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Quantitative Prediction Model of Tax Law's Substantial Authority

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Quantitative Prediction Model of Tax Law's Substantial Authority

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Abstract

Our earlier article, *Boundaries of the Prediction Model in Tax Law's Substantial Authority*, analyzed the substantial-authority standard, identified factors that taxpayers and their advisors can consider in determining whether substantial authority supports a reporting position, distinguished substantial-authority predictions from other types of predictions, and considered how substantial authority affects advisors' ethical responsibilities. In short, that article presented a qualitative analysis of substantial authority. This Article presents a quantitative model of tax law's substantial authority that introduces the concepts of horizontal substantiality and vertical substantiality. The prediction model places substantial authority and the other reporting standards on a zero-to-one horizontal scale that depicts the likelihood that a position will be upheld. Support for a reporting position satisfies horizontal substantiality if it provides the reporting position the required threshold likelihood of being upheld, which is generally thought to be around 40%. Vertical substantiality derives from substantial authority's weight-of-authority method (*i.e.*, the weight of positive authority in relation to contrary authority). The Article shows how to determine a value for vertical substantiality and convert it to a value on the horizontal scale and apply the well-reasoned method to determine whether substantial authority supports a reporting position. The Article presents the substantial-authority prediction model in a simple formula: $H = \frac{V}{V+1} + R$. The Article then illustrates how taxpayers and their advisors might consider applying the prediction model. That exercise reveals some of the model's shortcomings, which provide opportunities for additional work in this area, but, more importantly, demonstrates how the model clarifies the concept of substantial authority and some of its various components.

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I. Introduction

Our earlier article, *Boundaries of the Prediction Model in Tax Law's Substantial Authority*, describes the type of authority and the reasoning that taxpayers and their advisors may use to predict the likelihood that a reporting position will be upheld, for the purposes of assessing whether substantial authority

supports a reporting position.[1] That article also distinguishes substantial-authority predictions from other types of predictions,[2] reviews the legislative history and technical aspects of substantial authority,[3] defines the scope of the substantial-authority analysis,[4] and illustrates that other types of predictions apply beyond the scope of substantial authority.[5] That article also considered the extent to which substantial authority affects a tax advisor's ethical duties.[6] This Article narrows the analysis of the substantial-authority standard, presenting a quantitative model that converts the qualitative information into numeric values of the probability that the reporting position will be upheld. [7] The quantitative model of substantial authority consists of vertical substantiality and horizontal substantiality, which together incorporate the general definition of substantial authority, the weight-of-authority method, and the well-reasoned method. The model also provides a basic mathematical formula that produces a value representing the probability that a reporting position will be upheld. This Article presents the model, recognizing that more work is required to accurately determine values for the model's variables. If that work progresses, the quantitative model stands to provide a better method of predicting reporting-position outcomes than the current trust-my-gut approach that some practitioners feel compelled to adopt.[8]

Because the legislative history and regulations present substantial authority as a probabilistic phenomenon, the application of substantial authority calls for a quantitative approach, which leads to the prediction model presented in this Article. Part II presents the model's two primary axes: horizontal and

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[1] *See* Bradley T. Borden & Sang Hee Lee, *Boundaries of the Prediction Model in Tax Law's Substantial Authority*, 71 Tax Law. 33 (2017). The purpose of the prediction model is to quantify the likelihood of a position being upheld by the court if challenged by the Service, taking into account both the weight-of-authority method and well-reasoned method introduced in the earlier article.

[2] Borden & Lee, *supra* note 1, at 38-46.

[3] Borden & Lee, *supra* note 1, at 47-75.

[4] Borden & Lee, *supra* note 1, at 75-79.

[5] Borden & Lee, *supra* note 1, at 79-82.

[6] Borden & Lee, *supra* note 1, at 79-90.

[7] As demonstrated in our earlier article, "The regulations' use of the term 'likelihood of the position being upheld' is a technical term. The term does not refer broadly to a probability analysis. Instead, it refers to the result of an analysis that incorporates both the weight-of-authority and well-reasoned methods, the notions of objectivity, and good-faith efforts to self-assess tax liability. If, based upon such an analysis, a taxpayer determines that the outcome of a reporting position is uncertain but has at least a 40% likelihood of being upheld, substantial authority supports the reporting position." *See* Borden & Lee, *supra* note 1, at 76.

[8] *See* Daniel Kahneman, Thinking, Fast and Slow 226 (2011) ("Simple equally weighted formulas based on existing statistics or on common sense are often very good predictors of significant outcomes."); Philip E. Tetlock & Dan Gardner, Superforecasting: The Art and Science of Prediction 21 (2016) (citing Paul Meehl, Clinical Versus Statistical Prediction (1954) to state that "well-informed experts predicting outcomes—whether a student would succeed in college or a parolee would be sent back to prison—were not as accurate as simple algorithms that added up objective indicators like ability test and records of past conduct").

vertical substantiality. It also discusses how they are relevant in assessing whether substantial authority supports a reporting position, recognizing the two axes pave the way for quantifying the measure of substantial authority. Part III applies the weight-of-authority method to assign value to vertical substantiality, demonstrates how to convert vertical substantiality into a value on the horizontal plane, and shows how to apply the well-reasoned method to determine whether substantial authority supports a reporting position. Part IV uses cases to illustrate how courts have applied the weight-of-authority and well-reasoned methods to specific tax matters to reach conclusions. The selected decisions appear to contradict permitted authority, reflect a change in practice, or otherwise draw heavily from legal reasoning. The cases show how vertical substantiality and horizontal substantiality could work together to determine the likelihood that a reporting position will be upheld. The analysis then applies the model to a few uncertain reporting positions, demonstrating how it might help clarify the likelihood that uncertain reporting position will be upheld. Part V offers a brief conclusion.

II. Model's Axes

The definitional provision in the substantial-authority regulations and the weight-of-authority method in the application provision of the substantial-authority regulations both incorporate concepts of substantiality.[9] The definitional provision uses "substantial" in relation to the likelihood of a reporting position's being upheld.[10] The weight-of-authority method uses "substantial" to address the relation between positive and negative authority.[11] Substantial authority's prediction model distinguishes between the different uses of substantiality in the regulations by presenting the concept in the definitional provision as horizontal substantiality and in the weight-of-authority method as vertical substantiality.

A. *Horizontal Substantiality*

A horizontal scale from zero (no possibility that the event will occur) to one (certainty that the event will occur) depicts all the possibilities that an event will occur, as illustrated in Figure 1 below. The probability of an event not occurring falls at the far left of the scale, and has a 0% chance of occurring. The probability falls at the far right of the scale if the event has a 100% chance of occurring. An event that is more likely than not to occur falls to the immediate right of the center point of the scale (*i.e.*, has greater than 50% chance of occurring). For uncertain tax reporting positions, the factor being measured is the likelihood that the reporting position will be upheld. Substantial authority occupies the space between reasonable basis on the left

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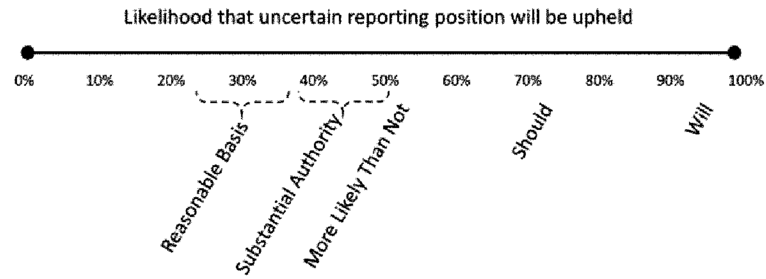
[9] *See* Reg. § 1.6662-4(d)(2) (definitional provision), (3)(i) (application provision); Borden & Lee, *supra* note 1, at 59-67.

[10] *See* Reg. § 1.6662-4(d)(2).

[11] *See* Reg. § 1.6662-4(d)(3)(i).

Figure 1: Likelihood of Position Being Upheld (i.e., Horizontal Substantiality)



and more likely than not on the right.[12] Reasonable basis exists when the position is more than merely arguable and significantly more than non-frivolous or not patently improper.[13] Other probabilities, such as "should" and "will," exist to the right of more likely than not.[14]

Figure 1 depicts the scale of the likelihood of a reporting position being upheld that applies to the understatement-penalty regime. The scale of the likelihood of being upheld provides a visual depiction of horizontal substantial authority—if the likelihood that a reporting position will be upheld lies to the right of reasonable basis, within or beyond the substantial authority range, the reporting position should avoid the substantial-understatement penalty under the substantial-authority standard.[15] The general understanding is that

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[12]*See* Reg. § 1.6662-4(d)(2); Borden & Lee, *supra* note 1, at 35-36 (citing Canal Corp. v. Commissioner, 135 T.C. 199, 219 n.15 (2010); Robert P. Rothman, *Tax Opinion Practice*, 64 TAX LAW. 301, 327 (2011); *Statements on Standards for Tax Services, IRS Nationwide Tax Forum*, AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, slide 3, 2010, https://www.irs.gov/pub/irs-utl/statements_on_standards_for_tax_services.pdf).

[13]*See* Reg. § 1.6662-3(b)(3).

[14]*See* Borden & Lee, *supra* note 1, at 35-36 (citing Canal Corp. v. Commissioner, 135 T.C. 199, 219 n.15 (2010); Robert P. Rothman, *Tax Opinion Practice*, 64 TAX LAW. 301, 327 (2011); *Statements on Standards for Tax Services, IRS Nationwide Tax Forum*, AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, slide 3 (2010), https://www.irs.gov/pub/irs-utl/statements_on_standards_for_tax_services.pdf).

[15]The legislative history of section 6662 suggests that a reasonable basis exists if a position is arguable, but fairly unlikely to prevail in court upon complete review of the relevant facts and authorities. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 218 (1982) ("This new standard will require that a taxpayer have stronger support for a position than a mere 'reasonable basis.' Thus, a taxpayer is required to have more support for [a] position than that it is arguable, but fairly unlikely to prevail in court upon complete review of the relevant facts and authorities.").

the reporting position would satisfy horizontal substantiality if it had at least about a 40% chance of being upheld.[16]

B. *Vertical Substantiality*

The weight-of-authority method provides that "[t]here is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment."[17] The regulations also enumerate permissible authorities that a taxpayer may consider when applying this method.[18] Weighing positive authorities against negative authorities invokes the image of placing relevant permissible authorities into a positive-authority stack or a negative-authority stack and comparing the heights of the stacks. Consequently, the weight-of-authority method is depicted as vertical substantiality. Quantifying the weight of the respective types of authority will, of course, be a challenge,[19] but the regulations appear to contemplate that at the end of the analysis some quantum of authority generally will support a reporting position and some quantum of authority generally will support the contrary position.[20] Until the law provides formal rules for determining vertical substantiality, taxpayers should be allowed to exercise good faith in assigning values to relevant types of authorities. Perhaps courts would accept such good faith values.[21] Figure 2 depicts a comparison of positive authority to negative authority (*i.e.*, vertical substantiality) using hypothetical values for the weights of positive and negative authority.

The regulations provide that the weight of the positive authorities must be substantial in relation to the weight of the negative authorities,[22] but they do not define what substantial means in this context.[23] The regulations do not imply that the weight of positive authorities needs to be at least as great as the weight of negative authorities. Nor does the language suggest that "substantial" in this context should have the same threshold as the substantial-authority threshold on the horizontal scale. Thus, taxpayers are left to reason through what substantiality means in the weight-of-authority method.

Under the weight-of-authority method, substantial authority is established when "the weight of the authorities supporting the treatment is substantial

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[16] *See* Borden & Lee, *supra* note 1, at 35-36.

[17] *See* Reg. § 1.6662-4(d)(3); Borden & Lee, *supra* note 1, at 62-67.

[18] *See* Reg. § 1.6662-4(d)(3)(iii).

[19] *See* Borden & Lee, *supra* note 1, at 65-67.

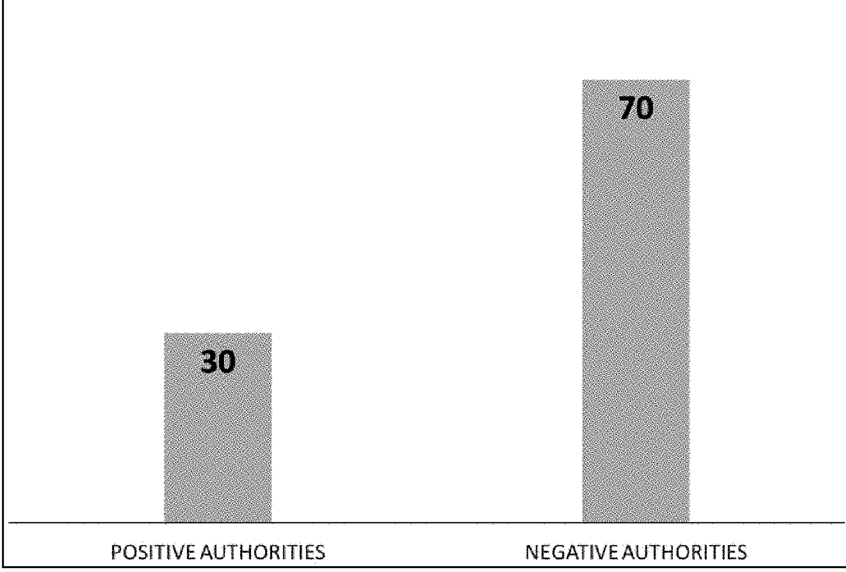
[20] *See* Reg. § 1.6662-4(d)(3)(i). Reporting positions may not always be binary. In some situations, taxpayers may be able to consider reporting a transaction in multiple ways. For instance, taxpayers who are considering whether a gain may be an ordinary or long-term capital gain might also benefit from considering whether the gain could be deferred or excluded. To simplify the illustration, this analysis assumes binary reporting positions.

[21] *See* Borden & Lee, *supra* note 1, at 54-56, 61-62, 72-73, 75-77 (discussing the role of good faith in the substantial-authority analysis).

[22] *See* Reg. § 1.6662-4(d)(3)(i).

[23] *See* Borden & Lee, *supra* note 1, at 65-67.

