

THE NEW TAX SHELTER OPINION LETTER REGULATIONS: CUTTING BACK ON A CLIENT'S ABILITY TO RELY ON THE ADVICE OF HIS COUNSEL

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I. INTRODUCTION

On December 31, 2002, the U.S. Department of Treasury ("Treasury") issued Proposed Treasury Regulations¹ ("Opinion Regs") relating to the issuance of tax opinions by counsel on matters that are "reportable transactions."² The Opinion Regs were the seemingly final piece in Treasury's offensive against tax shelters.³ Treasury previously had issued proposed changes to Circular 230 that address tax shelter opinion letters,⁴ but these proposals have not yet become finalized. In addition, Congress proposed the Tax Shelter Transparency Act ("TSTA") in 2002,⁵ which addressed tax shelter opinions as well.

¹ Prop. Treas. §§ 1.6662, 1.6664, 67 Fed. Reg. 79894 (Dec. 31, 2002).

² Temp. Treas. Reg. § 1.6011-4T (2002). As stated in the rules and regulations of the Treasury, "[a] reportable transaction is either: (1) A listed transaction, or (2) a transaction that meets two of five characteristics, satisfies a projected tax effect test, and does not satisfy any of the exceptions provided in the regulations." 67 Fed. Reg. 64,799 (Oct. 22, 2002) (to be codified at 26 C.F.R. pts. 1, 20, 25, 31, 53, 54, 56, 301).

³ See Temp. Treas. Reg. § 1.6011-4T (2002). In June 2002, the Treasury issued certain changes to the rules regulating tax shelters. As set forth by the proposed changes, disclosure of any reportable transaction is required. As such,

[e]very individual, trust, partnership, and S corporation that has participated, directly or indirectly, in a reportable transaction within the meaning of paragraph (b)(2) of this section must attach to its return for the taxable year described in paragraph (d) of this section a disclosure statement in the form prescribed by paragraph (c) of this section.

Temp. Treas. Reg. § 1.6011-4T(a)(1) (2002).

⁴ John E. Hambera, Jr., *Corporate Tax Shelter and Circular 230 Regs Highlighted*, 2001 TAX NOTES TODAY 111-6, June 8, 2001. The Treasury stated, "the proposed regs on circular 230 were aimed at curbing the race to the bottom by practitioners and would provide cover for practitioners that are hesitant to write questionable opinions." *Id.*

⁵ SEN. MAX BAUCUS, SEN. FIN. COMM., TAX SHELTER TRANSPARENCY ACT, S. REP. NO. 107-189 (2002), *reprinted in* 2002 TAX NOTES TODAY 127-16, July 2, 2002 [hereinafter FINANCE COMMITTEE REPORT]. The TSTA would "require adequate disclosure of transactions which have a

potential for tax avoidance or evasion.” *Id.*

The first proposed change would create a new penalty for those taxpayers who fail to include with their returns any information pertaining to a reportable transaction. *Id.* at 4. This penalty would be assessed to the taxpayer notwithstanding the accuracy-related penalties. *Id.* The new penalties would not be percentage based, but instead would have set dollar amounts depending on the violation. *Id.* at 6.

The second proposed change would change the accuracy-related penalty and the defenses available for reportable transactions with a significant tax avoidance purpose. *Id.* at 8-9. The new regulation would limit the use of the reasonable cause and good faith exception to the accuracy-related penalty when there was not adequate disclosure by the taxpayer. *Id.* at 9. In such cases, the penalty could raise from 20 percent to either 25 percent or 30 percent. *Id.*

The third proposed change would change what is considered to be a substantial understatement by a corporate taxpayer. *Id.* at 12. “Under the provision, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or (2) \$10 million.” *Id.*

The fourth change would modify “the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. *Id.* at 13. Accordingly, communications with respect to tax shelters are not subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.” *Id.*

The fifth proposed change would require that all those who are considered to be material advisors to a reportable transaction must:

[T]imely file an information return with the Secretary The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.

A “material advisor” means any person (1) who provides material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of \$250,000 (\$50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.”

Id. at 15. Also, a penalty will ensue where the material advisor fails to report the required information. *Id.*

The sixth change would require a material advisor “to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary.” *Id.* at 17. Again, failure to maintain this list would result in penalties. *Id.*

The seventh proposed change would allow for injunctions to be sought against material advisors. *Id.* at 18.

Thus, under the provision, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.”

Id.

The eighth proposal would change the standard that a tax return preparer would be required to meet if there is an understatement of tax. *Id.* at 18-19. “The bill replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment.” *Id.* at 19.

The ninth proposal would:

Recently, the chief Republican counsel to the Finance Committee has stated that the TSTA will be reintroduced in 2003.⁶ However, in general, the Circular 230 changes would only further penalize accountants and attorneys who give tax shelter advice⁷ and the TSTA would only add

modif[y] the IRS-imposed penalty by increasing the amount of the penalty to up to \$5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The provision also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration.

Id. at 21.

The tenth proposal would:

make[] two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the bill expressly permits censure as a sanction. Second, the bill permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure.”

Id. at 22.

The eleventh proposed change would increase the penalty amount that a promoter of a tax shelter would face. *Id.* at 23.

The provision modifies the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

Id.

As can be seen by the proposed changes set forth in the TSTA, the IRS is taking a harsh stance against those who are involved with tax shelters. Not only those who participate in these shelters, but also those who promote their existence, would be subject to penalties. Other proposed changes are set forth in the TSTA but none apply to the regulation of tax shelters.

6 Sen. Charles E. Grassley, *Grassley Release on Abusive Tax Transaction Regulations*, 2000 TAX NOTES TODAY 251-13, December 31, 2002 [hereinafter *Grassley Release*]. Following the announcement that new regulations would be proposed in the upcoming year, regarding those who participate in tax shelters, Senator Chuck Grassley announced:

I appreciate the Treasury Department’s attention to cracking down on abusive tax shelters. The practice of relying on abusive tax shelters didn’t grow overnight, and it won’t end overnight. Every step like this helps to weaken the fertile ground that’s allowed abusive tax shelters to flourish. In the new Congress, I look forward to re-introducing strong, bipartisan anti-tax shelter legislation to support and expand Treasury’s efforts to force the disclosure of shelter transactions. Sunshine is the best disinfectant.

Id.

7 Senate, Fin. Comm. Staff, *Finance Releases Draft of Corporate Tax Shelter Legislation*, 2000 TAX NOTES TODAY 102-9, May 25, 2000 [hereinafter *Finance Releases Draft*]. The proposed changes to Circular 230 seek to impose greater fines on those who prepare tax returns which have understatements because of the taxpayer’s involvement in a tax shelter. Subtitle B(a)(1)(B) provides:

further penalties to the administrative structure put in place by the Treasury during 2002 on tax shelters.⁸ As such, the main pillar that moors these changes to tax shelter opinion reliance is the Opinion Regs, while the other proposals simply provide additional teeth to the 2002 administrative proposals.⁹ The main question this article will discuss is whether the inability of a client to rely on a client's counsel on such complicated matters as tax shelters is good public policy.

II. REPORTABLE TRANSACTIONS REGULATIONS

According to Temp. Treas. Reg. § 1.6011-4T, all taxpayers who have participated in a reportable transaction as defined within this section must disclose their involvement whether it be a direct or indirect involvement.¹⁰ The six transactions which the Treasury list as reportable are as follows: listed transactions, confidential transactions, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference, and transactions involving a brief asset

any person who as an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, such person shall pay a penalty with respect to such return or claim in an amount equal to the greater of \$250 or 50 percent of the preparer's fee. Except in the case of an understatement of liability attributable to the participation of a large corporation in a corporate tax shelter, no penalty shall be imposed under this paragraph if it is shown that there is reasonable cause for the understatement and the person acted in good faith.

Id.

⁸ See FINANCE COMMITTEE REPORT, *supra* note 5 and accompanying text. According to the TSTA proposals set forth, penalties would be increased or now assessed in situations where previously there were no penalties. *Id.*

For example a new penalty is proposed to be imposed upon taxpayers who fail to accurately disclose a reportable transaction. This penalty would be on top of the accuracy-related penalty. As well, there is also a proposal to modify the amount of the accuracy-related penalty. The proposed change would increase the penalty to either 25 percent or 30 percent, depending on the situation. *Id.*

Other proposals would impose penalties on material advisors who fail to keep a list of investors in a tax shelter. There would also be the introduction of a civil fine on those who fail to report "when that person makes a transaction or maintains an account with a foreign financial entity." The penalty for filing a frivolous income tax return would also be increased. *Grassley Release, supra* note 6.

