation of business and other expenses”); *Cherame v. Commissioner*, T.C. Summary Opinion 2013-92 at *19 (2013) (in granting reasonable cause/good faith defense to penalties, finding “[i]t is clear from the record that petitioner is very inexperienced in legal, financial, accounting, and tax matters”); *Garcia v. Commissioner*, T.C. Summary Opinion 2013-28 at *19 (2013) (in granting reasonable cause/good faith defense to penalties, holding that taxpayer, “whose command of the English language is limited, made a good-faith effort to properly determine his 2008 Federal income tax liability and that the underpayment results from reliance on the advice of a return preparer, combined with an honest misunderstanding of fact or law that is reasonable in the light of his experience and knowledge”).

²⁴⁰ See Reg. § 1.6664-4(c) (pertaining to “reliance on opinion or advice”); I.R.C. § 6664(d) (4)(B)(ii) (pertaining to reasonable belief standard and “disqualified advisors” in the context of avoiding penalties with respect to tax shelters and reportable transactions).

²⁴¹ *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636, 717 (2008); see also *United States v. Boyle*, 469 U.S. 241, 251 (1985) (“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.”).

²⁴² Reg. § 1.6664-4(c)(2).

of care in rendering the advice.²⁴³ In fact, section 6664 explicitly cross-references “rules applicable to advisors” and flags a handful of standards for special scrutiny, including Circular 230 sections 10.22 (pertaining to diligence as to accuracy) and 10.34 (pertaining to advising return positions and preparing or signing returns) as well as Treasury Regulations sections 1.6694-1 through 1.6694-3 (pertaining to penalties for tax return preparers).²⁴⁴ It further reflects these standards in its own affirmative requirements, stating that advice must be based on “all pertinent facts and circumstances and the law as it relates to those facts and circumstances” (which invokes an advisor’s due diligence obligations),²⁴⁵ and furthermore, that the advice may not be based on “unreasonable factual or legal assumptions” or “unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person” (which invokes duties of due diligence as well as communication).²⁴⁶

Even when the section 6664 analysis seems to be concentrating on the taxpayer’s behavior, it effectively focuses on the tax advisor’s behavior. In this way, section 6664 has made the tax practitioner’s standard of care the taxpayer’s standard of care in overcoming penalties. If the practitioner fails to meet her own standard of care, so too does her taxpayer-client.

Consider three examples. First, a taxpayer cannot establish reasonable reliance on a tax professional if (absent adequate disclosure of the position) she relied on an advisor’s opinion or advice that a tax regulation was invalid.²⁴⁷ But taxpayers—even sophisticated ones—generally only know what their tax professionals tell them; most have never read a tax regulation, let alone one on which they formed an independent, negative opinion as to its validity.

²⁴³ See Reg. § 1.6664-4(b)(1) (stating that reliance on the advice of a professional tax advisor “does not necessarily demonstrate reasonable cause and good faith,” but such reliance may “constitute[] reasonable cause and good faith if, under all the circumstances,” it was “reasonable and the taxpayer acted in good faith”); see also *Fidelity*, 747 F. Supp. 2d at 243 (stating that a taxpayer’s reasonable reliance on professional advice “requires that the advice itself be reasonable”); *Stobie Creek*, 82 Fed. Cl. at 717 (finding that reliance on the advice of a tax professional “does not necessarily demonstrate reasonable cause and good faith” [citing to Reg. § 1.6664-4(b)(1)]). The reliance on professional advice must, under all circumstances, be reasonable.”) (quoting Reg. § 1.6664-4(b)(1)) (citation omitted).

²⁴⁴ See Reg. § 1.6664-4(c)(3).

²⁴⁵ Reg. § 1.6664-4(c)(1)(i) (and, furthermore, giving the example of the “taxpayer’s purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner”). Many of these same requirements appeared in the due diligence standards discussed in *supra* Part III.A.

²⁴⁶ Reg. § 1.6664-4(c)(1)(ii) (also giving the example of the “taxpayer’s purposes for entering into a transaction or for structuring a transaction in a particular manner”). Many of these same requirements appeared in the due diligence and communication standards discussed in *supra* Part III.A. and Part III.B. Taxpayers must meet an elevated standard of care when attempting to establish a reasonable cause and good faith defense to penalties in the context of tax shelters and reportable transactions. See I.R.C. § 6664(d) (pertaining to reasonable cause exception for reportable transaction understatements); Reg. § 1.6664-4(d) (pertaining to underpayments attributable to reportable transactions); Reg. § 1.6664-4(f) (pertaining to understatements attributable to tax shelter items of corporations).

²⁴⁷ See Reg. § 1.6664-4(c)(1)(iii).

Moreover, the kind of advisor that would base her advice on the invalidity of a regulation—a practice that is generally prohibited under the Code²⁴⁸—would likely be reluctant to share that deficient and prohibited analysis with her taxpayer-client. To be sure, taxpayers cannot ignore obvious signs that their advisors are playing loose with the rules,²⁴⁹ and in fact, they are themselves subject to penalty for “negligence and disregard of rules and regulations.”²⁵⁰ But as thoughtful and ethical tax advisors have long believed, taxpayer-clients are more often than not “honest innocents” such that the tax professional “bears a heavy responsibility” because “his standards may become the guiding standards for his client.”²⁵¹

Second, a taxpayer cannot show reasonable reliance on advice if she knows or has reason to know that she is entering into a transaction primarily for tax avoidance purposes; or that the transaction lacks sufficient economic substance; or that the transaction has no pretax profit potential; or that she

²⁴⁸See I.R.C. § 6694(b)(2) (subjecting practitioners to penalty for any willful attempt to understate a client's tax liability or to engage in a “reckless or intentional disregard of rules or regulations”); Reg. § 1.6694-3(c)(1) (stating that a practitioner recklessly or intentionally disregards a rule or regulation when advising a return position or a claim for refund “that is contrary to a rule or regulation,” and the practitioner “knows of, or is reckless in not knowing of, the rule or regulation in question”). But see Reg. § 1.6694-3(c)(2) (excepting from the general rule positions for which the practitioner possesses a reasonable basis for succeeding on the merits and adequately discloses).

²⁴⁹The best example in recent years of tax advisor misconduct—and of courts uncovering and describing the malfeasance—involved lawyers and accountants peddling marketed shelters. See, e.g., *Fidelity Int'l Currency Advisor A Fund LLC v. United States*, 747 F. Supp 2d, 49, 213-14, 242-43 (D. Mass. 2010) (blasting lawyers R.J. Ruble of Sidley Austin and Ira Akselrad of Proskauer for, among other things, providing no independent legal advice, ignoring and flaunting conflicts of interest, providing legal advice to tax shelter promoters and to taxpayer-investors at the same time, “assist[ing] in the design, development, marketing and implementation of the tax shelter strategy and its variants,” and “agree[ing] in advance to provide favorable legal opinions in order to induce taxpayer-investors to utilize the strategy”).

²⁵⁰I.R.C. § 6662(b)(1); see also Reg. § 1.6662-3(b)(1) (defining “negligence” in this context as “any failure to make a reasonable attempt to comply” with the tax law “or to exercise ordinary and reasonable care in the preparation of a tax return”); Reg. § 1.6662-3(b)(1)(ii) (providing an example of “negligence” as receiving a tax benefit that appears “too good to be true” under the circumstances”); *Neonatology Associates, P.A. v. Commissioner*, 299 F.3d 221, 234 (3d Cir. 2002) (finding that when a taxpayer “is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril”); *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636, 713-14 (2008); *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11, 56 (2007).

²⁵¹Norris Darrell, *The Tax Practitioner's Duty to His Client and His Government*, 7 PRAC. LAW. 23, 25 (1961); see also George Cooper, *The Avoidance: A Tale of Tax Planning, Tax Ethics, and Tax Reform*, 80 COLUM. L. REV. 1553, 1584 (1980) (maintaining that tax advisors “have great power to encourage or to discourage transactions”); Jerome R. Hellerstein, *Ethical Problems in Office Counseling*, Transcript of the TAX LAW REVIEW's Annual Banquet, 8 TAX L. REV. 1, 9 (1952) (stating that the tax advisor's “task is to use our skill and experience and the great confidence which our clients repose in us—our advice, our writing, our teaching—to improve the tax morality of the community”); cf. Randolph E. Paul, *The Lawyer as a Tax Adviser*, 25 ROCKY MTN. L. REV. 412, 417 (1953) (stating that it is not the tax advisor's “function to improve men's hearts”).

signed off on false or misleading representations.²⁵² Tax advisors are already prohibited from rendering such advice, however, or encouraging such behavior.²⁵³ Thus, an advisor who counsels positions or transactions suffering from these deficiencies is proffering faulty advice and leading her client down a road of unnecessary risk and liability.

Third, a taxpayer cannot establish reasonable reliance on professional advice if she knows or has reason to know that her tax advisor has a conflict of interest and thus cannot provide independent advice.²⁵⁴ Exemplary disqualifying conflicts include advice from an advisor who participates in the planning, promotion, or sale of a tax avoidance transaction;²⁵⁵ advisors receiving compensation from the planners or promoters of such a transaction rather than directly from the taxpayer-client;²⁵⁶ advisors whose compensation is contingent upon the

²⁵² See Reg. §§ 1.6664-4(c)(1)(i)-(ii).

²⁵³ For entering into a transaction primarily for tax avoidance purposes, see, e.g., I.R.C. § 6694(a)(2)(C) (pertaining to penalties for advising reportable transactions, defined in section 6707A(c)(1) as any transaction that must be described on a return or statement because the Treasury has flagged it “as having a potential for tax avoidance or evasion”); Reg. § 1.6694-1(a)(1) (same); Reg. §§ 1.6694-2(a)(1)(i)-(iii) (same); Reg. § 1.6694-2(d) (pertaining to exception for adequate disclosure of positions with a reasonable basis); Reg. § 1.6694-3(c) (pertaining to “reckless or intentional disregard” of a rule or regulation). For entering into a transaction lacking sufficient economic substance, see *supra* notes 173 and 192 and accompanying text; I.R.C. § 6662(b)(6) (pertaining to underpayment penalties “by reason of a transaction lacking economic substance”); I.R.C. § 7701(o) (pertaining to the codification of the economic substance doctrine); I.R.C. § 6664(c)(2), (d)(2) (prohibiting reasonable cause and good faith defense to penalties in the context of underpayments attributable to noneconomic substance transactions). For transactions without pretax profit potential, see *supra* note 122 and accompanying text. For signing off on false or misleading representations, see *supra* notes 120-121 and 129 and accompanying text.

²⁵⁴ See I.R.C. § 6664(d)(4)(B)(ii) (listing the characteristics of “disqualified advisors” in the context of reportable transactions, all of which involve conflicts of interests); see also *Fidelity Int'l*, 747 F. Supp. at 243 (stating that professional advice “may not be objectively reasonable where the taxpayers knew or reasonably should have known that the professional had a conflict of interest”); *Am. Boat Co. v. United States*, 583 F.3d 471, 482 (7th Cir. 2009) (noting that “[w]hat exactly constitutes an ‘inherent’ conflict of interest is somewhat undefined, but when an adviser 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 adviser may provide”); *Neonatology*, 299 F.3d at 234 (finding that a taxpayer’s “reliance itself must be objectively reasonable in the sense that . . . the professional himself does not suffer from a conflict of interest or lack of expertise that the taxpayer knew of or should have known about”); *Chamberlain v. Commissioner*, 66 F.3d 729, 732 (5th Cir. 1995) (“The reliance must be objectively reasonable; taxpayers may not rely on someone with an inherent conflict of interest.”); *Pasternak v. Commissioner*, 990 F.2d 893, 903 (6th Cir. 1993) (finding that “the purported experts were either the promoters themselves or agents of the promoters. Advice of such persons can hardly be described as that of ‘independent professionals’”); *Illes v. Commissioner*, 982 F.2d 164, 166 (6th Cir. 1992) (no reasonable reliance where accountant was “not a disinterested source” but rather a promoter of the shelter at issue).

²⁵⁵ See § 6664(d)(4)(B)(ii)(I).

²⁵⁶ See § 6664(d)(4)(B)(ii)(II).

taxpayer receiving some or all of intended tax benefits;²⁵⁷ and advisors with any other disqualifying financial interest in the transaction,²⁵⁸ such as getting compensated based on how many opinions they churn out rather than on the quality and independence of their advice. While these disqualifying conflicts pertain specifically to the reasonable cause and good faith defense to penalties in the context of “reportable transactions,”²⁵⁹ practitioners are also obliged to avoid similar conflicts and misaligned incentives when advising transactions ranging from plain vanilla to aggressive. As discussed above, Circular 230 prohibits all “conflicting interests”²⁶⁰ (including the personal interests of the practitioner),²⁶¹ it bans “unconscionable” and “contingent” fees,²⁶² and it expects disclosure of certain financial relationships between practitioners and promoters, including referral fees and fee-sharing arrangements.²⁶³

IV. Forging Accurate Advice and Accurate Returns: Five Key Developments

The importance placed on accurate, independent advice in the standard of care for tax advisors is nothing new. Indeed, it has been developing over the course of the last four decades. Beginning in the late 1970s, the Treasury and Congress explicitly connected inaccurate advice, marketed tax shelters, the audit lottery, noncompliance, and declining revenues with slumping ethical behavior among tax advisors. To address the perceived epidemic in deteriorating professional judgment, the government significantly elevated the standard of care for tax professionals with new rules and regulations as well as enhanced penalties for violating those rules. Tax advisors initially recoiled at being turned into pseudo-government regulators. But rather quickly, tax professionals, led by members of the ABA and the AICPA, contributed constructively to the discussion over regulating tax professionals nationwide with an integrated, affirmative, and disciplinary standard of care that emphasized accurate advice and accurate returns.

In this Part, we discuss the development of a more stringent and disciplinary standard of care through the lens of five key developments involving (1) due diligence as to marketed tax shelters, (2) communicating with clients as to penalties, judicial anti-abuse doctrines, covered opinions, and informed written consent to conflicts, (3) avoiding and overcoming conflicts

²⁵⁷ See § 6664(d)(4)(B)(ii)(III).

²⁵⁸ See § 6664(d)(4)(B)(ii)(IV).

²⁵⁹ See I.R.C. § 6707A(c)(1) (defining reportable transactions as those that must be described on a return or statement because the Treasury has flagged them “as having a potential for tax avoidance or evasion”).

²⁶⁰ See 31 C.F.R. § 10.29 (2014); *supra* notes 199-203 and accompanying text.

²⁶¹ See 31 C.F.R. § 10.29(a)(2) (2014); *see also* MODEL RULES OF PROF’L CONDUCT R. 1.7(a)(2) (same pertaining to lawyers).

²⁶² See 31 C.F.R. § 10.27 (2014); *supra* notes 218, 221-222, 228-230 and accompanying text; *see also* MODEL RULES OF PROF’L CONDUCT R. 1.5 (prohibiting lawyers from charging “unreasonable” fees); *supra* notes 219-220 and accompanying text.

²⁶³ See 31 C.F.R. § 10.35(e)(1)(i)-(ii) (2007).

of interest, (4) abstaining from contingent fees, and (5) due diligence as to advising return positions.

A. *Accuracy Through Due Diligence: Advising Marketed Tax Shelters*

In the early 1980s, the Treasury faced a tax shelter problem of “major proportions.”²⁶⁴ Mass-marketed shelters shunted billions of tax dollars from the public fisc²⁶⁵ and overwhelmed the court system.²⁶⁶ The “widespread nature” of tax shelters, moreover, “undermine[d] the public’s confidence in the fairness of the tax system” and adversely “affect[ed] the level of voluntary compliance.”²⁶⁷

Tax professionals were largely to blame for the shelter onslaught, at least according to the government. To be sure, taxpayers expressed insatiable appetites for tax avoidance. But tax advisors, particularly tax lawyers, whetted the craving through written opinions that accompanied the offering materials to mass-marketed shelters.²⁶⁸ In this way, tax lawyers effectively “control[led] access to the market place.”²⁶⁹ Their opinions legitimized aggressive reporting positions, provided penalty protection for shelter investors,²⁷⁰ and issued “a free ticket to the audit lottery.”²⁷¹

²⁶⁴Jerome Kurtz, *Kurtz on “Abusive Tax Shelters”*, 10 TAX NOTES (TA) 213, 213 (Feb. 18, 1980).

²⁶⁵Tax Shelters; Practice Before the Internal Revenue Service, 45 Fed. Reg. 58,594, 58,596 (Sept. 4, 1980) (reporting revenue lost to shelters “in recent years” exceeding \$5 billion).

²⁶⁶See Kurtz, *supra* note 264, at 213 (noting that nearly 200,000 individual returns representing 18,000 shelter schemes with “questionable deductions” clogged “various stages of the IRS examination and appeals process”); New York State Bar Association (NYSBA) Tax Section, *Managing the Tax Court Docket*, 85 TAX NOTES TODAY 146-93 (July 24, 1985) (finding that between 1980 and 1982, tax shelter cases in the U.S. Tax Court tripled in number from 5,000 to more than 15,000, representing one-third of the entire docket).

²⁶⁷Robert H. Mundheim, *Mundheim on “Abusive Tax Shelters”*, 10 TAX NOTES (TA) 213, 213 (Feb. 18, 1980); see also Kurtz, *supra* note 264, at 213 (“The great abuse we are finding in this area could result in a serious decline in taxpayers’ perception of the fairness and evenhandedness of our administration of the tax system and consequently in the level of voluntary compliance.”); James B. Lewis, *The Treasury’s Latest Attack on Tax Shelters*, 11 TAX NOTES (TA) 723, 723 (Oct. 13, 1980) (stating that shelters could cause “impairment to the fairness of the income tax, the perception of unfairness by the rest of the taxpaying public, and the feared adverse impact on the level and temper of voluntary compliance”).

²⁶⁸See Jerome Kurtz, *Professional Opinions as “Tickets to the Audit Lottery”*, 12 TAX NOTES (TA) 262, 262 (Feb. 9, 1981) (stating that “the product actually being marketed . . . is the lawyers’ or accountants’ opinion”).

²⁶⁹Mundheim, *supra* note 267, at 214; see also Kurtz, *supra* note 264, at 213 (stating that “abusive tax shelters depend for their successful marketing on the participation of professional tax advisors”).

²⁷⁰See, e.g., Laurence Goldfein & Stanley Weiss, *An Analysis of the Proposed Changes Under Circular 230 Affecting Tax Shelter Opinions*, 53 J. TAX’N 340, 345 (1980) (quoting Mundheim as saying, “At a minimum, the tax opinion is viewed as fraud insurance” where “the investor is protected against loss” and fraud penalties).

²⁷¹Kurtz, *supra* note 268, at 262.

Given their power to induce taxpayers to participate in abusive shelters, tax advisors owed “a particular responsibility to the Treasury.”²⁷² Their “privileged position”²⁷³ as federal tax practitioners and experts in tax law created public-minded obligations extending beyond “unalloyed avoidance-seeking.”²⁷⁴ In defining ethical conduct broadly, the government invoked a longstanding ethos among tax professionals that observed concurrent duties. While the tax practitioner’s primary duty ran to her client, she shouldered additional obligations to her professionalism,²⁷⁵ to other taxpayers,²⁷⁶ to her role as citizen,²⁷⁷ to her government,²⁷⁸ and to the tax system that supported her practice.²⁷⁹

The Treasury set about reminding tax practitioners of their multiple professional obligations and their role in promoting compliance. In late 1980, it issued proposed amendments to Circular 230 that imposed new duties on practitioners rendering opinions on tax shelter offerings. “A critical element in the typical promotion of an abusive tax shelter,” said the Treasury, “is the tax opinion generally provided by the promoter’s attorney” or other tax practitioner.²⁸⁰ Shelter promoters, the government surmised, viewed the opinion—even a qualified, negative, or incorrect opinion—as penalty insurance for investors in the event the shelter’s tax benefits were disallowed.²⁸¹ Meanwhile, investors viewed the opinion—again, even false or unfavorable opinions—as a tax professional’s endorsement of the shelter.²⁸² The Treasury identified four especially troublesome categories of opinions: (1) the intentionally false or incompetent opinion; (2) the opinion that relied on factual representations of the promoter, including representations that were

²⁷² *Id.*

²⁷³ Mundheim, *supra* note 267, at 214.

²⁷⁴ Cooper, *supra* note 251, at 158.

²⁷⁵ See Cooper, *supra* note 251, at 158 (concluding that at some point, “the tax lawyer had to stop being a tax advisor and become a professional”).

²⁷⁶ Henry Sellin, *Professional Responsibility of the Tax Practitioner*, 52 TAXES 584, 608 (1974) (stating that “a tax matter is not simply a matter between taxpayer and Treasury but between taxpayer and the Treasury and other taxpayers”).

²⁷⁷ See, e.g., Randolph E. Paul, *The Responsibilities of the Tax Adviser*, 63 HARV. L. REV. 378, 386 (1950) (calling the tax lawyer “a citizen as well as a tax adviser”) (emphasis in the original).

²⁷⁸ See, e.g., Darrell, *supra* note 251, at 25 (observing “multiple responsibilities” for the tax lawyer, including those to “his Government”).

²⁷⁹ Cooper, *supra* note 251, at 1578 (arguing that tax lawyers owed “at least a measure of allegiance to the fisc”); David E. Watts, *Professional Standards in Tax Practice: Conflicts of Interest, Disclosure Problems Under Regulatory Agency Rules, Potential Liabilities*, 33 NYU. INST. FED. TAX’N 649, 649 (1975) (stating tax lawyers “play an essential role in promoting informed tax reporting, in building mutual confidence between taxpayers and the Service, and in correspondingly reducing the burden on the Service’s audit system”); Darrell, *supra* note 251, at 25 (highlighting a duty “to help make our self-assessing income tax system work”).

²⁸⁰ Tax Shelters; Practice Before the Internal Revenue Service, 45 Fed. Reg. 58,595, 58,595 (Sept. 4, 1980). The Treasury noted that while its announcement discussed “attorneys’ opinions,” its “analysis would apply to opinions rendered by certified public accountants and others entitled to practice before the Service. The rule covers all such practitioners.” *Id.* at 58,595 n.2.

²⁸¹ *Id.*

²⁸² *Id.*

questionable given other facts and circumstances of the shelter; (3) the opinion that never offered a conclusion on the material tax aspects of the shelter or that relied on hypothetical facts rather than on actual facts; and (4) the “reasonable basis” opinion that failed to state the low likelihood of prevailing on the merits (typically between ten to 20% certainty)²⁸³ if the transaction was identified, challenged, and litigated by the Service.²⁸⁴

The opinions that propped up abusive tax avoidance shared a common characteristic: insufficient due diligence. Lack of due care, the Treasury maintained, led to inaccurate advice and, ultimately, to inaccurate return positions.²⁸⁵ The 1980 proposed amendments to Circular 230 raised diligence standards by requiring practitioners to exercise elevated levels of care in determining the accuracy of the facts on which their opinions were based,²⁸⁶ to use due diligence in ensuring that each material tax issue was addressed sufficiently in opinions,²⁸⁷ and to further ensure that offering materials for shelter investments “accurately and clearly” described the practitioner’s opinion and its conclusions as to the tax aspects of the transaction.²⁸⁸

The Treasury’s emphasis on due diligence, accurate facts, and accurate advice also informed its proposed rule permitting practitioners to provide an opinion on shelter offerings only if the opinion concluded that the tax benefits were “more likely than not” allowable.²⁸⁹ The Treasury acknowledged that this level of certainty (*i.e.*, more than 50% likelihood of success) “constitutes a significant step in the regulation of tax practitioners.”²⁹⁰ It required considerably more than “present professional practice standards,”²⁹¹ which permitted practitioners to advise clients on tax benefits so long as they believed in good faith that there was a “reasonable basis” (again, between ten to 20% likelihood of success) to support the claim.²⁹²

The elevated “more likely than not” standard was necessary in the tax shelter area to protect a trio of constituencies: (1) “careful” and ethical practitioners

²⁸³Reasonable basis opinions had long been the industry standard and were explicitly endorsed in ABA Formal Opinion 314, which governed the standard of care for tax lawyers advising clients on tax return positions. See ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 314; see also Dennis J. Ventry, Jr., *Reasonable Basis and Ethical Standards Before 1980*, 111 TAX NOTES (TA) 1047 (May 29, 2006).