Figure 2: Depiction of Vertical Substantiality



in relation to the weight of authorities supporting contrary treatment."[24] The language suggests that the weight of positive authorities can be stated as a percentage of negative authorities. Thus, vertical substantiality can be presented numerically as the weight of positive authorities divided by the weight of negative authorities. One potential interpretation of the requisite relationship between the respective authorities is that the weight of positive authorities is "substantial" in relation to the weight of negative authorities if it is at least 40% of the weight of the negative authorities.[25] That interpretation would make the weight-of-authority method the conclusive method for determining whether substantial authority supports a reporting position. Alternatively, perhaps the weight of positive authorities is substantial in relation to the weight of negative authorities if it is sufficient to allow taxpayers to conclude that substantial authority supports a reporting position.[26] This latter interpretation allows taxpayers to take the well-reasoned method into consideration when assessing whether a reporting position meets the substantial-authority standard. The prediction model presents the quantitative mechanics needed to resolve which of these two alternatives is most appropriate for the weight-of-authority method.

[24] Reg. § 1.6662-4(d)(3)(i) (emphasis added).

[25] Recall that commentators often conclude that a 40% likelihood of being upheld is the threshold for establishing that substantial authority supports a reporting position. *See supra* note 14.

[26] *See* Borden & Lee, *supra* note 1, at 68.

III. Mathematical Presentation of the Model

The values from Figure 2, above, provide the starting point for considering substantiality in the weight-of-authority method. Recall that the weight of positive authorities is 30 and the negative authorities is 70 in that figure. With those weights, positive authorities would be approximately 43% of negative authorities (30 ÷ 70). This result represents the vertical-substantiality quotient, expressed in Formula (1), below:

$$V = \frac{P}{N} \tag{1}$$

Where

V = vertical substantiality
P = weight of positive authority
N = weight of negative authority

At first blush, one might conclude that this 43% value is sufficient to establish substantial authority because the value of positive authorities is greater than 40% of the value of negative authorities. The vertical-substantiality quotient must, however, be converted to a value on the horizontal scale to help determine whether a reporting position satisfies the substantial-authority standard. Additional analysis reveals that a vertical-substantiality quotient of 40% probably does not translate into a 40% likelihood that a position will be upheld. To illustrate, the vertical-substantiality quotient for a position that has a weight of 70 for positive authorities and a weight of 70 for negative authorities would be 100% (70 ÷ 70).[27] If the authorities weighed evenly for and against a reporting position, and no other factors affected the reporting position's likelihood of being upheld, the position would appear to have a 50% likelihood of being upheld because only 50% of total weight of authorities that relates to the reporting position is positive (70 ÷ (70 + 70)). Thus, a position does not necessarily have a 40% likelihood of being upheld merely because the weight of positive authorities is at least 40% of the weight of negative authorities.

A. *Translation from Vertical to Horizontal*

Understanding that equal weights of positive and negative authorities translate into a 50% likelihood of a reporting position's being upheld is the foundation for translating the vertical-substantiality quotient into a value on the horizontal scale. To translate vertical substantiality into a value on the horizontal-substantiality scale, one divides the weight of positive authority by the sum of the weight of the positive authority and the weight of negative authority. The value on the horizontal-substantiality scale of a position that

[27] The analysis assumes weights of authority to illustrate how the relative weights affect vertical substantiality and translate to horizontal substantiality.

has a weight of 70 for positive authorities and a weight of 70 for negative authorities would be 50% (70 ÷ (70 + 70)). Formula (2) presents the mathematical expression of the translation of the vertical-substantiality quotient into a value on the horizontal scale.

(2) $$H = \frac{P}{P + N}$$

Where

H = horizontal substantiality

Because the same variables affect both vertical substantiality and horizontal substantiality, horizontal substantiality can be expressed as a function of vertical substantiality, as depicted in the vertical-to-horizontal formula (Formula (3)).[28]

(3) $$H = \frac{V}{V + 1}$$

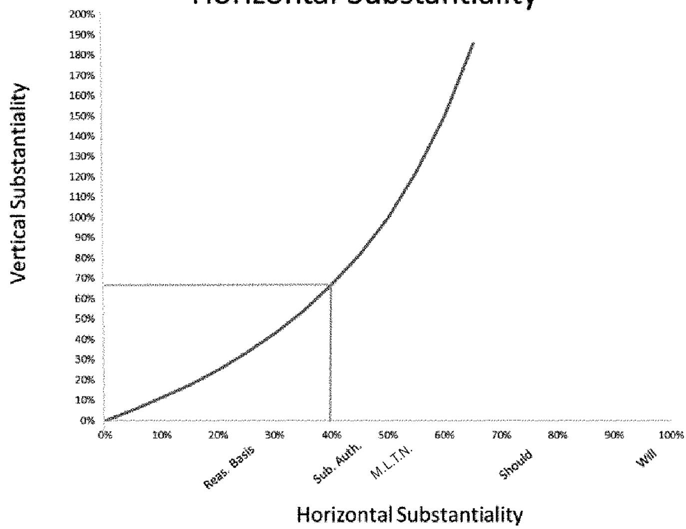
Additional examples apply the vertical-to-horizontal formula and illustrate how vertical substantiality translates into a value on the horizontal-substantiality scale. As just shown, if the weight of positive authorities and the weight of negative authorities are both 70, vertical substantiality would be 100% (70 ÷ 70) (*i.e.*, $V = 1$), which would translate into 50% (1 ÷ (1 + 1)) on the horizontal-substantiality scale. Based on these calculations and the vertical-to-horizontal formula, one would anticipate that vertical substantiality would be greater than the value it translates into on the horizontal-substantiality scale. Thus, although vertical substantiality may exceed 40%, it would translate into a value on the horizontal-substantiality scale that does not meet substantial authority's 40% threshold.

To illustrate, when the weight of positive authorities is 30 and the weight of negative authorities is 70, vertical substantiality would be approximately 43% (30 ÷ 70). That value would translate into a horizontal-substantiality score of approximately 30% (0.43 ÷ (0.43 + 1)). Thus, even though, at first blush, the weight of positive authorities may appear to be substantial in relation to the weight of negative authorities based upon the 40% derived from the vertical-substantiality quotient, the weight of authority might not translate into a value on the horizontal-substantiality scale that satisfies the substantial-authority threshold.

[28]This formula derives from the two formulas as follows: Using $H = \frac{P}{P+N}$, first factor out a P by multiplying the numerator and denominator by $1/P$, so the formula becomes $H = \frac{1}{1+N/P}$. Second, multiply both the numerator and denominator by P/N, so the formula becomes $H = \frac{P/N}{P/N+1}$. Third, substitute V for P/N, so the formula becomes $H = \frac{V}{V+1}$.

The vertical-to-horizontal formula can be presented in a graph to illustrate the relationship between vertical substantiality and the score it translates into on the horizontal-substantiality scale. Vertical substantiality is the independent variable, and horizontal substantiality is the dependent variable. Consequently, a traditional graph of the relationship between the respective types of substantiality would present vertical substantiality on the horizontal axis and horizontal substantiality on the vertical axis. Viewing the horizontal-substantiality scale on the vertical axis would be confusing, so the graph bucks graphing convention and places vertical substantiality (the independent variable) on the vertical axis and horizontal substantiality (the dependent variable) on the horizontal axis (see Figure 3).

Figure 3: Relationship Between Vertical and Horizontal Substantiality



1. *Minimum Required Stand-Alone Vertical-Substantiality Value*

The vertical-to-horizontal formula and its graphical presentation provide a tool to more closely consider various aspects of substantial authority. First, quantitative depictions present further insight into the regulations' provision that the weight of positive authorities must be substantial in relation to the weight of negative authorities.[29] One might conclude that the weight of positive authority is substantial in relation to the weight of negative authority only when it translates into a value on horizontal-substantiality scale of at least 40%. Under that assumption, the graph suggests that the weight of the

[29] *See* Reg. § 1.6662-4(d)(3)(i).

positive authorities must be greater than 65% of the weight of negative authorities to be substantial. Indeed, by rewriting the vertical-to-horizontal formula to solve for $V\left(V = \frac{H}{1\text{-}H}\right)$ and setting H equal to the 40% horizontal threshold, the formula reveals that vertical substantiality would have to be at least 66.67% for the weight-of-authority method to translate into a value of the horizontal-substantiality scale of greater than 40% (0.4 ÷ (1 - 0.4) = 0.6667).[30] That is a fairly high threshold for the relationship of positive to negative authorities. The discussion below regarding the application of the well-reasoned method demonstrates that taxpayers may be able to obtain the threshold horizontal substantiality, even if vertical substantiality is less than 66.67%. Thus, the analysis does not conclude at this point that positive authority must equal at least 66.67% of negative authority to be substantial. The analysis does, however, confirm that the value for vertical substantiality will be greater than the value it translates into on the horizontal-substantiality scale.

2. *Limits of Translated Values*

Second, the vertical-to-horizontal formula quantifies the limits of the values on the horizontal-substantiality scale (zero to one) that can derive from vertical substantiality. The curve of the graph of horizontal substantiality is asymptotic and could get closer and closer to one, but will never reach that limit. It also can never be less than zero. The mathematical representation of the upper limit of horizontal substantiality is $\lim_{V \to \infty} \frac{V}{V+1} = 1$. To illustrate, vertical substantiality could become very large if the weight of positive authorities was very large or the weight of negative authorities was very small. For example, if the weight of positive authority approached infinity or the weight of negative authorities approached zero, vertical substantiality would approach infinity. Stated mathematically, vertical substantiality approaches infinity when the weight of positive authorities becomes very large $\left(\lim_{P \to \infty} \frac{P}{N} = \infty\right)$, or the weight of negative authorities becomes very small $\left(\lim_{N \to 0} \frac{P}{N} = \infty\right)$, assuming the weight of negative authorities will never be zero.[31] Nonetheless, as the limit proof demonstrates, value on the horizontal-substantiality scale would

[30] This formula derives from the $H = \frac{V}{V+1}$ formula by multiplying both sides by $V + 1$ to get $V = H(V + 1)$ or $1 = HV + H$ and then subtracting HV from both sides to get $V - HV = H$. After factoring out V and dividing both sides by $1-H$, the formula becomes $V = \frac{H}{1\text{-}H}$.

[31] If the weight of negative authorities were zero, vertical substantiality would be undefined, according to vertical-substantiality quotient, because a number divided by zero is undefined. *See* Eric W. Weisstein, *Division by Zero*, WOLFRAM MATHWORLD, last accessed Mar. 7, 2018, http://mathworld.wolfram.com/DivisionbyZero.html.

never exceed one because the vertical-to-horizontal formula would be $H = \frac{\infty}{\infty + 1}$, when $V = \infty$, which gets very close to one, but never reaches it.

Inversely, the bottom limit of the translated value on the horizontal-substantiality scale is zero as vertical substantiality approaches zero. To illustrate, vertical substantiality would approach zero if the weight of positive authorities was very small in relation to weight of negative authorities. This phenomenon would occur for instance when the weight of positive authorities approaches zero $\left(\lim_{P \to 0} \frac{P}{N} = 0\right)$ or when the weight of negative authorities approaches infinity $\left(\lim_{N \to \infty} \frac{P}{N} = 0\right)$. Assuming the weight of positive authorities will never be zero, vertical substantiality could get closer to zero but never actually equal zero.[32] As vertical substantiality approaches zero the value it translates into on the horizontal-substantiality scale will also approach zero. The mathematical representation of this phenomenon is $\lim_{V \to 0} \frac{V}{V+1} = 0$.

Vertical substantiality will translate into a value on the horizontal scale that is never less than zero and is always less than one. This is consistent with intuition—most people cannot imagine a reporting position that has absolutely no chance of being upheld or a reporting position that is absolutely guaranteed to be upheld. Something can always happen to allow a perceived impossibility to occur. Even in situations that appear to be definitive, unexpected outcomes are possible.[33] Consequently, absolute certainty about a reporting position is a nonevent, and the vertical-to-horizontal formula helps illustrate that phenomenon.

3. *Substantial Authority Supporting Multiple Reporting Positions*

Third, the graph and vertical-to-horizontal formula also demonstrate how "[t]here may be substantial authority for more than one position with respect to the same item."[34] Substantial authority may support two reporting positions in at least two situations. First, two positions can have substantial authority mathematically, based solely on the weight-of-authority method. For example, a position with vertical substantiality of 66.67% (*e.g.*, 20 ÷ 30) would have an initial value on the horizontal-substantiality scale of at least 40% (0.667 ÷ (0.667 + 1)), and thus could be supported by substantial authority. The contrary position on the same issue would have a vertical-substantiality

[32] If the weight of positive authorities were zero, vertical substantiality would be zero, assuming the denominator is not zero. Roland E. Larson, Robert P. Hostetler & Bruce H. Edwards, College Algebra 10 (1993).

[33] As discussed below, well-reasoned arguments can affect the outcome of a reporting position. *See infra* Part IV. Thus, some of the intuition might be affected by logical reasoning and permitted authority may not directly address an issue. Even without permitted authority that directly addresses an issue however, a taxpayer may find some permitted authority that addresses an issue tangentially.

[34] *See* Reg. § 1.6662-4(d)(3)(i).

value of 150% (*e.g.*, 30 ÷ 20), which would translate into a value of 60% (1.5 ÷ (1.5 + 1)) on the horizontal-substantiality scale, which could also meet the substantial-authority threshold. Thus, the two reporting positions would appear each to have substantial authority, assuming the well-reasoned method does not alter the outcome of either reporting position.

Second, two reporting positions could have substantial authority if the well-reasoned method causes the horizontal substantiality of at least one position to cross the threshold, assuming it would not cross the threshold based solely upon the weight-of-authority method. For example, if the vertical substantiality of one reporting position is 333% (100 ÷ 30), that position would have a translated value on the horizontal-substantiality scale of approximately 77% (3.33 ÷ (3.33 + 1)), so it would appear to have substantial authority using only the weight-of-authority method. The substantiality of the other position would be 30%, and that value would translate into a value on the horizontal-substantiality authority scale of approximately 23% (0.3 ÷ (0.3 + 1)). The well-reasoned method should allow taxpayers to consider other factors that could move that value far enough along the horizontal-substantiality scale to achieve substantial authority in some situations.[35] The question is, To what extent can the well-reasoned method affect the horizontal-substantiality value? The discussion now advances to consider that question.