⁹ Prop. Treas. Reg. §§ 1.6662, 1.6664, 67 Fed. Reg. 79894 (Dec. 31, 2002).

¹⁰ Temp. Treas. Reg. § 1.6011-4T (2002). Subsection (a) reads in full:

[e]very taxpayer that has participated, directly or indirectly, in a reportable transaction within the meaning of paragraph (b) of this section must attach to its return for the taxable year described in paragraph (e) of this section a disclosure statement in the form prescribed by paragraph (d) of this section. The fact that a transaction is a reportable transaction shall not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.

Id.

holding period.¹¹ Each of the transactions listed need to be examined separately as well as the temporary regulations issued by the Treasury which further change the reporting requirements.¹²

Temp. Treas. Reg. § 1.6011-4T(b)(2) defines a listed transaction as a transaction which the Treasury has already pre-determined to be a transaction done for the purpose of avoiding tax.¹³ Listed transactions are the clearest of all reportable transactions as they have already been “identified by notice, regulation, or other form of published guidance as a listed transaction.”¹⁴

As the name sounds, confidential transactions are those transactions that are entered into “under the conditions of confidentiality.”¹⁵ In order to determine if in fact the transaction was confidential the relevant facts and circumstances surrounding the transaction will be examined, including “the prior conduct of the parties.”¹⁶ There are essentially two ways which the taxpayer’s transaction will be considered confidential and then, in turn, will become a reportable transaction.¹⁷ Most importantly, the fact that the transaction was entered into between the taxpayer and his attorney, and is therefore subject to attorney client privilege, does not mean that the transaction is confidential.¹⁸ In

11 See Temp. Treas. Reg. § 1.6011-4T(b)(2)-(7) (2002) for the list classifying these transactions as reportable.

12 See Temp. Treas. Reg. § 1.6011-4T (2002).

13 Temp. Treas. Reg. § 1.6011-4T(b)(2) (2002).

14 *Id.*

15 Temp. Treas. Reg. § 1.6011-4T(b)(3)(i) (2002).

16 *Id.*

17 The first type of transaction considered to be confidential is:

[i]f a taxpayer’s disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, (or for whose benefit a statement is made or provided) as to the potential tax consequences that may result from the transaction, a transaction is considered offered under conditions of confidentiality, whether or not such an understanding or agreement is legally binding.

Id.

The second type of transaction considered to be confidential is:

[i]f the taxpayer knows or has reason to know that the taxpayer’s use or disclosure of information relating to the structure or tax aspects of the transaction is limited in any other manner (such as where the transaction is claimed to be proprietary or exclusive) for the benefit of any person, other than the taxpayer, who makes or provides a statement, oral or written, (or for whose benefit a statement is made or provided) as to the potential tax consequences that may result from the transaction.

Id.

18 Temp. Treas. Reg. § 1.6011-4T(b)(3)(ii) (2002). The subsection allowing for transactions entered into under the guise of attorney-client privilege states, “[a] taxpayer’s privilege to maintain the confidentiality of a communication relating to a reportable transaction in which the taxpayer might participate or has agreed to participate, including a taxpayer’s confidential communication

addition, disclosure is limited based upon either federal or state securities laws, so the transaction may not necessarily be considered as confidential.¹⁹ Moreover, there is a presumption that the transaction is not considered confidential if there is “written authorization to disclose” the transaction.²⁰ Essentially there are three exceptions to the confidential transactions regulations, and if any of these three can be satisfied there may not be the requirement to report the transaction.²¹

Taxpayers who have participated in a transaction that has contractual protection are required to report their transaction.²² A transaction with contractual protection is a transaction that gives the taxpayer some financial assurance. The assurance is gained by a contractual provision between the taxpayer and any person who sold the taxpayer the transaction.²³ Essentially, the taxpayer assumes little or no risk; if the intended consequences of the transaction are not achieved, the taxpayer is entitled to some form of a refund. There is one exception to transactions with contractual protection, which is based upon the payment of interest.²⁴

with the taxpayer’s attorney, is not itself a condition of confidentiality.” *Id.*

19 Temp. Treas. Reg. § 1.6011-4T(b)(3)(iii) (2002). This section provides, [a] transaction is not considered offered under conditions of confidentiality if disclosure of the structure or tax aspects of the transaction is subject to restrictions reasonably necessary to comply with federal or state securities laws and such disclosure is not otherwise limited. *Id.*

20 Temp. Treas. Reg. § 1.6011-4T(b)(3)(iv) (2002).

Unless the facts and circumstances indicate otherwise, a transaction is not considered offered under conditions of confidentiality if every person who makes or provides a statement, oral or written, (or for whose benefit a statement is made or provided) as to the potential tax consequences that may result from the transaction, provides express written authorization to the taxpayer permitting the taxpayer (and each employee, representative, or other agent of such taxpayer) to disclose to any and all persons, without limitation of any kind, the structure and tax aspects of the transaction, and all materials of any kind (including opinions or other tax analyses) that are provided to the taxpayer related to such structure and tax aspects. This presumption is available only in cases in which the written authorization to disclose is effective without limitation of any kind from the commencement of discussions.

Id.

21 Temp. Treas. Reg. § 1.6011-4T(b)(3) (2002).

22 Temp. Treas. Reg. § 1.6011-4T(b)(4) (2002).

23 *Id.* A transaction with contractual protection is:

a transaction for which the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax consequences from the transaction will not be sustained, including, but not limited to, rescission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer’s realization of tax benefits from the transaction, insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than the customary indemnity provided by a principal to the transaction that did not participate in the promotion or offering of the transaction to the taxpayer).

Id.

The fourth transaction that requires reporting is a loss transaction.²⁵ Essentially a loss transaction is a transaction where there is an expected loss²⁶ under Treas. Reg. § 1.165 and certain other sections of the Code.²⁷ There are several dollar amounts of the loss that must arise to be considered to be a loss transaction and the amounts depend upon whether the loss is generated for a corporation, an individual, a beneficiary of a trust, etc.²⁸ When determining the value of the loss the

24 *Id.* The subsection further provides:

a transaction will not be considered to have contractual protection solely because the issuer of a debt instrument agrees to pay additional interest to compensate the holder of such debt instrument for withholding tax imposed on interest paid on the debt instrument, or because the requirement to pay such additional interest entitles the issuer to redeem the debt instrument.

Id.

25 Temp. Treas. Reg. § 1.6011-4T(b)(5) (2002).

26 Temp. Treas. Reg. § 1.60114T(b)(5)(i) (2002).

27 I.R.C. § 165-1 (2003). As defined by section 165:

[A]ny loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction

(b) To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. *Only a bona fide loss is allowable.* Substance and not mere form shall govern in determining a deductible loss.

(c)(1) The amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by § 1.1011-1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. In the case of each such deduction claimed, therefore, the basis of the property must be properly adjusted as prescribed by § 1.1011-1 for such items as expenditures, receipts, or losses, properly chargeable to capital account, and for such items as depreciation, obsolesce, amortization, and the depletion, in order to determine the amount of loss allowable as a deduction.

Id. (emphasis added).

28 Temp. Treas. Reg. § 1.6011-4T(b)(5)(1)(A)-(D).

A loss transaction is any transaction resulting in, or that is reasonably expected to result in, a taxpayer claiming a loss under section 165 of at least -

(A) \$10 million in any single taxable year or \$20 million in any combination of taxable years for corporations;

(B) \$5 million in any single taxable year or \$10 million in any combination of taxable years for partnerships or S corporations, whether or not any losses flow through to one or more partners or shareholders;

(C) \$2 million in any single taxable year or \$4 million in any combination of taxable years for individuals or trusts, whether or not any losses flow through to one or more beneficiaries; or

(D) \$50,000 in any single taxable year for individuals or trusts, whether or not the loss flows through from an S corporation or partnership, if the loss arises with respect to a section 988 transaction (as defined in section 988(c)(1) relating to foreign transactions).