²⁸⁴Tax Shelters; 45 Fed. Reg. at 58,595.

²⁸⁵*Id.*

²⁸⁶See *id.* The Treasury was careful to describe what it meant by diligence as to facts: “What constitutes ‘due diligence’ in assuring the *accuracy* of facts depends on the circumstances. Due diligence ordinarily includes the duty to examine any offering materials and to be satisfied that the facts upon which the opinion is based are *accurate and complete*. ‘Due diligence’ requires the practitioner to be alert to inconsistencies or implausibilities in the facts as presented to him or her and to resolve any doubts before rendering an opinion” (emphasis added).

²⁸⁷See *id.* at 58,596.

²⁸⁸See *id.*

²⁸⁹See *id.*

²⁹⁰*Id.* at 58,597.

²⁹¹*Id.* (citing to ABA Formal Opinion 314).

²⁹²*Id.* at 58,587.

who might lose clients to unethical advisors willing to render sloppy opinions on abusive transactions,²⁹³ (2) third-party shelter investors with whom practitioners had not established practitioner-client relationships,²⁹⁴ and (3) the public fisc.²⁹⁵ To further protect ethical practitioners, third parties, and tax revenues, the Treasury expanded “disreputable conduct” under Circular 230 (conduct that was punishable by suspension or disbarment)²⁹⁶ to include “a pattern of providing incompetent opinions on questions arising under the Federal tax laws.”²⁹⁷ It also explicitly made violation of Circular 230’s due diligence provisions (sections 10.22 and 10.33) punishable by suspension or disbarment,²⁹⁸ which, in conjunction with changes to the disreputable conduct standard, effectively eliminated the requirement of willfulness before a practitioner could be disciplined.²⁹⁹

Practitioners attacked the proposed amendments from every angle. They appreciated Treasury’s effort to combat abusive shelters,³⁰⁰ and they further recognized the importance of a practitioner’s opinion in inducing taxpayer-investors to participate in aggressive transactions.³⁰¹ But they opposed everything else. First, rather than combating tax shelters with more stringent practice rules for tax advisors, practitioners argued that the government should concentrate its scarce resources on an aggressive audit campaign focused on areas of the tax law that were producing the most shelter activity.³⁰² Second, instead of going after practitioners for advising on shelter transactions, the government should raise penalties on taxpayer-investors for purchasing questionable deals.³⁰³ Third, the Treasury’s proposed definition of “tax shelter” was too broad (capturing plain-vanilla and Congressionally-authorized tax minimization) as well as too subjective (requiring practitioners to glean investors’

²⁹³ *Id.* at 58,595 (noting that sloppy opinions propped up abusive shelters and “put significant and unhealthy pressure on the careful practitioner”).

²⁹⁴ *Id.* at 58,597 (stating that tax practitioners “have greater responsibility when their opinions are used to help merchandise an investment proposal to persons who are not their clients”).

²⁹⁵ *Id.* (stating that Treasury was “concerned about the possible defrauding of the Government. In many tax shelter promotions the true victim is the Treasury”).

²⁹⁶ *Id.*

²⁹⁷ *See id.* at 58,598; 31 C.F.R. § 10.51(j) (2014).

²⁹⁸ *See id.* at 58,598; 31 C.F.R. § 10.52 (2014). Existing section 10.22 pertained to “[d]iligence as to accuracy” for nontax shelter advice, while proposed section 10.33 pertained to “[t]ax shelter opinions.”

²⁹⁹ *See id.* at 58,597.

³⁰⁰ *See, e.g.,* American Bar Association (ABA) Section of Taxation, *Statement on Proposed Rule Amendment Circular 230 with Respect to Tax Shelter Opinions*, 34 TAX LAW. 745, 746 (1981) (the Tax Section’s article formed the basis of its testimony at Treasury hearings in November 1980); New York State Bar Association (NYSBA) Tax Section, *Circular 230 and the Standards Applicable to Tax Shelter Opinions*, 12 TAX NOTES (TA) 251, 252 (Feb. 9, 1981); Paul J. Sax, *Lawyer Responsibility in Tax Shelter Opinions*, 34 TAX LAW. 5 (1980–1981).

³⁰¹ NYSBA, *supra* note 300, at 253.

³⁰² ABA, *supra* note 300, at 747 (these areas of the law included partnerships, straddles involving commodity and Treasury bills, and the valuation of donated property).

³⁰³ *Id.*

“principal reason” for participating in shelters).³⁰⁴ Fourth, the new due diligence requirements were simply too onerous, obligating practitioners to audit both clients and promoters respecting the underlying facts and assumptions of shelter transactions, to opine on every “important Federal tax aspect” of the deal, and to refrain from issuing an opinion if the “bulk of the tax benefits” (which the Treasury defined as “substantially more than 51%”)³⁰⁵ did not exceed “more likely than not” certainty.³⁰⁶

Practitioners reserved their loudest opposition for Treasury’s intrusion on the autonomy of self-regulation. Ethical rules and practice standards, the ABA Section of Taxation argued, “should rest with those professional associations whose members engage in that practice.”³⁰⁷ The New York State Bar Association agreed, maintaining that existing ethical guidelines promulgated by practitioner groups could sufficiently regulate and discipline practitioner behavior.³⁰⁸ Meanwhile, administrative agency regulation suffered from “inherent conflicts of interest,” with the agency acting as “prosecutor and judge” in disciplinary actions.³⁰⁹ In so doing, Treasury’s proposed amendments to the standard of care for tax advisors reflected “a major change in the relationship between the government and practitioners.”³¹⁰ Moreover, practitioners criticized the practice rules for regulating what kind of opinions they could and could not write, including longstanding industry standards such as the “no conclusions” opinion (which took no position on the merits of a transaction), the limited scope opinion (which opined only on parts of a transaction), and the negative opinion (which concluded that a

³⁰⁴ See, e.g., *id.* at 747; Thomas Volet, *Circular 230 and the Definition of a Tax Shelter*, 12 TAX NOTES (TA) 949 (Apr. 27, 1981); *Practitioners Attack Limits on Tax Shelter Opinions*, 11 TAX NOTES (TA) 1143 (Dec. 8, 1980).

³⁰⁵ Tax Shelters; Practice Before the Internal Revenue Service, 45 Fed. Reg. 58,595, 58,596 (Sept. 4, 1980).

³⁰⁶ See, e.g., ABA, *supra* note 300, at 752 (requirement would produce “unnecessarily long and complex” opinions that, in turn, would be “unduly expensive for the promoter, and ultimately for the investor”); Gerald J. Robinson, *Attacking Tax Shelters: IRS in Blunderland?* 12 TAX NOTES (TA) 646 (Mar. 23, 1981) (arguing that under the new diligence standard practitioners would be “explaining and analyzing every tax feature in excruciating, mind-numbing detail”); NYSBA, *supra* note 300, at 260-61; Goldfein & Weiss, *supra* note 270, at 342.

³⁰⁷ ABA, *supra* note 300, at 747; *Practitioners Attack Limits on Tax Shelter Opinions*, *supra* note 304, at 1143; William L. Taylor, Jr., *Attorney Defends Profession Against Proposed Amendments to Rules on Tax Shelter Opinions*, 11 TAX NOTES (TA) 743 (Oct. 13, 1980).

³⁰⁸ See NYSBA, *supra* note 300, at 261 (arguing that existing ethical rules provided sufficient “guidance for the formulation of standards of practice pertinent to tax shelter opinions, which, though subject to special circumstances, are not unique in the practice of law”).

³⁰⁹ *Id.*; Goldfein & Weiss, *supra* note 270, at 342, 345 (arguing that “the final arbiter of a proceeding brought by the Treasury will be the Treasury itself”); see also Sax, *supra* note 300, at 44 (warning that “administrative agency regulation of those that practice before it should be approached with caution” and that agencies typically possessed “no special expertise in adjudicating disciplinary matters, and due process standards tend to be less strictly enforced”); Goldfein & Weiss, *supra* note 270, at 345 (arguing that “the final arbiter of a proceeding brought by the Treasury will be the Treasury itself”).

³¹⁰ NYSBA, *supra* note 300, at 261.

deal was impermissible).³¹¹ Finally, and vociferously, practitioners warned that Treasury's incursion into the daily practice of tax professionals endangered the attorney-client relationship by creating "a chilling effect on advocacy" and preventing practitioners from pursuing outcomes most favorable to taxpayer-clients.³¹²

What many tax practitioners refused to acknowledge in the early 1980s was that self-regulation had failed. In fact, it had failed miserably.³¹³ Existing ethical guidelines permitted practitioners to write (and get paid for) opinions on reporting positions or transactions that they knew (or should have known) were not supportable under existing law. State bar associations, moreover, were either incapable or unwilling to regulate the kind of professional behavior that created and sustained the tax shelter marketplace.³¹⁴ And the disparate standards of care promulgated by practitioner groups were an uncoordinated mess and infused with adversarial norms.³¹⁵

The failure of self-regulation forced the Treasury to intervene. More specifically, it prompted the agency to raise the standards of due diligence, to promulgate a unified standard of care for federal tax practitioners, to discipline both willful violations of due care as well as negligent and incompetent violations, and to increase significantly the penalties for violating the new rules. Practitioners were understandably anxious. Many of them had never given Circular 230 a second thought. Even fewer feared punishment under the recently enacted penalty statute aimed at tax return preparers for advising

³¹¹See Tax Shelters; Practice Before the Internal Revenue Service, 45 Fed. Reg. 58,596, 58,597 (Sept. 4, 1980); ABA, *supra* note 300, at 746; NYSBA, *supra* note 300, at 258-59; *Practitioners Attack Limits on Tax Shelter Opinions*, *supra* note 304, at 1143.

³¹²Sax, *supra* note 300, at 44; see also Jacques T. Schlenger, *Comments on the Proposed Regulations on Tax Shelter Opinions*, 59 TAXES 173, 178 (1981) (stating that the proposed rules "impinge[d] on the taxpayer's right to counsel"); ABA, *supra* note 300, at 747 (writing that the amendments caused "undue interference in the attorney-client relationship" and "vigorous and independent advocacy that is an important element in our self-assessment system"); NYSBA, *supra* note 300, at 252 (calling Treasury's proposal "an incipient threat to the right of American citizens to be represented by independent counsel").

³¹³See *supra* notes 268-271, 280-288 and accompanying text.

³¹⁴See *Practitioners Attack Limits on Tax Shelter Opinions*, *supra* note 304, at 1143 (summarizing practitioner preference for deferring to state bar associations to "promulgate and enforce ethical standards for its members despite the fact that the bars have been lax in policing this area in the past"); Mundheim, *supra* note 267, at 213 (stating that enforcement of ethical rules by state bar associations in the area of tax practice "has not been as vigorous or effective as those of us who believe in self-regulation would like"); see also Koniak & Cohen, *supra* note 21 and accompanying text.

³¹⁵It is worth noting that practitioners also recognized the "balkanization of discipline among several separate professional groups," which produced "great unevenness and ineffective enforcement." Lewis, *supra* note 267, at 725; see also *Practitioners Attack Limits on Tax Shelter Opinions*, *supra* note 304, at 1143 (quoting former Commissioner, Don Alexander, as endorsing a standard of care promulgated by the Treasury that would apply uniformly to all federal tax practitioners).

understatements of tax liability.³¹⁶ Treasury's proposed amendments—and, in particular, the threat of suspension or disbarment for violating the new practice rules—got their attention.

At the same time, the Treasury acknowledged practitioner concerns. In late 1982, the Treasury published a modified version of its proposed amendments that incorporated suggestions from the 100-plus written and oral comments it had received from the practitioner community.³¹⁷ The modified proposal also included many of the principles and guidelines contained in the ABA's recently finalized Formal Opinion 346, which, according to the government, "addresses many of the fundamental concerns of the Treasury Department with respect to tax shelter opinions."³¹⁸ Specifically, the modified proposal adopted the framework of Opinion 346 with respect to (1) diligence as to factual matters such that practitioners could reasonably rely on facts provided by clients without "audit[ing]" their authenticity;³¹⁹ (2) diligence as to opining on material tax issues "where possible" rather than in all cases;³²⁰ (3) the definition of "tax shelter" and of "tax shelter opinion;"³²¹ and (4) a disciplinary approach that continued to allow Treasury to punish negligent or incompetent conduct but that also paralleled the ABA Code of Professional Responsibility by "prohibiting knowing or reckless conduct and conduct involving gross negligence (gross incompetence, indifference to consequences, inadequate preparation under the circumstances and consistent failure to perform obligations to the client)."³²² In addition, the Treasury also responded to criticism that its amendments (1) were unnecessary given ethical guidelines promulgated by the professional licensing bodies;³²³ (2) intruded on the attorney-client relationship;³²⁴ (3) required practitioners to conclude with predictive certainty on all material tax issues even if the law

³¹⁶As part of the Tax Reform Act of 1976 Congress enacted section 6694, the preparer understatement penalty. The maximum penalty for violating the statute was a mere \$100 per infraction. Tax Reform Act of 1976, Pub. L. No. 94-455, § 6694(a), 90 Stat. 1520, 1689-90.

³¹⁷See Tax Shelters; Practice Before the Internal Revenue Service, 47 Fed. Reg. 56,144, 56,145 (Dec. 15, 1982) (to be codified at 31 C.F.R. pt. 10).

³¹⁸*Id.* at 56,145. For a full treatment of the ABA's adoption of Opinion 346, see generally Dennis J. Ventry, Jr., *ABA Formal Opinion 346 and a New Statutory Penalty Regime*, 111 TAX NOTES (TA) 1269 (June 12, 2006).

³¹⁹47 Fed. Reg. at 56,147, 56,149.

³²⁰*Id.*

³²¹*Id.* at 56,148, 56,150.

³²²*Id.* at 56,149, 56,150.

³²³*Id.* at 56,146 (noting that although the licensing bodies served "an important enforcement vehicle . . . the variation in enforcement because of the multiplicity of professional licensing authorities justifies the adoption of a rule which provides a basis for uniform, direct action by the Department").

³²⁴*Id.* (reiterating that the new practice rules would only apply to written opinions used in the marketing of tax shelter investments to persons "other than the client who engaged the practitioner to give the advice").

was uncertain;³²⁵ and (4) created a conflict of interest with the Treasury acting as both prosecutor and judge in the regulation of practitioner conduct.³²⁶

In two short years, the differences between the Treasury and the practitioner community had shrunk considerably respecting expected levels of care and diligence in advising tax shelter investments. For their part, practitioners largely conceded that they played a role in regulating the tax shelter marketplace and, furthermore, that the government was going to be looking over its shoulder with the threat of disciplinary action. Meanwhile, the government listened and responded to practitioner concerns respecting the requirements, application, and breadth of the new rules.

Nonetheless, differences persisted. Specifically, Treasury remained focused on achieving accurate advice and accurate returns through an elevated standard of care that exceeded prevailing standards as well as through further enlistment of practitioners in the fight against abusive tax avoidance. "Just as the lawyer has a duty to protect the integrity of the legal system as a whole," the Treasury argued, "so the practitioner . . . has a duty to protect the integrity and effectiveness of the tax system."³²⁷ That responsibility necessarily prohibited a practitioner from rendering an opinion unless she concluded that the "bulk" of the overall tax benefits (which the Treasury continued to define as "substantially more than 51%") were "more likely than not" correct,³²⁸ a higher level of certainty than that required under Opinion 346.³²⁹ Consequently, practitioners could not render opinions concluding that the bulk of the overall tax benefits were unlikely to be realized, much less negative opinions concluding that the tax benefits would not be realized.³³⁰ By providing such analyses to tax shelter promoters, a practitioner "authorizes use of his opinion for soliciting potentially large numbers of persons to seek tax benefits

³²⁵ *Id.* at 56,147 (writing that the proposal commanded "only a prediction as to outcome and not of course a requirement that the practitioner be certain as to the result").

³²⁶ *Id.* at 56,146 (explaining that the Treasury officer who enforces Circular 230 regulations is independent of the Service, and that the disciplinary provisions of Circular 230 provide administrative due process safeguards and judicial review extending all the way to the federal courts).

³²⁷ *Id.*

³²⁸ *Id.* at 54,147-48, 54,150 (with "more likely than not" reflecting at least 51% certainty).

³²⁹ See ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 346 (stating that a lawyer could render an opinion after concluding that the 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").

³³⁰ The 1982 proposed amendments to Circular 230 did not prohibit negative opinions, because, in the Treasury's view, newly enacted penalty statutes (particularly section 6661, the taxpayer penalty for substantial understatements) undermined "the usefulness and viability of negative opinions in tax shelter offerings" by undercutting a taxpayer's claim that a tax shelter position possessed "substantial authority" and that the taxpayer reasonably believed the tax treatment was more likely than not proper. Tax Shelters; Practice Before the Internal Revenue Service, 47 Fed. Reg. at 56,146. For discussion of section 6661 (and its reincarnation in 1989 as section 6662), see *supra* Part IV.E.1.

which the opinion says are not allowable under the tax laws.”³³¹ “Such conduct by a practitioner,” the Treasury continued, “is inimical to our voluntary self assessment tax system and its underlying principles,” and “actively encourages” inaccurate returns.³³² Practitioners providing tax shelter opinions that would be relied upon by nonclient shelter investors owed a heightened responsibility—both to the investors and to the tax system—to render full and accurate advice on factual issues, legal issues, and material tax issues, the last of which explicitly included potential penalties that could be assessed on disallowed tax benefits.³³³

A little more than a year later, and with little modification, the Treasury finalized the regulations.³³⁴ The new rules pertaining to opinions used in tax shelter offerings, the Treasury explained, “complement the new penalties and other tax law changes made by Congress relating to tax shelters.”³³⁵ The Treasury spotlighted section 6661, the substantial understatement penalty (and precursor to section 6662), which “increased the significance of determining whether there is sufficient legal authority for a position taken on a tax return.”³³⁶ The elevated reporting standard for taxpayers, in conjunction with the accompanying risk of penalty for submitting inaccurate returns, made it “even more important than before that a prospective investor receive *accurate* and *complete* tax advice in the opinion as to the merits of the tax shelter offering.”³³⁷

The Treasury’s practice rules had long reminded practitioners of their duty to seek and achieve accuracy and completeness in rendering advice to

³³¹ 47 Fed. Reg. at 56,145.

³³² *Id.* at 56,145-46.

³³³ In highlighting potential penalties, the Treasury was thinking of section 6661, the new substantial understatement penalty. *See id.* at 56,147-48.

³³⁴ *See* Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 49 Fed. Reg. 6719 (Feb. 23, 1984). The only notable differences between the 1982 modified proposed amendments and the 1984 final regulations involved: (1) incorporating into the rules an explicit statement on the expected level of due diligence pertaining to verifying facts, financial projections, and other valuation estimates (31 C.F.R. §§ 10.33(a)(1)(ii)-(iv)), 49 Fed. Reg. at 6722; (2) requiring practitioners to render an opinion “where possible” rather than in all circumstances on the overall likelihood that a shelter’s tax benefits would be realized, to “fully describe the reasons” in the event a practitioner could not provide an overall evaluation, and to “clearly and prominently disclose[d] in the offering materials” anything short of a favorable overall evaluation (31 C.F.R. § 10.33(a)(5)), 49 Fed. Reg. at 6722; and (3) permitting practitioners to render partial opinions so long as the practitioner had no reason to believe that the overall evaluation of another practitioner was incorrect “on its face” (31 C.F.R. § 10.33(a)(6)), 49 Fed. Reg. at 6722.

³³⁵ *Id.* at 6720. For a discussion of the new penalty regime, see Ventry, *supra* note 318, at 1273-75; Dennis J. Ventry, *No Joke: Circular 230 Is Here to Stay*, 111 TAX NOTES (TA) 1409, 1414-15 (June 19, 2006); *see also supra* Part IV.E.1.

³³⁶ 49 Fed. Reg. at 6719.

³³⁷ *Id.* (emphasis added).

taxpayer-clients.³³⁸ But the link between accurate and complete advice and accurate and complete returns established in the early 1980s began to appear in Circular 230's standard of care with increasing frequency and explicitness in the following decades.³³⁹

B. Accuracy Through Communication: Penalties, Anti-Abuse Doctrines, Covered Opinions, and Informed Written Consent to Conflicts

In elevating the standard of care on tax shelter opinions in 1984, the Treasury imposed more rigorous requirements on tax advisors not just with respect to due diligence but also communicating with clients. The new rules obliged practitioners to "make inquiry as to all relevant facts, be satisfied that the material facts are accurately and completely described in the offering materials, and assure that any representations as to future activities are clearly identified, reasonable and complete."³⁴⁰ These responsibilities, while reflective of due diligence principles, also required practitioners to have conversations with their promoter-clients. Similarly, while a practitioner might have avoided asking specific questions of her client when basing an opinion on hypothetical or assumed facts, satisfying the new duty that she "relate the law to the actual facts" compelled her to probe more deeply.³⁴¹ Furthermore,

³³⁸ See, e.g., Practice Before the Internal Revenue Service, 31 Fed. Reg. 10,773, 10,776 (Aug. 13, 1966) (pertaining to section 10.22, diligence as to accuracy: "Each attorney, certified public accountant, or enrolled agent shall exercise due diligence in preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to Internal Revenue Service matters, in determining the *correctness* of representations made by him to the Internal Revenue Service, and in determining the *correctness* of representations made by him to clients with reference to any matter administered by the Internal Revenue Service") (emphasis added).

³³⁹ See, e.g., 51 Fed. Reg. 29,113, 29,113 (proposed Aug. 14, 1986) ("The complexities of the tax and the limited number of tax return examinations the Service is able to perform impose a substantial burden upon the government. Hence, the representations made on tax returns must *accurately* reflect the facts, and positions taken on tax returns must be supportable by the law. A practitioner, during an engagement with a taxpayer-client, has an affirmative duty to assure that these occur.") (emphasis added); 66 Fed. Reg. 3276, 3280-81, 3291, 3294 (proposed Jan. 12, 2001) (pertaining to marketed opinions and more likely than not opinions: "A practitioner would be required to make inquiry as to all relevant facts, be satisfied that the opinion takes account of all relevant facts, and that the material facts are *accurately* and *completely* described in the opinion") (emphasis added); Regulations Governing Practice Before the Internal Revenue Service, 67 Fed. Reg. 48,760, 48,771 (July 26, 2002); Tax Return Preparer Penalties Under Sections 6694 and 6695, 73 Fed. Reg. 34,560, 34,562 (proposed June 17, 2008) ("In developing these proposed regulations, the Treasury Department and the Service recognize that the majority of tax return preparers serve the interests of their clients and the tax system by preparing *complete* and *accurate* returns."); Regulations Governing Practice Before the Internal Revenue Service, 76 Fed. Reg. 32,286, 32,294 (June 3, 2011) ("Tax return preparers are not only responsible for assisting taxpayers in filing *complete, timely, and accurate* returns, but also help educate taxpayers about the tax laws Increasing the *completeness* and *accuracy* of returns would necessarily lead to increased compliance with tax obligations by taxpayers.") (emphasis added).

³⁴⁰ 49 Fed. Reg. 6719, 6722 (Feb. 23, 1984); 31 C.F.R. § 10.33(a) (2004).