B. *Adjustment for Well-Reasoned Method*

The qualitative analysis in the prior article concluded that the weight-of-authority method and the well-reasoned method apply concurrently to reporting positions.[36] Having established how the weight-of-authority method may translate into a value on the horizontal-substantiality scale, the focus turns to applying the well-reasoned method to the quantitative model. The analysis above demonstrated that vertical substantiality of 40% translates into a value on the horizontal-substantiality scale of just less than 30%.[37] Based solely on weight of authority, the reporting position with those values would not satisfy the 40% substantial-authority threshold. In some situations, the well-reasoned method could, however, move the value on the horizontal scale, perhaps far enough to surpass the 40% threshold required for substantial authority. In other situations, the well-reasoned method could reduce the value translated from the vertical substantiality to a value on the horizontal-substantiality scale and could cause the value to become less than the substantial-authority threshold.

This analysis suggests that the well-reasoned method would appear to apply after translating the weight-of-authority measurement (vertical substantiality) into a value on the horizontal-substantiality scale. Formula (4) presents the vertical-to-horizontal formula (Formula (3)), amended to account for

[35] *See* Borden & Lee, *supra* note 1, at 67-75.
[36] *See* Borden & Lee, *supra* note 1, at 67-75.
[37] *See supra* text accompanying note 30.

the well-reasoned method. Formula (4) is a mathematical depiction of the substantial-authority prediction model.

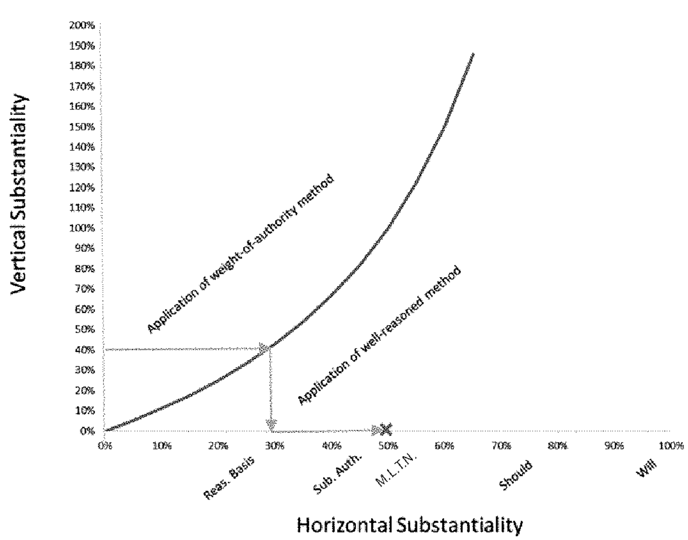
$$(4) \qquad H = \frac{V}{V+1} + R$$

Where

R = well-reasoned method

A simple numerical example illustrates the application of the substantial authority prediction model. If vertical substantiality is 40%, that value translates into slightly less than 30% (0.4 ÷ (0.4 + 1)) on the horizontal-substantiality scale. The well-reasoned method could apply to move the value to the right on the horizontal scale (R could have a positive or negative value, so the movement to the right suggests it has positive value). If the well-reasoned method were sufficiently strong (at least worth 11.5 percentage points), it could move the horizontal value from 30% to beyond the 40% threshold. An illustration of this blending of the two methods is provided in the graph in Figure 4. The discussion following the graph considers several issues that arise with the application of the well-reasoned method.

Figure 4: Effect of the Well-Reasoned Method



1. *Effect on Horizontal Substantiality of Two Reporting Positions*

Applying the well-reasoned method to the vertical-to-horizontal formula raises the question of whether the well-reasoned method must cause a

reporting position to lose substantial authority, if it causes a contrary position to gain substantial authority. Assume a reporting position's vertical substantiality value is 30% (*e.g.*, weight of positive authorities is 30 and weight of negative authorities is 100). That value would translate into a value of approximately 23% on the horizontal-substantiality scale (0.3 ÷ (0.3 +1)). With an addition of at least 17 percentage points from the well-reasoned method, the likelihood of the position's being upheld would cross the 40% threshold and appear to give the reporting position substantial authority. The contrary position would have vertical substantiality of 333% (100 ÷ 30), which translates into approximately 77% on the horizontal-substantiality scale (3.33 ÷ (3.33 + 1)). If the well-reasoned method reduced that amount by 17 percentage points, horizontal substantiality of the contrary reporting position would be approximately 60%, meaning that it meets the substantial-authority threshold. The total of the two values would be 100%, and substantial authority would appear to support both reporting positions. Thus, two opposing reporting positions can both be supported by substantial authority, even after applying the well-reasoned method.

The next question is whether the well-reasoned method that moves the horizontal-substantiality score for a reporting position, must move the horizontal-substantiality score in an equal but opposite direction for a contrary reporting position. In some situations, the equal and opposite movement for any well-reasoned adjustment appears to be appropriate. For instance, a well-reasoned argument that gain from the sale of property is capital should serve as an equally compelling argument that the gain is not ordinary income. Thus, the well-reasoned method would appear to have an equal, but opposite effect on two reporting positions. Despite the apparent equal-but-opposite offset of the well-reasoned method, it generally would not cause the substantial-authority conclusion to change for two opposing positions. For example, if vertical substantiality translated into a value of ten percent on the horizontal-substantiality scale, horizontal substantiality for the opposing position would be 90%. If the well-reasoned method moved the first reporting position 30 percentage points to 40% on the horizontal scale, it should also move the opposing position 30 percentage points to 60%. The well-reasoned method would cause the 10% position to gain substantial authority by moving it to the 40% threshold, but it would not cause the 90% position to lose substantial authority.

2. *Magnitude of Adjustment Caused by the Well-Reasoned Method*

The well-reasoned method will rarely cause one reporting position to gain substantial authority and another to lose it. To cause one reporting position to move from below the substantial-authority threshold to above it and the contrary position to move from above the threshold to below it, the well-reasoned method would have to move the respective positions at least 22 percentage points in opposite directions. For instance, the well-reasoned method would have to move one reporting position up from 39% to 61%

and the other reporting down from 61% to 39%.[38] Thus, reclassification of both reporting positions by use of the well-reasoned method would be rare.

The well-reasoned method could also apply to show that a position that might have a high vertical-substantiality score may miss the horizontal-substantiality threshold after the application of the well-reasoned method. Taxpayers may be able to make compelling arguments that a technical reading of permitted authorities provides substantial authority for a reporting position. Nonetheless, taxpayers should anticipate that the well-reasoned method could apply to the reporting position, and it could potentially move the likelihood below the substantial-authority threshold, allowing the Service to successfully impose the substantial-understatement penalty.[39] This could explain why the government has been able to impose penalties in tax-shelter cases in which preparers present technical arguments for their positions but lose on the underlying tax matter and face penalties.[40] As the Tax Court has explained, construing a regulation does not entail just looking at the words or phrases in isolation, but rather reading them in their context and with a view to their place in the overall statutory regime.[41] Thus, taxpayers must combine the weight-of-authority method with the well-reasoned method to assess the likelihood that a reporting position will be upheld and recognize that purely technical arguments may not be sufficient to avoid penalties.

3. *Problems with Assigning Relative Potency to Methods*

The interaction of the weight-of-authority method and the well-reasoned method raises the question of whether they have equal potency in all situations. The types of available permitted authorities may affect the potency of the weight-of-authority method in relation to the potency of the well-reasoned method, so the potency of the results of the two methods could vary from situation to situation. For instance, some strong types of authority, such as case law, may be tangentially related to a reporting position while other weaker types of authority, such as a private ruling, may be directly on point. The private letter ruling has less precedential weight than case law, but when the private ruling is directly on-point it could have greater weight than tangentially-related case law. Consider whether the weight-of-authority method should have less potency in situations in which private rulings relate to a reporting position than it would have if a statute or court opinion related to the reporting position.

Two hypothetical scenarios help illustrate this point. In both scenarios, identical authorities are the only permitted authorities that relate to the reporting position. Under the first scenario, two circuit court decisions each

[38] The needed movement from the well-reasoned method would increase for any other two starting points. For instance, if the starting points were zero and 100% the movement would have to be at least 60 percentage points to cause the 100% position to lose substantial authority.

[39] *See infra* Parts IV.A.2 to A.3.

[40] *See infra* Part IV.A.3.

[41] *See* Shea Homes v. Commissioner, 142 T.C. 60, 100 (2014).

support opposite sides of a reporting position, which will be decided by a third circuit. The vertical substantiality of that reporting position would be 100%, translating into a 50% value on the horizontal-substantiality scale.[42] Under the second scenario, two private letter rulings each support opposite sides of a reporting position. The vertical substantiality of that reporting position would be 100%, translating into a value of 50% on the horizontal-substantiality scale. Taxpayers may deem the vertical-substantiality value to be more potent when the type of authority that leads to the value is perceived to be stronger. For instance, they may believe that the score derived from the scenario with case law is more potent than the score derived from private rulings. Taxpayers therefore might consider taking the type of authority used for the weight-of-authority method into account when applying the well-reasoned method. For instance, if the weight-of-authority method relied primarily on a private ruling, the taxpayer may wish to rely more heavily on the result of the well-reasoned method. Despite the initial attractiveness of such a course, attempting to attach relative-potency scores to the weight-of-authority value and the well-reasoned value would most likely prove futile.

To appreciate the difficulty of assigning relative-potency scores to each method, consider scoring the relative potency of the methods on a scale of zero to one, with the total of the scores applied to each method equaling one. This approach would reduce the overall value for a reporting position because the weight-of-authority value and well-reasoned value would each be multiplied by a value less than one. For instance, if the weight of authority is very weak, it might take a potency score of 0.1 and the well-reasoned value would take a potency score of 0.9 (1 - 0.1). With such a scoring, a 37.5% weight-of-authority value on the horizontal scale would become 3.75% (37.5 x 0.1) after applying a potency score of 0.1, requiring the taxpayer to rely primarily on the well-reasoned method to reach the substantial-authority threshold. To cause the horizontal value to pass the substantial-authority threshold, the value of the well-reasoned method, before applying the 0.9 potency score would have to be at least 40.3% points.[43] If the well-reasoned value were 40% prior to applying the strength score, it would become 36% (40 × 0.9) after applying the potency score.

This type of potency assessment would make achieving substantial authority very difficult for most uncertain reporting positions. Perhaps, the analysis could correct for this problem by adding the difference between one and the potency score of the weight-of-authority value to the potency score for the well-reasoned method. Thus, if the potency score for the weight-of-authority method were 0.1, the 0.9 difference could be added to the potency score for

[42] *See supra* note 27 and accompanying text.

[43] (0.40 – 0.0375)/0.9 = 40.28%

the well-reasoned method, giving it a 1.9 value.[44] With such a scoring system, a 22% value from the well-reasoned method would be sufficient to establish substantial authority (22 × 1.9 = 41.8).[45] That result is suspect because it would allow a taxpayer who is otherwise unable to meet the substantial-authority threshold with either method to meet it by virtue of having a very low weight-of-authority potency score, which would bolster the well-reasoned score.

The model does not appear to be conducive to including relative potency scores for the weight-of-authority value and the well-reasoned value. Instead, taxpayers should account for the different values when applying the well-reasoned method. For instance, a weight-of-authority value based primarily on private rulings could be offset (or bolstered) by a strong well-reasoned method. Taxpayers should understand that the well-reasoned method could significantly alter a value on the horizontal-substantiality scale derived solely from private rulings and may have less of an effect on a score derived from case law.

The substantial-authority prediction model could help taxpayers assess the likelihood of a position's being upheld, as they apply it using these steps:

1. Determine the weight of authorities that supports the reporting position and the weight of authorities that is against the reporting position.
2. Compare the relative weights of authorities to determine vertical substantiality.
3. Translate vertical substantiality into a value on the horizontal-substantiality scale.
4. Determine a value for the well-reasoned method.
5. Apply the well-reasoned value to the translated horizontal-substantiality value derived from vertical substantiality.
6. Determine a final value that represents the likelihood that a reporting position will be upheld.

If that final value is greater than 40%, substantial authority supports the position. Figure 5 provides a visual depiction of the process, combined with the qualitative policy analysis presented in *Boundaries of the Prediction Model of Tax Law's Substantial Authority*.[46]

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[44] Formula (5) presents an unworkable version of the substantial-authority prediction model with adjustment for strength scores to both weight-of-authority value and the well-reasoned value.

$$(5) \qquad H = S_A \cdot \left(\frac{V}{V+1}\right) + R \cdot (2 - S_A)$$

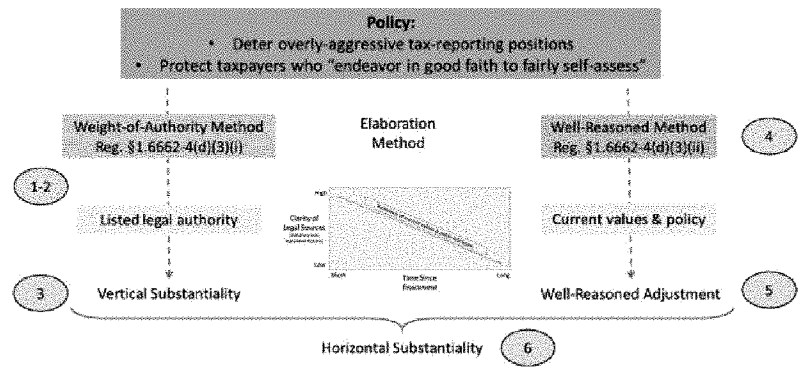
Where

S_A = Strength score of weight-of-authority value

[45] (40 - 3.75)/1.9.

[46] *See* Borden & Lee, *supra* note 1, at 47-79.

Figure 5:
Application of Substantial-Authority Standard



IV. Case-Studies Related to the Applications of Model

Congress adopted a no-fault penalty regime for substantial understatements, but, recognizing the law does not always provide certainty, it granted leeway for taxpayers who must take reporting positions in the face of uncertainty.[47] Where a gap exists, the weight-of-authority method may not adequately determine the likelihood that an uncertain reporting position will be upheld, so the well-reasoned method clearly applies. Gaps in the law create one type of legal uncertainty, but there are other types of uncertainty. Uncertainty also exists if statutes or other sources of law are contrary to social norms or general legal principles and a court might rule contrary to the published law. For instance, Congress may enact a statute that society accepts at the time of enactment, but rejects as time passes. As the statute loses favor, it becomes susceptible to attack on policy grounds under dynamic interpretation,[48] as determined through a well-reasoned construction of the statute that considers current social norms. In these situations, the well-reasoned method may trump the weight-of-authority method in determining the likelihood that a reporting position will be upheld.