Id.

value of any salvage or any insurance payments must be taken into consideration.²⁹ Finally, there are two subsections that determine that if a loss is generated by their occurrence, the transaction is not considered a loss transaction and is therefore not reportable.³⁰ There is also consideration of including two other exceptions to the loss transactions reporting requirements.³¹

The fifth type of reportable transaction are those transactions with a significant book-tax difference.³² The significant book-tax difference reporting requirements only apply to two classified groups.³³ There are different requirements in the case of returns filed by a taxpayer as a

29 Temp. Treas. Reg. § 1.6011-4T(b)(5)(ii) (2002). This provision states in relevant part, “[h]owever, a section 165 loss does not take into account offsetting gains or other income limitations.” *Id.* Further,

[f]or purposes of this section, a section 165 loss includes an amount deductible by virtue of a provision that treats a transaction as a sale or other disposition, or otherwise results in a deduction under section 165. A section 165 loss includes, for example, a loss resulting from a sale or exchange of a partnership interest under section 741 and a loss resulting from a section 988 transaction.

Temp. Treas. Reg. § 1.6011-4T(b)(5)(ii)(B) (2002).

30 Temp. Treas. Reg. § 1.6011-4T(b)(5)(iii) (2002), provides that:

[t]ransactions that result in the following losses under section 165 are not loss transactions under this paragraph (b)(5) -

(A) A loss from fire, storm, shipwreck, or other casualty, or from theft as defined in section 165(c)(3); or

(B) A loss from a compulsory or involuntary conversion as described in section 1231(a)(3)(A)(ii) and section 1231(a)(4)(b).

Id.

31 Temp. Treas. Reg. § 1.6011-4T (2002). Regarding proposed loss transaction exceptions, Treasury noted:

One exception would be losses resulting from a sale of securities on an established securities market within the meaning of § 1.7701-1(b), but only if the amount of basis used in computing the amount of the loss is equal to the amount of the cash paid by the taxpayer for the securities. The other potential exception would be for losses claimed under section 475(a) or section 1296(a).

Id. at 64801.

32 Temp. Treas. Reg. § 1.6011-4T(b)(6) (2002).

A transaction with a significant book-tax difference is a transaction where the treatment for Federal income tax purposes of any item or items from the transaction differs, or is reasonably expected to differ, by more than \$10 million on a gross basis from the treatment of the item or items for book purposes in any taxable year. For purposes of this paragraph (b)(6), book income is determined by applying U.S. generally accepted accounting principles (GAAP) for worldwide income. Adjustments to any reserve for taxes are disregarded for purposes of determining the book-tax difference.

Id.

33 Temp. Treas. Reg. § 1.6011-4T(b)(6)(ii)(A) (2002). The two groups are “[t]axpayers that are reporting companies under the Securities Exchange Act of 1934 (15 USCS 78a) and related business entities (as described in section 267(b) or 707(b); or [b]usiness entities that have \$100 million or more in gross assets (the assets of all related business entities (as defined in section 267(b) or 707(b)) must be aggregated).” *Id.*

consolidated return,³⁴ a foreign person,³⁵ owners of disregarded entities,³⁶ partners of partnerships,³⁷ or shareholders of foreign corporations.³⁸ There are thirteen exceptions to the reporting of transactions with a significant book-tax difference.³⁹ There is the

34 Temp. Treas. Reg. § 1.6011-4T(b)(6)(ii)(B) (2002).

[I]n the case of taxpayers that are members of a group of affiliated corporations filing a consolidated return, transactions between or among the members of the group will be disregarded. Moreover, where two or more members of the group participate in a transaction that is not solely between or among members of the group, items shall be aggregated (as if such members were a single taxpayer), but any offsetting items shall not be netted.

Id.

35 Temp. Treas. Reg. § 1.6011-4T(b)(6)(ii)(C) (2002).

In the case of a taxpayer that is a foreign person (other than a foreign corporation that is treated as a domestic corporation for Federal tax purposes under section 269B, 953(d), 1504(d) or any other provision of the Internal Revenue Code), only assets that are U.S. assets under § 1.884-1(d) shall be taken into account for purposes of paragraph (b)(6)(ii)(A)(2) of this section, and only transactions that give rise to income that is effectively connected with the conduct of a trade or business within the United States (or to losses, expenses, or deduction allocated or apportioned to such income) shall be taken into account for purposes of this paragraph (b)(6).

Id.

36 Temp. Treas. Reg. § 1.6011-4T(b)(6)(ii)(D) (2002).

In the case of an eligible entity that is disregarded as an entity separate from its owner for Federal tax purposes, items of income, loss, expense, or deduction that otherwise are considered items of the entity for book purposes shall be treated as items of its owner, and items arising from transactions between the entity and its owner shall be disregarded, for purposes of this paragraph.

Id.

37 Temp. Treas. Reg. § 6.011-4T(b)(6)(ii)(E) (2002).

In the case of a taxpayer that is a member or a partner of an entity that is treated as a partnership for Federal tax purposes, items of income, loss, expense, or deduction that are allocable to the taxpayer for Federal tax purposes but otherwise are considered items of the entity for book purposes shall be treated as items of the taxpayer, for purposes of this paragraph (b)(6).

Id.

38 Temp. Treas. Reg. § 1.6011-4T(b)(6)(ii)(F) (2002).

To the extent that a taxpayer is considered under paragraph (c)(3)(ii) of this section to have indirectly participated in a transaction to which a foreign corporation is a direct party, all items from the transaction that otherwise are considered items of the foreign corporation for Federal tax purposes or book purposes shall be considered items of the taxpayer for purposes of this paragraph (b)(6).

Id.

39 Temp. Treas. Reg. § 1.6011-4T(b)(6)(iii) (2002).

Items listed in paragraphs (b)(6)(iii)(A) through (M) of this section are not items for which reporting is required under paragraph (b)(6).

(A) Items to the extent a book loss or expense is reported before or without a loss or deduction for Federal income tax purposes.

(B) Items to the extent income or gain for Federal income tax purposes is reported before or without book income or gain.

(C) Depreciation, depletion, and amortization relating solely to differences in methods,

possibility that other exceptions will be allowed as the IRS and the Treasury has “specifically request[ed] comments . . . whether other exceptions should be provided.”⁴⁰

The sixth and final reportable transactions are transactions involving a brief asset holding period.⁴¹ In order to have to report a transaction involving a brief asset holding period a monetary value must be exceeded and a time period must be met.⁴²

When looking at the reporting requirements in general, there are very few exceptions which apply to reportable transactions.⁴³ In terms of disclosing the transactions, there are several requirements. The disclosure of a reportable transaction must be “attached to the taxpayer’s Federal income tax return.”⁴⁴ Even if the transaction was not previously designated as a reportable transaction, but is designated as such in the future, the taxpayer is required to attach the disclosure to the next

lives (for example, useful lives, recovery periods), or conventions.

(D) Bad debts or cancellation of indebtedness income.

(E) Federal, state, local, and foreign taxes.

(F) Compensation of employees and independent contractors, including stock options and pensions.

(G) Items that for Federal tax purposes cannot be deducted or capitalized, such as certain payments for meals and entertainment, and certain fines and penalties.

(H) Charitable contributions of cash or tangible property.

(I) Tax exempt interest, including municipal bond interest.

(J) Dividends, including amounts treated as dividends under section 78, distributions of previously taxed income under sections 959 and 1293, and income inclusions under sections 551, 951, and 1293.

(K) Items resulting from transactions under section 1033.

(L) Gains and losses arising under section 475 or section 1296.

(M) Section 481 adjustments.

Id.

40 Temp. Treas. Reg. § 1.6011-4T (2002).

41 Temp. Treas. Reg. § 1.6011-4T(b)(7) (2002).

42 *Id.* The subsection states:

A transaction involving a brief asset holding period is a transaction resulting in, or that is reasonably expected to result in, a tax credit exceeding \$250,000 (including a foreign tax credit) if the underlying asset giving rise to the credit is held by the taxpayer for less than 45 days. For purposes of determining the holding period, the principles in section 246(c)(3) and (c)(4) apply.

Id.

43 Temp. Treas. Reg. § 1.6011-4T(b)(8) (2002).

A transaction will not be considered a reportable transaction, or will be excluded from any individual category of reportable transaction under paragraphs (b)(2) through (7) of this section, if the Commissioner makes a determination, by published guidance, individual ruling under paragraph (f) of this section, or otherwise, that the transaction is not subject to the reporting requirements of this section.

44 Temp. Treas. Reg. § 1.6011-4T(e) (2002).

Federal income tax return.⁴⁵ The Treasury has even included a provision to allow for a taxpayer to request a ruling on whether the transaction is one which must be reported.⁴⁶ This essentially allows the Treasury to discover additional taxpayers who may not have disclosed these transactions.