³⁴¹ 49 Fed. Reg. 6719, 6722; 31 C.F.R. § 10.33(a)(2) (2004).

identifying material tax issues³⁴² and opining on the likelihood of success on the merits for each issue³⁴³ forced advisors to transmit information to clients about “the potential applicability of penalties, additions to tax, or interest charges that reasonably could be asserted against a tax shelter investor.”³⁴⁴ These communication obligations were designed to facilitate more accurate advice and to aid promoter-clients and third-party taxpayer-investors in making informed and accurate decisions.³⁴⁵

In 1986, the Treasury extended the communication principles applicable to marketed tax shelters to nonshelter situations. Proposed amendments to Circular 230 required practitioners to “advise a client fully” on potential penalties under recently enacted section 6661, the substantial understatement penalty.³⁴⁶ Although Circular 230 had never highlighted a specific provision of the Code for special treatment, the Treasury wished to emphasize “that the role of the practitioner in our tax system requires adherence to . . . all tax compliance laws,” including penalties that technically affected taxpayer-clients rather than tax advisors.³⁴⁷ Six years later, the Treasury modified the proposed regulations pertaining to this communication obligation, requiring practitioners to inform clients of penalties “reasonably likely to apply to the client with respect to the position, of the opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure.”³⁴⁸ Two additional years later, in 1994, the Treasury finalized the regulations,³⁴⁹ but not before making it clear to practitioners that the duty to inform clients of reasonably applicable penalties touched all forms of professional advice on tax positions “advised, prepared or reported.”³⁵⁰ At the same time, the Treasury reiterated its belief “that informing clients of penalties reasonably likely to apply with respect to return positions is an important component

³⁴² 49 Fed. Reg. 6719, 6722; 31 C.F.R. § 10.33(a)(2) (2004).

³⁴³ 49 Fed. Reg. 6719, 6722; 31 C.F.R. § 10.33(a)(3) (2004).

³⁴⁴ 49 Fed. Reg. 6719, 6722; 31 C.F.R. § 10.33(a)(3) (2004).

³⁴⁵ Following Treasury’s lead, the professional organizations acknowledged that the requisite standard of care in advising on return positions required practitioners to communicate information about penalties to taxpayer-clients. *See, e.g.*, ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 346, at 634 (instructing tax lawyers to inform clients of “potential penalties and other legal consequences should the client take the position advised”).

³⁴⁶ 51 Fed. Reg. 29,113, 29,115 (proposed Aug. 14, 1986); Reg. § 10.34(a) (2011).

³⁴⁷ 51 Fed. Reg. 29,113, 29,114.

³⁴⁸ 57 Fed. Reg. 46,356, 46,359 (proposed Oct. 8, 1992).

³⁴⁹ *See* Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 59 Fed. Reg. 31,523 (June 20, 1994).

³⁵⁰ *Id.* at 31,527.

of a practitioner's duty to his or her client."³⁵¹ So important, in fact, that the requirement survived the next 20 years without substantive change.³⁵²

The duty to communicate fully and diligently with taxpayer-clients expanded still further in the early 2000s when the Treasury began including anti-abuse doctrines and rules in the list of relevant potential risks and liabilities. In 2001, the Treasury issued proposed amendments to Circular 230 requiring practitioners rendering tax shelter opinions to consider "the possible application to the facts of all potentially relevant judicial doctrines, including the step transaction, business purpose, economic substance, substance over form, and sham transaction doctrines."³⁵³ It also obligated practitioners to consider "potentially relevant statutory and regulatory anti-abuse rules" and to "analyze whether the tax shelter item is vulnerable to challenge under all potentially relevant doctrines and anti-abuse rules."³⁵⁴ Even earlier, the Treasury alerted practitioners that it intended to leverage the economic substance doctrine in the fight against abusive tax shelters and to assess penalties on taxpayer-investors for participating in noneconomic substance

³⁵¹ *Id.* at 31,524. The only notable difference between the 1992 proposed regulations and the 1994 finalized regulations involved the Treasury's reminder to practitioners that the communication requirement existed "even if the practitioner is not subject to a penalty with respect to the position," a qualification that accounted for differences in the standard of care under the preparer penalty in section 6694 versus the taxpayer understatement penalty in section 6662. *Id.* at 31,527.

³⁵² See Regulations Governing Practice Before the Internal Revenue Service, 76 Fed. Reg. 32,286, 32,307 (June 3, 2011) (reissuing with no change to communication requirement); Regulations Governing Practice Before the Internal Revenue Service, 72 Fed. Reg. 54,540, 54,549 (Sept. 26, 2007) (renumbering to section 10.34(c)); 71 Fed. Reg. 6421, 6430 (proposed Feb. 8, 2006); Regulations Governing Practice Before the Internal Revenue Service, 67 Fed. Reg. 48,760, 48,774 (July 26, 2002) (renumbering to section 10.34(b)); 66 Fed. Reg. 3276, 3294 (proposed Jan. 12, 2001).

³⁵³ 66 Fed. Reg. 3276, 3294-95 (pertaining to sections 10.33, tax shelter opinions used by third parties to market tax shelters, and 10.35, more likely than not tax shelter opinions). The Treasury first notified practitioners in 2000 that it was considering this new communication requirement. See Regulations Governing Practice Before the Internal Revenue Service, 65 Fed. Reg. 30,375, 30,376 (proposed May 11, 2000).

³⁵⁴ 66 Fed. Reg. 3294-95. In addition, the proposed rule required practitioners to "take into account the taxpayer's non-tax and tax purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner," a requirement that effectively leveraged the communication obligation to glean taxpayer motive, a critical component in modern economic substance analysis (that is, the so-called objective and subjective prongs of the economic substance doctrine). *Id.* at 3295.

transactions.³⁵⁵ At the time, “well-meaning tax professionals” acknowledged that “proper ethical conduct” required “point[ing] to judicially developed doctrines such as economic substance, sham transaction, and the like” in advising on aggressive tax avoidance deals.³⁵⁶ In 2004, the Treasury finalized the requirement that practitioners must consider “potentially applicable judicial doctrines” in relating the relevant law to the facts of a reporting position or transaction.³⁵⁷ Given the increased salience of these doctrines, moreover, it was clear that practitioners owed a duty to evaluate the possibility—and to inform clients of the potential likelihood—that a court could (and often did) invalidate tax benefits and impose penalties for transactions lacking in economic substance.

Several additional components of the standard of care pertaining to communication deserve mention. First, in the same year that Treasury finalized amendments to Circular 230 requiring practitioners to consider “potentially applicable judicial doctrines,” it added other communication provisions. One of these new requirements stated that “best practices” included “[c]ommunicating clearly with the client regarding the terms of the engagement” and determining the client’s “expected purpose for and use of the advice” as well as “the form and scope of the advice or assistance to be rendered.”³⁵⁸ Yet another “best practice” urged “[a]dvising the client regarding the import of the conclusions reached,” such as whether and how a taxpayer might defend against potential penalties by claiming that she reasonably relied on the advice of a tax professional.³⁵⁹ (It was hardly a coincidence that this particular “best practice” followed the guideline that tax advisors consider “potentially applicable judicial doctrines.”³⁶⁰ A taxpayer could not be said to reasonably rely in good

³⁵⁵ See, e.g., Notice 2000-44, 2000-2 C.B. 255 (identifying partnership inflated-basis transactions as listed transactions, and quoting Notice 99-59, “a loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable”); Rev. Rul. 2000-12, 2000-1 C.B. 744-45 (involving “debt straddles” and stating that courts “have disallowed losses from option-straddle transactions that were found to be devoid of economic substance”); Notice 99-59, 1999-2 C.B. 761 (pertaining to corporate inflated-basis transactions); Rev. Rul. 99-14, 1999-1 C.B. 835-36 (pertaining to lease-in/lease-out transactions and stating, “[c]ourts have refused to recognize the tax consequences of a transaction that does not appreciably affect the taxpayer’s beneficial interest except to reduce tax. The presence of an insignificant profit is not enough to provide a transaction with sufficient economic substance to be respected for tax purposes”).

³⁵⁶ See Letter from Paul J. Sax, Chair, American Bar Association Section of Taxation, to Hon. Daniel P. Moynihan, Ranking Minority Member, Senate Finance Committee (Mar. 21, 2000), reproduced in 87 TAX NOTES (TA) 145, 146 (Apr. 3, 2000).

³⁵⁷ The quoted language appeared in two new sections, § 10.33(a)(2) (2004); 69 Fed. Reg. 75,839, 75,842 (Dec. 20, 2004) (pertaining to best practices), and § 10.35(c)(2)(i) (2007); 69 Fed. Reg. at 75,843 (Dec. 20, 2004) (pertaining to covered opinions).

³⁵⁸ 31 C.F.R. § 10.33(a)(1) (2004); 69 Fed. Reg. 75,841 (Dec. 20, 2004).

³⁵⁹ 31 C.F.R. § 10.33(a)(3) (2004); 69 Fed. Reg. 75,842 (Dec. 20, 2004).

³⁶⁰ 31 C.F.R. § 10.33(a)(2) (2004); 69 Fed. Reg. 75,842 (Dec. 20, 2004).

faith on professional advice to mitigate or avoid penalties if the advice failed to account for judicial anti-abuse doctrines.)

Second, the 2004 amendments raised the communication standard of care in the new section on “covered opinions,” a catchall category of written opinions that analyzed the federal tax aspects of listed or otherwise potentially abusive transactions.³⁶¹ Among other communication-related provisions, the new covered opinion standards strongly discouraged opinions that contained “conditions of confidentiality” or disclosure limitations that effectively prohibited the taxpayer-client from discussing the transaction with other tax professionals.³⁶² Such a restriction was antithetical to a practitioner’s communication obligation and prevented taxpayer-clients from making informed, accurate decisions about their return positions. At the same time, the new rules treated less harshly written advice that “prominently disclosed”³⁶³ (1) potentially tainted relationships between promoters and practitioners (including compensation and referral arrangements),³⁶⁴ (2) that certain opinions could not be relied upon for avoiding penalties,³⁶⁵ (3) that certain opinions were provided to support the promotion of marketed shelters and that taxpayers should seek additional advice from independent tax advisors,³⁶⁶ (4) that certain opinions only covered limited federal tax issues and that other relevant issues could exist and should be considered,³⁶⁷ and (5) that certain opinions failed to reach “more likely than not” certainty on one or more significant tax issues.³⁶⁸

Third, and finally, the Treasury sent a clear message to practitioners over the years about the importance of communicating with taxpayer-clients through Circular 230’s conflicting interests standard. Section 10.29 had long

³⁶¹ In June 2014, the Treasury eliminated the detailed covered opinion rules in favor of an overarching, principles-based standard for all written tax advice. *See supra* notes 143-153 and accompanying text.

³⁶² *See* 31 C.F.R. § 10.35(b)(6) (2007); 69 Fed. Reg. at 75,842 (Dec. 20, 2004).

³⁶³ “Prominently disclosed” was defined as “set[ing] forth in a separate section at the beginning of the written advice in a bolded typeface that is larger than any other typeface used in the written advice.” 31 C.F.R. § 10.35(b)(8) (2007); 69 Fed. Reg. at 75,843. According to the Treasury, the heightened disclosure requirement was “intended to ensure transparency between taxpayers and practitioners and to provide taxpayers with notice of any limitation on their ability to rely on written advice.” Regulations Governing Practice Before the Internal Revenue Service, 70 Fed. Reg. 28,824, 28,824-25 (May 19, 2005).

³⁶⁴ *See* 31 C.F.R. § 10.35(e)(1) (2007); 69 Fed. Reg. 75,844 (Dec. 20, 2004).

³⁶⁵ *See, e.g.*, 31 C.F.R. § 10.35(b)(4)(ii) (2007); 69 Fed. Reg. 75,842 (Dec. 20, 2004) (pertaining to “reliance opinions”); 31 C.F.R. § 10.35(b)(5)(ii)(A) (2007); 69 Fed. Reg. 75,842 (Dec. 20, 2004) (pertaining to “marketed opinions”); 31 C.F.R. § 10.35(e)(3)(iii) (2007); 69 Fed. Reg. 75,844 (Dec. 20, 2004) (pertaining to significant federal tax issues that the practitioner failed to analyze in “limited scope opinions”); 31 C.F.R. § 10.35(e)(4)(ii); 69 Fed. Reg. 75,844 (Dec. 20, 2004) (pertaining to significant federal tax issues on which the practitioner failed to reach “more likely than not” certainty).

³⁶⁶ *See* 31 C.F.R. § 10.35(e)(2)(ii)(C) (2007).

³⁶⁷ *See id.* § 10.35(e)(3)(i)-(ii) (2007).

³⁶⁸ *See id.* § 10.35(e)(4)(i) (2007).

prohibited practitioners from representing “conflicting interests” except “by express consent of all directly interested parties after full disclosure has been made.”³⁶⁹ As the next Part of this Article explains, the Treasury proposed altering the conflicting interests standard in 2001 by, among other things, adding the requirement that practitioners obtain a client’s written consent to conflicts.³⁷⁰ The following year, the Treasury finalized the rule to require that any taxpayer-client affected by a conflicting interest (including a personal interest of the practitioner)³⁷¹ provide “informed consent, confirmed in writing.”³⁷² The idea behind the informed, written consent requirement reflected Treasury’s concern “that the parties understand the conflict,”³⁷³ and furthermore, as the Director of the Service’s Office of Professional Responsibility recently emphasized, that practitioners “must have a conversation with the taxpayer about whether representation is possible.”³⁷⁴ And while some practitioner groups continued to allow its members to receive verbal informed consent followed by a confirmatory letter authored by the practitioner, the Treasury imposed a strict signing requirement on conflicts waivers (including those prepared by the practitioner).³⁷⁵

C. Accuracy Through Avoiding and Overcoming Conflicting Interests

In May 2000, the Treasury announced that it aimed to revise Circular 230’s “general standards of practice and standards of practice relating to tax

³⁶⁹Practice Before the Internal Revenue Service, 31 Fed. Reg. 10,773, 10,776 (Aug. 13, 1966).

³⁷⁰See § 10.29(a)(2) (2002); 66 Fed. Reg. 3276, 3291 (Jan. 12, 2001). The Treasury had presaged this change in 2000 when it issued a notice of proposed rulemaking soliciting public comment on “[w]hether § 10.29 should be expanded to define conflicting interests and to delineate what constitutes informed consent permitting a practitioner to represent clients with conflicting interests.” Regulations Governing Practice Before the Internal Revenue Service, 65 Fed. Reg. 30,375, 30,376 (proposed May 11, 2000). In fact, some of the comments received “expressed concern about the current practice used by some practitioners to obtain oral consents to represent parties where there is a direct conflict of interest” and recommended to the Treasury that practitioners “be required to obtain written consents to represent” directly conflicting interests. 66 Fed. Reg. 3276, 3277 (Jan. 12, 2001).

³⁷¹See § 10.29(a)(2) (2002); 67 Fed. Reg. 48,760, 48,773 (July 26, 2002).

³⁷²31 C.F.R. § 10.29(b)(3) (2002); 67 Fed. Reg. at 48,773.

³⁷³Sheryl Stratton, *Practitioners Take First Shots at IRS Over Transparency Proposal*, 110 TAX NOTES (TA) 710, 711 (Feb. 24, 2006) (paraphrasing Deborah Butler, IRS Associate Chief Counsel).

³⁷⁴Jeremiah Coder, *Recusal Not Always Required in Conflicts*, *Hawkins Says*, 139 TAX NOTES (TA) 35, 35 (Apr. 8, 2013) (quoting OPR Director Karen Hawkins).

³⁷⁵In 2007, for instance, the Treasury issued final amendments to Circular 230 altering the language of section 10.29 in order to “clarif[y] that a practitioner is required to obtain consents in writing from each affected client in order to represent the conflicting interests.” Regulations Governing Practice Before the Internal Revenue Service, 71 Fed. Reg. 6421, 6424 (proposed Feb. 8, 2006). Preserving and reanimating the signing requirement, the Treasury explained, was “appropriate to protect taxpayer interests.” Regulations Governing Practice Before the Internal Revenue Service, 72 Fed. Reg. 54,540, 54,542 (Sept. 26, 2007).

shelters.”³⁷⁶ The announcement followed closely on the heels of a detailed and highly publicized Treasury report on the proliferation of corporate tax shelters,³⁷⁷ as well as the publication of regulations requiring disclosure of certain transactions by corporate taxpayers,³⁷⁸ registration of confidential corporate tax shelters with the Service,³⁷⁹ and maintenance of lists containing the names of taxpayer-clients who invested in certain shelter transactions.³⁸⁰ For years, the government had been playing catch up with sophisticated shelters and the associated loss in revenue. But a series of high-profile cases in which courts invalidated sought after tax benefits in abusive shelters³⁸¹—in addition to anonymous packages and envelopes sent to government officials and the press containing confidential transaction documents³⁸²—began to close the gap and provide crucial insights into the operations of the professionals that designed, advised, and marketed the schemes.

The Treasury’s inventory of possible revisions to Circular 230 in May 2000 gave an indication of what it had learned. Practitioners, primarily (but not exclusively) tax lawyers, were writing opinions without exercising sufficient

³⁷⁶65 Fed. Reg. 30,375, 30,375 (proposed May 11, 2000).

³⁷⁷DEPARTMENT OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS (1999).

³⁷⁸See Tax Shelter Disclosure Statement, 65 Fed. Reg. 11,205 (Mar. 2, 2000).

³⁷⁹See *id.* at 11,215.

³⁸⁰See *id.* at 11,211.

³⁸¹See *Saba P’ship v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001) (at which point the Tax Court once again invalidated the transaction); *ASA Investorings P’ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000); *ACM P’ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 562 U.S. 1017 (1999); *ACM P’ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 562 U.S. 1017 (1999); *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999); *Saba P’ship v. Commissioner*, 78 T.C.M. (CCH) 684, 1999 T.C.M. (RIA) ¶ 99,359 (vacated and remanded in light of *ASA Investorings P’ship*); *Saba P’ship v. Commissioner*, 85 T.C.M. (CCH) 817, 2003 T.C.M. (RIA) ¶ 2003-31.

³⁸²See, e.g., Lee A. Sheppard, *Captain Sandy’s Tax Shelter*, 89 TAX NOTES (TA) 1208 (Dec. 4, 2000) (describing a “package” sent to the author “with the identity of the recipient removed and an anonymous handwritten note asking ‘Why is a VP Tax of a major company peddling this crap?’”); Lee A. Sheppard, *Corporate Tax Shelters: More Plain Brown Wrappers*, 87 TAX NOTES (TA) 321, 322 (Apr. 17, 2000) (discussing “unmarked envelopes [and their contents] that contain tax shelter materials sent anonymously to journalists and government officials”); Lee A. Sheppard, *Shelter Opinions: The Tax Equivalent of Pasties*, 87 TAX NOTES (TA) 17 (Apr. 3, 2000) (discussing contents of a “plain brown envelope” the author received, “the tax equivalent of porno—one of the legal opinions used by the investment banker in *ACM Partnership v. Commissioner*”); Janet Novak & Laura Saunders, *The Hustling of X-Rated Shelters*, FORBES, Dec. 14, 1998, at 198, 200 (reporting on “two different letters” authored by tax professionals at accounting firm Deloitte & Touche peddling a marketed shelter to nonaudit clients, and further, discussing an anonymous letter received by the Service “blowing the lid off a particularly smelly scheme . . . signed simply ‘A Pressured Practitioner’”).

due diligence or independent factual inquiry³⁸³ and simply assuming that a taxpayer-investor entered into a shelter transaction with a business purpose.³⁸⁴ These lawyers were also ignoring or discounting the implication of judicial anti-abuse doctrines in their analyses of whether an avoidance transaction would succeed on the merits.³⁸⁵ Furthermore, they were charging contingent fees on abusive transactions as a way to lure taxpayer-investors with lower up-front costs and risk.³⁸⁶ And they forced taxpayer-investors to sign confidentiality agreements designed to keep the transactions secret from the government, from competitors, and from other, more ethical, practitioners.³⁸⁷

The Treasury had also learned that lawyers were rendering professional advice and writing opinions while awash in conflicting interests. For starters, some lawyers often had no relationship whatsoever with taxpayer-investors who purchased their opinions. Instead, they received all information about the shelter from the promoter, including the taxpayer's purported business purpose as well as the pre-arranged steps that the various members of the tax shelter syndicate would carry out to effectuate the shelter transaction. Moreover, these lawyers got paid by the shelter promoter rather than by the taxpayer-client, and they typically got paid based on how many opinions to which they were willing to append their firm's name rather than on the quality of their professional advice. Such fee arrangements violated Circular 230's longstanding prohibition against unconscionable fees (as well as a similar prohibition on unreasonable fees contained in ABA Model Rule 1.5).³⁸⁸ It was not unusual for these lawyers to charge a flat fee of, say, \$75,000 per opinion for dozens of nearly identical opinions on the same shelter product, with perhaps only the original opinion justifying an hourly-billed invoice of \$75,000. These conflicts also undermined the taxpayer-investor's potential defense

³⁸³ See Regulations Governing Practice Before the Internal Revenue Service, 65 Fed. Reg. 30,375 (May 11, 2000) (codified at 31 C.F.R. pt. 10) (requesting comment on whether the factual due diligence standards that applied to marketed shelters should apply to all shelters as well as whether the standards "should be modified to further limit the circumstances" in which practitioners could rely on the "factual assertions of other persons").

³⁸⁴ See *id.* (requesting comment on whether a practitioner should be permitted to "base an opinion on hypothetical facts or factual assumptions and conclusions, including assumptions regarding the existence of a business purpose and the significance of such purpose relative to the intended tax benefits").

³⁸⁵ See *id.* (requesting comment on whether opinions should be required to "state that the transaction in question was analyzed under all applicable judicial doctrines (including step transaction, business purpose, economic substance, substance over form, and sham transaction doctrines)").

³⁸⁶ See *id.* (requesting comment on whether practitioners should be permitted to charge contingent fees under any circumstances). For further discussion on contingent fees and their role in encouraging taxpayers to play the "audit lottery," see *supra* Part IV.D.

³⁸⁷ See *id.* (requesting comment on whether practitioners should be permitted to charge contingent fees under any circumstances).

³⁸⁸ See I.R.C. § 10.27(a) ("A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service."); see also *supra* notes 218-220 and accompanying text.

against accuracy-related penalties that she “reasonably relied in good faith” on professional advice in undertaking the transaction.³⁸⁹ Indeed, rather than rendering independent professional advice to taxpayer-clients, many shelter lawyers were simply getting paid by promoters to endorse fraudulent deals.³⁹⁰

Armed with the knowledge that these conflicts of interest were creating biased, inaccurate opinions and harming taxpayers, the Treasury solicited feedback on section 10.29 of Circular 230. The Circular’s “conflicting interests” standard had been largely unchanged for 25 years, and prohibited practitioners from representing “conflicting interests” except by “express consent” of directly affected parties “after full disclosure.”³⁹¹ The Treasury proposed defining “conflicting interests” more specifically and “delineat[ing] what constitutes informed consent permitting a practitioner to represent clients with conflicting interests.”³⁹²

Eight months later, Treasury released proposed amendments to section 10.29 that, while failing to define “conflicting interests,” injected a clear requirement of “informed consent” before clients could be said to have waived potential, current, or future conflicts.³⁹³ In particular, the amendments prohibited practitioners from representing “potential conflicting interests” unless the practitioner reasonably believed that the representation of any party would not be adversely affected, and that all parties consented in writing after full disclosure of the conflict.³⁹⁴ The proposed amendments also expressly obligated the practitioner to consider her “own interests” when determining the existence of a conflict and to receive written consent from affected clients after full disclosure (including “disclosure of the implications of the potential conflict and the risks involved”) in the event that she believed her own interests, though perhaps in conflict with a taxpayer-client’s interest, would not adversely affect the representation.³⁹⁵

In July 2002, the Treasury finalized amendments to Circular 230.³⁹⁶ The final changes to section 10.29 were perceptibly different than the proposed

³⁸⁹ Reg. § 1.6664-4(c)(i). The advice described above would also fail to satisfy the requirements of the “reasonable cause and good faith” defense against penalties because it neglected to examine “all pertinent facts and circumstances and the law as it relates to those facts and circumstances,” Reg. § 1.6664-4(c)(1)(i), and it incorporated “unreasonable factual or legal assumptions” and “unreasonably rel[ied] on the representations, statements, findings, or agreements” of the taxpayer or other persons, Reg. § 1.6664-4(c)(1)(ii).