Uncertainty also exists if law provides technical support for a reporting position that clearly is contrary to the purpose of the law or ignores economic substance. In these situations, the well-reasoned method, based on general principles like substance over form, may override the weight-of-authority method that relies upon technical analysis. Thus, the well-reasoned method

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[47] *See* 128 Cong. Rec. 21,611 (1982); *see also* Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 217-18 (1982); Borden & Lee, *supra* note 1, at 54-56.

[48] *See* Borden & Lee, *supra* note 1, at 72-75.

could move a value based on the weight-of-authority method from above the substantial-authority threshold to below it.

The following discussion illustrates how courts have used the well-reasoned method to reach conclusions that differ from the result that would otherwise be apparent under the weight-of-authority method. These decisions provide the opportunity to consider whether substantial authority should support a reporting position that is contrary to a statute, and, if so, how that support could affect taxpayers who take reporting positions based upon application of the weight-of-authority method or take the contrary reporting position based upon the well-reasoned method. The analysis then considers how taxpayers might apply the multi-step analysis to determine whether substantial authority supports a reporting position that has little or no support under the weight-of-authority method because little or no permitted authority exists relating to a reporting position.

A. *Derivation of Analyses from Existing Case Law*

In some situations, a well-reasoned construction of a statute appears to require disregarding the statute's express language and relying upon other tools to formulate tax law's support for a reporting position. For instance, in some situations, social norms and government policies change as time passes after the enactment of a statute, and those changes may prompt a court to disregard the plain meaning or prior interpretations of the statute. Two examples illustrate how courts account for changes in social norms and how taxpayers might incorporate changing social norms and government policy into their well-reasoned construction of statutes when considering whether substantial authority supports a reporting position that is contrary to a statute's plain meaning. The lack of significant analysis in cases that consider the existence of substantial authority requires the discussion to draw from cases that apply the well-reasoned method in other contexts. After considering the outcome of those cases, the analysis considers how the quantitative prediction model might have applied if the issues had raised the prospect of a substantial-understatement penalty.

1. *Changed Social Norms Nullify Explicit Statutory Language*

United States v. Windsor[49] provides an example of a situation in which a well-reasoned construction of a statute, based upon changing social norms, prevailed over the plain meaning of the statute. In that case, Edith Windsor, survived her wife, Thea Spyer.[50] The two New York residents married in Ontario, Canada, but the State of New York recognized their marriage at a time when same-sex marriages could not be performed in the state.[51] Windsor sought to claim an estate tax exemption for surviving spouses that removes

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[49] United States v. Windsor, 570 U.S. 744 (2013).
[50] *Id.* at 749-50.
[51] *Id.* at 749-51.

from the taxable estate of a decedent the value of any property that passes to a surviving spouse.[52] The definition of marriage in the Defense of Marriage Act (DOMA), enacted in 1996 before any state had enacted a statute to permit same-sex marriage, applied to all federal statutes including estate tax law.[53] That definition provided that marriage "means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife."[54] Even though Windsor and Spyer's marriage was legally recognized by the State of New York, the plain language of DOMA as applied to the Code clearly prohibited Windsor from claiming the estate tax exemption for property she received from Spyer, so she paid the estate tax and sued for a refund.[55] Ruling in Windsor's favor, the Court held that the definition of marriage in DOMA violated the Fifth Amendment by "seeking to displace [the protection in personhood and dignity afforded by the State of New York's recognition of same-sex marriages] and treating those persons . . . living in [same-sex] marriages [as] less respected than others [.]"[56]

To reach its conclusion, the Court recognized that New York and certain other states had come to view the "limitation of lawful marriages to heterosexual couples" as an unjust exclusion, even though such marriages had been deemed necessary and fundamental for centuries.[57] "New York acted to enlarge the definition of marriage to correct what its citizens and elected representatives perceived to be an injustice that they had not earlier known or understood."[58] The Court recognized that the federal government had traditionally "deferred to state-law policy . . . with respect to domestic relations," and DOMA deviated from that tradition.[59] It then explained how New York's law conferred upon a class of people "dignity and status of immense import" by recognizing same-sex marriage, and DOMA injures that same class.[60] Consequently, the Court ruled that DOMA violated the Fifth Amendment[61] and in so doing, nullified the plain language of the federal statute.

Consider how the *Windsor* decision informs the understanding of the substantial-authority analysis. The Constitution does not appear in the exclusive list of permitted authorities,[62] so the use of constitutional arguments can apply only through the well-reasoned method. With negative statutory authority directly on point, and no apparent permitted authority to support

[52] *See* I.R.C. § 2056(a); *Windsor*, 570 U.S. at 752-53.

[53] *See* Defense of Marriage Act, Pub. L. No. 104-199, 110 Stat. 2419 (1996); *Windsor*, 570 U.S. at 751.

[54] *See* 1 U.S.C. § 7 (1996), *invalidated by* United States v. Windsor, 570 U.S. 744 (2013).

[55] *See Windsor*, 570 U.S. at 753.

[56] *See id.* at 755.

[57] *See id.* at 763.

[58] *See id.*

[59] *See id.* at 767-68.

[60] *See id.* at 768-75.

[61] *See id.* at 775.

[62] *See* Reg. § 1.6662-4(d)(3)(iii); Borden & Lee, *supra* note 1, at 62-63.

the taxpayer's reporting position, the weight-of-authority value was very low for the taxpayer in *Windsor*, perhaps approaching zero. Nonetheless, she won based upon a well-reasoned argument that showed how the perception of marriage had changed over time in the State of New York and how the people of the state began to recognize the injustice of a narrow definition of marriage.[63] That reasoning led the court to conclude that the statute was unconstitutional.[64] The well-reasoned interpretation of the statute overcame the unambiguous direct reading of the statute and a very low weight-of-authority value (all of the apparent permitted authority appeared to favor the contrary position). Now, consider whether the same reasoning would have been sufficient to avoid a substantial-understatement penalty if the court had assessed a tax and asserted a penalty under different circumstances.

Prior to *Windsor*, undoubtedly some same-sex married couples filed joint returns in defiance of DOMA. The authors are unaware of the Service's challenging joint returns filed by same-sex couples prior to the *Windsor* decision, but the situation of such couples would have been different from Windsor's situation. The taxpayer in *Windsor* paid the tax and sued for refund.[65] If she had not prevailed in that case, she would not have received the refund, but she would not have been exposed to the substantial-understatement penalty because she had paid the tax.[66] To analyze the substantial-authority standard, consider a thought experiment in which the Service challenged married same-sex couple's treatment as being married and tried to impose penalties on taxpayers whose filing status would have resulted in a substantial understatement. The question is whether, prior to the *Windsor* decision, such taxpayers could have shown that substantial authority supported the reporting position. Taxpayers fearing the imposition of a penalty would most likely be unable to show that the vertical substantiality, based upon the weight-of-authority method, was much greater than zero. DOMA clearly applied and clearly excluded same-sex couples from the definition of married persons. Thus, the taxpayers would have to show that the well-reasoned method provided an argument that was strong enough to provide their reporting position had at least a 40% likelihood of being upheld.

Undoubtedly, same-sex couples facing a penalty for filing jointly would have presented the arguments that the Supreme Court adopted in *Windsor*. They would have had to convince the court that disregarded their married status that their reporting position had at least a 40% likelihood of being upheld based upon those arguments. In hindsight, following the *Windsor* decision, the Court's application of the well-reasoned method and Windsor's victory indicate that the reporting position of same-sex married couples filing jointly should have had at least a 40% likelihood of being upheld against the

[63] *See Windsor*, 570 U.S. at 763-64.
[64] *See id.* at 775.
[65] *See id.* at 753.
[66] *See* I.R.C. § 6662(a), (b)(5); *Windsor*, 570 U.S. at 753.

Service's challenge of their filing status, if they adopted the reasoning the Court applied. Consequently, they would appear to have had substantial authority for the position, even though it was contrary to the statutory language.

Some observers may quibble with this conclusion that a reporting position that defies a statute can be supported by substantial authority. These observers might argue that the statute was the law until the Supreme Court decided *Windsor*, and, thus, substantial authority could not support any other interpretation of the law. The substantial-authority standard requires taxpayers to predict the likelihood that a reporting position will be upheld and allows them to use the well-reasoned method in that analysis.[67] When assessing the likelihood that a position will be upheld, taxpayers should be able to consider the arguments a court would consider in deciding the case.[68] A court would consider the constitutional arguments, so taxpayers should also consider those arguments when assessing whether substantial authority supports a reporting position. In the years leading up to the *Windsor* decision, the likelihood that a constitutional argument would prevail was increasing. At some point, before the *Windsor* decision, undoubtedly that likelihood crossed the 40% threshold. Consequently, there would have been substantial authority for same-sex married couples filing joint returns prior to the *Windsor* decision.

2. *Changed Social Norms and Policy Override Prior Treatment*

In *Bob Jones University v. United States*,[69] the question was whether the Service exceeded its authority by rescinding the section 501(c)(3) tax-exempt status of two schools that had racially discriminatory admissions practices.[70] The rescissions followed a 1970 change in the Service's position regarding the availability of tax-exempt status to schools that discriminate based upon race in the admission process.[71] The statute providing a tax exemption for "[c]orporations . . . organized and operated exclusively for religious, charitable . . . or educational purposes" did not change to reflect the Service's changed position.[72] The schools argued that the plain language of the statute granted educational institutions tax-exempt status and that the absence of express language in the statute requiring all exempt organizations to be charitable in the common-law sense meant they qualified for the exemption.[73]

The Court could not rely solely upon the statute to reach a conclusion that supported the Service's position. The Court nonetheless held that the Service did not exceed its authority in changing its interpretation of the statute, even though the statute did not expressly prohibit racial discrimination and even though the Service had not formerly denied tax exemption on account of

[67] *See* Borden & Lee, *supra* note 1, at 44-47, 67-75.
[68] *See* Borden & Lee, *supra* note 1, at 75-77.
[69] *See* Bob Jones Univ. v. United States, 461 U.S. 574 (1983).
[70] *See id.* at 579-85.
[71] *See id.* at 577-79.
[72] *See* I.R.C. § 501(c)(3) (1954).
[73] *See Bob Jones Univ.*, 461 U.S. at 585.

racial discrimination.[74] To reach this conclusion, the Court interpreted the legislative history of section 501(c)(3) to incorporate the common-law concept of charity into the statute.[75] Once the Court had determined that the statute incorporated the common-law definition of charity, it connected the benefits bestowed upon charities to the public benefit the law expects them to provide.[76] The Court thus concluded that section 501(c)(3) organizations must serve and be in harmony with the public interest, and that the purpose of these organizations cannot be so at odds with the community conscience as to undermine any public benefit that the organization might otherwise confer.[77] Legislative history and case law are permitted authorities,[78] so their use would come within the weight-of-authority method, but the Court also had to rely upon the well-reasoned method to find support for the Service's position.

The Court showed that racial discrimination was at odds with the community conscience, thus undermining public policy. To show that racial discrimination was contrary to public policy,[79] the Court relied upon: "deeply and widely accepted views of elementary justice";[80] pronouncements of the Court, myriad acts of Congress, and executive orders that attest to a firm national policy to prohibit racial segregation and discrimination in public education;[81] fundamental national public policy, as stated in case law;[82] fundamental public policy expressed in the Civil Rights Act of 1964 and numerous other acts;[83] executive orders that prohibit racial discrimination;[84] and public policy.[85] The Court also considered Congress's inaction, recognizing that over the 12 years preceding its decision no fewer than 13 bills had been introduced to overturn the Service's interpretation of section 501(c)(3), but none of them had emerged from any committee.[86] None of these items are on the list of permitted authorities, so their use comes within the well-reasoned method. Based upon all of those statements of then-current public policy, the Court ruled that racially discriminatory educational institutions do not provide a public benefit and do not fit within the congressional intent of section 501(c)(3).[87]

The Court dismissed the schools' arguments that the Service lacked authority to alter the scope of a statute because the Service is under oath to

[74] *See id.* at 605.
[75] *See id.* at 586-88.
[76] *See id.* at 588-91.
[77] *See id.* at 592.
[78] *See* Reg. § 1.6662-4(d)(3)(iii); Borden & Lee, *supra* note 1, at 62-63.
[79] *See Bob Jones Univ.*, 461 U.S. at 595.
[80] *See id.* at 592.
[81] *See id.* at 593.
[82] *See id.*
[83] *See id.* at 594.
[84] *See id.*
[85] *See id.* at 595.
[86] *See id.* at 600.
[87] *See id.* at 595-96.

implement congressional will when Congress does not act to address a problem that arises.[88] Speculating that Congress understood what the Service's position was, the Court interpreted Congress's inaction as acquiescing to the Service's position.[89] The Court relied upon various forms of support that fall outside the weight-of-authority method to conclude that "[c]learly an educational institution engaging in practices affirmatively at odds with [the] declared position of the whole Government cannot be seen as exercising a 'beneficial and stabilizing influenc[e] in community life.'"[90] Consequently, the Court found the Service was in the right to deny tax exemption to educational institutions that discriminated based upon race. The Court was able to reach this conclusion, despite a prior understanding of the statute's plain language and the Service's prior practice, by relying upon a well-reasoned construction of the statute.

Bob Jones University is an example of a situation in which a taxpayer relied upon the plain meaning of a statute and believes a reporting position is supported by the weight-of-authority method, but loses under the well-reasoned method. The tax year at issue preceded the enactment of the substantial-understatement penalty,[91] so the Service could not have imposed that penalty, and the question of substantial authority would have been irrelevant.[92] Despite the inapplicability of the substantial-underpayment penalty the decision provides a case study for considering how the weight-of-authority method and the well-reasoned method might work in tandem.

In *Bob Jones University*, the weight-of-authority argument appeared to support the taxpayer, but the taxpayer lost because the government successfully presented a well-reasoned construction of the statute.[93] In this case, vertical substantiality for the schools' reporting position would have been high because the statute does not expressly address racial discrimination and schools had qualified for tax exemption under the statutory language for some time, despite maintaining discriminatory practices.[94] Nonetheless, the statute does

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[88] *See id.* at 596-97.