III. THE NEW TAX SHELTER OPINION LETTER REGULATIONS

On December 31, 2002, the Treasury issued the Opinion Regs in an effort to “limit the defenses available to the imposition of the accuracy-related penalty when taxpayers fail to disclose reportable transactions or fail to disclose that they have taken a position on a return based upon a regulation being invalid.”⁴⁷ The newly proposed changes mainly effect

⁴⁵ *Id.*

⁴⁶ Temp. Treas. Reg. § 1.6011-4T(f) (2002).

If a taxpayer is uncertain whether a transaction must be disclosed under this section, the taxpayer may, on or before the date that disclosure would otherwise be required under this section, submit a request to the IRS for a ruling as to whether the transaction is subject to the disclosure requirements of this section. If the request fully discloses all relevant facts relating to the transaction, the potential obligation of that taxpayer to disclose the transaction will be suspended during the period that the ruling request is pending and, if the IRS subsequently concludes that the transaction is a reportable transaction subject to disclosure under this section, until the 60th day after the issuance of the ruling (or, if the request is withdrawn, 60 days after the date that the request is withdrawn).

(2) Protective disclosures. If a taxpayer is uncertain whether a transaction must be disclosed under this section, the taxpayer may disclose the transaction in accordance with the requirements of this section, and indicate on the disclosure statement that the taxpayer is uncertain whether the transaction is required to be disclosed under this section and that the disclosure statement is being filed on a protective basis.

Id.

⁴⁷ Internal Revenue Service, *IRS Issues Regs on Avoiding Accuracy-Related Penalties*, 2002 TAX NOTES TODAY 251-1, Dec. 31, 2002 [hereinafter *IRS Issues Regs*]. The article provides:

[t]he IRS and Treasury believe that taxpayers have improperly relied on opinions or advice issued by tax advisors to establish reasonable cause and good faith as a basis for avoiding the accuracy-related penalty, even when the opinion or advice relates to a reportable transaction that the taxpayer should have, but did not, disclose pursuant to § 1.6011-4T. The IRS and Treasury also believe that taxpayers have improperly relied upon opinions or advice that a regulation is invalid without disclosing on their returns their position that the regulation is invalid.

Accordingly, the IRS and Treasury have concluded that the regulations under sections 6662 and 6664 should be amended and clarified so that (1) a taxpayer who takes a position that a regulation is invalid cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under section 6664(c) with respect to any underpayment attributable to such position if the position was not disclosed on a return; and (2) a taxpayer who engages in a reportable transaction cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under section 6664(c) with respect to any underpayment attributable to the transaction if the transaction was not disclosed pursuant to the regulations promulgated under section 6011. Further, a

Treas. Reg. § 1.6662⁴⁸ and Treas. Reg. § 1.6664.⁴⁹

The newly proposed Opinion Regs seek to alleviate certain defenses to the accuracy-related penalty when the taxpayer was involved in a reportable transaction, but chose not to report the transaction.⁵⁰ According to Treas. Reg. § 1.6662 there are five specific instances in which the accuracy-related penalty will apply to a taxpayer.⁵¹ Treas. Reg. § 1.6662 will impose accuracy related penalties on any portion of an underpayment of tax required to be shown on a return that is attributable to one or more of the following: negligence or disregard of

taxpayer who engages in a reportable transaction cannot rely on the realistic possibility standard under section 6662 to avoid the accuracy related penalty for negligence or disregard of rules or regulations if the position regarding the reportable transaction is contrary to a revenue ruling or notice.

Id. at ¶¶ 9-10.

48 *Id.* The IRS stated that “[s]ection 6662 provides for the imposition of an accuracy-related penalty for underpayments of tax, including underpayments due to negligence or disregard of rules or regulations and understatements that are substantial within the meaning of the statute.” *Id.*

49 Treas. Reg. § 1.6664-4(a) (2002).

No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (g) of this section.

Id.

50 *IRS Issues Regs, supra* note 47.

Under the proposed regulations, the adequate disclosure exception to the accuracy-related penalty for underpayments of tax attributable to negligence or disregard of rules or regulations (see §1.6662-3(a)) will not apply to underpayments relating to a reportable transaction unless the reportable transaction also is disclosed under §1.6011-4T. In addition, if a position relates to a reportable transaction and is contrary to a revenue ruling or notice (other than a notice or proposed rulemaking), a taxpayer may not rely upon the fact that the position has a realistic possibility of being sustained on the merits as a defense to the penalty imposed under section 6662(b)(1). The taxpayer instead would be required to satisfy the adequate disclosure exception under §1.6662-3(c)(1), including the disclosure of the reportable transaction under §1.6011-4T.

Id. at ¶ 12.

51 Treas. Reg. § 1.6662-1 (2002).

Section 6662 imposes an accuracy-related penalty on any portion of an underpayment of tax required to be shown on a return that is attributable to one or more of the following:

- (a) Negligence or disregard of rules or regulations;
- (b) Any substantial understatement of income tax;
- (c) Any substantial valuation misstatement under chapter 1;
- (d) Any substantial overstatement of pension liabilities; or
- (e) Any substantial estate or gift tax valuation understatement. . .

No accuracy-related penalty may be imposed on any portion of an underpayment if there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. The reasonable cause and good faith exception to the accuracy-related penalty is set forth in § 1.6664-4.

Id.

rules or regulations,⁵² any substantial understatement of income tax,⁵³ any substantial valuation misstatement under Chapter 1,⁵⁴ any substantial overstatement of pension liabilities,⁵⁵ or any substantial estate or gift tax valuation understatement.⁵⁶ For those taxpayers who trigger the accuracy-related penalty, the amount of the penalty will depend upon the violation.⁵⁷ The only way to avoid paying the accuracy related penalties in §6662 is to fall within the reasonable cause and good faith exception found in Treas. Reg. §1.6664-4.⁵⁸

The Opinion Regs will significantly change the application of the negligence or disregard of rules or regulations standard. The proposed changes to Treas. Reg. § 1.6662-3 alter the character of Treas. Reg. § 1.6662-3 enough to allow the Treasury to penalize those who are participating in tax shelters and do not disclose their participation. The Opinion Regs apply only after the accuracy related penalties affecting penalties for negligence or disregard of the rules or regulations.⁵⁹ Under these Opinion Regs, there is no attempt to change any other types of the accuracy-related penalties.⁶⁰ In addition, the proposed changes to the regulations only seek to include language concerning reportable transactions.⁶¹ These newly proposed regulations are clearly intended to have an effect on those who the Treasury believes are participating in tax shelters.⁶²

52 Treas. Reg. § 1.6662-1(a) (2002).

53 Treas. Reg. § 1.6662-1(b) (2002).

54 Treas. Reg. § 1.6662-1(c) (2002).

55 Treas. Reg. § 1.6662-1(d) (2002).

56 Treas. Reg. § 1.6662-1(e) (2002).

57 Treas. Reg. § 1.6662-2 (2002).

(b) Amount of Penalty- (1) In general. The amount of the accuracy-related penalty is 20 percent of the portion of an underpayment of tax required to be shown on a return that is attributable to any of the types of misconduct listed in paragraphs (a)(1) through (a)(3) of this section, except as provided in paragraph (b)(2) of this section.

(2) Increase in penalty for gross valuation misstatement. In the case of a gross valuation misstatement as defined in section 6662(h)(2) and § 1.6662-5(e)(2), the amount of the accuracy-related penalty is 40 percent of the portion of an underpayment of tax required to be shown on a return that is attributable to the gross valuation misstatement, provided the applicable dollar limitation set forth in section 6662(e)(2) is satisfied.

Id.

58 *Supra* note 47. The IRS also stated, “[t]axpayers, however, can avoid the accuracy-related penalty if they can establish, among other things, that there was reasonable cause for the underpayment and that they acted in good faith within the meaning of 6664(c). *Id.*

59 *See generally* Prop. Treas. Reg. § 1.6662, 67 Fed. Reg. 79894 (Dec. 31, 2002).