³⁹⁰ For an excellent and rigorously researched study on the tax shelter industry in the late 1990s and early 2000s, see TANINA ROSTAIN & MILTON C. REGAN, JR., *CONFIDENCE GAMES: LAWYERS, ACCOUNTANTS, AND THE TAX SHELTER INDUSTRY* (2014).

³⁹¹ Practice Before the Internal Revenue Service, 31 Fed. Reg. 10,773, 10,776 (Aug. 13, 1966).

³⁹² 65 Fed. Reg. 30,375, 30,376 (proposed May 11, 2000).

³⁹³ 66 Fed. Reg. 3276, 3291 (proposed Jan. 12, 2001).

³⁹⁴ *Id.*

³⁹⁵ *Id.*

³⁹⁶ Regulations Governing Practice Before the Internal Revenue Service, 67 Fed. Reg. 48,760 (July 26, 2007).

amendments. Indeed, in the intervening 18 months, the practitioner community had bombarded Treasury with suggested revisions and clarifications. Among other suggestions, practitioners recommended restricting “conflicting interests” to “actual” conflicts and not “potential” conflicts;³⁹⁷ limiting “potential conflicts” to the parties’ economic interests;³⁹⁸ applying section 10.29 only in situations where the practitioner is “manifestly taking positions or representing a taxpayer in a manner that is contrary to the taxpayer’s best interests;”³⁹⁹ defining “conflicting interests” with specific examples;⁴⁰⁰ providing examples when a practitioner’s “own interests” would materially limit representation;⁴⁰¹ issuing guidance as to the “extent and manner” of what would constitute sufficient disclosure of a conflict in addition to “the precise form and content of the waiver;”⁴⁰² explain how practitioners might determine how a conflict could adversely affect representation;⁴⁰³ and eliminate altogether the requirement that taxpayer-clients provide written consent for waiving conflicts of interest.⁴⁰⁴

Given the reaction to proposed alterations to Circular 230’s conflicting interest standard, one wonders how some of these practitioners—particularly the lawyers among them—had been resolving conflicts of interest, or even acknowledging their existence. Under ethical guidelines promulgated by the ABA, lawyers were long obligated to identify, consider, and disclose “potentially differing interests,”⁴⁰⁵ while the prevailing conflicts provision of the ABA Model Rules prior to 2002 required that lawyers evaluate actual as well as potential conflicts.⁴⁰⁶ Similarly, longstanding ethical rules required law-

³⁹⁷N. Jerold Cohen, *Writer Suggests Changes to Proposed Circular 230 Regs*, 91 TAX NOTES (TA) 1680 (June 4, 2001); John E. Hembera, Jr., *Witnesses Say Circular 230 Regs Are Too Burdensome*, 91 TAX NOTES (TA) 880, 881 (May 7, 2001) (summarizing comments of John Gardner of the AICPA); Joseph B. Schimmel, *Attorney Suggests Changes to Proposed Circular 230 Regs.*, 90 TAX NOTES (TA) 1790 (Mar. 26, 2001).

³⁹⁸New York State Bar Association Tax Section, *New York State Bar Association Recommends Changes to Circular 230*, 2001 TAX NOTES TODAY 149-41, 18 (Aug. 2, 2001).

³⁹⁹Pamela J. Pecarich, *AICPA Suggests Changes to Proposed Circular 230 Regs*, 91 TAX NOTES (TA) 745, 745 (Apr. 30, 2001).

⁴⁰⁰Hembera, Jr., *supra* note 397, at 881 (summarizing comments of Lawrence Hill, White & Case LLP).

⁴⁰¹New York State Bar Association Tax Section, *supra* note 398.

⁴⁰²*Id.*

⁴⁰³*Id.*

⁴⁰⁴Cohen, *supra* note 397.

⁴⁰⁵MODEL RULES OF PROF’L RESPONSIBILITY EC 5-15 (1980); *see also* MODEL RULES OF PROF’L RESPONSIBILITY EC 5-17 to 5-19 (1980).

⁴⁰⁶*See* MODEL RULES OF PROF’L CONDUCT R. 1.7 cmt. 3 (stating that a lawyer “should adopt reasonable procedures, appropriate for the size and type of firm and practice, to determine in both litigation and non-litigation matters the parties and issues involved and to determine whether there are actual or potential conflicts of interest”); *see also* MODEL RULES OF PROF’L CONDUCT R. 1.7 cmts. 7, 11, 14 (1980).

yers to adhere to a broad definition of “conflicting” or “differing” interests;⁴⁰⁷ to account for multiple kinds of “potential conflicts,” including a lawyer’s “personal” or “own” interests;⁴⁰⁸ to avoid representation of clients that would “adversely affect” a lawyer’s “judgment on behalf or dilute . . . loyalty to a client;”⁴⁰⁹ and to receive “consent after consultation” in the event the lawyer reasonably believed she could represent multiple clients without “adversely affecting” or “materially limiting” responsibilities to any client, third person, or her own interests.⁴¹⁰

With the exception of obtaining a client’s consent to conflicts with written confirmation, the Treasury’s proposed amendments to Circular 230 respecting “conflicting interests” did not create any new duties for tax lawyers. Even the consent requirement was about to become an affirmative obligation for lawyers of all stripes.

Several years earlier, in 1997, the ABA Center for Professional Responsibility had formed the “Ethics 2000 Commission” and charged it with undertaking a comprehensive review of the ABA Model Rules of Professional Conduct. In August 2001, the Commission released its report containing recommendations to, among other rules, the guidelines for conflicting interests.⁴¹¹ The ABA House of Delegates approved the Committee’s amendments and

⁴⁰⁷ See MODEL RULES OF PROF’L RESPONSIBILITY EC 5-14 (stating that a lawyer’s judgment could be affected adversely and her independent judgment compromised whenever she “is asked to represent two or more clients who may have differing interests, whether such interests be conflicting, inconsistent, diverse, or otherwise discordant”); see also ABA CANONS OF PROF’L ETHICS Canon 6 (1908) (providing a sweeping definition of “conflicting interests”: “Within the meaning of this canon, a lawyer represents conflicting interests when, in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose”).

⁴⁰⁸ See MODEL RULES OF PROF’L RESPONSIBILITY DR 5-101 (1980) (absent consent after full disclosure, prohibiting a lawyer from accepting employment “if the exercise of his professional judgment on behalf of his client will be or reasonably may be affected by his own *financial, business, property, or personal* interests”) (emphasis added); see also MODEL RULES OF PROF’L RESPONSIBILITY EC 5-2 to EC 5-13 (1980) (pertaining to “Interests of a Lawyer that May Affect His Judgment”); MODEL RULES OF PROF’L CONDUCT R. 1.7(b) cmts. 6, 10 (2011).

⁴⁰⁹ MODEL RULES OF PROF’L RESPONSIBILITY EC 5-14 (1980); see also ABA CANONS OF PROF’L ETHICS Canon 7; MODEL RULES OF PROF’L CONDUCT R. 1.7(a)(1), (b)(1) cmts. 8, 9.

⁴¹⁰ See MODEL RULES OF PROF’L CONDUCT R. 1.7(a)(2), (b)(2) cmts. 1, 3, 5, 8, 10 (2011); see also MODEL RULES OF PROF’L RESPONSIBILITY EC 5-16 (1980) (“In those instances in which a lawyer is justified in representing two or more clients having differing interests, it is nevertheless essential that each client be given the opportunity to evaluate his need for representation free of any potential conflict and to obtain other counsel if he so desires. Thus before a lawyer may represent multiple clients, he should explain fully to each client the implications of the common representation and should accept or continue employment only if the clients consent.”); MODEL RULES OF PROF’L RESPONSIBILITY EC 5-19 (1980).

⁴¹¹ ABA CTR. FOR PROF’L RESPONSIBILITY, REPORT TO THE ABA HOUSE OF DELEGATES (2001).

accompanying commentary to Rule 1.7 (as well as Rules 1.8 and 1.9),⁴¹² and the changes went into effect in February 2002.⁴¹³ Amended Rule 1.7 (as well as Rule 1.9) required lawyers to receive “informed consent, confirmed in writing” for all conflict waivers.⁴¹⁴

As the Ethics 2000 Commission explained, the amended rules adopted “informed consent” in place of “consent after consultation” because the latter “does not sufficiently indicate the extent to which clients must be given adequate information and explanation in order to make reasonably informed decisions.”⁴¹⁵ Similarly, the Commission believed that it was appropriate to oblige lawyers to seek signed confirmation of conflict waivers from clients “in order to impress upon clients the seriousness of the decision the client is being asked to make and to avoid disputes or ambiguities that might later occur in the absence of a writing.”⁴¹⁶ Moreover, both new requirements—that is, general disclosure by informed consent as well as the understanding that certain consents required a client’s written confirmation—reflected the “recurring theme” throughout the Commission’s report that “insist[ed] on clear communication between lawyer and client.”⁴¹⁷

By the time the Treasury finalized amendments to Circular 230 in July 2002, there were no substantive differences between the standard of care for conflicting interests under the ABA’s Model Rules and the Treasury’s practice rules.⁴¹⁸ The convergence was no accident. According to Treasury, the final regulations had been “modified from the proposed regulations to conform more closely with the approach of the recently revised Model Rule 1.7 of

⁴¹²ABA CTR. FOR PROF’L RESPONSIBILITY, EVALUATION OF THE RULES OF PROFESSIONAL CONDUCT, REPORT NO. 401 (2001) (amended and retitled Rule 1.7 pertained to “Conflict of Interest: Current Clients,” amended and retitled Rule 1.8 pertained to “Conflict of Interest: Specific Rules,” and amended and retitled Rule 1.9 pertained to “Former Clients”); ABA CTR. FOR PROF’L RESPONSIBILITY, SUMMARY OF HOUSE OF DELEGATES ACTION ON ETHICS 2000 COMMISSION REPORT (Aug. 2001 and Fed. 2000).

⁴¹³ABA CTR. FOR PROF’L RESPONSIBILITY, EVALUATION OF THE RULES OF PROFESSIONAL CONDUCT, REPORT NO. 401 (2001).

⁴¹⁴MODEL RULES OF PROF’L CONDUCT R. 1.7(b)(4), 1.9(a), (b)(2)(2011).

⁴¹⁵MODEL RULES OF PROF’L CONDUCT R. 1.0 (defining “informed consent” as “the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct”); ABA Ctr. For Prof’l Responsibility, Model Rule 1.0, Reporter’s Explanation of Changes, *available at* http://www.americanbar.org/groups/professional_responsibility/policy/ethics_2000_commission/e2k_rule10rem.html; MODEL RULES OF PROF’L CONDUCT R. 1.7, cmt. 18 (“Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client.”).

⁴¹⁶MODEL RULES OF PROF’L CONDUCT R. 1.7 cmt. 20 (2011).

⁴¹⁷ABA CTR. FOR PROF’L RESPONSIBILITY, *supra* note 411, at 3. The theme of “clear communication” animated amendments and clarifications to other rules, including: Model Rules of Professional Conduct Rule 1.2, Scope of Representation and Allocation of Authority between Client and Lawyer; Rule 1.4, Communication; Rule 1.5, Fees; Rule 1.16, Declining or Terminating Representation; Rule 1.18, Duties to a Prospective Client (2011).

⁴¹⁸*See infra* note 423 for the sole difference.

the American Bar Association Rules of Professional Conduct.”⁴¹⁹ Indeed, the text of section 10.29 and Rule 1.7 were mirror images of each other.⁴²⁰ Both prohibited tax lawyers and other practitioners from representing a client if the representation of one client was directly adverse to another client or if there existed a significant risk that the representation of one client would be materially limited by the lawyer’s or practitioner’s responsibilities to another client, a former client, a third person, or by “a personal interest” of the lawyer or practitioner.⁴²¹ In addition, notwithstanding such conflicts, both standards permitted representation if the lawyer or practitioner reasonably believed (1) she could provide “competent and diligent” representation to each affected client, (2) the representation was not prohibited by law, and (3) each affected client gave “informed consent, confirmed in writing.”⁴²² The convergence in conflicts standards was complete⁴²³ and, to date, lasting.⁴²⁴

D. *Accuracy Through Averting Contingent Fees*

Like its restrictions on conflicting interests, the Treasury’s position on contingent fees has derived from its desire to minimize biases and inaccuracies in professional judgment and to reinforce compliance with the law. The allure of contingent fees—which the Treasury defines as any fee “based, in whole or in part” on whether a tax position “avoids challenge” by the Service or is ultimately sustained by the government or a court⁴²⁵—can, on the one hand, encourage practitioners to render advice on over-aggressive positions that take advantage of the audit lottery and, on the other hand, attract taxpayer-investors to aggressive tax planning at low risk and low net present cost.

⁴¹⁹Regulations Governing Practice Before the Internal Revenue Service, 67 Fed. Reg. 48,760, 48,764 (July 26, 2002).

⁴²⁰It is worth noting that Rule 1.7 covers “current clients” (with Rule 1.9 covering “former clients”), while section 10.29 uses the catchall category of “conflicting interests.” MODEL RULES OF PROF’L CONDUCT R.1.7, 1.9 (2011); 31 C.F.R. § 10.29 (2002). The more expansive terminology in its single conflicts provision, however, does not necessarily mean that Circular 230 casts a wider ethical net with respect to conflicts. In addition to conflicts Rules 1.7 and 1.9, Rule 1.18 requires lawyers to consider conflicts in the context of prospective clients, while Rule 1.7 countenances actual conflicts (Comment 22), “reasonably foreseeable” conflicts (Comments 18 and 22), and potential conflicts (Comments 26, 28, and 29). MODEL RULES OF PROF’L CONDUCT R. 1.18, 1.7 cmts. 18, 22, 26, 28, 29; MODEL RULES OF PROF’L CONDUCT R. 1.9 (2011).

⁴²¹31 C.F.R. § 10.29(a) (2002); MODEL RULES OF PROF’L CONDUCT R. 1.7(a).

⁴²²31 C.F.R. § 10.29(b) (2002); MODEL RULES OF PROF’L CONDUCT R. 1.7(b).

⁴²³The sole difference between the two conflicts rules at the end of 2002 was that Circular 230 required practitioners to retain copies of written consents for at least three years from the end of the representation, and furthermore, that the consents be made available upon request by the Service. *See* 31 C.F.R. § 10.29(c) (2002).

⁴²⁴Only one point of divergence since 2002 is worth highlighting: the Treasury has continued to impose stricter signing requirements on conflicts waivers compared to the ABA Model Rules of Professional Conduct. *See supra* note 375 and accompanying text.

⁴²⁵31 C.F.R. § 10.27(c)(1)(2014); 72 Fed. Reg. 54,540, 54,548 (Sept. 26, 2007).

As discussed in Part IV.A, the Treasury in the early 1980s linked the practitioner's written opinion to abusive reporting positions and "a free ticket to the audit lottery."⁴²⁶ Its corresponding amendments to Circular 230 targeted the gatekeeper role played by tax practitioners advising on tax shelters as well as the game of chance played by taxpayer-investors.⁴²⁷ At the same time, Treasury officials and concerned observers urged Congress to complement these regulatory efforts with "a financial penalty [that] would discourage taxpayers from playing the audit lottery."⁴²⁸ Congress dutifully complied by enacting a new penalty for substantial understatements of tax,⁴²⁹ which significantly elevated the risk for taxpayers wishing to hit the audit lottery jackpot,⁴³⁰ a prize that had grown increasingly valuable given plummeting audit rates.⁴³¹

Over the next two decades, the Treasury used Circular 230 to combat the audit lottery in various ways, including by restricting contingent fees. Since 1966, (former) section 10.28 (amended and renumbered as 31 C.F.R. § 10.27 in 2002)⁴³² had provided a short, blanket prohibition on charging "an unconscionable fee" for representing clients in federal tax matters.⁴³³ In

⁴²⁶Kurtz, *supra* note 268, at 262. In fact, Treasury made the connection between a practitioner's opinion and the tax shelter marketplace even earlier. See Dennis J. Ventry, Jr., *Tax Shelter Opinions Threatened the Tax System in the 1970s*, 111 TAX NOTES (TA) 947 (May 23, 2006).

⁴²⁷See Tax Shelters; Practice Before the Internal Revenue Service, 45 Fed. Reg. 58,594 (Sept. 4, 1980); Tax Shelters; Practice Before the Internal Revenue Service, 47 Fed. Reg. 56,144 (Dec. 15, 1982); Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 49 Fed. Reg. 6719 (Feb. 23, 1984).

⁴²⁸Jerome Kurtz, *Notes to a New Commissioner of Internal Revenue*, 12 TAX NOTES (TA) 1195, 1197 (June 1, 1981).

⁴²⁹See Pub. L. No. 97-248, tit. III, § 323(a), 96 Stat. 613 (1982), *repealed by* Pub. L. No. 101-239, tit. VII, § 7721(c)(2), 103 Stat. 2399 (1989), *replaced with* I.R.C. § 6662(d)(2). For discussion of section 6661 (and its reincarnation in 1989 in section 6662), see Part IV.E.1.

⁴³⁰See STAFF OF J. COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 216 (1982) (explaining that Congress "believed that an increasing part of the compliance gap is attributable to taxpayers playing the 'audit lottery,'" that under prior law taxpayers were "not exposed to any downside risk in taking questionable positions," and that taxpayers "should be deterred from playing the audit lottery through the imposition of a penalty designed to deter the use of undisclosed questionable reporting positions").

⁴³¹The audit rate fell steadily in the 1980s, reaching a (then) historic low of 1.2% in 1986. See Susan B. Long, *Estimating Criminal Tax Violations*, 12 TAX NOTES (TA) 1325 (June 8, 1981), excerpted from Long's book, *THE INTERNAL REVENUE SERVICE: MEASURING TAX OFFENSES AND ENFORCEMENT RESPONSE* (1980) (reporting audit coverage of 1.77% for 1981); John André LeDuc, *An Evaluation of Recent Taxpayer Compliance Legislation and Future Options*, 20 TAX NOTES (TA) 115, 116 (July 11, 1983) (reporting audit coverage of 1.55% for 1982); Lucia N. Smeal, *Senate Finance Committee Considers Nominations for IRS*, *Treasury Posts*, 22 TAX NOTES (TA) 1173, 1173 (Mar. 19, 1984) (reporting audit coverage of 1.36% for 1985); Lee A. Sheppard, *Unpopular Spending: IRS Budget and Tax Administration*, 28 TAX NOTES (TA) 821, 821 (Aug. 19, 1985) (reporting audit coverage of 1.2% for 1986).

⁴³²See *infra* note 443 and accompanying text.

⁴³³Practice Before the Internal Revenue Service, 31 Fed. Reg. 10,773, 10,776 (Aug. 13, 1966) (changing "unreasonable" fee to "unconscionable" fee).

1992, the Treasury proposed adding to the prohibition by limiting contingent fees to refund claims that “the practitioner reasonably anticipates, at the time the claim is filed . . . will be denied by the Service and subsequently litigated by the client.”⁴³⁴ At the same time, the Treasury forbade practitioners from charging contingent fees for original returns because “permitting contingent fees for tax return preparation would undermine voluntary compliance by encouraging return positions that exploit the audit selection process.”⁴³⁵ Charging fees based on the likelihood of eluding detection rather than on the substance of the advice, the Treasury believed, was not only unethical and should subject practitioners to discipline, but also encouraged noncompliance and inaccurate returns.

Two years later, in 1994, the Treasury finalized amendments to Circular 230.⁴³⁶ The new rule for fees prohibited a practitioner from charging a contingent fee on an original return and allowed a limited exception for an amended return or claim for refund that the practitioner “reasonably” anticipated “would receive substantive review by the Service.”⁴³⁷ The final amendments also added a non-contingent fee provision that also discouraged consideration or use of the audit lottery. New 31 C.F.R. § 10.34 (pertaining to standards for advising on return positions) banned practitioners from accounting for the “possibility that a position will not be challenged by the Service (*e.g.*, because the taxpayer’s return may not be audited or because the issue may not be raised on audit)” when analyzing a position’s likelihood of success on the merits.⁴³⁸ No longer would a tax advisor’s analysis of a tax position or a taxpayer’s deliberation over whether to reflect that position on her return depend on the chances of getting caught.

For the next 15 years, the Treasury, through Circular 230, continued to discourage practitioners and taxpayers from profiting off inaccurate returns and the audit lottery. Further restricting contingent fees played a prominent role in this effort. In 2001, the Treasury proposed preventing practitioners from charging a contingent fee not only for preparation of an original return but also for “any advice rendered in connection with a position taken or to

⁴³⁴ 31 C.F.R. § 10.27(b) (2014); 57 Fed. Reg. 46,357, 46,359 (Feb. 14, 1992).

⁴³⁵ 57 Fed. Reg. at 46,357.

⁴³⁶ 31 C.F.R. § 10.28(b) (2014).

⁴³⁷ 31 C.F.R. § 10.27(b) (2014); 59 Fed. Reg. 31,523, 31,527 (June 20, 1994).

⁴³⁸ 31 C.F.R. § 10.34(a)(4)(i) (2011); 59 Fed. Reg. at 31,528. The 1992 amendments proposed adding this section. *See* 57 Fed. Reg. 46,356, 46,359 (Oct. 8, 1992).

be taken on an original tax return,”⁴³⁹ an extension of the rule that practitioners endorsed as a curb on exploitation of the audit lottery.⁴⁴⁰ The Treasury excepted contingent fees for the preparation of an amended return or claim for refund as well as for advice rendered in connection with a position taken on such filings, on the theory that both categories of submissions received sufficient scrutiny and did not exploit the audit lottery.⁴⁴¹ In either case, the practitioner still had to reasonably believe that the filing would “receive substantive review” by the Service.⁴⁴² The following year, Treasury finalized the proposed changes⁴⁴³ yet indicated that it “remain[ed] concerned regarding the use of contingent fees” and would continue to study the problem.⁴⁴⁴

Finally, in 2007, the Treasury adopted proposed regulations issued the preceding year⁴⁴⁵ that permitted contingent fees only in the following contexts: for services rendered in connection with a Service examination or challenge

⁴³⁹31 C.F.R. § 10.27(b); 66 Fed. Reg. 3276, 3290 (Jan. 12, 2001). In 2000, the Treasury issued a notice of proposed rulemaking that indicated it was considering this change. See 65 Fed. Reg. 30,375, 30,376 (proposed May 11, 2000) (asking for comments on “[w]hether § 10.28 should prohibit a practitioner from charging a fee for an opinion or advice relating to a position taken or to be taken by a taxpayer in an original return where such fee is contingent upon whether the tax treatment of the transaction is sustained”). In addition, the proposed amendments renumbered section 10.28 as section 10.27. The Treasury had also roundly criticized contingent fees in its 1999 report, *THE PROBLEM OF CORPORATE TAX SHELTERS*. See DEPARTMENT OF THE TREASURY, *supra* note 377, at 23-24 (reporting on contingent and refundable fees that “reduce the cost and risk of the shelter to the participants. In a contingent fee arrangement, the promoter receives a portion, as much as one-half, of any tax savings realized by the corporate participant”). The widespread use of such fee arrangements was also reported in the tax press and popular press. See Lee A. Sheppard, *Is There Constructive Thinking About Corporate Tax Shelters?* 83 TAX NOTES (TA) 782, 787 (May 10, 1999) (discussing the “repulsive practice” of contingent fees); Novak & Saunders, *supra* note 382 (reporting that PriceWaterhouseCoopers charged shelter clients contingent fees ranging between eight to 30% of tax savings).