[89] *See id.* at 601.

[90] *See id.* at 598-99.

[91] The tax years at issue in *Bob Jones University* were prior to 1980. *See id.* at 577-85. The substantial-understatement penalty was enacted in 1982. *See* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324.

[92] Furthermore, the substantial-underpayment penalty only applies to income tax. *See* I.R.C. § 6662(a), (b)(2). Income tax for this purpose includes any income tax imposed under subtitle A of the Code. *See* Reg. § 1.6662-4(a). The rules governing tax exemption are in subchapter F of chapter 1 of subtitle A of the Code, so an income tax imposed as a result of losing tax-exempt status should be subject to penalties under the current regime. Further, the unemployment taxes that the Service claimed that the University owed are outside of the purview of the income tax laws. Employment taxes are in subtitle C of the Code, *see* I.R.C. §§ 3101-3512, so an understatement of employment tax would not be subject to the understatement penalty. The discussion of *Bob Jones University* nonetheless illustrates the manner in which a court applied the well-reasoned method to a tax question.

[93] *See Bob Jones Univ.*, 461 U.S. at 598-99.

[94] *See id.* at 599-600.

not expressly prohibit the Service from denying tax exemption to schools that discriminate.[95] Consequently, one would expect vertical substantiality to be significantly greater than 100% because the weight of authority supporting tax exemption was greater than contrary authority. If vertical substantiality were 125%, it would translate into a value of approximately 56% on the horizontal-substantiality scale. The well-reasoned method would reduce that value, but it probably would not reduce the likelihood of schools' reporting positions being upheld to less than 40%. Consequently, even though the schools lost, if the Service had imposed the substantial-understatement penalty, the schools should have been able to make a compelling defense that substantial authority supported their reporting positions.

3. *Application to Tax Shelters*

When an issue of tax shelter is raised,[96] the analysis addresses the overarching principles of tax law for both the substantive question and the question of whether substantial authority supports the reporting position.[97] Specifically, courts examine the economic realities[98] of the transaction at issue by applying the economic-substance doctrine and the substance-over-form doctrine.[99]

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[95] *See id.*

[96] *See* § 6662(d)(2)(C)(ii) (defining "tax shelter" as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax"); Reg. § 1.6662-4(g)(2)(i) (describing tax shelter as "[a] partnership or other entity (such as a corporation or trust), [a]n investment plan or arrangement, or [a]ny other plan or arrangement, if the principal purpose of the entity, plan or arrangement, based on objective evidence, is to avoid or evade Federal income tax. The principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose").

[97] Authors acknowledge that "substantial authority" is not a taxpayer defense to the section 6662 penalty with respect to a section 6662 tax shelter. This section is intended to illustrate the underlying principles of the substantial-authority defense.

[98] *See* Reg. § 1.6662-4(g)(2)(i) ("Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter."). Furthermore, violations of the economic substance doctrine are now subject to a strict liability penalty under the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029.

[99] *See* Fidelity Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49, 225 (2010) (holding that substantial authority cannot exist for transactions that either "lack economic substance or must be recharacterized under the step transaction doctrine"); *see also* Stobie Creek Invs., LLC v. United States, 82 Fed. Cl. 636, 706 (2010) (holding that the principle of substance over form overrides the cases cited by the taxpayer where the transactions at issue lacked economic substance or must be disregarded pursuant to the step transaction doctrine); Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 204-05 (D. Conn. 2004); Santa Monica Pictures v. Commissioner, 89 T.C.M. (CCH) 1157, 1229, 2005 T.C.M. (RIA) ¶ 2005-104.

The economic substance doctrine, originating from the Supreme Court's holding in *Gregory v. Helvering*,[100] provides that "transactions that are shams, or without economic substance, will not be recognized under the Internal Revenue Code."[101] The economic substance doctrine can be tested through an objective inquiry, a subjective inquiry, or both. An objective inquiry asks whether the transaction "'appreciably affect[s]' a taxpayer's beneficial interest except to reduce his taxes."[102] The subjective inquiry asks "whether the taxpayers have shown that they had a business purpose for engaging in the transaction other than tax avoidance."[103]

The substance over form doctrine stands for the basic principle of tax law that "incidence of taxation depends upon the substance of a transaction."[104] Along the same lines of this doctrine is the step transaction doctrine, which stands for the principle that "effect should be given to the substance, rather than the form, of a transaction, 'by ignoring for tax purposes, steps of an integrated transaction.'"[105]

Currently, substantial-authority defense is only available in limited circumstances when a matter relates to a tax shelter.[106] In most, if not all circumstances, once the court finds that the transaction at issue is a tax shelter, the analysis of whether substantial authority exists becomes moot. In such case, it means that taxpayers who have acted with bad faith by engaging in a tax shelter transaction may not now avail themselves of the substantial-authority defense. *New Phoenix Sunrise Corp. v. Commissioner* further supports the notion that the underlying rationale for disallowing the substantial-authority

[100]Gregory v. Helvering, 293 U.S. 465 (1935).

[101]*See Fidelity Int'l*, 747 F. Supp. 2d at 225 (holding that substantial authority cannot exist for transactions that either "lack economic substance or must be recharacterized under the step transaction doctrine").

[102]*Id.* at 231 (quoting Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM P'ship v. Commissioner, 157 F.3d 231, 248 (1998)).

[103]*Id.* at 232 (quoting Casebeer v. Commissioner, 909 F.2d 1360, 1363-64 (9th Cir. 1990)).

[104]Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

[105]*Fidelity Int'l*, 747 F. Supp. 2d at 233 (quoting Falconwood Corp. v. United States, 422 F.3d 1339, 1349 (Fed. Cir. 2005)).

[106]*See* I.R.C. § 6662(d)(2)(C) (providing that the substantial-authority defense alone may not reduce the amount of any item attributable to a tax shelter, including a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement that has as a significant purpose the avoidance or evasion of federal income tax); Reg. § 1.6662-4(g)(1)(i) (providing that a non-corporate taxpayer may reduce the amount of an item attributable to a tax shelter with substantial authority only if "[t]he taxpayer also reasonably believed at the time the return was filed that the tax treatment of that item was more likely than not the proper treatment"); Reg. § 1.6662-4(g)(1)(ii) (providing that the substantial-authority defense is not available under any circumstances for corporate taxpayers that engage in tax shelters unless the transaction at issue occurred prior to December 9, 1994). Congress has also enacted penalties for underpayments attributable to nondisclosed, noneconomic substance transactions and reportable transaction understatements. *See* I.R.C. §§ 6662(i), 6662A.

defense to tax shelters in certain cases is the lack of good faith in self-assessing its reporting position.[107]

In *New Phoenix Sunrise,* the Tax Court disallowed the recognition of a loss of approximately $10 million on the sale of stock held by the taxpayer's corporate subsidiary because the court found that the subsidiary's basis in the stock was artificially inflated by a transaction that lacked economic substance.[108] The taxpayer, through its subsidiary corporation, entered into a simultaneous purchase and sale of option contracts and contributed the long and short options to a partnership newly formed with the president-CEO of the taxpayer corporation.[109] With the contribution, the subsidiary corporation stepped up its outside basis in the partnership by the amount of the long position's premium but did not reduce its outside basis by the amount of the short position's premium on the premise that short options are, more likely than not, not treated as a liability for tax purposes.[110]

Shortly after, the partnership purchased stock in a third-party corporation.[111] Once the options matured, the partnership was liquidated.[112] The taxpayer argued that the liquidation resulted in a step-up in the basis of the assets formerly held by the partnership (*i.e.*, the third-party corporate stock) to the stepped-up outside basis of the subsidiary corporation.[113] When the subsidiary corporation later sold the third-party corporation stock, the subsidiary corporation claimed a tax loss of approximately $10.5 million due to the inflated basis it had in the stock.[114] In addition to finding that the option transaction lacked economic substance,[115] the court also found that the taxpayer lacked substantial authority.[116] The taxpayer claimed that it "relied on caselaw in taking the position that the short option sold was contingent and not required to be taken into account when calculating [the subsidiary corporation]'s basis in [the partnership]."[117]

In response to that claim, the court focused on the awareness that the taxpayer and its advisors had with respect to the government's intent on investigating "transactions substantially similar to the transaction at issue" as potential tax shelters.[118] Specifically, the court addressed the fact that the taxpayer and its advisors were aware of Notice 2000-44 and subsequent Service releases, which "warned taxpayers of transactions calling for simultaneous

[107] *See* New Phoenix Sunrise Corp. v. Commissioner, 132 T.C. 161 (2009).

[108] The case was issued in 2009, prior to the enactment of a strict liability penalty for violations of the economic substance doctrine. *See supra* text accompanying note 98.

[109] *New Phoenix*, 132 T.C. at 167-68.

[110] *Id.* at 184-85.

[111] *Id.* at 169-70.

[112] *Id.* at 170.

[113] *Id.* at 172.

[114] *Id.*

[115] *Id.* at 182.

[116] *Id.* at 190.

[117] *Id.*

[118] *Id.*

purchase and sale of offsetting options which were then transferred to a partnership."[119] Hence, the court in *New Phoenix Sunrise* was not attacking the taxpayer's technical argument that short options should not be taken into account in the calculation of a partner's outside basis in a partnership. Rather, the court was questioning the taxpayer's claimed reliance on the case law. In other words, the taxpayer's lack of good faith in self-assessing its reporting position makes its technical argument futile.[120]

New Phoenix Sunrise demonstrates that tax shelters raise complex issues related to the substantial-authority analysis. The taxpayers relied upon technical arguments, to support their claimed loss deduction. The cases they relied upon are permitted authorities. The Notice and other Service releases that the Service relied upon are also permitted authorities. Consequently, the case could be made that the vertical substantiality in a case like *New Phoenix Sunrise* would, at best, be 100%, which would translate into a 50% value on the horizontal-substantiality scale.[121] The well-reasoned method would apply a negative amount and move the value on the horizontal-substantiality scale to below the 40% threshold. Even if a transaction is not a listed transaction, the Service and courts may rely upon the well-reasoned method to show the likelihood of the position being upheld did not meet the threshold and impose a substantial-understatement penalty.

Taxpayers who engage in transactions that lack economic substance face penalties in one of three ways. First, their technical arguments may lose to judicial doctrines, such as the economic-substance doctrine, and they will not meet the substantial-authority threshold under the weight-of-authority test. In such situations, the well-reasoned method will only provide negative results, so it will not help. Second, they could reach the substantial-authority threshold under the weight-of-authority method, but lose ground when the well-reasoned method applies. Third, if their transaction is found to be a sham, their technical arguments will fail because those arguments would apply to a transaction that did not exist. They would not meet the substantial-authority threshold under the weight-of-authority method. Thus, even without the statutory restrictions on the use of the substantial-authority defense in tax-shelter cases, taxpayers would likely have a difficult time reaching the 40% threshold.

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[119] *See* Notice 2000-44, 2000-36 I.R.B. 255.

[120] *See* Rosen v. Commissioner, 67 T.C.M. (CCH) 2082, 2092, 1994 T.C.M. (RIA) ¶ 94,040 at 19-40 (finding that substantial authority existed where "the [taxpayer]'s position was supported by a well-reasoned, albeit erroneous, construction of Ohio law, which could be refuted only after a complex and extensively researched analysis of various pertinent State and Federal authorities").

[121] *See supra* note 27 and accompanying text.

B. *Application of Model to Reporting Positions*[122]

Some tax issues that arise are not directly governed by clear law. There are numerous areas in which tax law simply has gaps. Congress expressly recognized this type of uncertainty in its legislative history that accompanies the penalty regime.[123] Despite that uncertainty, taxpayers must make reporting decisions. This part of the Article considers two situations that are not governed by clear law and considers how taxpayers might apply the substantial-authority prediction model to determine the likelihood that reporting positions in these areas would be upheld. The application of the model advances understanding of the substantial-authority standard and reveals shortcomings of the model. In particular, the application reveals that the lack of a weighting system limits the model's application and that the line dividing the weight-of-authority method and the well-reasoned method is not always clear.

1. *Allocations in Accordance with Partners' Interests*

The allocation of tax items to members of tax partnerships is a central and complex aspect of partnership taxation.[124] Allocations are valid if they have substantial economic effect or are in accordance with the partners' interests in the partnership.[125] Relatively little authority exists regarding whether partnership allocations of tax items are in accordance with partners' interests in a partnership.[126] Of course, partnerships can structure their arrangements

[122] *Disclaimer*: The discussion that follows and application of the model is illustrative. The Authors recognize that taxpayers who are pressed to take a reporting position in the face of uncertainty might find additional authorities that support their position or the opposing position. They may draw different conclusions. The illustration is not intended to provide an exhaustive analysis of the issues discussed. Instead, it draws upon the cited authorities, treating them as the universe of permitted authorities that relate to the various reporting positions. This approach allows the discussion to cover several topics and consider multiple potential applications of the substantial authority's quantitative prediction model.

[123] *See supra* note 47; Borden & Lee, *supra* note 1, at 70.

[124] *See* Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 Tax Law. 97 (2010); Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 Va. Tax Rev. 465 (2011); Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 Brook. L. Rev. 1381, 1433-35 (2009); Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Transactions*, 59 S.C. L. Rev. 297, 335-38 (2008); Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 Va. Tax Rev. 1047, 1074-79 (2006); Stephen Utz, *Allocation and Reallocation in Accordance with the Partners' Interests in the Partnership*, 56 Tax Law. 357, 364-66 (2003); Walter D. Schwidetzky, *The Partnership Allocation Rules of Section 704(b): To Be or Not to Be*, 17 Va. Tax Rev. 707, 708, 740 (1998); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 Tax L. Rev. 1, 9-15 (1990); Lawrence Lokken, *Partnership Allocations*, 41 Tax L. Rev. 545, 613 (1986).

[125] *See* I.R.C. § 704(b).