60 *Id.*

61 *Id.*

62 *Grassley Release, supra* note 6. “[T]he Treasury Department announced proposed rules limiting the penalty defenses for tax shelter participants who do not disclose tax shelter on their returns.” *Id.*

Treas. Reg. § 1.6663-3, defines “negligence” and “disregard of rules or regulations” which are found in Treas. Reg. § 1.6662-1. If there is negligence or disregard of rules or regulations, a penalty will be imposed if there is no valid defense to the failure to report the transaction.⁶³ Treas. Reg. § 1.6663-3 attempts to define negligence and provides four examples of what would likely indicate that there was in fact negligence on the part of the taxpayer.⁶⁴ This definition of negligence is somewhat vague, as there is no standard for “reasonable attempt to comply.” It seems as if the Treasury has specifically written the definition of negligence to be vague so they could use it as a catchall against all taxpayers. However, the definition given to “disregard of rules or regulations” is more rigid and well defined.⁶⁵ As a final part to

63 Treas. Reg. § 1.6662-3(a) (2002). The section fully states:

If any portion of an underpayment, as defined in section 6664(a) and § 1.6664-2, of any income tax imposed under subtitle A of the Code that is required to be shown on a return is attributable to negligence or disregard of rules or regulations, there is added to the tax an amount equal to 20 percent of such portion. The penalty for disregarding rules or regulations does not apply, however, if the requirements of § 1.6662-3(c)(1) are satisfied and the position in question is adequately disclosed as provided in § 1.6662-3(c)(2), or to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664-4 applies. In addition, if a position with respect to an item is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin, this penalty does not apply if the position has a realistic possibility of being sustained on its merits. See § 1.6694-2(b) of the preparer penalty regulations for a description of the realistic possibility standard.

Id.

64 Treas. Reg. § 1.6662-(b)(1) (2002).

The term negligence includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. ‘Negligence’ also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. A return position that has a reasonable basis as defined in paragraph (b)(3) of this section is not attributable to negligence. Negligence is strongly indicated where—

(i) A taxpayer fails to include on an income tax return an amount of income shown on an information return, as defined in section 6724(d)(1);

(ii) A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be ‘too good to be true’ under the circumstances;

(iii) A partner fails to comply with the requirements of section 6222, which requires that a partner treat partnership items on its return in a manner that is consistent with the treatment of such items on the partnership return (or notify the Secretary of the inconsistency); or

(iv) A shareholder fails to comply with the requirements of section 6242, which requires that an S corporation shareholder treat subchapter S items on its return in a manner that is consistent with the treatment of such items on the corporation’s return (or notify the Secretary of the inconsistency).

Id.

the definitions within Treas. Reg. § 1.6663-3, “reasonable basis” is defined.⁶⁶ The definitions written into Treas. Reg. § 1.6662-3 creates broad maneuverability for the Treasury. There is sufficient leeway even without the proposed changes for the Treasury to assess penalties under the negligence or disregard of rules or regulations standard of Treas. Reg. § 1.6662-3. If a taxpayer does in fact violate Treas. Reg. § 1.6662-3 there are exceptions to the rule, which may not trigger the penalties associated with the violation of the rule.⁶⁷ For example, a penalty may not be triggered when the taxpayer does disclose that there was an underpayment and that disclosure was done in an adequate manner.⁶⁸

65 Treas. Reg. § 1.6662-3(b)(2) (2002).

The term ‘disregard’ includes any careless, reckless or intentional disregard of rules or regulations. The term ‘rules or regulations’ includes the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. A disregard of rules or regulations is ‘careless’ if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. A disregard is ‘reckless’ if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is ‘intentional’ if the taxpayer knows of the rule or regulation that is disregarded. Nevertheless, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.

Id.

66 Treas. Reg. § 1.6662-3(b)(3) (2002).

Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662-4(d)(2). (See § 1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in § 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

Id.

67 Treas. Reg. § 1.6662-3(c) (2002).

68 *Id.* The exception to the negligence or disregard of the rules or regulations standard is as follows:

(c) Exception for adequate disclosure—

(1) In general. No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section and, in case of a position contrary to a regulation, the position represents a good faith

But in order for the taxpayer to meet this required standard there must be disclosure that is adequate under Treas. Reg. § 1.6662-3.⁶⁹ In addition, within Treas. Reg. § 1.6662-3 there are several special situations that apply to both carrybacks and carryovers.⁷⁰

challenge to the validity of the regulation. This disclosure exception does not apply, however, in the case of a position that does not have a reasonable basis or where the taxpayer fails to keep adequate books and records or to substantiate items properly.

Id.

69 Treas. Reg. § 1.6662-3(c)(2) (2002). The regulation provides: Disclosure is adequate for purposes of the penalty for disregarding rules or regulations if made in accordance with the provisions of §§ 1.6662-4(f)(1), (3), (4), and (5), which permit disclosure on a properly completed and filed Form 8275 or 8275-R, as appropriate. In addition, the statutory or regulatory provision or ruling in question must be adequately identified on the Form 8275 or 8275-R, as appropriate. The provisions of § 1.6662-4(f)(2), which permit disclosure in accordance with an annual revenue procedure for purposes of the substantial understatement penalty, do not apply for purposes of this section.

Id.

70 Treas. Reg. § 1.6662-3(d) (2002).

(d) Special rules in the case of carrybacks and carryovers—

(1) In general. The penalty for negligence or disregard of rules or regulations applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried, which portion is attributable to negligence or disregard of rules or regulations in the year in which the carryback or carryover of the loss, deduction or credit arises (the 'loss or credit year').

(2) Transition rule for carrybacks to pre-1990 years. A 20 percent penalty under section 6662(b)(1) is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to negligence or disregard of rules or regulations in a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

(3) Example. The following example illustrates the provisions of paragraph (d) of this section. This example does not take into account the reasonable cause exception under § 1.6664-4. Example. Corporation M is a C corporation. In 1990, M had a loss of \$200,000 before taking into account a deduction of \$350,000 that M claimed as an expense in careless disregard of the capitalization requirements of section 263 of the Code. M failed to make adequate disclosure of the item for 1990. M reported a \$550,000 loss for 1990 and carried back the loss to 1987 and 1988. M had reported taxable income of \$400,000 for 1987 and \$200,000 for 1988, before application of the carryback. The carryback eliminated all of M's taxable income for 1987 and \$150,000 of taxable income for 1988. After disallowance of the \$350,000 expense deduction and allowance of a \$35,000 depreciation deduction with respect to the capitalized amount, the correct loss for 1990 was determined to be \$235,000. Because there is no underpayment for 1990, the penalty for negligence or disregard of rules or regulations does not apply for 1990. However, as a result of the 1990 adjustments, the loss carried back to 1987 is reduced from \$550,000 to \$235,000. After application of the \$235,000 carryback, M has taxable income of \$165,000 for 1987 and \$200,000 for 1988. This adjustment results in underpayments for 1987 and 1988 that are attributable to the disregard of rules or regulations on the 1990 return. Therefore, the 20 percent penalty rate applies to the 1987 and 1988 underpayments attributable to the disallowed carryback.

The proposed changes will have the most effect on negligence penalties with regard to reportable transactions.⁷¹ Looking at the currently codified version of Treas. Reg. § 1.6662-3, one can see that there is no specific mention of reportable transactions.⁷² The Opinion Regs incorporate reportable transactions into Prop. Treas. Reg. § 1.6662-3, by changing the definition of disregard of rule or regulations under Prop. Treas. Reg. § 1.6662.⁷³ This proposed regulation creates a situation where a taxpayer who fails to report one of the enumerated reportable transactions would be found to have disregarded the rules⁷⁴ even if he takes a position that is dissimilar to a revenue ruling and there was a possibility that the revenue ruling would be found invalid. The final proposed change focuses on the possibility of not imposing penalties for the disclosure of taking a position contrary to a ruling.⁷⁵ However, once

Id.

71 Prop. Treas. Reg. § 1.6662-3, 67 Fed. Reg. 79894 (Dec. 31, 2002). The proposed regulations concerning negligence read as follows:

(a) In general. If any portion of any underpayment, as defined in section 6664(a) and §1.6664-2, of any income tax imposed under subtitle A of the Internal Revenue Code that is required to be shown on a return is attributable to negligence or disregard of rules or regulations, there is added to the tax an amount equal to 20 percent of such portion. The penalty for disregarding rules or regulations does not apply, however, if the requirements of paragraph (c)(1) of this section are satisfied and the position in question is adequately disclosed as provided in paragraph (c)(2) of this section (and, *if the position related to a reportable transaction as defined in §1.6011-4T(b)*, the transaction is disclosed in accordance with §1.6011-4T), or to the extent that the reasonable cause and good faith exception to this penalty set forth in §1.6662-4 applies. In addition, if a position with respect to an item (other than with respect to a reportable transaction as defined in §1.6011-4T(b)) is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), this penalty does not apply if the position has a realistic possibility of being sustained on its merits. See §1.6694-2(b) of the income tax return preparer penalty regulations for a description of the realistic possibility standard.

Id. (emphasis added).