⁴⁴⁰The proposed rulemaking in 2001 stated that the “majority” of public comments received by the Treasury “supported a contingent fee limitation with respect to original tax returns if the fee arrangement was contingent on the return position being sustained. Such fee arrangements may indicate an inappropriate reliance on the ‘audit lottery.’” 66 Fed. Reg. at 3278.

⁴⁴¹*Id.*

⁴⁴²*Id.* at 3290.

⁴⁴³See Regulations Governing Practice Before the Internal Revenue Service, 67 Fed. Reg. 48,760, 48,772-73 (July 26, 2002).

⁴⁴⁴*Id.* at 48,760. In fact, less than six months later, the Treasury issued an advance notice of proposed rulemaking that invited comments on, among other matters, whether contingent fees should be allowed for taxpayers making requests for prefilling guidance (such as private letter rulings), whether they should be restricted still further with respect to amended returns or refund claims to taxpayer-clients with taxable income exceeding a certain dollar threshold, and whether the exception for amended returns and claims for refund should be sustained or repealed. See Regulations Governing Practice Before the Internal Revenue Service, 67 Fed. Reg. 77,724, 77,725 (Dec. 19, 2002).

⁴⁴⁵See Regulations Governing Practice Before the Internal Revenue Service, 71 Fed. Reg. 6421, 6429 (Feb. 8, 2006).

to an original return,⁴⁴⁶ timely filed amended returns and refund claims,⁴⁴⁷ claims for credit or refund on assessed interest or penalties⁴⁴⁸ (“because there is no exploitation of the audit lottery in these situations as they are generally completed on a post-examination basis”),⁴⁴⁹ and any judicial federal tax proceeding.⁴⁵⁰ As in 1992 so in 2007: restricting contingent fees for tax preparation or advice, the Treasury argued, “supports voluntary compliance with the Federal tax laws by discouraging return positions that exploit the audit selection process.”⁴⁵¹

Before proceeding to our final key historical development, it is worth highlighting how the Treasury used Circular 230 to fight the audit lottery and inaccurate returns in other ways. We witnessed one such example in 31 C.F.R. § 10.34 (pertaining to standards for advising return positions), which prohibited practitioners from estimating a position’s likelihood of success on the merits by accounting for the “possibility that a position will not be challenged” by the Service, either because the taxpayer’s return escaped audit or because the position was not raised in the event of an audit.⁴⁵² Adopted in 1994, the Treasury subsequently amended (and effectively readopted) the section in 2002 and 2006.⁴⁵³ In 2004, for another example, the Treasury finalized regulations pertaining to “covered opinions” under new 31 C.F.R. § 10.35 that instructed practitioners when making probability estimates to ignore “the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.”⁴⁵⁴ The Treasury also carved out a special contingent fees prohibition for covered opinions subject to contractual protection.⁴⁵⁵ And it added 31

⁴⁴⁶ 31 C.F.R. § 10.27(b)(2)(i); 72 Fed. Reg. 54,540, 54,548 (Sept. 26, 2007).

⁴⁴⁷ 31 C.F.R. § 10.27(b)(2)(ii); 72 Fed. Reg. at 54,548.

⁴⁴⁸ 31 C.F.R. § 10.27(b)(3); 72 Fed. Reg. at 54,548.

⁴⁴⁹ 31 C.F.R. § 10.27(b)(3); 72 Fed. Reg. at 54,542.

⁴⁵⁰ 31 C.F.R. § 10.27(b)(4); 72 Fed. Reg. at 54,548.

⁴⁵¹ 31 C.F.R. § 10.27(b)(4); 72 Fed. Reg. at 54,542.

⁴⁵² See *supra* note 438 and accompanying text.

⁴⁵³ See, respectively, 67 Fed. Reg. 48,760, 48,774 (July 26, 2002); 71 Fed. Reg. 6421, 6430 (proposed Feb. 8, 2006).

⁴⁵⁴ Regulations Governing Practice Before the Internal Revenue Service, 69 Fed. Reg. 75,839, 75,843 (Dec. 20, 2004). In 2001, the Treasury hinted at this explicit prohibition for tax shelters in proposed amendments to Circular 230. See 66 Fed. Reg. 3276, 3292 (proposed Jan. 12, 2001) (to be codified at 31 C.F.R. § 10.33(a)(5)(iv)) (shelters marketed to third persons); 66 Fed. Reg. at 3295 (to be codified at 31 C.F.R. § 10.35(a)(4)(iii)) (more likely than not shelters) (“In ascertaining that all material Federal tax issues have been considered, evaluating the merits of those issues and evaluating whether the Federal tax treatment of the tax shelter item or items is the proper treatment, the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.”).

⁴⁵⁵ See 69 Fed. Reg. at 75,842 (to be codified at 31 C.F.R. § 10.35(b)(7)) (the new regulations defined such advice as where a “taxpayer has the right to a full or partial refund of fees paid to the practitioner . . . if all or a part of the intended tax consequences . . . addressed in the written advice are not sustained, or if the fees paid to the practitioner . . . are contingent on the taxpayer’s realization of tax benefits from the transaction”).

C.F.R. § 10.37 for non-tax shelter written advice that restricted practitioners from accounting for the likelihood that a return would be audited or that a position would be raised on audit or resolved through settlement.⁴⁵⁶ Finally, the requirement that practitioners make probability estimates based on the merits of a position rather than on the likelihood that the tax agency will never see the position has become firmly embedded not just in the Treasury's practice rules but also in the penalty provisions of the Code.⁴⁵⁷

E. Accuracy Through Due Diligence: Advising on Accurate Return Positions

1. Disparate Standards for Tax Advisors and Taxpayer-Clients

As we saw in Part IV.A, the Treasury linked elevated due diligence standards among tax professionals in the early 1980s to accurate advice and accurate positions. In 1984, it finalized amendments to Circular 230 detailing new and particularized standards of care for federal tax practitioners when rendering opinions used in the promotion and marketing of tax shelters.⁴⁵⁸ The final regulations, we also saw, reflected Treasury's "concern about the proliferation of abusive tax shelters in recent years and the role of the IRS practitioner's opinion in the promotion of such shelters."⁴⁵⁹ The Service expressed special concern for legal opinions disseminated to nonclient investors of mass-marketed tax shelters. In such circumstances, tax lawyers had "unique ethical responsibilities"⁴⁶⁰ to provide "accurate and complete tax advice in the opinion as to the merits of the tax shelter offering" and, furthermore, to make detailed assessments of the risk and contingencies associated with tax avoidance schemes.⁴⁶¹ At the end of the day, the Treasury's elevated due diligence standards for shelter opinions obligated practitioners, especially tax lawyers,

⁴⁵⁶ See 31 C.F.R. § 10.37(a) (2005); 69 Fed. Reg. at 75,844-45.

⁴⁵⁷ See I.R.C. § 6664(d)(4)(A)(ii) (pertaining to reasonable belief in defense against penalties for noncorporate taxpayers); Reg. § 1.6662-4(d)(2) (pertaining to substantial authority standard); Reg. § 1.6662-4(g)(4)(i) (pertaining to reasonable belief for tax shelter items for noncorporate taxpayers); Reg. § 1.6664-4(f)(2)(i)(B) (pertaining to reasonable belief for tax shelter items for corporate taxpayers); Reg. § 1.6694-2(b)(1) (pertaining to "reasonable to believe that the position would more likely than not be sustained on its merits" for tax shelter items). The substantial authority standard has contained a prohibition against accounting for the audit lottery since 1991, one year before the Treasury proposed adding the restriction to Circular 230. See 56 Fed. Reg. 67,492, 67,501 (Dec. 31, 1991).

⁴⁵⁸ See 49 Fed. Reg. 6719 (Feb. 23, 1984).

⁴⁵⁹ *Id.*

⁴⁶⁰ *Id.*

⁴⁶¹ *Id.* at 6720.

to scrutinize rather than neglect “whether there is sufficient legal authority for a position taken on a return.”⁴⁶²

Two short years later, the Treasury sought to raise diligence standards yet again. Having already addressed professional conduct in the context of tax shelter advice, the Treasury now sought to tackle lax professional conduct involving all forms of tax practice. In announcing another round of amendments to Circular 230 in 1986, the Treasury did not mince words.

This notice of proposed rulemaking is premised on the concern of the Department of the Treasury that the professional responsibility of some of those eligible to practice before the Internal Revenue Service with respect to tax return preparation and advice relative to positions on tax returns has eroded over the years.⁴⁶³

Dereliction of professional duty, the Treasury maintained, “has led to serious problems concerning taxpayer compliance with the revenue laws,” which “adversely affects the integrity of our voluntary compliance tax system.”⁴⁶⁴

Degraded professional conduct also conflicted with Congressional efforts to curb aggressive tax avoidance. Between 1981 and 1984, Congress enacted a suite of new anti-shelter and penalty provisions while strengthening others.⁴⁶⁵ Amidst the legislative flurry, a new “substantial understatement” pen-

⁴⁶²*Id.* The new standard of care required practitioners to exercise heightened due diligence as to: factual matters (to be codified at 31 C.F.R. § 10.33(a)(1)(i)); evaluating information furnished by the client (to be codified at 31 C.F.R. § 10.33(a)(1)(ii)); relating the law to actual facts rather than hypothetical facts (to be codified at 31 C.F.R. § 10.33(a)(1)(iii)(iv)(2)); identifying all material federal tax issues (to be codified at 31 C.F.R. § 10.33(a)(1)(ii)(iv)(3)); opining on the likelihood of success on the merits for each material federal tax issue (to be codified at 31 C.F.R. § 10.33(a)(1)(ii)(iv)(4)) as well as the shelter's aggregate tax benefits (to be codified at 31 C.F.R. § 10.33(a)(1)(ii)(iv)(5)); and relying on the opinion or work product of other practitioners (to be codified at 31 C.F.R. § 10.33(b)). *Id.* at 6722-23.

⁴⁶³51 Fed. Reg. 29,113 (Aug. 14, 1986).

⁴⁶⁴*Id.*

⁴⁶⁵*See* Economic Recovery Tax Act (ERTA) of 1981, Pub. L. No. 97-34, 95 Stat. 172; Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, Pub. L. No. 97-248, 96 Stat. 324; Deficit Reduction Act (DEFRA) of 1984, Pub. L. No. 98-369, 98 Stat. 494. Each of these legislative achievements shut down various components of the tax shelter marketplace by, among other things: limiting the tax advantages of commodity straddles (I.R.C. § 1092); imposing an ad valorem penalty on income tax underpayments attributable to substantial valuation overstatements (I.R.C. § 6659); providing that interest on underpayments and overpayments equaled 100% of the average annual prime rate (I.R.C. § 6621(c)); imposing penalties on promoters (I.R.C. § 6700); enacting penalties for substantial understatements (I.R.C. § 6661) and aiding and abetting understatements (I.R.C. § 6701); permitting the Service to enjoin promoters of abusive tax shelters (I.R.C. § 7408); increasing interest on tax deficiencies (I.R.C. §§ 6621-22); increasing fines for criminal offenses under the tax code under I.R.C. § 7201 (attempt to evade or defeat tax), I.R.C. § 7203 (willful failure to supply return, supply information, pay tax), I.R.C. § 7206 (fraud and false statements), and I.R.C. § 7207 (fraudulent returns, statements, other documents); requiring shelter arrangers to register investments (I.R.C. § 6111), to include registration numbers in tax return filings (I.R.C. § 6707), and to maintain investor lists of “potentially abusive tax shelters” (I.R.C. § 6112) or face penalties for failing to maintain such lists (I.R.C. § 6708); and repealing safe-harbor leasing.

alty received the most attention.⁴⁶⁶ In enacting section 6661, Congress added downside risk to the compliance calculus to frustrate taxpayers “from playing the audit lottery through the imposition of a penalty designed to deter the use of undisclosed questionable reporting positions.”⁴⁶⁷

Section 6661 imposed a penalty on shelter investors for understatements of tax exceeding the greater of \$5,000 (\$10,000 for corporate taxpayers) or ten percent of tax owed.⁴⁶⁸ Taxpayers could avoid the penalty by showing that the position had “substantial authority,” a standard of care Congress considered “less stringent than a ‘more likely than not’ (*i.e.*, more than 50%) standard and more stringent than a ‘reasonable basis’ (*i.e.*, non-negligent) standard.”⁴⁶⁹ In the absence of substantial authority, the taxpayer could still avoid the penalty for non-tax shelter items by adequately disclosing relevant facts associated with the position,⁴⁷⁰ while for tax shelter items, the taxpayer could avoid the penalty if she showed substantial authority for the position *and* that she reasonably believed the position was more likely than not correct.⁴⁷¹ Finally, Congress authorized the Service to mitigate or waive the penalty on a showing that the taxpayer acted in good faith and with reasonable cause.

The Treasury’s proposed amendments to Circular 230 adopted the new statutory standard of care for taxpayers under section 6661, “substantial authority,” and imposed it on tax practitioners.⁴⁷² Treasury thought, not unreasonably, that if taxpayers were required to demonstrate “substantial authority” for undisclosed positions, tax professionals should be held to the

⁴⁶⁶ See Pub. L. No. 97-248, tit. III, § 323(a), 96 Stat. 324 (1982), *repealed by* Pub. L. No. 101-239, tit. VII, § 7721(c)(2), 103 Stat. 2106 (1989). The 1989 legislation replaced section 6661 with section 6662, the accuracy-related penalty provision. See Pub. L. No. 101-239, tit. VII, § 7721(a), 103 Stat. at 2395.

⁴⁶⁷ STAFF OF J. COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 216 (1982).

⁴⁶⁸ *Id.*

⁴⁶⁹ *Id.*; see also H.R. REP. NO. 97-760, at 575 (1982) (Conf. Rep.) (defining the “substantial authority” standard as “less stringent than a ‘more likely than not’ standard and more stringent than a ‘reasonable basis’ standard,” the latter of which reflected a level of support that although arguable was “fairly unlikely to prevail in court upon a complete review of the relevant facts and authority”); IRS, *supra* note 163, at 43 (stating that substantial authority “should approach” 51% but could extend as low as 45%). In analyzing whether a position possessed “substantial authority,” taxpayers and their advisors could rely on court opinions, Treasury regulations, revenue rulings, revenue procedures, and similar administrative pronouncements, but not law review articles, opinion letters, private letter rulings, determination letters, or technical advice memoranda. See I.R.C. § 6661(b)(2)(B)(ii). For the estimated numerical level of certainty required for “reasonable basis” position in the 1980s, see Philipps, *supra* note 35 (ten to 20% likelihood of success); Banoff, *supra* note 161, at 1128 (same).

⁴⁷⁰ See I.R.C. § 6661(b)(2)(B)(ii).

⁴⁷¹ See § 6661(b)(2)(C)(i)(II).

⁴⁷² See 51 Fed. Reg. 29,113 (Aug. 14, 1986).

same standard for advising those positions.⁴⁷³ Under prevailing ethical guidelines promulgated by practitioner groups, the standard for tax practitioners was considerably less rigorous. Under ABA ethics rules, tax lawyers could render advice on a position that possessed a “realistic possibility of success” if litigated,⁴⁷⁴ a level of certainty that approximated a 33% likelihood of success.⁴⁷⁵ Meanwhile, under their own set of rules, accountants were free to advise positions contrary to the government’s interpretation of the tax law so long as they could muster “reasonable support,”⁴⁷⁶ a level of certainty analogous to the debased “reasonable basis” standard⁴⁷⁷ (reflecting ten to 20%

⁴⁷³ See, e.g., *id.* at 29,114 (stating that the proposed standard “would prohibit a practitioner from recommending or advising a client that a position be taken with respect to the tax treatment of any item on a tax return if, in the exercise of due diligence, the practitioner determines that the taxpayer filing the return may be liable for an addition to tax under section 6661 of the Internal Revenue Code as a result of the position”).

⁴⁷⁴ ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 85-352 (1985).

⁴⁷⁵ ABA Tax Section, *Report of the Special Task Force on Formal Opinion 85-352*, 39 TAX LAW. 635, 638 (1986). According to this report compiled by the ABA Section of Taxation on the “realistic possibility of success” standard, while a “5 percent or 10 percent likelihood of success was not enough to meet the new standard . . . a position with a likelihood of success approaching one-third should pass muster.” The report also observed that a reporting position supported by “substantial authority” as defined under section 6661 (and, subsequently, in the 1986 proposed amendments to Circular 230) would satisfy the realistic possibility of success standard.

⁴⁷⁶ See AICPA, TAX DIVISION’S FEDERAL TAXATION DIVISION, *Positions Contrary to Treasury Department or Internal Revenue Service Interpretations of the Code*, in STATEMENTS ON RESPONSIBILITIES IN TAX PRACTICE (SRTP) No. 10 (1977).

⁴⁷⁷ The ABA’s interpretation of the “reasonable basis” standard for a return position was outlined in Formal Opinion 314, as discussed at *supra* note 29. By the late 1970s and early 1980s, the standard had few defenders. According to critics, it permitted tax lawyers to advise “noncompliance with scienter” (John André LeDuc, *The Legislative Response of the 97th Congress to Tax Shelters, the Audit Lottery, and Other Forms of Intentional or Reckless Noncompliance*, 18 TAX NOTES (TA) 363, 365 (July 31, 1983)) and to “support the use of any colorable claim” (BERNARD WOLFMAN, JAMES P. HOLDEN & KENNETH L. HARRIS, STANDARDS OF TAX PRACTICE: PROFESSIONAL RESPONSIBILITY AND ETHICS 59 (1992)). Wolfman also criticized reasonable basis as “anything you can articulate without laughing.” Lee A. Sheppard, *Ethics Opinion and Tax Shelters Addressed at ABA Meeting*, 22 TAX NOTES (TA) 757 (Feb. 27, 1984) (quoting Wolfman). In addition to facilitating “reckless disregard under traditional standards,” (LeDuc, *supra*, at 371), it allowed tax lawyers to advise positions they knew did not comply with the tax law. In the words of one critic, “A poor lawyer is he who cannot find a reasonable basis for his client’s position.” Ray Patterson, *Tax Shelters for the Client: Ethics Shelters for the Lawyer*, 61 TEX. L. REV. 1163, 1165 (1982-1983). Furthermore, it promoted aggressive tax avoidance and a lowest common denominator brand of professionalism (See Cooper, *supra* note 251; Commissioner Jerome Kurtz, *Discussion on “Questionable Positions,”* 32 TAX LAW. 24 (1978-1979) (Kurtz stating that reasonable basis produced “the lowest common denominator. The one with the least conscience gets the best result.”)), and created a perverse paradox by providing “a basis for rationalizing as ethical conduct that which the lawyer himself in a different context would characterize as unethical.” Patterson, *supra*, at 1165. For a fuller discussion and criticism of the reasonable basis standard, see Ventry, *supra* note 283.

certainty),⁴⁷⁸ which the ABA had recently abandoned for purposes of advising return positions in Opinion 85-352.⁴⁷⁹

The government knew that its proposed amendments inflicted a higher standard of diligence on tax practitioners than they were used to.⁴⁸⁰ It also knew that the national governing bodies for tax professionals had just reconsidered or (in the case of the AICPA) were in the process of reconsidering the standard of care for advising return positions, with “realistic possibility of success” replacing the lowly “reasonable basis” standard.⁴⁸¹ Nonetheless, the Treasury rejected *any* standard of care—including the ABA’s newly adopted “realistic possibility of success standard”—that permitted tax practitioners to meet their professional duty while exposing taxpayers to penalty under new

⁴⁷⁸ See Banoff, *supra* note 161, at 1128.

⁴⁷⁹ See ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 85-352 (1985); see also ABA Tax Section, *supra* note 475, at 638 (concluding that unlike the reasonable basis standard, the realistic possibility of success standard required more than just any possibility of success: the possibility of success “must be ‘realistic,’” and it could not be realistic “if it is only theoretical or impracticable. This clearly implies that there must be a substantial possibility of success”). For a more detailed discussion of the ABA’s decision to abandon the reasonable basis standard for return positions and to adopt the realistic possibility of success standard, see Dennis J. Ventry, Jr., *Lowering the Bar: ABA Formal Opinion 85-352*, 112 TAX NOTES 69 (July 5, 2006). For additional commentary and criticism of Opinion 85-352, see Gwen Thayer Handelman, *Constraining Aggressive Return Advice*, 9 VA. TAX REV. 77, 94-95 (1989); Matthew C. Ames, *Formal Opinion 352: Professional Integrity and the Tax Audit Lottery*, 1 GEO. J. LEGAL ETHICS 411 (1987); Theodore C. Falk, *Tax Ethics, Legal Ethics, and Real Ethics: A Critique of ABA Formal Opinion 85-352*, 39 TAX LAW. 643 (1985-1986).

⁴⁸⁰ See, e.g., Mark N. Uhlfelder & Lee A. Sheppard, *IRS Director of Practice Shapiro Comments on Proposed Changes to Circular 230*, 34 TAX NOTES (TA) 1150, 1151 (Mar. 23, 1987) (quoting Shapiro as acknowledging that the standard of care in Treasury’s proposed amendments to Circular 230 were “at variance” with the standard reflected in Opinion 85-352). Director Shapiro elaborated at a meeting of the Commissioner’s Advisory Group (composed of Service executives and tax practitioners), observing that practitioners viewed advice rendered in good faith and evidenced by a realistic possibility of success as equating with good tax practice, while the Service did not necessarily share that view. *Minutes of December 1987 Commissioner’s Advisory Group Meeting, Complexity and Change*, 88 TAX NOTES TODAY 59-33 (Mar. 16, 1988).

⁴⁸¹ As noted in *supra* note 479 and accompanying text, the ABA abandoned “reasonable basis” in favor of “realistic possibility of success” in 1985. For its part, the AICPA undertook wholesale revision of its Statements on Responsibilities in Tax Practice (SRTP) in 1985, a process that culminated in 1988 with old Statement No. 10 becoming new Statement No. 1, “Tax Return Positions,” which contained the AICPA’s new due diligence standard for return positions, “realistic possibility of being sustained administratively or judicially on its merits if challenged.” See AICPA, FEDERAL TAXATION COMMITTEE, STATEMENTS ON RESPONSIBILITIES IN TAX PRACTICE (SRTP) NO. 1, TAX RETURN POSITIONS (1988 Revised).

section 6661.⁴⁸² As the Treasury explained, “when the revenue laws mandate or suggest a higher standard than would be applied otherwise, that higher standard [*i.e.*, “substantial authority”] must be the one followed.”⁴⁸³ In the exercise of due diligence, a practitioner “should not . . . place his or her client in a position of being assessed any penalty or addition to tax in connection with section 6661.”⁴⁸⁴ To do otherwise amounted to “counseling a false or fraudulent tax position” and could subject the practitioner to discipline under Circular 230.⁴⁸⁵

In explicit terms, Treasury tied a practitioner’s fate to her clients, “punctuat[ing] the link between a practitioner’s responsibility to exercise due diligence and his or her responsibility to adhere to the compliance provisions of the Internal Revenue Code.”⁴⁸⁶ To this end, the proposed amendments to Circular 230 required practitioners to advise clients “fully” of the potential application of the section 6661 penalty for positions without “substantial authority” and to further apprise them of how to avoid the penalty through adequate disclosure.⁴⁸⁷ In addition, the Treasury proposal prohibited practitioners from advising or recommending return positions that exposed taxpayer-clients to liability under section 6661⁴⁸⁸ and from preparing or signing returns reflecting such positions.⁴⁸⁹ In other words, and unlike the practice

⁴⁸² ABA Formal Opinion 85-352 permitted tax lawyers to advise reporting positions “so long as the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law and there is some realistic possibility of success if the matter is litigated.” ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 85-352 (1985). Competent representation required the lawyer to analyze whether the position was supported by substantial authority as contemplated under section 6661, to communicate that determination to the taxpayer-client, and to advise the client on the likelihood of the position being subject to penalty as well as any opportunity to avoid penalties through disclosure. “If after receiving such advice,” Opinion 85-352 allowed, “the client decides to risk the penalty by making no disclosure and to take the position initially advised by the lawyer in accordance with the standard stated above, the lawyer has met his or her ethical responsibility with respect to the advice.” In other words, a lawyer could advise a position even if she believed it “probably will not prevail, there is no ‘substantial authority’ in support of the position, and there will be no disclosure of the position in the return.”