[126] *See* Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. Cin. L. Rev. 1077 (2011). Federal tax law generally treats limited liability companies that have at least two members as partnerships. *See* Reg. § 301.7701-2 to -3. This Article uses the term "partnership" to refer to all entities taxed as partnerships under federal tax law.

to comply with substantial-economic-effect rules,[127] but those rules were drafted for partnerships that adopt allocation-dependent equity structures and are dated with respect to many current tax partnerships that adopt distribution-dependent structures.[128] Consequently, partnerships often forgo trying to comply with substantial economic effect and instead depend upon the very vague rules defining partners' interests in a partnership to claim their allocations have substantial economic effect.[129] Because the rules are not clear, they cannot definitively establish whether some allocations are or are not in accordance with the partners' interests in a partnership.[130] This is thus an area of law in which a gap exists, often making the reporting position related to the allocations uncertain. Consequently, taxpayers cannot reach a definitive conclusion under the weight-of-authority method and must rely upon a well-reasoned construction of the statute and regulations to determine the likelihood that their allocations are in accordance with partners' interests in a partnership.[131] An example illustrates how taxpayers might assess the likelihood of an allocation being upheld based on partners' interests in a partnership, and whether reliance on partners' interest in a partnership meets the substantial-authority threshold.

Example. Assume that Ingrid contributes $1,000,000 in exchange for Class A and Class B interests in REF LLC, a tax partnership, formed to acquire and manage residential real estate. Miguel receives Class B interests in exchange for agreeing to manage REF LLC. Ingrid contributes 100% of the capital and Miguel contributes 100% of the member services to the LLC. The Class A interests entitle Ingrid to distributions of available cash until she has received her $1,000,000 contribution plus an 8.5% preferred return on her contribution. The Class B interests entitle Ingrid to 80% and Miguel to 20% of available cash that remains after REF LLC satisfies the Class A distribution requirements. The REF LLC operating agreement provides that the LLC will allocate taxable income to holders of Class A interests to the extent of accrued, unpaid preferred return. It will then allocate any remaining income to the Class B holders in proportion to their Class B interests. REF LLC does not attempt to satisfy the test for substantial economic effect, and its operating agreement provides that allocations will be in accordance with members'

[127] *See* § 704(a)-(b); Reg. § 1.704-1(b)(2).

[128] *See, e.g.*, Daniel S. Goldberg, *The Target Method for Partnership Special Allocations and Why It Should be Safe-Harbored*, 69 TAX LAW. 663 (2016); Bradley T. Borden, *Equity Structure of Noncorporate Entities*, 31 REAL EST. FIN. J., Summer/Fall 2016, at 35.

[129] *See* Reg. § 1.704-1(b)(3) (providing generally for a facts-and-circumstances test and list of factors to consider in determining whether allocations are in accordance with the partners' interests in the partnership).

[130] *See* Borden, *supra* note 126, at 1103-27 (describing how the rules in the regulations do not provide a definitive answer about the partners' interests in a partnership in many situations).

[131] In case of partners' interests in a partnership, both the statute and regulations address the concept, but the regulations provide the general rules relating to the definition. *See* § 704; Reg. § 1.704-1(b)(3).

interests in the LLC. In Year 1, REF LLC has $650,000 of taxable income and $750,000 of available cash that it will distribute.

According to the REF LLC operating agreement, Ingrid would receive all $750,000 of the available cash—$85,000 as a preferred return ($1,000,000 x 8.5%) and $665,000 as a return of investment. REF LLC would allocate $85,000 of taxable income to Ingrid to match her accrued preferred return. Of the remaining $565,000, it will allocate 80% ($452,000) to Ingrid and 20% ($113,000) to Miguel. Thus, the total allocated to Ingrid would be $537,000 ($85,000 + $452,000) and the total allocated to Miguel would be $113,000, and REF LLC would allocate approximately 83% ($537,000 ÷ $650,000) of taxable income to Ingrid and 17% ($113, 000 ÷ $650,000) to Miguel. Miguel and Ingrid must consider whether the allocations are in accordance with their interests in REF LLC, and what the likelihood is that the allocations will be upheld.

Miguel and Ingrid would most likely begin their analysis in the regulations, which provide guidance on how to determine the partners' interests in a partnership. The regulations adopt a facts-and-circumstances approach and provide several factors that indicate the partners' interests.[132] The factors in those regulations are (1) the partners' relative contributions to the partnership, (2) the partners' interests in the partnership's economic profits and losses, (3) the partners' interests in the partnership's cash flows and non-liquidating distributions, and (4) the partners' rights to distributions on liquidation.[133]

In some situations, applying those factors might definitively establish the partners' interests in a partnership. For instance, if a partnership allocates economic items and makes distributions in proportion the partners' proportionate contributions, the result for each factor equals the partners' proportionate contributions. REF LLC's situation is different from that basic situation because the values of the several factors may never be the same, and the values of each factor may vary from year to year, as a result of the entity's distribution structure. Nonetheless, Ingrid and Miguel must determine whether there is substantial authority for claiming the allocations are in accordance with their interests in REF LLC. They could start their analysis by considering the values of the several factors in the regulations.

Relative Contributions. The first step of the analysis is to determine the relative values of the contributions. The relative values of the members' different types of contributions are not obvious. Ingrid contributed $1,000,000 of cash, and Miguel agreed to contribute services. They must attach a value to Miguel's promised services to be able to determine the members' relative contributions. One way to consider the value of Miguel's contribution is to consider the amount of the LLC's value that the LLC would receive if the LLC's value became worth billions or trillions of dollars before liquidated. If that were to happen, Miguel's share of total value would get closer and closer

[132] *See* Reg. § 1.704-1(b)(3)(i)-(ii).

[133] *See* Reg. § 1.704-2(b)(3).

to the 20%—the available cash after REF LLC returned Ingrid's contribution and paid her preferred return—but his share would never actually reach 20%. Consequently, Miguel's contribution appears to be less than 20% of total contributions. Furthermore, LLC probably will not experience that type of growth, so the parties must believe that Miguel's contributions are less than 20% of total contributions. They might determine a relative value of his contribution by estimating the percentage of the total distributions that Miguel would receive. For instance, they may estimate that Miguel will receive 13% of total distributions over the life of REF LLC.[134] Thus, for the first factor, they may determine that Miguel's services total 13% of total contributions, and Ingrid's capital contribution is 87% of the total.

Interests in Profits and Losses. The next part of the analysis is to determine the members' interests in REF LLC's profits and losses. The operating agreement does not specify the members' interests in profits and losses. It only provides for the allocation of taxable income and loss. If profits were to equal taxable income, perhaps they would consider using their respective shares of taxable income as a measure of their shares of profit. The analysis to test interests in profits for purpose of testing allocations would be circular if it relied upon allocations to determine the members' shares of profits and losses. Consequently, this factor most likely does not refer to shares of taxable income.

Perhaps they would consider their current shares of distributions to determine their shares of profits. Over the life of REF LLC, the members will receive all of their shares of REF LLC's profits through distributions and thus be able to determine their shares of profits only after REF LLC liquidates. The amount of available cash exceeds REF LLC's taxable income at the end of the current year. The difference between tax accounting and computation of cash flow may explain why the amount of cash available for distribution exceeds taxable income. Available cash may also differ from the current year's profits. Thus, REF LLC cannot merely follow distributions to determine the members' shares of profits and losses. Consequently, Ingrid and Miguel may realize that a value for their interests in profits and losses is not available in Year 1.

Interests in Cash Flows. Ingrid and Miguel must next consider their interests in the cash flows of REF LLC. The regulations do not describe how partners should determine their interests in partnership cash flows. Perhaps the LLC's available cash represents its cash flows. At the end of the first year, Ingrid's undistributed preferred return would be $85,000 ($1,000,000 × 8.5%), and her unreturned contribution would be $1,000,000. After distributing $85,000 as a preferred return, REF LLC would distribute the remaining $665,000 of available cash to Ingrid as a return of her contribution. Thus,

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[134] In some situations, the ultimate payout may not reflect the relative value of contributions because the members may determine that the members' respective returns on contributions may vary.

REF LLC is distributing $750,000 of available cash, all of which will go to Ingrid. If that $750,000 represents REF LLC's cash flows for the year, Ingrid's interest in those cash flows would be 100% and Miguel's would be zero.[135] Of course, if the LLC's cash flows differ from available cash, then the member's interest in the LLC's cash flows may differ from their interests in available cash. Ultimately their interest in cash flows will equal their interests in distributed available cash, but they will not know their interests in total available cash until the LLC liquidates.

Interests in Non-Liquidating Distributions. The next step is to consider Ingrid's and Miguel's interests in non-liquidating distributions. As just shown, Ingrid would receive 100% of a non-liquidating distribution in Year 1 and Miguel would receive zero percent. Those amounts appear to represent their Year 1 interests in non-liquidating distributions.

Rights to Liquidating Distributions. Finally, Ingrid and Miguel would consider their rights to distributions on liquidation. If REF LLC were to liquidate at the end of Year 1, before making any other distribution, it would have $1,750,000 million to distribute ($750,000 of available cash + $1,000,000 contribution). Thus, if REF LLC were to liquidate at the end of the Year 1, before making any other distribution, instead of making the $750,000 distribution, it would distribute $1,085,000 ($1,000,000 contribution + $85,000 return) to Ingrid on her Class A interests and distribute 80% ($532,000) of the remaining $665,000 to Ingrid and 20% ($133,000) to Miguel. Ingrid's total distribution would be $1,617,000 ($1,085,000 + $532,000) and Miguel's would be $133,000. Ingrid's percentage of the total distribution would be 92.4% ($1,617,000 ÷ $1,750,000) and Miguel's would be 7.6% ($133,000 ÷ $1,750,000). These percentages would appear to present a snapshot as of the end of Year 1 of what the members' interests in liquidating distributions might be. Table 1 summarizes the allocations and the factors the regulations provide for determining the partners' interests in a partnership. Notice that at the end of the first year, the percentages of many of the factors differ.

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[135]If the $750,000 represented a fraction of REF LLC's cash flows, perhaps the members' interests in them would be something other than 100% and 0%. This analysis ensures the $750,000 is REF LLC's cash flows for the year.

Table 1: Summary of Factors of Partners' Interests (end of Year 1)

	Dollar amount		Percentage	
Factor	Ingrid	Miguel	Ingrid	Miguel
Tax-Item Allocations	$537,000	$113,000	83%	17%
1. Contributions	$1,000,000	$0 Services	87%	13%
2. Share of profits and losses	N/A	N/A	N/A	N/A
3. Interests in cash flows	$750,000	$0	100%	0%
4. Interests in non-liquidating distributions	$750,000	$0	100%	0%
5. Interests in liquidating distributions	$1,617,000	$133,000	92.4%	7.6%

Notice that the 83% of total tax items allocated to Ingrid is less than any of her percentage interest in any of the factors used to determine partners' interests in the partnership, and Miguel's 17% of tax items is greater than his percentage interest in any of the factors. The values of the various factors will most likely vary from year to year, so Ingrid and Miguel may consider results of another year when considering the likelihood that their allocations will be upheld.

Assume that at the end of Year 2, REF LLC has $500,000 of available cash and $625,000 of taxable income. The REF LLC operating agreement provides that it would allocate the taxable income first to Ingrid to the extent of her $28,475 accrued preferred return ($335,000 unreturned capital at beginning of Year 2 x 8.5%). REF LLC would allocate 80% ($477,220) of the remaining $596,525 ($625,000 - $28,475) to Ingrid and 20% ($119,305) to Miguel. Thus, the total allocation to Ingrid will be $505,695 ($28,475 + $477,220) and to Miguel it would be $119,305. Ingrid's share of the allocation would be 81% and Miguel's would be 19%.

Again, Ingrid and Miguel will consider the factors to determine whether the allocations are in accordance with their interests in REF LLC. The members' shares of contributions would not change, and their shares of profits and losses would still be uncertain. The challenge of identifying interests in cash flow will remain, but it would appear to be similar to their interests in non-liquidating distributions.

Interests in Non-Liquidating Distributions. REF LLC will distribute the $500,000 of available cash first to satisfy Ingrid's undistributed preferred

return then to return her unreturned capital contribution. Ingrid's undistributed preferred return will be $28,475 ($335,000 unreturned capital × 8.5%). Her remaining unreturned contribution will be $335,000 ($1,000,000 contribution - $665,000 distribution at the end of Year 1). After satisfying those distribution obligations, REF LLC will have $136,525 of available cash for non-liquidating distributions ($500,000 - $28,475 - $335,000). It will distribute that cash 80% ($109,220) to Ingrid and 20% ($27,305) to Miguel. Ingrid's total non-liquidating distribution will be $472,695 ($335,000 unreturned contribution + $28,475 preferred return + $109,220 residual) and Miguel's will be $27,305. Thus, Ingrid would receive 94.54% ($472,695 ÷ $500,000) of the non-liquidating distribution and Miguel would receive 5.46% ($27,305 ÷ $500,000) of the distribution.

Rights to Liquidating Distributions. If REF LLC were to liquidate at the end of Year 2 instead of making interim distributions, it would have $1,900,000 to distribute. It would distribute $500,000 in the same manner it would have if it had made the interim distribution, and it will distribute 80% ($1,120,000) of the remaining $1,400,000 to Ingrid and 20% ($280,000) to Miguel. Ingrid's total liquidating distribution would be $1,592,695 ($1,120,000 + $472,695), which is 83.83% of the $1,900,000 total. Miguel's total distribution would be $307,305 ($280,000 + $27,305), which is 16.17% of the $1,900,000 total. Notice that the values for Year 2 in Table 2 for the several factors differ somewhat from the values for Year 1 in Table 1.

Table 2: Summary of Factors of Partners' Interests (end of Year 2)

	Dollar Amount		Percentage	
Factor	Ingrid	Miguel	Ingrid	Miguel
Tax-Item Allocations	$505,695	$119,305	81%	19%
1. Contributions	$1,000,000	$0 Services	87%	13 %
2. Share of profits and losses	N/A	N/A	N/A	N/A
3. Interests in cash flows	$472,695	$27,305	94.54%	5.46%
4. Interests in non-liquidating distributions	$472,695	$27,305	94.54%	5.46%
5. Interests in liquidating distributions	$1,592,695	$307,305	83.83%	16.17%

In Year 2, the percentage of taxable income allocated to Ingrid is less than her percentage of any other factor, and the percentage of taxable income allocated to Miguel is greater than his percentage of any other factor. Miguel

and Ingrid might now consider whether the allocations are in accordance with their interests in REF LLC. This confirms that the values for the various factors not only generally fail to be identical within any given tax year, but they can also vary from year to year.[136] The variability makes determining the members' interests in REF LLC challenging. Despite the inconclusiveness of the definition of partners' interests in a partnership, partnerships must allocate taxable income to their members. However, the law does not definitively establish whether the allocations are in accordance with the members' interests. Consider approaches that Ingrid and Miguel might deploy to address the lack of authority in this area and determine if substantial authority supports the allocations. They should first apply the weight-of-authority method and then the well-reasoned method.