72 Compare *id.* with Treas. Reg. § 1.6662-1(b) (2002) (giving an overview of the accuracy related penalty).

73 Prop. Treas. Reg. § 1.6662-3(2), 67 Fed. Reg. 79894 (Dec. 31, 2002). In the proposed modification to the final sentence of the definition of disregard of rules or regulations, the proposal reads, “[n]evertheless, a taxpayer who takes a position (*other than with respect to a reportable transaction, as defined in §1.6011-4T(b)*) contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.” *Id.* (emphasis added).

74 *Id.*

75 Prop. Treas. Reg. § 1.6662-3(c)(1), 67 Fed. Reg. 79894 (Dec. 31, 2002). The proposed Opinion Regulation reads:

No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section (*and, if the position*

again, as can be seen by examining the currently codified version of Treas. Reg. § 1.6662-3, there is no mention of reportable transactions, which makes an exception for adequate disclosure.⁷⁶

The second proposed regulation change would affect Treas. Reg. § 1.6664, which would limit the ability of a taxpayer to rely on outside advice in order to meet the reasonable cause exception to the accuracy-related penalties.⁷⁷ The currently codified version and the proposed new version of the good faith exception differ, in that under the new version, the taxpayer's reliance on an expert's advice in certain instances will make no difference in the assessment of accuracy-related penalties.⁷⁸

Treas. Reg. § 1.6664-4 sets forth the reasonable cause and good

relates to a reportable transaction as defined in §1.6011-4T(b), the transaction is disclosed in accordance with §1.6011-4T) and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation.

Id. (emphasis added).

⁷⁶ Compare *id.* with Treas. Reg. § 1.6662-3(c) (2002), quoted in *supra* note 68.

⁷⁷ *IRS Issues Regs*, *supra* note 47.

The proposed regulations also clarify and modify the standards for, and limits on, the use of opinions and advice to satisfy the reasonable cause and good faith exception under section 6664(c) as a defense to the imposition of the accuracy-related penalty under section 6662. The proposed regulations, for instance, clarify that a taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on the opinion or advice was reasonable and made in good faith. The IRS currently takes these facts and circumstances into account in determining whether a taxpayer has satisfied the reasonable cause exception and good faith exception under section 6664(c).

Id. at ¶ 13.

⁷⁸ *Id.* at ¶ 14.

These proposed regulations amend §1.6664-4(c) to specify when a taxpayer cannot rely upon an opinion or advice to satisfy the reasonable cause and good faith exception. Taxpayers who do not disclose positions based upon a regulation being invalid (see §1.6662-3(c)(2)) cannot use an opinion or advice concerning the invalidity of the regulation as a basis for satisfying the reasonable cause and good faith exception under section 6664(c). Similarly, the proposed regulations prohibit taxpayers from using an opinion or advice as a basis for satisfying the reasonable cause and good faith exception under section 6664(c) with respect to a reportable transaction that the taxpayer did not disclose in accordance with §1.6011-4T.

Under these proposed regulations, a taxpayer, in order to properly disclose a transaction, may be required to file with the taxpayer's return more than one disclosure form for the same transaction in order to satisfy the requirements in the regulations under sections 6662 and 6664 (as modified by these proposed regulations), and section 6011. The IRS and Treasury may consider permitting taxpayers to use a single disclosure document to satisfy those regulations, provided that all required information is provided by the taxpayer and provided that the taxpayer files a copy of the document with the Office of Tax Shelter Analysis as required under §1.6011-4T (or as may be otherwise provided in any successor regulations).

Id. at ¶¶ 14-15.

faith exception to the accuracy-related penalty.⁷⁹ The section lays out certain facts and circumstances that will be taken into account in order to determine what is considered reasonable cause and good faith.⁸⁰ When

⁷⁹ Treas. Reg. § 1.6664-4(a) (2002).

No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (g) of this section.

Id.

⁸⁰ Treas. Reg. § 1.6664-4(b)(1) (2002), states that the following facts and circumstances will be taken into account when applying the reasonable cause and good faith exception to accuracy-related penalties:

The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. *Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith.* Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. *Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.* (See paragraph (c) of this section for certain rules relating to reliance on the advice of others.) For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors. Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. (See paragraph (g) of this section for certain rules relating to appraisals for charitable deduction property.) A taxpayer's reliance on erroneous information reported on a Form W-2, Form 1099, or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows, or has reason to know, that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.

looking at what will be taken into consideration to make a determination of the reasonable cause and good faith exception, there seem to be several inconsistencies within Treas. Reg. 1.6664-4.⁸¹ One such inconsistency is found in the first sentence of the section, which says that reliance on a professional opinion does not always show reasonable cause or good faith.⁸² However, the related code section states that if the reliance on the professional advice was done in good faith and the reliance was reasonable, then the advice will show that the taxpayer was in fact acting with reasonable cause and good faith.⁸³ The regulation provides examples of what would be considered reasonable reliance and what would not be considered reasonable reliance. However, a reading of these two examples does not actually demonstrate what would not be considered reasonable reliance by a taxpayer on professional advice. As seen in the second example, it is fairly clear that there should be no reliance by the taxpayer to advice being given by a person that is not a professional.⁸⁴ Therefore, while the section attempts to provide “guidance” on what is considered reasonable or unreasonable reliance on advice, the examples provide little more than an obvious statement, that most sophisticated business people would already be aware of, and provides little to no guidance as to the grayer situations of what would be considered reasonable reliance by a taxpayer. This is problematic because this is where not only the most litigation will occur but where most taxpayers will need the most guidance.

Before determining if the good faith expectation should apply because of the taxpayer’s reliance on professional advice,⁸⁵ the definition of what is actually considered as “advice” is important.⁸⁶ This definition is specific but is also written to include instances, for example, when the advice given is not by a professional.⁸⁷ When determining if the taxpayer was in fact reasonable in relying upon the information

Id. (emphasis added).

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ Treas. Reg. §1.6664-4(c)(i)-(ii) (2002).

⁸⁶ Treas. Reg. §1.6664-4(c)(2) (2002). This section defines advice as:

[a]ny communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.

Id.

⁸⁷ *Id.*

given by the professional advisor the first point of examination is the facts and circumstances surrounding the transaction.⁸⁸ This is important because it leaves sufficient room for the Treasury to make an argument that in fact there was a fact not disclosed by the taxpayer,⁸⁹ therefore the good faith exception should not apply. The second point of examination that needs to be taken into consideration is that of not making any unreasonable assumptions.⁹⁰ As defined by Treas. Reg. 1.6664-4, it is fairly clear what is considered as a reasonable and unreasonable assumption.⁹¹

There are also separate ways of determining whether the reasonable cause and good faith basis should apply in the situation of a pass-through item,⁹² and that of tax shelter understatements for corporations.⁹³ When looking at a pass through item, the method for determining if there was reasonable cause and good faith is fairly similar to the process previously described.⁹⁴ However, when a corporation is involved with a tax shelter the method for determining reasonable cause and good faith is somewhat more complicated.⁹⁵ As seen previously, what first must be taken into account are the facts and circumstances of a corporation's

88 Treas. Reg. §1.6664-4(c)(1)(i) (2002).

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item.

Id.

89 *Id.*

90 Treas. Reg. §1.6664-4(c)(1)(ii) (2002).

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

Id.

91 *See generally id.*

92 Treas. Reg. §1.6664-4(d) (2002).

93 Treas. Reg. §1.6664-4(e) (2002).

94 Treas. Reg. §1.6664-4(d) (2002).

The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity.

Id.

95 *See generally* Treas. Reg. §1.6664-4(e) (2002).

involvement with a tax shelter.⁹⁶ The section then goes on to define when and how reasonable cause can be justified based upon the corporation's legal right to do the transaction.⁹⁷ Then this section goes on to further elaborate that even if the minimum requirements were met

96 Treas. Reg. §1.6664-4(e)(1) (2002).

The determination of whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item (as defined in § 1.6662-4(g)(3)) is based on all pertinent facts and circumstances. Paragraphs (e)(2), (3), and (4) of this section set forth rules that apply, in the case of a penalty attributable to a substantial understatement of income tax (within the meaning of section 6662(d)), in determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter item.

Id.