⁴⁸³ 51 Fed. Reg. 29,113 (Aug. 14, 1986).

⁴⁸⁴ *Id.*

⁴⁸⁵ *Id.*

⁴⁸⁶ *Id.*; see also Dennis J. Ventry, Jr., *Filling the Ethical Void: Treasury’s 1986 Circular 230 Proposal*, 112 TAX NOTES (TA) 691, 692 (Aug. 22, 2006) (“By tying a practitioner’s fate to her client’s, Treasury allocated shared stewardship responsibilities for the tax system to practitioners, making them interested parties in the regulatory and legislative effort to curb noncompliance.”).

⁴⁸⁷ 51 Fed. Reg. at 29,115 (proposed Aug. 14, 1986) (to be codified at 31 C.F.R. § 10.34(a)).

⁴⁸⁸ *Id.* (to be codified at 31 C.F.R. § 10.34(b)).

⁴⁸⁹ *Id.* (to be codified at 31 C.F.R. § 10.34(c)).

rules promulgated by the ABA in Opinion 85-352,⁴⁹⁰ a practitioner could not discharge her duty by advising a reporting position that she believed would not prevail on the merits, that did not reflect “substantial authority,” and that was not adequately disclosed in the absence of substantial authority.

The proposed amendments reflected Treasury’s general philosophy that tax practitioners owed dual responsibilities, both to the client and the tax system. To the client, practitioners owed diligence duties of competence, loyalty, and confidentiality, while to the system they owed an obligation “to be fair and honest in their dealings with the IRS and to foster confidence by their clients in our tax system and in tax compliance.”⁴⁹¹ When those duties conflicted, moreover, “the practitioner is required to decide which obligation prevails and, in so doing, may correctly conclude that the obligation to the tax system is paramount.”⁴⁹² Representing clients in front of the Service was not the same as representing clients in a court of law during an adversary proceeding. Submitting a tax return served a “self-assessment function.” It was not a first offer, nor should it be used “to exploit the audit selection process.”⁴⁹³ At its heart, the tax return reflected “a citizen’s report to the government of his or her relevant activities for the year,” and practitioners, in rendering advice related to the return, had an obligation to ensure that “representations made on tax returns must accurately reflect the facts, and positions taken on tax returns must be supportable by the law.”⁴⁹⁴

While the Treasury viewed the proposed amendments as formalizing a natural partnership between the government and tax practitioners in promoting compliance, practitioners believed (quite rightly) that they were being deputized as pseudo-government regulators. In effect, they were being asked to underwrite an insurance policy—both for taxpayer-clients and the government—against the section 6661 penalty for all reporting positions on

⁴⁹⁰ See ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 85-352 (1985) (stating a lawyer could advise reporting positions “even where the lawyer believes the position probably will not prevail, there is no ‘substantial authority’ in support of the position, and there will be no disclosure of the position in the return”).

⁴⁹¹ 51 Fed. Reg. at 29,113; see also Doug Briggs, *Tax Attorneys Debate Merits of Amendment to Circular 230*, 35 TAX NOTES (TA) 635 (May 18, 1987) (paraphrasing IRS Director of Practice Leslie Shapiro as saying that every practitioner “has an obligation to deal fairly and honestly with the government and to foster client confidence in the system”); *Remarks by Lawrence Gibbs Commissioner of Internal Revenue Before the North Carolina Association of CPAs*, 86 TAX NOTES TODAY 203-3 (Oct. 9, 1986) (quoting Gibbs as saying, “The thrust of the emerging rules is to define a practitioner not as a go-between for sending tax information to the Service but as an instrument for the full and accurate reporting of clients’ tax information”); *Remarks of IRS Commissioner Roscoe L. Egger Jr. Before the AICPA Tax Division Meeting*, 85 TAX NOTES TODAY 98-5 (May 16, 1985) (“People who are engaged in tax practice are in a category all by themselves. No group of people has a more clear-cut double responsibility—to clients and to society at large.”).

⁴⁹² 51 Fed. Reg. at 29,113.

⁴⁹³ *Id.*

⁴⁹⁴ *Id.*

which they advised.⁴⁹⁵ Such an obligation was “draconian”⁴⁹⁶ and a “pernicious attack”⁴⁹⁷ on tax practitioners. Traditionally, practitioners were held to familiar standards of conduct that, before the imposition of penalties or discipline, required a showing of negligence or willful disregard,⁴⁹⁸ reckless disregard,⁴⁹⁹ knowing disregard,⁵⁰⁰ or negligence and fraud.⁵⁰¹ By adopting the “no-fault” standard imposed on taxpayers in section 6661 and making it the due diligence standard for practitioners, a practitioner could conceivably be suspended or disbarred by the Treasury for her client’s understatement of tax “without proof of fault.”⁵⁰² In this way, charged practitioners, the Treasury had taken the taxpayer’s no-fault civil penalty and inappropriately “expand[ed] its scope by making it a disciplinary provision for tax practitioners.”⁵⁰³

Even more worrisome, if practitioners were reduced to “quasi-IRS agents”⁵⁰⁴ and made part of the government’s “enlisted army,”⁵⁰⁵ clients might view them “as an enforcement arm of the IRS” rather than as zealous advocates for a client’s interest.⁵⁰⁶ Moreover, and perversely, practice rules preventing practitioners from asserting advantageous positions would end up hurting ethical practitioners—now forced to render safe and conservative advice—while rewarding aggressive tax shelter advisors who would never be deterred

⁴⁹⁵ *Letter from Herbert J. Lerner & Leonard Podolin, American Institute of Certified Public Accountants, to Leslie S. Shapiro, IRS Dir. of Practice*, 87 TAX NOTES TODAY 35-9 (Feb. 13, 1987).

⁴⁹⁶ *Letter From David Sachs, Chair, Bar Association of the City of New York, to Dir. of Practice, IRS*, 87 TAX NOTES TODAY 25-44 (Jan. 9, 1987).

⁴⁹⁷ Briggs, *supra* note 491, at 635 (quoting Jules Ritholz of Kostelanetz, Ritholz, Tighe & Fink at a meeting of the D.C. Bar Tax Section).

⁴⁹⁸ See, e.g., I.R.C. §§ 6700, 6694 (1989).

⁴⁹⁹ See, e.g., § 6694.

⁵⁰⁰ See, e.g., I.R.C. § 6701.

⁵⁰¹ See, e.g., I.R.C. § 6653 (1989). The Omnibus Budget Reconciliation Act of 1989 drastically altered former section 6653 and changed the section title from “Additions to tax for negligence and fraud” to “Failure to pay stamp tax.” Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(1), 103 Stat. 2399 (1989).

⁵⁰² *Comments on Proposed Modification of Circular 230*, 34 TAX NOTES (TA) 1113, 1115 (Mar. 16, 1987). “The use of such a no-fault standard” in the Treasury’s practice rule, concluded the NYSBA, “is inappropriate.” *Id.*

⁵⁰³ *Id.* at 1115; see also Lerner & Podolin, *supra* note 495 (“Congress chose to apply section 6661, which is a ‘no-fault’ provision, only to the taxpayer whose return reflects a substantial understatement”); Lin M. Trucksess, *Painting the Gray Zone Grayer: Why Substantial Authority Fails as a Replacement for the Reasonable Basis Standard in Assessing Practitioner Conduct Under Circular 230*, 8 VA. TAX REV. 743, 751-57 (1989) (finding no evidence that Congress intended to extend section 6661 penalty to practitioners).

⁵⁰⁴ Karin M. Skadden, *Circular 230 Revisions and Pending Passive Loss Regulations Focus of AICPA Tax Division Meeting*, 37 TAX NOTES (TA) 1080 (Dec. 14, 1987) (paraphrasing the head of the AICPA Subcommittee on Responsibilities in Tax Practice).

⁵⁰⁵ *Letter from Schuyler M. Moore, Member, Gibson, Hoffman & Pancione, to Leslie S. Shapiro, IRS Dir. of Practice*, 86 TAX NOTES TODAY 167-26 (Aug. 14, 1986).

⁵⁰⁶ *Letter from Robert R. Feazell, President, Nat’l Soc’y of Pub. Accountants, to Leslie S. Shapiro, IRS Dir. of Practice*, 86 TAX NOTES TODAY 227-27 (Nov. 4, 1986).

by penalties and professional discipline.⁵⁰⁷ Taxpayers would shop around for the most favorable advice, ethical practitioners would lose clients to “the least competent advisors,”⁵⁰⁸ and compliance would decrease rather than increase.

Turning practitioners into pseudo-regulators also threatened the attorney–client (as well as the accountant–client) relationship. Advice rendered to clients—particularly advice on section 6661 and its substantial authority standard—would become the subject of disciplinary investigations for practitioners and affirmative defenses against penalties for taxpayer-clients. On the one hand, a practitioner might have to waive the client’s right to keep attorney–client communications privileged in the event the practitioner were called to defend herself against charges that she violated the due diligence standard under Circular 230.⁵⁰⁹ On the other hand, a taxpayer-client might be forced to waive the attorney–client privilege in defending against understatements of tax and associated penalties versus helping his advisor avoid penalty and defending against Circular 230 violations.⁵¹⁰ Such conflicts and adversity would undermine the time-honored relationship between attorneys and clients⁵¹¹ and force lawyers to choose between risks to careers versus client loyalty. For their part, taxpayer-clients would be forced to choose between providing a full and forceful defense to penalties versus hanging their advisors out to dry.

Even if they wanted to, practitioners could not guarantee clients’ compliance with the law. Nor could they police their clients’ morals.⁵¹² The best

⁵⁰⁷ Sachs, *supra* note 496 (arguing that subjecting practitioners to penalties failing to meet the due diligence standard in section 6661 would not “achieve the desired goal of” decreasing noncompliance “insofar as practitioners who are insensitive to the possible importance of the penalty would very likely not alter their conduct in any event”).

⁵⁰⁸ William L. Raby, *The Role of Disclosure in Tax Return Preparation*, 3-89 TAX ADVISER 157, 159 (1989).

⁵⁰⁹ See Sachs, *supra* note 496 (stating that holding practitioners to the section 6661 standard would force disclosure of information “that would not be necessary absent the proposed changes”); see also *American Bar Association Tax Section Kicks Off Spring Meeting With Committee Meetings*, 87 TAX NOTES TODAY 96-1 (May 18, 1987) (arguing that such disclosure could undermine a taxpayer-client’s position in the event of litigation over the underlying reporting position).

⁵¹⁰ See, e.g., Sachs, *supra* note 496 (writing that the NYSBA Tax Section queried “whether it is appropriate for taxpayers to be questioned as to whether they received advice as to the applicability of the section 6661 penalty. Such inquiry would subject a taxpayer to the dilemma of waiving his attorney–client privilege or jeopardizing his attorney’s eligibility to practice before the Internal Revenue Service. We do not believe that the taxpayer and his attorney should be potentially placed in adversarial postures”).

⁵¹¹ See Feazell, *supra* note 506 (stating that the proposed amendments would create “serious conflicts in the role of the practitioners”); Lerner & Podolin, *supra* note 495 (noting that the proposal “would potentially cause practitioners to have a conflict between their own interests and those of their clients”).

⁵¹² See, e.g., Karin M. Skadden, *Substantial Understatement Penalty Centers Debate on Role of the Practitioner in the Tax System*, 41 TAX NOTES (TA) 253, 257 (Oct. 17, 1988) (quoting Hugh Calkins of Jones Day as saying, “Moral opprobrium couched in the form of a penalty is inappropriate . . .”).

they could do was advise a client as to the relevant authority for a position, estimate the likelihood of success on the merits for the position based on current law, communicate any penalties that might apply as well as the ability to avoid penalties through disclosure (if relevant), describe any other reasonably foreseeable legal consequences associated with the position, and then let the client decide what to put on the return.⁵¹³ If the Service subsequently assessed penalties on the position for lack of substantial authority without disclosure, and the practitioner communicated that likelihood to the client, the practitioner had “met his or her ethical responsibility with respect to the advice.”⁵¹⁴ To expect practitioners to “underwrite an insurance policy against the possible imposition of the section 6661 penalty”⁵¹⁵ was “wholly unrealistic,”⁵¹⁶

⁵¹³See, e.g., Lerner & Podolin, *supra* note 495 (“The primary responsibility for a tax return is that of the taxpayer, not the practitioner.”).

⁵¹⁴See ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 85-352 (1985); see also Sachs, *supra* note 496 (arguing that disciplinary rules for tax advisors “should depend upon the practitioner’s beliefs and conduct rather than upon those of the taxpayer”).

⁵¹⁵Lerner & Podolin, *supra* note 495.

⁵¹⁶*Id.*

particularly given the inherent uncertainties in tax law⁵¹⁷ and the relatively new and evolving “substantial authority” standard.⁵¹⁸

The animated response from the practitioner community prompted the Treasury to twice extend the comment period on its proposed amendments to Circular 230.⁵¹⁹ But Treasury refused to back down. Its latest recommendations to regulate federal tax practitioners represented an active and ongoing anti-shelter battle waged not just by the Treasury but also by Congress and

⁵¹⁷New York State Bar Association Tax Section Tax Analysts, *supra* note 502, at 1115, 1116 (arguing that proposed amendments to Circular 230 “impose[d] an unfair and unworkable standard on tax practitioners due to the uncertainties of a constantly changing tax law” and that certainty on reporting positions “is rarely possible”).

⁵¹⁸See Karen M. Skadden, *Commissioner's Advisory Group Concentrates on Penalties and IRS Relationships With Practitioners and the States*, 88 TAX NOTES TODAY 190-1 (Sept. 16, 1988) (reporting that the Advisory Group argued strongly against “utilizing section 6661 as a disciplinary standard for practitioners” due to “uncertainty as to what constitutes acceptable ‘substantial authority’ and ‘adequate disclosure,’” in addition to the “possibility of conflict with ethical standards recently revised by the American Bar Association and the American Institute of CPAs”); New York State Bar Association Tax Section Tax Analysts, *supra* note 502, at 1116 (noting that “the question whether the penalty under section 6661 is applicable in a given case is not ordinarily susceptible of easy resolution”). A primary concern among practitioners involved the category of authorities that comprised “substantial authority” under section 6661. Treasury regulations listed the Code and other statutory provisions, temporary and final regulations, court cases, revenue rulings and procedures, tax treaties and accompanying regulations and Treasury explanations, and congressional reports reflecting Congressional intent. See Reg. § 1.6661-3(b) (as issued in 1985). At the same time, the regulations failed to include commonly recognized sources on tax law such as proposed regulations, private letter rulings, and the Joint Committee on Taxation's annual Blue Book publication. Skadden, *supra* note 512, at 254. Some of the excluded authorities and interpretations, moreover, constituted “authority” to substantiate positions for the Service—in particular, proposed regulations and private letter rulings—but not for taxpayers or their advisors. See Skadden, *supra* note 512, at 254 (paraphrasing James E. Merritt of Morrison & Foerster). The Treasury's somewhat restrictive list of authorities derived from its interpretation of the legislative history surrounding section 6661, which stated that in applying the substantial authority standard, “the courts will not be bound by the conclusions reached in law review articles, opinion letters, or private letter rulings . . . but will instead examine the authorities that underlie such expressions of opinion.” S. Rep. No. 97-530, at 575 (1982); H.R. Rep. No. 97-760, at 575 (1982)(Conf. Rep.); H.R. Rep. No. 97-530 (1982)(Conf. Rep.); H.R. 4961, 97th Cong. (1982). But see Kenneth L. Harris, *Resolving Questionable Positions on a Client's Federal Tax Return: An Analysis of the Revised Section 6,694(a) Standard*, 47 TAX NOTES (TA) 971, 973 (May 21, 1990) (“While it is true that a court may not be bound by any of the above materials, this does not mean that a taxpayer who relies on such materials has engaged in the type of conduct that should be subject to penalty. Indeed, a practitioner who ignores the above government interpretations in rendering tax advice probably fails in his duty of competence to the client.”). All of the major tax professional organizations endorsed an expanded definition of “substantial authority.” See New York State Bar Association Tax Section Tax Analysts, *supra* note 502, at 1115-16; Sachs (Bar Association of the City of New York), *supra* note 496; *Tax Section of D.C. Bar Opposes Certain Proposed Amendments to Circular 230*, 87 TAX NOTES TODAY 43-15 (Mar. 5, 1987); Lerner & Podolin (AICPA), *supra* note 495.

⁵¹⁹See Extension of Comment Period, 51 Fed. Reg. 30,510 (Aug. 27, 1986) (to be codified at 31 C.F.R. pt. 10); Solicitation for Extended Comments, 51 Fed. Reg. 40,340 (Nov. 6, 1986) (to be codified at 31 C.F.R. pt. 10).

the courts. Much work remained to be done with tax shelter cases overburdening court dockets and constituting almost 50% of all cases in the United States Tax Court.⁵²⁰ Still more shelters went undetected due, at least in part, to tight Service budgets and historically low audit rates.⁵²¹ And while the practitioner organizations had joined the anti-shelter fight by elevating their own standards for advising tax shelters and return positions, they did so reluctantly and with a standard of care that still permitted attorneys and accountants to counsel noncompliance without violating professional standards or facing discipline.⁵²² As in 1980,⁵²³ attacking noncompliance in the latter half of the decade required attacking the professional standards that facilitated (and often protected) questionable behavior.

Between 1987 and 1989, while the Treasury waited to finalize amendments to Circular 230, a vigorous discussion over professional standards and penalty provisions ensued. Both the U.S. House and Senate created task forces and launched hearings on the role of penalty provisions in the Code pertaining to taxpayers and tax practitioners.⁵²⁴ The New York State Bar Association and Tax Executives Institute released detailed reports on civil tax penalties,⁵²⁵ while the AICPA conducted a national survey of tax practitioners that informed its own proposals⁵²⁶ and also concluded a multi-year review of its ethical rules by raising the due diligence standard for return positions from “reasonable support” to “realistic possibility of being sustained” on its merits if challenged.⁵²⁷ For its part, the ABA released a comprehensive review of civil and criminal penalties, which, among other recommendations, called for repealing the “no-fault” approach in the substantial understatement penalty

⁵²⁰ See Kathleen Matthews, *Nelson Discusses Service's Plans on Large Case Litigation*, 39 TAX NOTES (TA) 553 (May 2, 1988) (shelter caseload at 55%); *American Bar Association Tax Section Kicks Off Spring Meeting With Committee Meetings*, 87 TAX NOTES TODAY 96-1 (May 18, 1987) (tax shelter caseload at 45% of Tax Court docket); Mark N. Uhlfelder, *Interview With Chief Counsel William F. Nelson*, 33 TAX NOTES 888, 890 (Dec. 8, 1986) (reporting that tax shelter cases represented 46.5% of the U.S. Tax Court's docket).

⁵²¹ See Lee A. Sheppard, *Unpopular Spending: IRS Budget and Tax Administration*, 28 TAX NOTES (TA) 821 (Aug. 19, 1985) (reporting audit coverage of 1.2% for 1986).

⁵²² See *Remarks by IRS Commissioner Lawrence Gibbs Before the D.C. Bar Section of Taxation*, 86 TAX NOTES TODAY 202-3 (Oct. 8, 1986) (discussing the wide-ranging anti-shelter effort).

⁵²³ See Part IV.A.

⁵²⁴ See Congressional Roundup, *Prior to Form Penalty Reform Task Force*, 38 TAX NOTES (TA) 867 (Feb. 22, 1988); Pat Jones, *Civil Tax Penalties Attracting Lawmakers' Attention*, 38 TAX NOTES (TA) 1019 (Mar. 7, 1988); *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code: Hearings Before the Subcomm. on Oversight of the Comm. on Ways & Means*, 100th Cong. 100-75 (1988) [hereinafter *Civil Tax Penalties Hearings*].

⁵²⁵ Charles M. Morgan, III, *NYSBA Section of Taxation Tax on Civil Penalties*, 38 TAX NOTES (TA) 511 (Feb. 1, 1988); Tax Executives Institute, Inc., *TEI Submits Proposals for Civil Penalty Tax Reform*, 43 TAX NOTES (TA) 1580 (June 26, 1989).

⁵²⁶ Pat Jones, *Pickle Panel Prepares for Penalty Proposals*, 42 TAX NOTES (TA) 905 (Feb. 20, 1989).

⁵²⁷ See AICPA, *supra* note 481.

(and the analytically related “substantial authority” standard)⁵²⁸ in favor of a three-tier penalty system that linked severity of penalties to degrees of misconduct (25% penalty for negligent conduct; 50% penalty for reckless or intentional conduct; 75% penalty for willful intent to evade).⁵²⁹

Meanwhile, the Service established a task force on civil penalties that released three reports in quick succession analyzing the penalty system from philosophical, economic, political, and administrative perspectives.⁵³⁰ In this endeavor, the Service worked closely with the major practitioner groups and other professional, academic, and business groups.⁵³¹ With respect to the substantial understatement penalty, the Service thought that taxpayers should be expected to file “accurate” returns⁵³² and that the taxpayer standard of care “should be properly coordinated with the traditional role” of practitioners, “whose obligation is to advise their clients under the law.”⁵³³ To this end, the Service initially required taxpayers and practitioners to exercise “reasonable care” in determining that every undisclosed return position would “more

⁵²⁸The ABA spent a good deal of time criticizing the “complex” substantial authority standard and explaining that it was “impossible to predict” the probability of a reporting position under such an imprecise standard. ABA SECTION ON TAXATION, COMMITTEE ON CIVIL AND CRIMINAL TAX PENALTIES, PENALTIES STUDY REPORT 22 (July 28, 1988), *reprinted in Civil Tax Penalties Hearings*, *supra* note 524. In the absence of a more precise standard, other practitioners and commentators argued that a tax advisor became “an oddsmaker at best, a divine at worst.” Philipps, et al., *supra* note 35, at 1175.

⁵²⁹See ABA SECTION ON TAXATION, *supra* note 528, at 28; *see also* Washington Roundup, *ABA Tax Section Penalties Task Force Advocates Repeal of Substantial Understatement Penalty and Greater Focus on Levels of Culpability*, 40 TAX NOTES (TA) 678 (Aug. 15, 1988); Pat Jones, *ABA Presents Penalty Reform Study to Pickle Subcommittee*, 40 TAX NOTES (TA) 457 (Aug. 1, 1988). For a discussion of the ABA report and its additional recommendations (such as avoiding the “stacking” of the substantial understatement penalty on top of the fraud, negligence, and delinquency penalties as well as expanding the list of authorities on which practitioners could rely in determining substantial authority), see Dennis J. Ventry, Jr., *Vices and Virtues of an Objective Reporting Standard*, 112 TAX NOTES (TA) 1085, 1086-88 (Sept. 19, 2006). It is worth noting that there was significant dissent among the authors of the ABA report with respect to no-fault, objective penalties. Without such penalties, the signed dissenters argued, taxpayers would have “little motivation to disclose aggressive positions supported by an opinion of counsel,” which would create a “‘race to the bottom’ in advisor opinions which called forth Congressional action in the first place.” ABA SECTION ON TAXATION, *supra* note 528, at 25; *see also Civil Tax Penalties Hearings*, *supra* note 524, at 447 (statement of James E. Merritt, Member, ABA Section of Taxation) (spotlighting the “downside risk” for taking aggressive reporting positions as a result of the section 6661 penalty and endorsing the objective approach as a workable and familiar standard).

⁵³⁰See IRS, EXEC. TASK FORCE, COMMISSIONER’S PENALTY STUDY, A PHILOSOPHY OF CIVIL TAX PENALTIES (Discussion Draft June 1988); IRS, EXEC. TASK FORCE, COMMISSIONER’S PENALTY STUDY, REPORT ON CIVIL TAX PENALTIES (Working Draft Dec. 1988); IRS, *supra* note 163.