The analysis under the weight-of-authority method may first deem that the allocation of any tax item is in accordance with the partners' interests in the partnership if it follows the allocation of a corresponding economic item.[137] Identifying allocations of economic items in this context is challenging because the REF LLC operating agreement only provides for allocations of tax items and distributions of cash. The several factors indicate their interests in various other items, but the percentages of taxable income allocated to Ingrid and Miguel in Year 1 and Year 2 are not the same as any of the percentages representing the various factors. Thus, if the allocations of taxable income must reflect the percentages of at least one factor, this analysis would weigh against the validity of the allocations.

Another approach would be to conclude that as long as the allocations of taxable income for any partner are within a range of percentages, from the highest percentage in the list of factors to the lowest percentage in the list of factors, for any one individual they should be valid.[138] No listed authority directly sanctions this approach, but an example in the regulations uses a range to provide a safe harbor for assessing whether allocations of nonrecourse deductions are in accordance with the members' interests in a partnership.[139] Ingrid's and Miguel's allocations of taxable income do not come within that range, so they could not rely upon the example as positive authority. Nonetheless, that example relates to interests in a partnership, Ingrid and Miguel might deem that example to be a tangentially related, permitted authority that applies to their situation. They would, however, hope it is weak authority because it does not support their reporting position.

The range appears in an example in the regulations that is not part of the definition of partners' interest in a partnership. Three reasons therefore reduce its weight as authority. First, the range is part of an example, not the text of a rule, so it should not be read to invalidate any allocations that fall

[136] *See* Borden, *supra* note 126, at 1112-27.
[137] *See* Borden, *supra* note 126, at 1133-37.
[138] *See* Borden, *supra* note 126, at 1135.
[139] *See* Reg. § 1.704-2(m), Ex. (1)(ii).

outside the range. Second, the nonrecourse-deduction rule was not written for the definition of partners' interest in a partnership outside of the context of nonrecourse deductions. Third, the example illustrates a safe harbor, so it does not address situations that extend beyond those to which it provides certainty. Consequently, the example in the regulation is not very strong authority against Ingrid's and Miguel's reporting positions. Even though Ingrid's and Miguel's allocations are beyond the range established by the factors, they would assign a very low weight to the example as negative authority for ignoring the range.[140]

Here, the weight-of-authority method may assign a very low negative weight to the tangential example in the nonrecourse-deduction regulations. The multiple-factor test is inconclusive. It does not establish a single value for the members' interests in REF LLC, and the tax-item allocations are not consistent with values of any of the factors. Based upon this analysis, Ingrid and Miguel may conclude that the negative permitted authorities outweigh the positive authorities. Perhaps they would conclude that weight of positive authority is 10 and the weight of negative authority is 3, so the vertical substantiality value would be 33.33%, which would translate into a value of 25% (0.333 ÷ (1 + 0.3333)).

Under the well-reasoned method, Ingrid and Miguel would most likely note that (1) nothing suggests that they used the allocations to affect their respective tax liabilities, and (2) they used a reasonable method to allocate income. Consider how Miguel and Ingrid might analyze whether these allocations are in accordance with their interest in REF LLC under the well-reasoned method. Over the life of the partnership, the sum of the preferred return distributions and the residual distributions will equal REF LLC's taxable income. Thus, allocations of taxable income, first to Ingrid to the extent of her accrued preferred return and then to the members in accordance with their rights to residual equity, will ultimately reflect their shares of the entity's income, as reflected in distributions that exceed a return of Ingrid's capital. This life-of-the-partnership approach would appear to support their allocations, as everything will eventually even out. The timing of allocations and distributions may not accurately track with current distributions, but the totals over time will be equal. Based on that analysis, they may reason that their allocations are not the type that the regulations and case law disfavor[141] and that the allocations are in accordance with their interests in REF LLC because they reflect the distributions of income that the members will receive.

[140] Contrast this situation with one in which the allocations came within the range established by the factors. In such a situation, taxpayers might deem the example in the nonrecourse-deductions regulations to be positive authority for treating them as being in accordance with the partners' interests in the partnership.

[141] Regulations and case law generally disfavor allocations that the members use strictly for tax purposes to reduce the members' overall tax liability. *See, e.g.*, Orrisch v. Commissioner, 55 T.C. 395 (1970); Reg. § 1.704-1(b)(2).

Ingrid and Miguel may conclude that the well-reasoned method provides a better analysis of their interests in REF LLC than does the weight-of-authority method. Based upon this reasoning, Ingrid and Miguel may conclude that the well-reasoned method supports the allocations and increases horizontal substantiality more than 15 percentage points. That amount combined with the vertical substantiality value would move support for their position beyond substantial-authority threshold. Thus, if a court were to rule that the allocations were not according to the members' interest, a substantial-understatement penalty should not be imposed.

2. *Limited Partner and Self-Employment Income*

The definition of net earnings from self-employment is another area of uncertainty worthy of analysis. The distributive share of income of members of tax partnerships generally comes within the definition of net earnings from self-employment.[142] An exception to that rule applies to limited partners, whose distributive shares are exempted from the definition of net earnings from self-employment, if they are not guaranteed payments for services.[143] Congress enacted the limited-partner exception before limited liability companies (LLCs) had become mainstream,[144] so it did not consider whether a member of an LLC could come within the definition of limited partner for purpose of the tax on self-employment income. Since the enactment of the limited-partnership exception, LLCs have become prominent, and the question arises whether the limited-partner exception applies to members of LLCs, and, if so, under what circumstances.

Example. Consider the context in which this issue might arise. Doug is one of three members of Three Person LLC. Three Person LLC's operating agreement provides that the LLC will be member-managed, and Doug, as managing member, will have all management authority. The LLC will pay Doug $175,000 for work he does as managing member and will allocate and distribute all income (after paying $175,000 to Doug) equally among the members. Doug recognizes that the $175,000 payment for his services will come within the definition of net earnings from self-employment,[145] but he would like to treat his one-third share of income as an allocation of income to a limited partner that is excluded from the definition of net earnings from self-employment. Consider how he might analyze this matter to

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[142] *See* I.R.C. § 1402(a). Section 1402 is in chapter 2 of subtitle A of the Code, so it comes within the section 6662 definition of income and any substantial understatement of the tax would be subject to the penalty, if not supported by substantial authority. *See supra* note 92.

[143] *See* § 1402(a)(13).

[144] Congress added the limited-partner exception to section 1402(a) of the Code in 1977. *See* Social Security Amendments of 1977, Pub. L. No. 95-216, § 313, 91 Stat. 1536. Wyoming enacted the first limited liability company act in 1977. *See* Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 537 (repealed 2010); Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1460 (1998).

[145] *See* Reg. § 1.1402(a)-1(b); Rev. Rul. 69-184, 1969-1 C.B. 256.

determine whether substantial authority supports excluding the allocation from the definition of net earnings from self-employment under the limited-partner exception.

Congress clearly focused on limited partners in enacting the limited-partner exception with the concern that passive investors would qualify for Social Security benefits by paying self-employment tax on their passive income from limited partnerships.[146] Thus, the limited-partner exception is designed to prevent limited partners, who at the time the exception was enacted did not participate in management of partnerships, from claiming their distributive shares of partner income as net earnings from self-employment. Instead of wishing to avoid the definition of limited partner and qualify for future Social Security payments, high-income taxpayers now prefer to come within the definition of limited partner to avoid having income classified as net earnings from self-employment. The limited-partner exception appears to allow limited partners who do participate in management to receive remunerative payments from the partnership as net earnings from self-employment, while their distributive shares of income are not considered net earnings from self-employment.[147] Consider how Doug might analyze whether substantial authority supports excluding his allocation from the definition of net earnings from self-employment. He would begin with the weight-of-authority method.

The Tax Court recently held in *Renkemeyer v. Commissioner* that members of a law firm limited liability partnership (LLP) and in *Castigliola v. Commissioner* that members of a law firm professional limited liability company (PLLC) do not come within definition of limited partner for purposes of the limited-partner exception. Thus, partnership income allocated to them is considered net earnings from self-employment.[148] In each case, the person in question had equal rights to management but had limited liability.[149] The decisions show that, in deciding whether a member other than a state-law limited partner comes within the definition of limited partner, courts consider the nature of the member's management authority and not merely whether the member has limited liability. In *Renkemeyer*, the partnership would have been a general partnership if it had not registered as an LLP.[150] Registration affected the partners' liability exposure, but not the partners' management authority.[151] Partners of a general partnership have authority

[146] *See* David W. Mayo & Rebecca C. Freeland, *Delimiting Limited Partners: Self-Employment Tax of Limited Partners*, 66 TAX LAW. 391, 393-94 (2013).

[147] *See* § 1402(a)(13); Reg. § 1.1402(a)-1(b).

[148] *See* Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011) (considering the status of a member of an LLP); Castigliola v. Commissioner, 113 T.C.M. (CCH) 1296, 2017 T.C.M. (RIA) ¶ 2017-062 at 431 (considering the status of a member of a PLLC).

[149] *See Renkemeyer*, 136 T.C. at 148; *Castigliola*, 65 T.C.M. at 1296, 2017 T.C.M. (RIA) ¶ 2017-062 at 431.

[150] *See Renkemeyer*, 136 T.C. at 148.

[151] *See id.*

to act on behalf of the partnership.[152] In *Castigliola*, the PLLC was member-managed,[153] and members of a member-managed LLC have authority to act on behalf the LLC.[154] Thus, parties in those cases had authority to act on behalf of the entities in their capacity as members. This ability to act on behalf of the entity in a member capacity distinguishes general partners, who have state-granted authority to act on behalf of a limited partnership,[155] from limited partners, who do not have state-granted authority to act on behalf of the limited partnership.[156] The state-granted management authority appears to be an important factor in excluding general partners and other members with management authority from the traditional definition of limited partner.

These cases appear to be negative authorities for Doug's position, but he can distinguish them from his situation. Doug has authority to act as a member, but not exclusively through the state's grant of authority. Instead, Three Person LLC's operating agreement restricts management authority to only Doug. Although Doug has authority to act in his member capacity on behalf of Three Person LLC, that authority derives from the operating agreement, not solely from state law. Doug's sole authority to act on behalf of Three Person LLC distinguishes his situation from the facts at issue in *Renkemeyer* and *Castigliola*, in which all members had authority to act on behalf of the entity. The ability to distinguish these cases would reduce their weight against the reporting position he is considering.

In another recent case, *Hardy v. Commissioner*, the Tax Court held that a physician-member's distributive share of income of a doctor-group LLC is not subject to self-employment tax, even though the physician-member provided services to the LLC.[157] The LLC was professionally managed, and the physician had no management authority.[158] The physician was both an investor in the LLC and an investor in that group.[159] The physician received a fee for services he provided, but also received a share of the LLC's income.[160] The physician's distributive share of the income was not subject to self-employment tax because the physician received it in his capacity as an investor.[161] Because the court held that an LLC member's distributive share of income does not come within the definition of net earnings from self-employment,

[152] *See* Unif. P'ship Act § 301(1) (Nat'l Conference of Comm'rs of Unif. State Laws 1997) (amended 2013).

[153] *See Castigliola*, 65 T.C.M. at 1296, 2017 T.C.M. (RIA) ¶ 2017-062 at 431.

[154] *See* Unif. Ltd. Liab. Co. Act § 407(b) (Nat'l Conference of Comm'rs of Unif. State Laws 2006) (amended 2013).

[155] *See* Unif. Ltd. P'ship Act § 402 (Nat'l Conference of Comm'rs of Unif. State Laws 2001) (amended 2013).

[156] *See id.* § 302.

[157] *See* Hardy v. Commissioner, 113 T.C.M. (CCH) 1070, 2017 T.C.M. (RIA) ¶ 2017-016 at 28-29.

[158] *See id.*

[159] *See id.*

[160] *See id.*

[161] *See id.*

this case provides positive authority for Doug's claim that his distributive share of income from Three Person LLC does not come within the definition of net earnings from self-employment.

The strength of *Hardy* as positive authority is reduced, however, because Doug has authority to act on behalf of Three Person LLC as a member. That distinguishes him from the physician in *Hardy*, who did not appear to have authority as a member to act on behalf of the LLC. Nonetheless, the court's effectively treating a member of an LLC as a limited partner for purposes of the definition of net earnings from self-employment does support Doug's position that he, as a member of an LLC, can come within the definition of limited partner. Thus, although *Hardy* is not directly on point, it is moderately positive authority for Doug.

Doug could also argue that his authority to act on behalf of Three Person LLC is different from the authority granted to the members in *Renkemeyer* and *Castigliola* and distinguish his situation from those cases. He could also argue that a person's authority to act on behalf of a partnership does not, in itself, exclude the person from the definition of limited partner. The statute recognizes that a person may be both a limited partner and provide services to the limited partnership, and treats the limited partner's distributive share differently from the limited partner's remuneration.[162] The statute's recognition that a person can have dual capacities should be broad enough to encompass a person who can be both a limited partner and a general partner, as allowed by state law.[163] The *Hardy* court also recognized that a member of an LLC can be both an employee and an investor in an LLC,[164] recognizing the possibility that a single person can have dual capacities. The statute and *Hardy* therefore are positive authority for a person having dual capacities, one of which may be a member of an LLC that is treated as a limited partner for purposes of the definition of net earnings from self-employment.

The statute is also negative authority for Doug's position because it uses the term "limited partner," and a member of an LLC is a not a limited partner under the state-law definition.[165] The decision in *Hardy* indicates that courts read "limited partner," as used in the statute, to include more than state-law limited partners.[166] Thus, *Hardy* diminishes the weight of the statute's negative authority.

[162] *See* I.R.C. § 1402(a)(13) (providing that the limited-partner exception applies to the "limited partners, as such," suggesting that a limited partner could also receive payments from a limited partnership in a capacity other than the limited-partner capacity); Reg. § 1.1402(a)-1(b).