97 Treas. Reg. § 1.6664-4(e) (2002) (describing the analysis required to demonstrate that in fact the corporation did have legal justification to complete the transaction and therefore should not be subject to accuracy-related penalties). The section reads as follows:

(2) Reasonable cause based on legal justification (i) Minimum requirements. A corporation's legal justification (as defined in paragraph (e)(2)(ii) of this section) may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item only if the authority requirement of paragraph (e)(2)(i)(A) of this section and the belief requirement of paragraph (e)(2)(i)(B) of this section are satisfied (the minimum requirements). Thus, a failure to satisfy the minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on the corporation's legal justification. (A) Authority requirement. The authority requirement is satisfied only if there is substantial authority (within the meaning of § 1.6662-4(d)) for the tax treatment of the item.

(B) Belief requirement. The belief requirement is satisfied only if, based on all facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment. For purposes of the preceding sentence, a corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(1) The corporation analyzes the pertinent facts and authorities in the manner described in § 1.6662-4(d)(3)(ii), and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(2) The corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in § 1.6662-4(d)(3)(ii) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service. (For this purpose, the requirements of paragraph (c) of this section must be met with respect to the opinion of a professional tax advisor.)

(ii) Legal justification defined. For purposes of this paragraph (e), legal justification includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the entity, plan, or arrangement that gave rise to the item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification.

Id.

it does not mean that the reasonable cause and good faith exception should apply.⁹⁸ Once again it becomes important to examine all the facts and circumstances of the transaction in order to determine if there was a reasonable cause and a good faith basis.⁹⁹ To demonstrate that there was a legal justification for the corporation to be involved with the tax shelter, there are only two requirements: authority¹⁰⁰ and belief.¹⁰¹

98 Treas. Reg. § 1.6664-4(e)(3) (2002) (establishing the premise that satisfying the minimum requirements does not mean that the accuracy-related penalty should not apply).

Satisfaction of the minimum requirements of paragraph (e)(2) of this section is an important factor to be considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith, but is not necessarily dispositive. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.

Id.

99 Treas. Reg. § 1.6664-4(e)(4) (2002). "Facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether the corporation acted with reasonable cause and in good faith with respect to a tax shelter item regardless of whether the minimum requirements of paragraph (e)(2) of this section are satisfied." *Id.*

100 Treas. Reg. § 1.6664-4(e)(2)(i)(A) (2002), *quoted in supra* note 97. This provision states that in order to satisfy the authority requirement there must be adequate authority as defined within section 1.6662-4(d). *Id.*

Treas. Reg. § 1.6662-4(d) sets forth a specific procedure for determining if there is authority. The procedure is as follows:

(1) Effect of having substantial authority. If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to the item is not included in the understatement for that year. (For special rules relating to tax shelter items see § 1.6662-4(g).)

(2) Substantial authority standard. The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in § 1.6662-3(b)(3). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

(3) Determination of whether substantial authority is present –

(i) Evaluation of authorities. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is

substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

(ii) Nature of analysis. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

(iii) Types of authority. Except in cases described in paragraph (d)(3)(iv) of this section concerning written determinations, only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item: Applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statutes; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin. Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item. Notwithstanding the preceding list of authorities, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. In the case of court decisions, for example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district. However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals. Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin.

(iv) Special rules —(A) Written determinations. There is substantial authority for the tax

However, even demonstrating that there was both authority and belief will not automatically trigger the reasonable cause and good faith exception.¹⁰²

In conclusion, the proposed Opinion Regs to Prop. Treas. Reg. § 1.6664-4 will hinder a taxpayer from relying on an opinion given by a professional tax advisor.¹⁰³ The new Opinion Regs require a determination of the taxpayer's education and business sophistication in determining whether the reliance on the advice was reasonable.¹⁰⁴ The

treatment of an item by a taxpayer if the treatment is supported by the conclusion of a ruling or a determination letter (as defined in § 301.6110-2(d) and (e)) issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer ('written determinations'). The preceding sentence does not apply, however, if—

(1) There was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination was based, or

(2) The written determination was modified or revoked after the date of issuance by—

(i) A notice to the taxpayer to whom the written determination was issued,

(ii) The enactment of legislation or ratification of a tax treaty,

(iii) A decision of the United States Supreme Court,

(iv) The issuance of temporary or final regulations, or

(v) The issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin. Except in the case of a written determination that is modified or revoked on account of § 1.6662-4(d)(3)(iv)(A)(1), a written determination that is modified or revoked as described in § 1.6662-4(d)(3)(iv)(A)(2) ceases to be authority on the date, and to the extent, it is so modified or revoked. See section 6404(f) for rules which require the Secretary to abate a penalty that is attributable to erroneous written advice furnished to a taxpayer by an officer or employee of the Internal Revenue Service.

(B) Taxpayer's jurisdiction. The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. Notwithstanding the preceding sentence, there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item.

(C) When substantial authority determined. There is substantial authority for the tax treatment of an item if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.

Id.

101 Treas. Reg. § 1.6664-4(e)(2)(i)(B) (2002), *quoted supra* note 97. This section sets forth the belief requirement which provides an easier analysis than that of determining authority. *Id.*

102 Treas. Reg. § 1.6664-4(e)(2)(i)(B)(3) (2002), *quoted supra* note 98. This section sets forth the premise that in certain situations demonstrating that minimum requirements were satisfied is not "dispositive" and other facts may need to be examined. *Id.*

103 See generally Prop. Treas. Reg. § 1.6664, 67 Fed. Reg. 79894 (Dec. 31, 2002).

104 *Id.* The proposed changes to section (c)(1) read as follows:

proposed change to Prop. Treas. Reg. § 1.6664-4(c) also includes a disqualification of certain advice.¹⁰⁵ The Opinion Regs also require a facts and circumstances analysis as a new onus on the taxpayer.¹⁰⁶ In the current version of Treas. Reg. § 1.6664-4(c)(i) the word “reasonably” is not included.¹⁰⁷ In addition, the Opinion Regs add an entire subsection concerning a taxpayer’s reliance on advice that a regulation is invalid.¹⁰⁸ Read together, Treas. Reg. §§ 1.6662-3(c)(2)¹⁰⁹ and 1.6011-4T¹¹⁰ would add a stringent disclosure requirement when applying the reasonable cause and good faith exception.¹¹¹ The final proposed change to Prop. Treas. Reg. § 1.6664-4 would add another subsection concerning disqualifying any advice as a reasonable cause or good faith basis if it

All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. *For example, the taxpayer’s education, sophistication and business experience will be relevant in determining whether the taxpayer’s reliance on the advice was reasonable and made in good faith.* In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied and the advice is not disqualified under paragraph (c)(2) of this section. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

Id. (emphasis added).

105 *Id.* In relevant part, the new regulation would read: “[i]n no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied *and the advice is not disqualified under paragraph (c)(2) of this section.*” *Id.* (emphasis added).

106 Prop. Treas. Reg. § 1.6664(c)(1)(i), 67 Fed. Reg. 79894 (Dec. 31, 2002). The proposed change to the regulation provides, “[i]n addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or *reasonably* should know, to be relevant to the proper treatment of an item.” *Id.* (emphasis added).

107 Compare *id.* with Treas. Reg. § 1.6664-4(c)(1)(i) (2002), *quoted in supra* note 106.

108 Prop. Treas. Reg. § 1.6664(c)(1)(iii).

(iii) Reliance on the invalidity of a regulation. A taxpayer may not rely in an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with §1.6662-3(c)(2), including the disclosure of the position that the regulation in question is invalid, and, if the position relates to a reportable transaction as defined in §1.6011-4T(b), the transaction is disclosed in accordance with §1.6011-4T.

Id. (emphasis removed).

109 See *supra* note 69.

110 See Treas. Reg. § 1.6011-4T (2002). Essentially all reportable transactions must be disclosed and in compliance with this regulation. See *id.*

111 See generally Prop. Treas. Reg. § 1.6664-4(c)(iii), 67 Fed. Reg. 79894 (Dec. 31, 2002).

concerns a reportable transaction.¹¹² This proposed addition essentially would make a tax advisor's advice meaningless when looking at reportable transactions. If, for example, a taxpayer sought advice from a professional advisor who told the taxpayer that the transaction was not reportable based upon the facts, and the taxpayer reasonably relied on this advice, the Treasury could still find that the transaction was in fact reportable and was not disclosed. Thus, the taxpayer would be unable to use the reasonable cause and good faith exception to avoid the accuracy-related penalties.¹¹³

IV. THE POLICY OF DETERRING A CLIENT'S USE OF COUNSEL

The Treasury seems content with deterring clients from relying upon the advice of attorneys when there is a reportable transaction which was not adequately disclosed.¹¹⁴ The fact that a client cannot rely upon the advice of their attorney to satisfy the reasonable cause and good faith exception to accuracy-related penalties,¹¹⁵ interferes with the attorney client privilege, and puts clients in a disadvantaged position where they can no longer trust their attorneys advice on matters of potential "reportable transactions."