⁵³¹*Civil Tax Penalties Hearings*, *supra* note 524, at 9 (statement of Lawrence Gibbs, Commissioner of Internal Revenue).

⁵³²IRS (Dec. 1988), *supra* note 530, at 8.

⁵³³*Id.* ch. 8, at 7.

likely than not” prevail on the merits.⁵³⁴ Moreover, it proposed eliminating the existing accuracy-related penalties—including the “no-fault” substantial understatement penalty—and replacing them with a three-tier system (also applicable to practitioners under a reconstituted section 6994),⁵³⁵ thereby abandoning the objective approach in favor of an approach based on culpability (similar to the ABA approach discussed above).⁵³⁶ The Service was “willing to put the substantial understatement penalty on the table,” Commissioner Lawrence Gibbs explained, “provided taxpayers and practitioners are willing to talk about raising the standard in terms of the accuracy level.”⁵³⁷

One minute the Service was prepared to hold taxpayers and practitioners to higher standards of care—indeed, to “more likely than not” levels of accuracy—and the next minute it nearly retreated to the status quo. The Service’s final report on civil penalties allowed taxpayers to take undisclosed positions that were “probably correct”⁵³⁸ (rather than “accurate”), which meant they had to meet a beefed-up “substantial authority” standard that “should” approach 51% but could fall to 45%.⁵³⁹ The more robust substantial authority standard still reflected an objective approach to penalties, but it was less burdensome than the previously proposed “more likely than not” standard.

Meanwhile, the Service retreated still further with respect to regulating tax advisors by substituting a pliable negligence standard of care for the rigid objective standard. In particular, it proposed amending section 6694 to require that practitioners exercise “reasonable care” in determining whether a taxpayer-client’s return position complied with the “substantial authority” standard.⁵⁴⁰ So long as a practitioner could demonstrate reasonable care in

⁵³⁴ *Id.* at 8; see also Karin M. Skadden, *Commissioner’s Advisory Group Previews Replacement for Substantial Understatement Penalty*, 41 TAX NOTES (TA) 1151 (Dec. 12, 1988). In determining whether a position met the “more likely than not” standard, the Service further recommended that the list of authorities on which practitioners could rely be expanded to include proposed regulations, letter rulings, JCT Blue Book definitions and interpretations, and even legal periodicals, treatises, and the practitioner’s own review and analysis of the facts of asserted items and reporting positions. For further discussion of the Service reports, see Dennis J. Ventry, Jr., *IRS Penalty Study: A Call for Objective Standards*, 112 TAX NOTES (TA) 1183 (Sept. 26, 2006).

⁵³⁵ See IRS (Dec. 1988), *supra* note 530, ch. 8, at 34.

⁵³⁶ The three-tier system included a negligence penalty for undisclosed positions taken without reasonable care and failing to meet the elevated “more likely than not” standard; a gross negligence penalty for positions taken without reasonable care and falling below the “realistic possibility of success” standard; and a fraud penalty for positions evincing actual or willful intent to evade the tax.

⁵³⁷ Karin M. Skadden, *Gibbs Outlines Challenges for Tax Administration in 1989*, 41 TAX NOTES (TA) 1258 (Dec. 19, 1988) (paraphrasing Gibbs).

⁵³⁸ IRS, *supra* note 163, ch. 8, at 13.

⁵³⁹ *Id.* at 43. The report also defined “probably correct” as positions with levels of certainty “at less than, but close to, 50 percent.” *Id.* at 39. In addition, the Service proposed expanding the list of authorities on which taxpayers could rely in determining a position’s likelihood of success to include private letter rulings, technical advice memoranda, general counsel memoranda, and JCT Bluebook explanations and interpretations of tax legislation. *Id.* at 43-44.

⁵⁴⁰ *Id.* at 43-44, 46.

advising that a return position had substantial authority (and did not otherwise require disclosure), she would not be subject to penalty, even if a court later determined that the position on which she advised lacked substantial authority. By comparison, under this scenario, the practitioner's taxpayer-client would suffer a penalty, still held to the strict liability standard, not the negligence standard.⁵⁴¹ So much for aligning the standards of care for taxpayers and their advisors.

After the Service submitted its report on tax penalties to Congress, commentators predicted that policymakers would "take action sometime during the current session."⁵⁴² They were right. In December 1989, Congress enacted significant reforms to the Code's penalty provisions.⁵⁴³ For taxpayers, Congress consolidated the existing negligence, overvaluation, and understatement penalties into a single category of accuracy-related penalties in new section 6662, which included the reimagined substantial understatement penalty in section 6662(d)(2). The revamped penalty still required taxpayers to exercise reasonable care in determining whether undisclosed positions possessed "substantial authority." But to the delight of practitioners,⁵⁴⁴ Congress lowered the penalty rate from 25% to 20% and expanded the list of authorities

⁵⁴¹The Service's final report endorsed its earlier recommendation for treating all accuracy-related penalties under a three-tier penalty system: a 20% negligence penalty for failure to exercise reasonable care to file a "probably correct" return or to make a required disclosure; a 50% penalty for willfully or intentionally failing to file a "probably correct" return or to make a required disclosure; and a 100% fraud penalty for willful intent to evade tax owed. *Id.* at 42-43. The Service also recommended coordinating the standard of care under Circular 230 with the standard of care required of taxpayers under the Code. Specifically, it prohibited practitioners from advising a reporting position unless they could conclude that the position was supported by "substantial authority" and did not otherwise require disclosure or that it had a "realistic possibility of success" if challenged and the practitioner advised disclosure. *Id.* at 46. This recommendation lowered the threshold standard of care from "more likely than not" (as reflected in the Service's penultimate report) to "realistic possibility of success." *Id.*

⁵⁴²Prentice Hall, *Penalties, Standards of Practice, and Circular 230: 1989 Style*, 43 TAX NOTES (TA) 1318 (June 12, 1989).

⁵⁴³Penalty reform legislation started out as H.R. 2528, the Improved Penalty Administration and Compliance Tax Act (IMPACT) of 1989. See J. COMM. ON TAXATION, DESCRIPTION OF H.R. 2528, IMPROVED PENALTY ADMINISTRATION AND COMPLIANCE TAX ACT OF 1989 (JCX-11-89) (1989). Subsequently, Congress incorporated IMPACT into the Revenue Reconciliation Act of 1989. See H.R. Rep. No. 101-247, *Explanation of Revenue Reconciliation Act of 1989* (H.R. 3299) (Sept. 20, 1989); see also S. Rep. No. 101-56 (1989). The Revenue Reconciliation Act of 1989 itself was then incorporated into the Omnibus Budget and Reconciliation Act of 1989 (OBRA 89). See Pub. L. No. 101-239, 103 Stat. 2106 (1989).

⁵⁴⁴See, e.g., Dennis J. Ventry, Jr., *Tax Politics and a New Substantial Understatement Penalty*, 113 TAX NOTES (TA) 91, 94 (Oct. 3, 2006) (quoting practitioner groups calling the near-final reform bill "an excellent piece of legislation" (AICPA), praising it for promoting "fairness" and "simplicity" in the tax system (ABA), and considering it "a significant congressional contribution to the American taxpayer" (National Society of Public Accountants)).

on which taxpayers and practitioners could rely in making substantial authority assessments.⁵⁴⁵

Also to the delight of practitioners, Congress held them to a lower standard of care than that imposed on their clients. Revised section 6694 allowed practitioners to advise return positions without penalty so long as the position had a “realistic possibility of success” on the merits, a standard that lawmakers noted “generally reflects the professional conduct standards applicable to lawyers and to certified public accountants.”⁵⁴⁶ And although the new standard departed upward from the more lenient negligence standard contained in old section 6694,⁵⁴⁷ it mirrored the standard recently adopted by the ABA and AICPA for advising return positions.⁵⁴⁸ Also, it did not require practitioners to conclude that a position possessed “substantial authority,” a probability of success somewhere between 40% and 51%.⁵⁴⁹ Rather, it only commanded a 33% probability of success for a practitioner to meet her obligation (and to avoid penalty), the same probability threshold to avoid discipline under the licensing bodies’ code of conduct.⁵⁵⁰

The weaker “realistic possibility of success” standard encouraged noncompliance and exposed taxpayer-clients to liability.⁵⁵¹ It permitted practitioners to advise aggressive reporting positions at 33% probability of success, even though taxpayer-clients needed to reach at least 40% certainty. In the end, the Treasury lost the fight to align standards of care for taxpayers and tax

⁵⁴⁵The new list of authorities still omitted treatises and law review articles, but it now included proposed regulations, private letter rulings (PLRs), technical advice memorandums (TAMs), actions on decisions, general counsel (GC) memorandums, information or press releases, Notices, any additional documents published by the Service in the Internal Revenue Bulletin, and the JCT Blue Book explanations. *Id.*

⁵⁴⁶H.R. Rep. No. 101-247, at 1396 (1989).

⁵⁴⁷Former section 6694(a) read: “If any part of any understatement of liability with respect to any return or claim for refund is due to the negligent or intentional disregard of rules and regulations by any person who is an income tax return preparer with respect to such return or claim, such person shall pay a penalty of \$100 with respect to such return or claim.” See I.R.C. § 6694(a) (amended 1989).

⁵⁴⁸See *supra* notes 479 (for ABA) and 481 (for AICPA) and accompanying text.

⁵⁴⁹See *supra* notes 479 (for ABA) and 481 (for AICPA) and accompanying text.

⁵⁵⁰Some observers criticized Congress for basing the practitioner standard of care on the standards used by major tax organizations, which had failed to “police themselves” and “whose members benefit from low standards.” Professors of Tax and Professional Responsibility (Calvin Johnson, Joseph M. Dodge, Patricia Cain, Mark P. Gergen, John Dzienkowski, Robert Peroni & Tom Evans), *Position Paper on IMPACT (H.R. 2,528) Section 302: “Realistic Possibility of Success” Is Too Low a Standard for a Tax Return*, 89 TAX NOTES TODAY 156-25 (July 31, 1989) [hereinafter Tax Professors].

⁵⁵¹See Tax Professors, *supra* note 550 (calling realistic possibility of success “a fundamental bar to better tax administration”); Calvin Johnson, “*True and Correct: Standards for Tax Return Reporting*,” 43 TAX NOTES (TA) 1521, 1528 (June 19, 1989) (criticizing realistic possibility of success as “not an enforceable standard” that allowed practitioners to advise positions based on a reversal or modification of existing law, “prevented self-assessment under any enforceable standard, and further prevented the Service from fulfilling its mission to collect the correct tax”).

practitioners.⁵⁵² It thus failed to institutionalize the norm that practitioners owed dual responsibilities to taxpayer-clients and the tax system.⁵⁵³ At the end of the day, the “realistic possibility of success” standard perpetuated “the faulty premise that the filing of an income tax return is like a brief or complaint in a lawsuit,”⁵⁵⁴ simply “the opening round”⁵⁵⁵ or “first offer”⁵⁵⁶ in an adversarial setting. The public-private partnership model of tax administration—with the government and practitioners regulating taxpayer compliance—lost out to the adversarial model.

In the wake of congressional action on statutory penalties, the Treasury withdrew its earlier proposed amendments to Circular 230. Dutifully, it issued new amendments with a diligence standard “that more closely reflects the realistic possibility standards adopted by professional organizations and the preparer penalty provisions of section 6694.”⁵⁵⁷ New 31 C.F.R. § 10.34 prohibited practitioners from advising a taxpayer-client to take an undisclosed position without a “realistic possibility of the position being sustained on its merits.”⁵⁵⁸ A position met the “realistic possibility” standard, moreover, if “a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.”⁵⁵⁹ In conducting the due diligence analysis, practitioners could rely on an expanded list of authorities to determine whether a position possessed “substantial authority,” but they were prohibited from accounting for the possibility “that a position will not be challenged by the Service (*e.g.*, because the taxpayer’s return may not be audited or because the issue may not be raised on audit).”⁵⁶⁰ Practitioners also had to advise clients of penalties reasonably likely to apply to a position, of opportunities to avoid penalties by disclosure, and of the requirements for adequate disclosure.⁵⁶¹ Finally, the proposed rules allowed practitioners to “generally rely without verification” on information furnished by clients, but they still had to make “reasonable inquiries”

⁵⁵²Some commentators criticized Congress’ failure to align the penalty standards for taxpayers and tax practitioners. *See Harris, supra* note 518, at 971 (“One might have expected that Congress, having amended the taxpayer penalty standard to provide for an expanded [and more reasonable] definition of substantial authority, would have incorporated a similar reporting standard for return preparers.”).

⁵⁵³*See supra* notes 491-494 and accompanying text.

⁵⁵⁴Tax Professors, *supra* note 550.

⁵⁵⁵*Id.*

⁵⁵⁶Karin M. Skadden, *CAG Considers Penalty Study, Resources, Filing Season*, 43 TAX NOTES (TA) 11 (Apr. 3, 1989) (paraphrasing Professor Calvin Johnson).

⁵⁵⁷Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 57 Fed. Reg. 46,356, 46,356 (Oct. 8, 1992).

⁵⁵⁸31 C.F.R. § 10.34(a) (2011); 57 Fed. Reg. at 46,359.

⁵⁵⁹31 C.F.R. § 10.34(a)(4)(i) (2011); 57 Fed. Reg. at 46,359.

⁵⁶⁰31 C.F.R. § 10.34(a)(4)(i) (2011); 57 Fed. Reg. at 46,359.

⁵⁶¹31 C.F.R. § 10.34(a)(2) (2011); 57 Fed. Reg. at 46,359.

of “incorrect, inconsistent, or incomplete” information.⁵⁶² Two years later, the Treasury finalized the amendments without significant modification.⁵⁶³

A campaign that began in 1986 with the Treasury trying to elevate industry practice standards ended in 1994 with it being forced to adopt those same lowly standards as its own.⁵⁶⁴

2. *Equalizing the Standards for Tax Advisors and Taxpayer-Clients*

Fast-forward nearly 15 years. In 2007, Congress lent a heavy hand in raising practitioners’ standard of care. Buried in that year’s Small Business and Work Opportunity Tax Act, Congress replaced the “realistic possibility of success standard” for undisclosed positions under section 6694 with the requirement that practitioners demonstrate a “reasonable belief that the position would more likely than not be sustained on its merits.”⁵⁶⁵ For disclosed positions, Congress swapped out the “not frivolous” standard for “reasonable basis,”⁵⁶⁶ a threshold that taxpayers had been obligated to meet since 1993.⁵⁶⁷ Legislators also significantly increased the penalty for violating the new standard of care,

⁵⁶²31 C.E.R. § 10.34(a)(3) (2011); 57 Fed. Reg. at 46,359.

⁵⁶³The only change worth noting involved the practitioner’s duty to alert the client to opportunities to avoid certain penalties. In 1993, Congress raised the standard for taxpayers wishing to avoid accuracy-related penalties on aggressive, disclosed positions by requiring taxpayers to demonstrate a “reasonable basis” for the position rather than meeting the lower “not frivolous” standard. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, pt. V, § 13251, 107 Stat. 312. As a result of the change, the Treasury finalized amendments to Circular 230 in 1994 requiring practitioners to advise clients of any opportunity to avoid accuracy-related penalties through disclosure, 59 Fed. Reg. 31,523, 31,527 (June 20, 1994), rather than requiring *actual* disclosure of the position, 57 Fed. Reg. at 46,359. In addition, practitioners could advise disclosed positions going forward that were “not frivolous,” while taxpayers had to demonstrate “reasonable basis” for disclosed positions, creating a still larger chasm between standards of care for taxpayers and tax practitioners. The Treasury acknowledged the different standards by reminding practitioners in the 1994 final regulations that the requirement to advise clients of penalties and opportunities to avoid penalties “appl[y] even if the practitioner is not subject to a penalty with respect to the position.” 59 Fed. Reg. at 31,527. As one commentator wrote at the time, practitioners were “predictably relieved” that Congress freed them of the stricter standard and allowed them to “take an aggressive position on a taxpayer’s return and still protect themselves through disclosure” (assuming the position was not frivolous). Rita L. Zeidner, *Conferees’ Double Standard is Good News for Preparers, Not Taxpayers*, 60 TAX NOTES (TA) 689 (Aug. 9, 1993).

⁵⁶⁴Finalized in 59 Fed. Reg. at 31,523 (noting that the new due diligence standard under Circular 230 “reflect[ed] more closely the standards for return preparers under section 6694 of the Internal Revenue Code of 1986 (Code) and professional guidelines”).

⁵⁶⁵U.S. Troop Readiness, Veterans’ Care, Katrina Recovery, & Iraq Accountability Appropriations Act, Pub. L. No. 110-28, 121 Stat. 203 (2007).

⁵⁶⁶*Id.* For an explanation of the changes, see STAFF OF J. COMM. ON TAXATION, 110TH CONG., TECHNICAL EXPLANATION OF THE SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007 AND PENSION RELATED PROVISIONS CONTAINED IN H.R. 2206, at 26 (Comm. Print 2007).

⁵⁶⁷See *supra* note 563.

raising forfeitures from a meaningless \$250 to as much as half the practitioner's fees for advising on or preparing a return position.⁵⁶⁸

The amended standard of care and enhanced penalties "blindsided" practitioners and Treasury officials alike.⁵⁶⁹ There was some evidence that in targeting practitioners Congress set out to attack "scams and schemes" and other abusive transactions.⁵⁷⁰ There were also signs that politicians were concerned more generally about noncompliance,⁵⁷¹ the widening "tax gap,"⁵⁷² and budget rules that required them to find revenue to offset spending measures.⁵⁷³ Whatever the exact contours of the impetus for changing the rules, it was clear, in the words of Tax Analysts' Lee Sheppard, that Congress was notifying practitioners "not to tell customers to take positions they know are dubious."⁵⁷⁴ In this way, Congress reinforced Treasury's long-running effort

⁵⁶⁸Small Business and Work Opportunity Tax Act, Pub. L. No. 110-28, 121 Stat. 203 (2007). Or, as one commentator described the change in penalty amounts: former "section 6694(b) prescribed a small penalty for understatements on returns that were willful or reckless. Section 6694(a) prescribed a pocket-change penalty for understatements that the preparer had reason to know lacked a 'reasonable possibility of being sustained on the merits,' or were frivolous, or lacked reasonable cause and good faith." Lee A. Sheppard, *New Preparer Penalties Sweep Away Circular 230*, 118 TAX NOTES (TA) 597, 600 (Feb. 4, 2008).

⁵⁶⁹Jeremiah Coder, *Many Blindsided by New Return Preparer Standards*, 118 TAX NOTES (TA) 133 (Jan. 7, 2008) (quoting IRS Chief Counsel Donald Korb).

⁵⁷⁰See S. Rep. No. 109-336, at 51 (2006) (justifying an amendment to section 6694 to raise the standard of care for practitioners to reasonable belief that the (undisclosed) positions would more likely than not be sustained on its merits by stating: "Existing preparer penalties do not adequately deter and prevent noncompliance with tax laws. They should be broadened to include returns other than income tax returns. The thresholds of behavior to establish preparer noncompliance should be raised so that scams and schemes and other abusive transactions are discouraged. Penalty amounts have remained constant for years and are considered by some preparers to be a cost of business instead of an economic deterrent. The amounts should be increased to restore their deterrent impact"). For earlier calls to raise the standard of care for practitioners advising undisclosed return positions to reasonable basis or belief and more likely than not certainty, see Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2005, H.R. 2625, 109th Cong., § 105(a) (2005) (died in committee), *available at* <http://www.govtrack.us/congress/bills/109/hr2625/text>; STAFF OF J. COMM. ON TAXATION, 106TH CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS (Comm. Print 1999); IRS (Dec. 1988), *supra* note 530 and accompanying text; *see also* Jeremiah Coder, *Old Return Preparer Standard Regs Problematic, Practitioners Say*, 117 TAX NOTES (TA) 1017 (Dec. 10, 2007) (summarizing comments by Treasury Tax Legislative Counsel, Michael Desmond, indicating that Congress had "kicked around" for several years the idea of elevating the standard of care).

⁵⁷¹Sheppard, *supra* note 568, at 601 (paraphrasing Desmond as saying that Congress was worried about "both unscrupulous preparers of individual returns and elaborate tax shelters").

⁵⁷²Coder, *supra* note 569, at 133 (quoting Anita Soucy, an official in the Treasury's Office of Tax Policy); Coder, *supra* note 570, at 1017 (quoting Desmond). Practitioners opposed Congressional efforts to raise penalties "under the guise of closing the tax gap" and "in a narrow, rifle-shot perspective." *IRS Operations, 2007 Filing Season, and Tax Gap: Hearing Before the H. Subcomm. on Oversight, Comm. on Ways & Means, 110th Cong. 3* (2007) (statement of American Institute of Certified Public Accountants (AICPA)).

⁵⁷³Coder, *supra* note 569, at 133 (noting possible influence of "pay as you go" rules).

⁵⁷⁴Sheppard, *supra* note 568, at 601.

to promote “accurate and complete tax advice”⁵⁷⁵ by making practitioners responsible for what clients put on their returns.

For its part, the Treasury had never sought to impose standards of care on practitioners that exceeded the standards required of taxpayers. In 1986 it had only proposed equalizing the standards by prohibiting practitioners from advising on positions falling below the substantial authority standard, the same obligation required of taxpayers in reflecting positions on returns.⁵⁷⁶ With little advance warning in 2007, Congress drastically changed the rules of the game. It now required practitioners to meet an elevated “more likely than not” standard (reflecting at least 51% certainty), while taxpayers were still subject to the “substantial authority” standard (reflecting a level of certainty ranging as low as 40%).

Practitioners attacked every aspect of the new standard. First, the complexity of the tax law and the relative lack of guidance or indicia of authority on many tax planning issues made it impossible to predict probabilities of success with any precision.⁵⁷⁷ It was hard enough reaching “realistic possibility of success” or “substantial authority,” much less “more likely than not.”⁵⁷⁸ In fact, given the law’s uncertainty, two practitioners could adopt otherwise opposing positions and, while acting diligently and in good faith, conclude

⁵⁷⁵ *Supra* notes 337 and 461 and accompanying text.

⁵⁷⁶ 51 Fed. Reg. 29,113 (Aug. 14, 1986).

⁵⁷⁷ See, e.g., ABA TAX SECTION, *Letter and Comments on Changes to Standards for Imposition of Certain Penalties, November 19, 2007*, SECTION 6,694 PENALTY, last accessed Oct. 12, 2014, <http://www.section6694penalty.com/asp/aba1172007.asp> (“Because the tax law is complex and ambiguous, it is often difficult to quantify the likelihood of success on the merits of a particular position.”).