[163] *See* Unif. Ltd. P'ship Act § 109 (Nat'l Conference of Comm'rs of Unif. State Laws 2001) (amended 2013).

[164] *See Hardy*, 113 T.C.M. (CCH) 1070, 2017 T.C.M. (RIA) ¶ 2017-016 at 31-32.

[165] *See* Unif. Ltd. Liab. Co. Act § 102(11) (Nat'l Conference Comm'rs on Unif. State Laws 2001) (amended 2013).

[166] *See Hardy*, 113 T.C.M. (CCH) 1070, 2017 T.C.M. (RIA) ¶ 2017-016 at 29-31.

The legislative history is positive authority for Doug's position. The definition of net earnings from self-employment is a federal statute that was designed to exclude investment income from the definition of net earnings from self-employment.[167] Therefore, it supports bifurcating some members' status and excluding investment income from net earnings from self-employment, if the interest giving rise to such income does not generally bestow management rights.

Treasury published proposed regulations that would bring some members of LLCs within the definition of limited partner but could also exclude some state law limited partners from the definition.[168] Those proposed regulations applied a functional test and provided generally that a person would be deemed to be a limited partner, subject to three exceptions.[169] The first exception applies the traditional view of limited partners to exclude some persons from the definition of limited partner. Traditionally, limited partners were not liable for a limited partnership's obligations and had no authority to act on behalf of the partnership.[170] The proposed regulations adopt that traditional view of limited partner and exclude from the definition of limited partner anyone who (1) has personal liability for the partnership's obligations by reason of being a partner,[171] (2) has authority to contract on behalf of the partnership,[172] or (3) participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.[173]

The second exception provides that a person who holds more than one class of interest in an entity may come within the definition of limited partner with respect to one of the classes of interest, even if the person cannot

[167] *See* H.R. Rep. No. 95-702, pt. 1, at 11 (1977) ("Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. The bill would exclude from social security coverage, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. *This is to exclude for coverage purposes certain earnings which are basically of an investment nature.* However, the exclusion from coverage would not extend to guaranteed payments (as described in 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership." (emphasis added)); *Hardy*, 113 T.C.M. (CCH) 1070, 2017 T.C.M. (RIA) ¶ 2017-016 at 29-31 (exempting the physician's income from the definition of net earnings from self-employment because the physician received the income in his capacity as an investor).

[168] *See* Prop. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702 (1997). The proposed regulations are not finalized, and many practitioners believe that state-law classification as a limited partner qualifies a person as a limited partner for purposes of section 1402(a)(13).

[169] *See* Prop. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. 1702 (1997). The purpose of the functional test was to ensure that similarly situated individuals owning interests in different types of entities or entities from under different state statutes would be treated the same. *See* Definition of Limited Partner for Self-Employment Tax Purposes, 62 Fed. Reg. 1702 (Jan. 13, 1997).

[170] *See* Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137, 147-50 (2011).

[171] *See* Prop. Reg. § 1.1402(a)-2(h)(2)(i), 62 Fed. Reg. 1702 (1997).

[172] *See* Prop. Reg. § 1.1402(a)-2(h)(2)(ii), 62 Fed. Reg. 1702 (1997).

[173] *See* Prop. Reg. § 1.1402(a)-2(h)(2)(iii), 62 Fed. Reg. 1702 (1997).

be considered a limited partner under the traditional view with respect to another class of interest.[174] A person can be considered a limited partner with respect to one class of interest if at least one person who is considered a limited partner under the traditional view owns a substantial, continuing interest in the particular class of interest,[175] and the rights and obligations of the person seeking limited-partner status are identical to the rights obligations of the person who is limited partner under traditional view.[176]

Under the third exception, a person who owns only one class of interest and participates more than 500 hours during the partnership's taxable year in the partnership's trade or business may come within the definition of limited partner.[177] To do so, however, limited partners under the traditional view must own a substantial and continuing interest in the class of interest the person owns,[178] and the rights and obligations of all holders of that interest must be identical.[179]

The proposed regulations define class of interest for purposes of the tests as "an interest that grants the holder specific rights and obligations."[180] Interests belong to separate classes if one interest-holder's rights and obligations are different from another holder's rights and obligations.[181] A person may hold more than one class of interest in the same partnership if each class grants the person different rights and obligations.[182] Guaranteed payments made to a person for services are not, however, relevant in determining the person's rights and obligations or a class of interest.[183] Thus, if the rights and obligations of two members of an entity are otherwise identical, guaranteed payments made to one of those members will not create a separate class of interests.

The proposed regulations include an example, which suggests that merely holding the right to contract on behalf of an LLC as a manager does not create a separate class of interest.[184] The entity in that example appears to be manager-managed because the example provides that state law grants the manager the authority to contract on behalf of the entity, and state law grants such authority to managers of manager-managed LLCs.[185] If the entity is

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[174] *See* Prop. Reg. § 1.1402(a)-2(h)(3), 62 Fed. Reg. 1702 (1997).

[175] *See* Prop. Reg. § 1.1402(a)-2(h)(3)(i), 62 Fed. Reg. 1702 (1997). The proposed regulations apply a facts-and-circumstances analysis to the question of substantial interest, but also provide that ownership of 20% or more of a class of interests is considered substantial. *See* Prop. Reg. § 1.1402-2(h)(6)(iv), 62 Fed. Reg. 1702 (1997).

[176] *See* Prop. Reg. § 1.1402(a)-2(h)(3)(ii), 62 Fed. Reg. 1702 (1997).

[177] *See* Prop. Reg. § 1.1402(a)-2(h)(4), 62 Fed. Reg. 1702 (1997).

[178] *See* Prop. Reg. § 1.1402(a)-2(h)(4)(i), 62 Fed. Reg. 1702 (1997).

[179] *See* Prop. Reg. § 1.1402(a)-2(h)(4)(ii), 62 Fed. Reg. 1702 (1997).

[180] *See* Prop. Reg. § 1.1402(a)-2(h)(6)(i), 62 Fed. Reg. 1702 (1997).

[181] *See id.*

[182] *See id.*

[183] *See id.*

[184] *See* Prop. Reg. § 1.1402(a)-2(i), 62 Fed. Reg. 1702 (1997).

[185] *See* Unif. Ltd. Liab. Co. Act § 407(c) (Nat'l Conference of Comm'rs on Unif. State Laws 2006) (amended 2013).

manager-managed, the authority to contract on behalf of the entity does not derive from a membership interest, but from the management position. Thus, the authority to contract on behalf of the LLC is not a right or obligation granted by a membership interest.

Congress responded to the proposed regulations by urging Treasury to withdraw them.[186] Congress appeared to be more concerned that the proposed regulations would restrict the application of the statute and exclude some limited partners from the definition, rather than being concerned that the regulations would increase the scope of the statute and include members of LLCs.[187] Treasury did not act in response to Congress's urging. The proposed regulations' ultimate effect on this area of the law is uncertain. The question remains whether members who participate in management may exclude their non-remunerative distributive shares of income from an LLC from the definition of net earnings from self-employment and treat the proposed regulations as positive authority.

Doug could rely upon the proposed regulations to support his position that a member of an LLC can hold dual capacities with respect to the LLC and that allocations with respect to an investor interest are not net earnings from self-employment. State law grants members of member-managed LLCs the authority to act on behalf of the LLC.[188] Doug could argue that his authority is distinguished from the authority granted to the LLC member in the example in the proposed regulations. If only one member has the authority to act on behalf of the LLC, this authority arguably would create a class of interest that differs from a class held by other members who have the right to vote and receive distributions but do not have the authority to contract on behalf of the LLC.[189] The member who has the authority to act on behalf of the LLC could hold two classes of interests under the proposed regulations definition of class of interest.[190] Thus, Doug could argue that the proposed regulations support extending his allocations from net earnings from self-employment. The strength of that authority is arguably weakened by Congress's urging Treasury to withdraw the proposed regulations, but Treasury has not acted to withdraw them and they are a permitted authority.[191] Doug would therefore consider them in determining whether substantial authority supports excluding the allocations from net earnings from self-employment.

Thus, Doug has both negative authorities, which he can distinguish from his situation, and positive authorities that support the dual capacity of a member of an LLC. The negative authorities include the statute's use of the term "limited partner" and the distinguished cases *Renkemeyer* and

[186] *See* 143 Cong. Rec. 13,168 (1997).

[187] *See id.*

[188] *See* Unif. Ltd. Liab. Co. Act § 407(b) (Nat'l Conference of Comm'rs on Unif. State Laws 2006) (amended 2013).

[189] *See* Prop. Reg. § 1.1402(a)-2(h)(6)(i), 62 Fed. Reg. 1702 (1997).

[190] *See* Prop. Reg. § 1.1402(a)-2(h)(3), 62 Fed. Reg. 1702 (1997).

[191] *See* Reg. § 1.6662-4(d)(3)(iii).

Castigliola.[192] The positive authorities include: the statute, which recognizes that limited partners can provide services and receive remuneration; *Hardy*, which is not directly on point, but does recognize that an LLC member can come within the statute's definition of limited partner;[193] the legislative history, which states that income allocated to an investor should not be treated as net earnings from self-employment; and the proposed regulations, which recognize that a person can hold multiple classes of interests, one of which can be an investor class.[194] These authorities appear to be fairly evenly weighted for and against Doug's reporting position. With no clear guidance on how to weigh the respective authorities, Doug could conclude that they are evenly weighted, which would translate into a 50% ($1 \div (1 + 1)$) on the horizontal-substantiality scale. To be conservative, he might conclude that the positive authority is less than 50%, perhaps 40%, which would translate to approximately 29% ($0.4 \div (1 + 0.4)$) on the horizontal-substantiality scale.

The well-reasoned method overlaps with the weight-of-authority method, but it appears to favor Doug. The well-reasoned argument begins by recognizing that business practices have changed since the enactment of the limited-partner exception in the definition of net earnings from self-employment. The advent of LLCs requires courts to recognize that the statute is outdated, and that they must consider the purpose of the statute when considering allocations to a member of an LLC that has a dual capacity, one of which is investor. Doug can argue that his non-management interest is like a limited partnership interest because it provides limited liability and allows Doug to participate in the profits of Three Person LLC as an investor with other members who own similar investment interests and are clearly investors.

Doug could also use an equity analysis to support his position. Tax law distinguishes between compensation and dividends paid to members of S corporations for employment tax purposes. Compensation paid to members of S corporations for services they render is subject to employment tax.[195] By contrast, and subject to the payment of reasonable compensation, dividends paid to members of S corporations (even those who provide services) are not subject to employment tax and do not come within the definition of net earnings from self-employment.[196] Thus, tax law recognizes dual capacity for purposes of the employment tax in the S corporation context. As shown above, the law also recognizes the dual capacity in the limited partnership

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[192] Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011); Castigliola v. Commissioner, 113 T.C.M. (CCH) 1296, 2017 T.C.M. (RIA) ¶ 2017-062.

[193] Hardy v. Commissioner, 113 T.C.M. (CCH) 1070, 2017 T.C.M. (RIA) ¶ 2017-016.

[194] Prop. Reg. § 1.1402(a)-2(h)(3), 62 Fed. Reg. 1702 (1997).

[195] *See, e.g.*, David E. Watson, P.C. v. United States, 757 F. Supp. 2d 877 (S.D. Iowa 2010).

[196] *See id.*

context and LLC context for member-employees.[197] Doug could reason that for employment tax purposes, the distinction between those arrangements and Doug's arrangement is formalistic. Consequently, equity dictates that the law should treat Doug's distributive share of income from Three Person LLC in the same manner that it treats the distributive shares of income to a limited partner and to members of an S corporation.

Based on the well-reasoned analysis, Doug might conclude that this reasoning is sufficient to move the 29% derived from the weight-of-authority method at least 11 percentage points. If that is correct, substantial authority would support Doug's position that the allocations are not earnings from self-employment. Doug can take further comfort knowing that the Tax Court did not impose substantial-understatement penalties in the two cases discussed above that went against the taxpayers.[198]

V. Conclusion

This Article presents a quantitative model for predicting the likelihood that a reporting position will be upheld. The model presents the concepts of horizontal substantiality and vertical substantiality. It incorporates the weight-of-authority method into vertical substantiality to derive the vertical-substantiality quotient, which presents the relationship of weight of positive authorities to the weight of negative authorities. That derivation helps reveal that the weight-of-authority method typically does not alone determine the likelihood that a reporting position will be upheld. When the vertical-substantiality quotient is translated into a value on the horizontal-substantiality scale, the resulting value should be less than the vertical-substantiality quotient. Applying the well-reasoned method after translating the vertical-substantiality quotient to a value on the horizontal-substantiality scale helps a taxpayer determine the likelihood that a reporting position will be upheld.

After presenting the model, the Article demonstrates its potential application revealing that the model will only have value if reliable values can be affixed to positive and negative authorities and to the value of well-reasoned arguments. Applying the model also demonstrates that the distinction between the weight-of-authority method and the well-reasoned method is not always clear. Taxpayers often struggle to apply permitted authorities to a reporting position without resorting to legal reasoning, and legal reasoning often draws upon permitted authorities. Application of the model also reveals one line of analysis for each of the issues. Other attorneys may approach the analyses differently, even if they rely upon the same authorities. The ability to reach different conclusions regarding application of authorities and reasoning

[197] *See supra* text accompanying notes 162-164; *see also* Definition of Limited Partner for Self-Employment Tax Purposes, 62 Fed. Reg. 1702 (Jan. 13, 1997) (referring to comments regarding the proposed regulations that argued the statute and legislative history support the dual-capacity application of the law).

[198] *See* Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011); Castigliola v. Commissioner, 113 T.C.M. (CCH) 1296, 2017 T.C.M. (RIA) ¶ 2017-062.

may prevent predicting the likelihood of a position being upheld from ever becoming a perfect science.

Despite the quantitative model's shortcomings, it provides some promise. It helps delineate the distinction and relative significance of the two types of analytical methods in the substantial-authority regulations. It also moves closer to a system that provides quantifiable measurements of the likelihood that a reporting position will be upheld. Additional thought in this area may help refine legal analysis and spur the creation of more exact standards for applying the law and legal reasoning. Additional research may also help eliminate some of the barriers that prevent full implementation of a quantitative prediction model for substantial authority.