When a client goes to see an attorney, the client typically expects that the discussions held are privileged and confidential. However, according to the Treasury, in certain cases an attorney is required to

112 Prop. Treas. Reg. § 1.6664-4(c)(1)(iii)(2), 67 Fed. Reg. 79894 (Dec. 31, 2002). The proposed regulation would be included under the subsection of reliance on opinion or advice and reads:

(2) *Opinions or advice relating to reportable transaction.* Taxpayers may not reasonably rely on an opinion or advice of a tax advisor if the opinion or advice is disqualified under this paragraph. An opinion or advice is disqualified if it relates to the appropriate tax treatment of a reportable transaction, as defined in §1.6011-4T(b), and the taxpayer does not disclose the transaction in accordance with §1.6011-4T.

Id. (emphasis in original).

Treas. Reg. §1.6011-4T(b) (2002), states:

A reportable transaction is either a transaction that is described in paragraph (b)(2) of this section, or is a transaction that is described in paragraph (b)(3) of this section and that meets the projected tax effect test in paragraph (b)(4) of this section. The term transaction includes all of the factual elements necessary to support the tax benefits that are expected to be claimed with respect to an entity, plan, or arrangement, and includes any series of related steps carried out as part of a prearranges plan and any series of substantially similar transactions entered into in the same taxable year.

Id.

113 See generally Prop. Treas. Reg. § 1.6664-4(c)(2), 67 Fed. Reg. 79894 (Dec. 31, 2002).

114 See generally Treas. Reg. § 1.6664-4(e) (2002).

115 See generally Treas. Reg. § 1.6664-4 (2002); see also Prop. Treas. Reg. § 1.6664-4 , 67 Fed. Reg. 79894 (Dec. 31, 2002).

register transactions with the Secretary.¹¹⁶ The confidentiality problem arises in IRC § 6112.¹¹⁷ IRC § 6112 creates this problem with confidentiality because the attorney is required to keep a record of his or

116 I.R.C. § 6111 (2003). We must look first to the statute to determine which attorneys must register the transactions in which their clients participate. "Any tax shelter organizer shall register the tax shelter with the Secretary (in such form and in such manner as the Secretary may prescribe) not later than the day on which the first offering for sale of interests in such tax shelter occurs." I.R.C. § 6111(a)(1).

Following is what the attorney must include in the registration:

Any registration under paragraph (1) shall include—

- (A) Information identifying and describing the tax shelter,
- (B) Information describing the tax benefits of the tax shelter represented (or to be represented) to investors, and
- (C) Such other information as the Secretary may prescribe.

Id.

The Code then goes on to define what is considered a tax shelter:

The term 'tax shelter' means any investment—

- (A) with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio for any investor as of the close of any of the first 5 years ending after the date on which such investment is offered for sale may be greater than 2 to 1, and
- (B) which is—
 - (i) required to be registered under a Federal or State law regulating securities,
 - (ii) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating the offering or sale of securities, or
 - (iii) a substantial investment.

I.R.C. § 6111(c)(1)(A)-(B).

- (1) organizes any potentially abusive tax shelter, or
 - (2) sells any interest in such a shelter,
- shall maintain (in such manner as the Secretary may by regulations prescribe) a list identifying each person who was sold an interest in such shelter and containing such other information as the Secretary may by regulations require.

Id.

117 I.R.C. § 6112 (2002). This section requires that an attorney who sells a tax shelter, as was defined in section 6111, must keep a list of the clients who were involve in the transaction. The code section reads:

Any person who—

- (1) organizes any potentially abusive tax shelter, or
 - (2) sells any interest in such a shelter,
- shall maintain (in such manner as the Secretary may by regulations prescribe) a list identifying each person who was sold an interest in such shelter and containing such other information as the Secretary may by regulations require.

Id.

The code section then continues by stating that:

Any person who is required to maintain a list under subsection (a)—

- (A) shall make such list available to the Secretary for inspection upon request by the Secretary, and
- (B) except as otherwise provided under regulations prescribed by the Secretary, shall retain any information which is required to be included on such list for 7 years.

Id.

her clients who have participated in the transaction.¹¹⁸ Moreover, the Secretary can request this list, and the attorney must furnish the list with the names of all the clients who have participated in the reportable transaction,¹¹⁹ which completely subrogates the attorney client privilege because the transaction and information pertaining to the transaction will no longer remain confidential.

Probably the most troubling consequence that arises from the Opinion Regs,¹²⁰ is that a client can no longer trust the advice of his attorney. The reliance issue is a problem because the Opinion Regs have included language, which will exclude an attorney's advice from the good faith exception to an accuracy-related penalty.¹²¹ Basically, Treas. Reg. § 1.6664-4 provides that even if all the requirements to qualify for the good faith exception are met, it will not necessarily preclude the Treasury from stating that the taxpayer did not reasonably rely on the advice (including the opinion of a professional tax advisor) in good faith.¹²²

This inability of a client to rely on their attorney's advice is very troubling for several reasons. First, it will lead to attorneys and clients not disclosing all relevant information to each other out of fear that the reportable transaction will have to be disclosed to the Treasury. This will effectively undermine the entire relationship between an attorney and his client because this relationship traditionally has always been defined and worked through open, honest and frank communication. Second, the proposed regulations offer very little guidance to taxpayers or their attorneys in order to determine what would or would not be considered

118 I.R.C. § 6112(c) adds:

[a]ny person who is required to maintain a list under subsection (a)—

(A) shall make such list available to the Secretary for inspection upon request by the Secretary, and

(B) except as otherwise provided under regulations prescribed by the Secretary, shall retain any information which is required to be included on such list for 7 years.

Id.

119 *Id.*

120 Prop. Treas. Reg. § 1.6664-4(c)(1)(iii)(2), 67 Fed. Reg. 79894 (Dec. 31, 2002).

121 Prop. Treas. Reg. § 1.6664-4(c)(1), 67 Fed. Reg. 79894 (Dec. 31, 2002), stating in relevant part:

[i]n no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied and the advice is not disqualified under paragraph (c)(2) of this section. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith.

Id.

122 Treas. Reg. § 1.6664-4 (b)(2)(c) (2003).

reasonable reliance. This lack of guidance effectively provides the Treasury with unmitigated power to declare unreasonable a taxpayer's reliance on his attorney's advice based solely upon the whim of the Treasury as opposed to declaring the reliance unreasonable due to set standards that would put taxpayers and their attorney's on notice as to what would or would not constitute reasonable reliance.

V. CONCLUSION

If finalized, the Opinion Regs will have a dramatic effect on the relationship between attorney and client. Clients will be put into a situation where the information provided by their attorney to them, even when made with reasonable cause and good faith, might fail to avail the clients of the exception to the accuracy-related penalties.¹²³ Seemingly, this is the result the Treasury has been aiming for beginning with its proposed changes to Circular 230.¹²⁴ Since Circular 230 has yet to be finalized, the current Opinion Regs will likely achieve the same result.¹²⁵

VI. AUTHOR'S NOTE

This article was submitted for publication in January 2003. Since that time, the Treasury Department finalized these regulations by removing the Temp. Treas. Regs. and replacing them with final regulations that are nearly identical to the Temp. Treas. Regs. These final regulations became effective on February 28, 2003.

¹²³ Prop. Treas. Reg. § 1.6664-(c)(1)(iii), 67 Fed. Reg. 79894 (Dec. 31, 2002). If the transaction is reportable according to Treas. Reg. § 1.6011-4T, an attorney's advice will no longer satisfy the reasonable cause and good faith exception. *Id.*

¹²⁴ *Finance Releases Draft*, *supra* note 7. Circular 230 was intended to "discourage the creation and use of abusive corporate tax shelters." *Id.* In addition,

[t]he draft would require additional disclosure by corporations and promoters regarding tax shelters and prohibit "tax opinion writers from providing opinions on deals in which they participate or otherwise have an interest." The draft legislation would also expand current tax law on aiding and abetting to further discourage promoters and advisors from engaging in corporate tax shelter activity.

Id.

¹²⁵ Compare *Finance Releases Draft*, *supra* note 7, with Prop. Treas. Reg. §§ 1.6662, 1.6664, 67 Fed. Reg. 79894 (Dec. 31, 2002).