⁵⁷⁸ See, e.g., *id.* (arguing that “due to the significant complexity of the Code and the Treasury Regulations, as well as the lack of clear guidance interpreting many of those provisions, many situations arise where it simply is not possible for return preparers to conclude that any position is more likely than not correct”); AM. INST. OF CERTIFIED PUB. ACCOUNTANTS (AICPA), Tax Executive Comm., COMMENTS ON THE DEVELOPMENT OF INITIAL GUIDANCE FOR THE REVISED PREPARER PENALTY PROVISIONS IN SECTION 6,694 OF THE INTERNAL REVENUE CODE app. A (2007) (stating “it will be extremely difficult, if not impossible, to determine the probable correctness of the treatment of some routine items with the degree of certainty required for the higher ‘more likely than not’ standard because: (1) there sometimes is little guidance for the tax treatment of an item at the time the item must be reported on a return; and (2) the proper treatment of an item frequently depends on an analysis of unique or unusual facts and circumstances that were not contemplated in published guidance.”); NY STATE BAR ASS’N (NYSBA) TAX SECTION, REPORT ON THE DEFINITION OF “TAX RETURN PREPARER” AND OTHER ISSUES UNDER CODE SECTIONS 6,694, 6,695, AND 7,701(A)(36) 18 (2007) (concluding “MLTN is too high a standard given the complexity of our tax system”).

with a reasonable belief that both positions would more likely than not be sustained on the merits.⁵⁷⁹

Second, meeting the heightened accuracy requirement increased compliance costs on both practitioners and taxpayers. Practitioners had to conduct additional factual and legal research in analyzing return positions. Moreover, the new rules forced them to advise taxpayer-clients to file “so many disclosure statements” on positions failing to meet the elevated standard of care “that the disclosures will become practically meaningless,”⁵⁸⁰ or overburden the government’s administrative capacity to process returns efficiently and effectively,⁵⁸¹ or, worse, “be viewed as a concession on the merits.”⁵⁸²

Third, the “really screwed up”⁵⁸³ mismatch in standards of care between practitioners and taxpayers produced “a fundamental change” in the tax advisor’s role “from that of an advocate to that of an advisor.”⁵⁸⁴ Under the old law, practitioners could advise on positions without fear of penalty so long as the position could be estimated to succeed on the merits 33% of the time (even if the practitioner was advising on a position that subjected her client to penalty for not meeting the substantial authority standard).⁵⁸⁵ To avoid penalty under the new law, however, practitioners were required to advise disclosure of all positions that did not meet the “more likely than not” standard of at least 51% certainty (even if the practitioner was advising on positions that her taxpayer-client did not have to disclose because they exceeded the substantial authority standard).⁵⁸⁶ In these ways, and by design, practitioners were forced to offer more conservative advice.

The discrepancy in standards also created conflicts of interest between practitioners and taxpayer-clients. If a practitioner advised disclosure on a position failing to meet the more likely than not threshold, and her taxpayer-client informed her that she had no intention to disclose, practitioners wondered if

⁵⁷⁹In other words, for two positions straddling 50% certainty, it was not uncommon for the combined probability of success on the merits for the two positions to add up to more than 100% certainty. How could one of those positions be wrong (and thus subject to penalty under the new standard) while the other be right (and thus escape penalty)? See Sheppard, *supra* note 568, at 603 (quoting Allison Rosier of PricewaterhouseCoopers as saying, “I’ve seen people get to more likely than not on opposing positions”).

⁵⁸⁰ABA TAX SECTION, *supra* note 577; see also Coder, *supra* note 569, at 133 (reporting practitioner concern over “disclosure dump”); AICPA, *supra* note 572, at 5.

⁵⁸¹See AICPA, *supra* note 578, at 11 (stating that the “excessive disclosures for routine tax return positions will overburden tax administration”).

⁵⁸²*Id.* at 14.

⁵⁸³Coder, *supra* note 569, at 133 (quoting Diana Wollman of Sullivan & Cromwell).

⁵⁸⁴AICPA, *supra* note 578, at 11. The AICPA also argued that the disparate standards “affect[] the nature of the representation of taxpayers and a taxpayer’s right to representation.” *Id.* at 13; see also NYSBA TAX SECTION, *supra* note 578, at 2 (arguing that the difference in standards “undermines . . . the proper role of tax advisors”).

⁵⁸⁵See 59 Fed. Reg. 31,523 (June 20, 1994).

⁵⁸⁶See Small Business and Work Opportunity Tax Act, Pub. L. No. 110-28, 121 Stat. 203 (2007).

they must “insist” on disclosure to avoid a penalty?⁵⁸⁷ Or, alternatively, terminate the representation?⁵⁸⁸ Or, for that matter, blow the whistle on the client in the event the undisclosed position fell short of the taxpayer’s substantial authority requirement? The disparate standards created an intractable problem: advise or prepare a return without disclosure and risk penalty for the practitioner versus insist on disclosure and risk penalty for the client. Such considerations assumed greater severity due to significantly increased penalties under section 6694,⁵⁸⁹ so severe in fact that when combined with Circular 230 penalties,⁵⁹⁰ practitioners faced potential monetary fines exceeding “150

⁵⁸⁷Kip Dellinger, *The Proposed, New and Improved Tax Preparer Standard: Will Tragedy Become Farce?*, 119 TAX NOTES (TA) 867 (May 26, 2008) (“The tension this produces between a tax professional and a client is obvious—to comply literally with the statute, the tax professional must insist that a client ‘disclose’ a tax position that the taxpayer would not otherwise need to disclose solely to insulate the tax professional from a potential penalty.”).

⁵⁸⁸Tax lawyers had to meet a high bar before terminating representation of a client. Under Model Rule 1.16(a), the only possibility for mandatory withdrawal under the circumstances described above would be if the representation resulted in “violation of the rules of professional conduct or other law.” MODEL RULES OF PROF’L CONDUCT R. 1.16(a) (2011). The prevailing rules of professional conduct for tax lawyers (ABA Formal Opinion 85-352 and 31 C.F.R. § 10.34 of Circular 230) permitted the lawyer to advise on positions all the way down to “realistic possibility of success.” ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 85-352 (1985); see 31 C.F.R. § 10.34. Meanwhile, ascertaining whether the representation resulted in the lawyer violating some “other law” (in this case, section 6694) depended on whether the lawyer would be subject to penalty even after apprising the client of the conflicting penalty standards and documenting the communication (a situation that the Treasury had indicated would not subject the practitioner to penalty). The other possible justification for withdrawal would be permissive termination under Rule 1.16(b). However, the only relevant circumstance described under the Rule would be if she could withdraw “without material adverse effect on the interests of the client,” and that would depend on the specific facts and circumstances of the situation. MODEL RULES OF PROF’L CONDUCT R. 1.16(b)(2011).

⁵⁸⁹See, e.g., AICPA, *supra* note 578, at 11 (writing that “the potential penalties on a preparer for failure to satisfy that high standard are so severe that preparers will feel compelled to protect themselves by urging their clients to include disclosures for virtually every item for which there is even the slightest uncertainty regarding the proper treatment”).

⁵⁹⁰For a discussion of how the discrepant standards created exposure to discipline and penalty under Circular 230 for violating not just 31 C.F.R. § 10.34 (2014) but also 31 C.F.R. § 10.29 (2014), see The New York State Bar Association Tax Section, *Proposed Circular 230 Amendments on Tax Return Standards*, 118 TAX NOTES (TA) 1015, 1022 (Mar. 3, 2008) (observing that Treasury’s 2007 proposed amendments to Circular 230 conforming 31 C.F.R. § 10.34 (2014) to the civil penalty standards for return preparers under section 6,694 would “substantially expand the circumstances in which a conflict of interest will exist [under section 10.29] because a ‘significant risk’ to the client that the practitioner’s personal interest will limit his representation of the client will be present in a number of situations (including, but not limited to, every situation in which there must be disclosure for the practitioner to be free from exposure under section 10.34 but the taxpayer is not required to disclose to avoid penalties”).

percent of the fees from the deal.”⁵⁹¹ Fixing the problem meant equalizing the standards of care, practitioners conceded, but not by raising the substantial authority standard for taxpayers to the practitioners’ new more likely than not standard.⁵⁹² Rather, achieving parity should involve lowering the standard for practitioners to substantial authority.⁵⁹³

The Treasury shared many of the same concerns expressed by the practitioner community. Officials acknowledged that the elevated “more likely than not” standard could create “a real problem,” and not just for novel or aggressive positions for which authority—much less substantial authority—had yet to emerge, but also for less problematic positions.⁵⁹⁴ In addition, the Treasury worried that practitioners’ fear over heightened penalties for violating the elevated standard of care might “lead to a flood of disclosure statements,” threatening the government’s administrative capacity and diluting the submissions’ value.⁵⁹⁵ The potential conflicts between practitioners and taxpayers caused by the discrepant standards also concerned officials.⁵⁹⁶ The Treasury’s Assistant Secretary for Tax Policy, Eric Solomon, called the inconsistent standards a “very interesting and unstable dynamic” and “not a good long-term solution.”⁵⁹⁷ It was a mess that Congress created.⁵⁹⁸ And one that the Treasury

⁵⁹¹Lee A. Sheppard, *How Much Trouble Can You Get Into?*, 115 TAX NOTES (TA) 1101, 1102 (June 18, 2007) (reporting figure from Diana Wollman of Sullivan & Cromwell). Practitioners were visibly shaken by the elevated penalty exposure. *See id.* at 1101 (“Disclosure by the taxpayer . . . would protect both the taxpayer and the preparer But the taxpayer has no incentive to disclose if it has substantial authority for its position but not a ‘more likely than not’ chance of prevailing That is, for these in-between situations, the preparer’s fate may depend on the taxpayer’s behavior.”).

⁵⁹²*See* Coder, *supra* note 569 (reporting on practitioners warning that complaining about the disparate standards to policymakers might only “lead Congress to raise the standards on taxpayers too”); ABA TAX SECTION, *supra* note 577 (expressing the opinion, “we do not believe that the answer is to raise the taxpayer penalty standard to a reasonable belief/more likely than not standard with respect to all understatements”).

⁵⁹³*See* ABA TAX SECTION, *supra* note 577; AICPA, *supra* note 578.

⁵⁹⁴Coder, *supra* note 570 (quoting Treasury Tax Legislative Counsel, Michael Desmond).

⁵⁹⁵Coder, *supra* note 569 (quoting Desmond).

⁵⁹⁶*See* Coder, *supra* note 570 (quoting Desmond as being aware and concerned about the “potential conflicts between preparers and clients as a result of preparers being held to a higher standard,” and as saying, “It’s front and center on our radar screen” in formulating revised regulations).

⁵⁹⁷Dustin Stamper, *Treasury to Address Conflict of Interest Raised by New Penalties*, 117 TAX NOTES (TA) 653 (Nov. 12, 2007).

⁵⁹⁸*Id.* at 653 (quoting Assistant Secretary Solomon as “blam[ing] Congress for creating . . . a conflict”); *see also* Jeremiah Coder & Lee A. Sheppard, *Preparer Penalty Issues on Full Display at ABA Midyear Meeting*, 118 TAX NOTES (TA) 470, 471 (Jan. 28, 2008) (“It’s no secret that executive branch officials were not happy with Congress’s legislative changes to section 6694 . . .”).

started trying to clean up immediately⁵⁹⁹ under intense time constraints⁶⁰⁰ by issuing guidance and transition rules,⁶⁰¹ proposing conforming changes to Circular 230,⁶⁰² and undertaking a “comprehensive review and overhaul” of all practitioner penalty provisions and underlying regulations.⁶⁰³

At the same time, some of the reaction was overblown. While the Treasury had a legitimate beef with Congress for putting it in the position of issuing guidance on complicated and far-reaching issues in an unreasonably short period of time, many practitioner concerns were grossly overstated. In criticizing the “more likely than not” standard as unduly burdensome and expensive, the ABA Section of Taxation claimed that practitioners were now forced “to ensure that a position is absolutely correct every time they give oral or written advice to a client.”⁶⁰⁴ In fact, the new standard required practitioners to reach 51% certainty, not “absolute” certainty. For another example, practitioners argued that “to comply literally with the statute,” a practitioner “must insist” that a client disclose positions falling below the “more likely than not” standard “to insulate the tax professional from a potential liability.”⁶⁰⁵ In fact, the Treasury issued interim guidance for the 2007 filing season that assured practitioners they could avoid penalty for undisclosed positions failing to meet the “more likely than not” standard simply by advising clients of the conflicting penalty standards and documenting the communication.⁶⁰⁶

⁵⁹⁹For commentary on these efforts, see Jeremiah Coder, *Preparing for Penalties: Updating the Preparer Penalty Standard*, 122 TAX NOTES (TA) 35 (Jan. 5, 2009); Coder & Sheppard, *supra* note 598; Coder, *supra* note 569; Stamper, *supra* note 597, at 653 (quoting Treasury official Anita Soucy, “Given the current difference in the standard, we will be thinking about rules [when writing section 6694 regulations] that ameliorate the conflict, not exacerbate it”).

⁶⁰⁰See Coder & Sheppard, *supra* note 598, at 471 (quoting Treasury officials saying that “timing is of the essence” and that the government “would have to work in a ‘fairly aggressive time’” to issue guidance in a timely manner).

⁶⁰¹See Notice 2007-54, 2007-27 I.R.B. 12 (announcing that prior law and current penalty regulations will apply to returns, amended returns, and refund claims due on or before December 31, 2007); Notice 2008-11, 2008-3 I.R.B. 279 (clarifying earlier transition relief provided in Notice 2007-54); Notice 2008-12, 2008-3 I.R.B. 280 (indicating which returns must be signed by a preparer); Notice 2008-13, 2008-3 I.R.B. 282 (providing interim guidance regarding: (1) categories of returns or claims for refund when applying the penalty under I.R.C. § 6694(a); (2) definition of “tax return preparer” under I.R.C. §§ 6694, 7701(a)(36); (3) date a return is considered prepared; (4) standards of conduct applicable to tax return preparers for disclosed and undisclosed return positions; and (5) penalty compliance obligations applicable to tax return preparers); Notice 2008-46, 2008-18 I.R.B. 868 (updating Notice 2008-13).

⁶⁰²See 72 Fed. Reg. 54,540, 54,621 (Sept. 26, 2007).

⁶⁰³73 Fed. Reg. 34,560, 34,561 (June 17, 2008).

⁶⁰⁴ABA TAX SECTION, *supra* note 577.

⁶⁰⁵Dellinger, *supra* note 587, at 867; see also NYSBA TAX SECTION, *supra* note 578, at 8 (stating “there are situations in which a preparer faces a penalty with respect to a taxpayer’s return when the taxpayer who filed that return is not subject to penalty.” In those situations, the preparer would “necessarily” face a penalty).

⁶⁰⁶See Notice 2008-13, 2008-3 I.R.B. 282 (providing two examples for avoiding penalty under interim rules).

Practitioners were too scared of penalties to find the guidance reassuring. They talked as if the new standard of care created an “ethical dilemma,” pitting practitioners against clients.⁶⁰⁷ The truth was that the standard created a considerably larger *financial* dilemma for practitioners. While they need not choose between “insisting” on disclosure versus client fidelity,⁶⁰⁸ they did have to worry about penalties for the first time. Raising the standard of care for practitioners above that for taxpayers, Tax Analysts’ Lee Sheppard wrote, was “deliberate on the part of Congress, which wanted practitioners to be more careful, but practitioners have been in shock ever since.”⁶⁰⁹ As Sheppard pointedly observed, many practitioners “had been living in a dream world in which their say-so got the customer out of penalties, and they never worried about penalties for themselves.”⁶¹⁰ With elevated penalties alongside elevated standards, practitioners (particularly the lawyers who considered themselves planners not preparers)⁶¹¹ were finally “paying attention.”⁶¹² If practitioners were really concerned about conflicting interests and client fidelity, one wonders what kept them on the sidelines when they enjoyed a lower standard of care than their clients and when they could render advice that exposed clients to penalty while remaining personally insulated from liability.⁶¹³

⁶⁰⁷NYSBA TAX SECTION, *supra* note 578, at 10 (claiming that practitioners “now must face the ethical dilemma of having to choose between, on the one hand, a course of action that protects the advisor but may subject the client to risks the client would not otherwise face, and on the other hand, a course of action that protects the client in a way that is perfectly legal and appropriate for the client but risks subjecting practitioners” to penalties).

⁶⁰⁸*Supra* notes 583-589, 596, and 605 and accompanying text.

⁶⁰⁹Lee A. Sheppard, *Diluting the Preparer Penalties By Regulation*, 119 TAX NOTES (TA) 1213 (June 23, 2008).

⁶¹⁰*Id.*

⁶¹¹In fact, the tax law had defined “preparer” broadly enough for 30 years (or since Treasury promulgated final regulations in 1977 under I.R.C. §§ 6694, 6695, and 7701) to include sophisticated tax planners and not just scriveners. *See* Certain Requirements for Income Tax Return Preparers, 42 Fed. Reg. 59,961, 59,966 (Nov. 23, 1977); *see also* Sheppard, *supra* note 609, at 1213 (writing that the new law “raised preparer penalties and reminded many practitioners that they are preparers”); Coder & Sheppard, *supra* note 598, at 470. Some practitioners acknowledged that planners had been preparers all along. *See* Sheppard, *supra* note 591, at 1101 (stating the belief among practitioners who “probably do not consider themselves return preparers,” and quoting Diana Wollman of Sullivan & Cromwell as warning practitioners, “[t]his is wrong”).

⁶¹²Coder & Sheppard, *supra* note 598, at 470; *see also* Sheppard, *supra* note 568, at 598 (telling practitioners, “you have been preparers for 30 years. You just didn’t have any reason to care because the preparer penalties were so small”).

⁶¹³Some commentators picked up on this paradox. *See* Sheppard, *supra* note 609, at 1218 (“It should be remembered that for two decades the preparer standard was vastly lower than the taxpayer standard.”); Donald B. Tobin, *Congress Should Not Lower the Standard for Tax Return Preparers*, 120 TAX NOTES (TA) 471, 472 (Aug. 4, 2008) (observing that historically “tax return preparers actually had a lower standard than taxpayers who acted without professional assistance”).

In the end, practitioner anxiety and vocal opposition to the elevated standard of care convinced Congress to change the law yet again.⁶¹⁴ The Tax Extenders and AMT Relief Act of 2008 lowered the practitioner standard for disclosed positions from “more likely than not” to “substantial authority,” while maintaining “reasonable basis” for disclosed positions, thereby creating parity with the taxpayer standard of care.⁶¹⁵ Shortly thereafter, the Treasury further aligned the obligations of practitioners and their clients by requiring advisors to analyze substantial authority using the same definition and parameters relied on by taxpayers.⁶¹⁶

While the practitioner community expressed relief over the shared standard of care and lobbed praise on the Treasury for incorporating its input into the regulations,⁶¹⁷ others were less sanguine. Some argued that the short-lived “more likely than not” standard would have done “more to rein in irresponsible return positions than economic substance codification is thought to do” and that Congress should have “resist[ed] calls to change the statute from high-end practitioners who are inconvenienced by it.”⁶¹⁸ Others maintained that requiring a tax advisor “to believe that the position she advocates has at least a 50-percent chance of success makes perfect sense. Why should tax professionals advise a taxpayer to take a position if they do not believe the position is more likely right than wrong?”⁶¹⁹ The accounting profession already required such a standard before booking 100% of a business taxpayer’s tax benefits. “So why shouldn’t the tax penalty standard be the same?”⁶²⁰ Equalizing the standards between practitioners and taxpayers certainly made

⁶¹⁴See, e.g., Jeremiah Coder, *Final Preparer Penalty Regs Adopt Some Changes, New Guidance*, 121 TAX NOTES (TA) 1351 (Dec. 22, 2008) (writing that “due in large part to strong practitioner outcry, Congress relaxed the preparer penalty standard”); Joseph DiSciullo, *Return Preparer Guidance Reflects Amended Threshold for Penalties*, 121 TAX NOTES (TA) 1373 (Dec. 22, 2008) (also attributing Congressional action “to strong practitioner outcry”); Lee A. Sheppard, *Technical Objections to the Bailout*, 121 TAX NOTES (TA) 20, 26 (Oct. 6, 2008) (discussing practitioners “howling for” changes to the elevated standard).

⁶¹⁵Pub. L. No. 110-343, § 506, 122 Stat. 3765, 3880 (2008). The 2008 law also maintained “reasonable to believe that the position would more likely than not be sustained on its merits” for tax shelter items and reportable transactions. *Id.*

⁶¹⁶See Tax Return Preparer Penalties Under Sections 6,694 and 6,695, 73 Fed. Reg. 78,430, 78,434 (Dec. 22, 2008); Notice 2009-5, 2009-3 I.R.B. 309.

⁶¹⁷See Coder, *supra* note 614, at 1354 (quoting Charles Rettig as saying the Service “has worked hard to bring about meaningful regulations” that “represent a significant effort in coordination with the practitioner community”).

⁶¹⁸Sheppard, *supra* note 568, at 598.

⁶¹⁹Tobin, *supra* note 613, at 472; see also Sheppard, *supra* note 609, at 1218 (noting that under Financial Accounting Standards Board Interpretation No. 48 (FIN 48), “Accounting for Uncertainty in Income Taxes,” accountants were required “to assign percentage chances of prevailing to tax return positions mostly for the purpose of deciding whether it is proper to book the benefits. More likely than not is required to book 100 percent of the tax benefit. So why shouldn’t the tax penalty standard be the same?”).

⁶²⁰Sheppard, *supra* note 609, at 1218 (discussing the “more likely than not” standard under FIN 48).

sense. But tax compliance and “accurate self-reporting” would have been “better served” under the more likely than not standard.⁶²¹

In retrospect, while “substantial authority” fell short of “more likely than not” probability, it represented a significant step toward the goal of “complete and accurate returns.”⁶²² Requiring “substantial authority” under section 6694, and subsequently under Circular 230,⁶²³ raised diligence standards on tax advisors from “realistic possibility of success” to the same, higher standard required of taxpayers. Practitioners were now prohibited from advising positions that exposed taxpayers-clients to liability while shielding themselves from penalty and misconduct. The Treasury may have lost the battle over practice standards in the early 1990s,⁶²⁴ but it ultimately won the war, getting almost everything it had proposed in 1986: substantial authority for undisclosed positions, reasonable basis for disclosed positions, aligned standards for practitioners and taxpayers,⁶²⁵ and new partners in the quest for accurate advice and accurate returns.

V. Conclusion

The three-decade effort to elevate practice standards—particularly its transformation of tax advisors into “quasi-IRS agents”⁶²⁶ and conscripts in Treasury’s “enlisted army”⁶²⁷—continues to rankle and even frighten tax lawyers and other tax practitioners. In some respects, fear is a reasonable response. The Treasury and Congress require practitioners to quantify seemingly unquantifiable risks in filing positions and tax-minimizing transactions. Moreover, practitioners must satisfy this affirmative and disciplinary obligation for both plain-vanilla positions and novel, grey-area, aggressive positions; for positions with more than one equally meritorious answer or with opposing probability assessments that add up to more than 100%; and even for positions with no authority, insufficient authority, or authority on which the taxpayer-client is not entitled to rely. Amidst manifold uncertainties, tax practitioners must predict outcomes for these positions, often with numerical precision.

The standard of care governing tax lawyers and other tax practitioners helps navigate the uncertainty. It provides a roadmap for deriving probabilities pertaining to the success or failure of a client’s sought after tax treatment. By adopting an approach that leverages the benefits of accumulating knowledge

⁶²¹Tobin, *supra* note 613, at 472.

⁶²²73 Fed. Reg. 34,560, 34,562 (June 17, 2008).

⁶²³76 Fed. Reg. 32,286, 32,308 (June 3, 2011).

⁶²⁴See *supra* Part IV.E.1.

⁶²⁵To the extent the due diligence standards in Circular 230 differ from the penalty standards in Code section 6694, the “limited differences” reflect “the different purposes” of the two regimes and a philosophy that the practice standards under Circular 230 should “provide broader guidelines that are more appropriate for professional ethics standards.” 76 Fed. Reg. at 32,292.

⁶²⁶Skadden, *supra* note 504.

⁶²⁷Moore, *supra* note 505.

and minimizing biases to reduce errors in judgment, the prevailing standard of care assists tax professionals in forming stronger and more informed beliefs, rendering more accurate advice, and achieving greater certainty in outcome. And while at the end of the day we might be better off with a standard of care that focuses on the persuasiveness of a tax advisor's reasoning rather than on numerical estimates of probable outcomes,⁶²⁸ the parameters of the standard of care discussed and analyzed in this Article promote accurate advice and accurate returns under either method.

⁶²⁸Lee Sheppard of Tax Analysts has argued for such a standard, tying threshold ethical behavior not to achieving precise likelihoods of success on the merits, but on "the presence of persuasive substantial authority and good judgment on the part of the preparer." Sheppard, *supra* note 568, at 602. "Instead of 50 percent or 40 percent or 30 percent, maybe the question should be what the preparer did in making the decision how to report . . . There has to be a point," Sheppard smartly observes, "when the preparer has done enough, assuming good faith."

