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Effective Responses to Aggressive Tax Planning

What Canada Can Learn from Other Jurisdictions

Instalment 7: United States -
Ethical Standards in Tax Matters

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With a collaboration from
Lyne Latulippe

This instalment is the seventh in a series that presents a detailed study on aggressive tax planning. It underpins the issuance of *Tax Paper No. 112* published in July 2009 by the Canadian Tax Foundation (CTF). As mentioned in the preface of the book in order to keep publishing costs reasonable and to avoid delaying its publication, the CTF has given us permission to publish this document in French and English on our Website.

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The Mission of the Research Chair in Taxation and Public Finance

The **Research Chair in Taxation and Public Finance** (RCTPF) was formed on April 15, 2003 via an unconditional grant from the Québec Government, to whom we are grateful. We are specifically thankfull to the Government for having given us total freedom in selecting topics we thought were important, thus expressing its confidence in the selection of our projects. In Québec, there are few official forums where practitioners, public-sector executives and researchers can discuss new issues in taxation and public finances. In addition, research in these fields generally focuses on a single discipline to the detriment of the multi-disciplinary aspect of relations between the state and its taxpayers. The **Research Chair in Taxation and Public Finance** was formed in response to these two realities. Its primary mission is to stimulate interdisciplinary research and training by bringing together professors and researchers interested in the political economy of taxation. For more information on the **Research Chair in Taxation and Public Finance**, visit its official Website at: http://www.usherbrooke.ca/adm/recherche/chairefiscalite/.

Gilles Larin holds the RCTPF. Marie Jacques is a full professor at the Université de Sherbrooke. Robert Duong[1] was a research professional with the RCTPF when this study was produced. Lyne Latulippe was a consultant at the RCTPF.

We wish to express our gratitude for their observations and suggestions to Gaston Bédard, a consultant, as well as to other readers who wished to remain anonymous. Of course, the opinions expressed herein are those of the authors, who assume full responsibility for the comments and interpretations in this study.

[1] Robert Duong, who is a lawyer, was a research associate with the Research Chair of Taxation and Public Finance at the University of Sherbrooke when this study was done. He is now working with the federal Department of Finance as a policy officer in the area of income tax. The views expressed in this publication are those of the authors and do not in any way represent the position of the Department of Finance of Canada. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

Abstract

Instalment 7: The United States – Ethical Standards in Tax Matters

In 2005, the Research Chair in Taxation and Public Finance initiated studies on aggressive tax planning in light of concerns expressed by tax administrations, the courts, taxpayers and tax advisers ("**stakeholders**"). This project analyses the tools developed by some of Canada's major trading partners in response to aggressive tax planning schemes put into effect by taxpayers and tax advisers.

This study aims to spark thinking among the various stakeholders in Canada by taking a comprehensive and pragmatic approach to several issues inherent in aggressive tax planning. In view of the scope of the subject, its complexity and the specific features of the taxation systems of foreign jurisdictions, our study should be seen as a reflection on aggressive tax planning rather than an exhaustive analysis of each of the tools examined and all the associated issues. This project was written over a more than a two year period. As the underlying logic was the key element we wished to convey, we wish to emphasise that these documents do not necessarily represent the state of tax legislation or jurisprudence.

As part of this project, the Chair held a symposium in 2006 on the risks inherent in aggressive tax planning for all stakeholders and published a discussion paper detailing the major issues of these schemes.

This project is being pursued here by a study of the tools developed by Australia, United States, United Kingdom and European Union. Our goal is to assess whether it would be worthwhile for Canada to adopt one or more of these tools to safeguard its taxation system. The assessment was carried out taking into consideration the point of view of each stakeholder, according to generally recognized principles of tax administration.

The study comprises 10 instalments detailing the study framework that guided our analysis of the tools developed in other countries and our study of each of the selected tools. Our conclusions for Canada were originally destined to be published as the 10th instalment. However, it is not published here, because it was recast and augmented to become Tax Paper No. 112, published in July 2009 by the Canadian Tax Foundation: *Effective Responses to Aggressive Tax Planning – What Canada Can Learn from Other Jurisdictions.*

We refer the reader to instalment 1, "Study Framework", for an overview of our thinking throughout the instalments.

This instalment focuses on ethical standards in tax matters in the United States. Those standards impose on tax advisers requirements and penalties that are markedly more stringent than those stipulated by the administrative penalty levied on third parties in Canada. This instalment pinpoints the main ethical standards and the questions inherent in the application of this tool for all stakeholders in the United States. Based on those observations, we have pinpointed in a preliminary manner possible solutions for Canada.

In light of the US experience, the implementation by the tax administration of ethical standards poses major challenges in order to reasonably delineate the tax advisers' duty of care and to apply the standards. The main difficulty stems from the sharing of responsibility between taxpayers who have engaged in a planning scheme and the degree of diligence that the advisers must display to inform their clients of the risks inherent in the planning scheme.

We believe that the implementation of ethical standards is subordinate to a penalty for under-stating tax payable that applies to aggressive tax planning schemes. The rules governing this penalty to which the taxpayers are subject establish the level of diligence that advisers must display in respect of aggressive tax planning schemes. Moreover, the ethical standards are formulated according to principles similar to the standards of care applicable for the purposes of that penalty. It is incumbent upon taxpayers to obtain, if need be, damages from their advisers or the advisers' insurers in case of negligence or misrepresentation of the facts, in particular as regards the economic substance doctrine and the penalty for under-stating tax payable.

In our opinion, coercive ethical standards governing aggressive tax planning schemes should only be elaborated, if need be, in the wake of a consultation between the professional boards and the tax administration. For the sake of fairness and simplicity, the stakeholders concerned could jointly elaborate standards of care in this respect according to each group of advisers' field of expertise. In this way, professional boards could maintain public trust in the tax advisers' integrity.

To conclude, we believe that subjecting tax advisers to other tools such as disclosure rules allows the tax administration to manage the risks inherent in aggressive tax planning schemes in a more targeted manner than by means of ethical standards.

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1

General Context

We refer the reader to Instalment 5, entitled "The United States - General Context and Presentation of the American Broad-Spectrum Approach."

Instalment 5 presents an overview of the tools applied by the US tax administration, using in particular case law to illustrate the application of these tools.

2

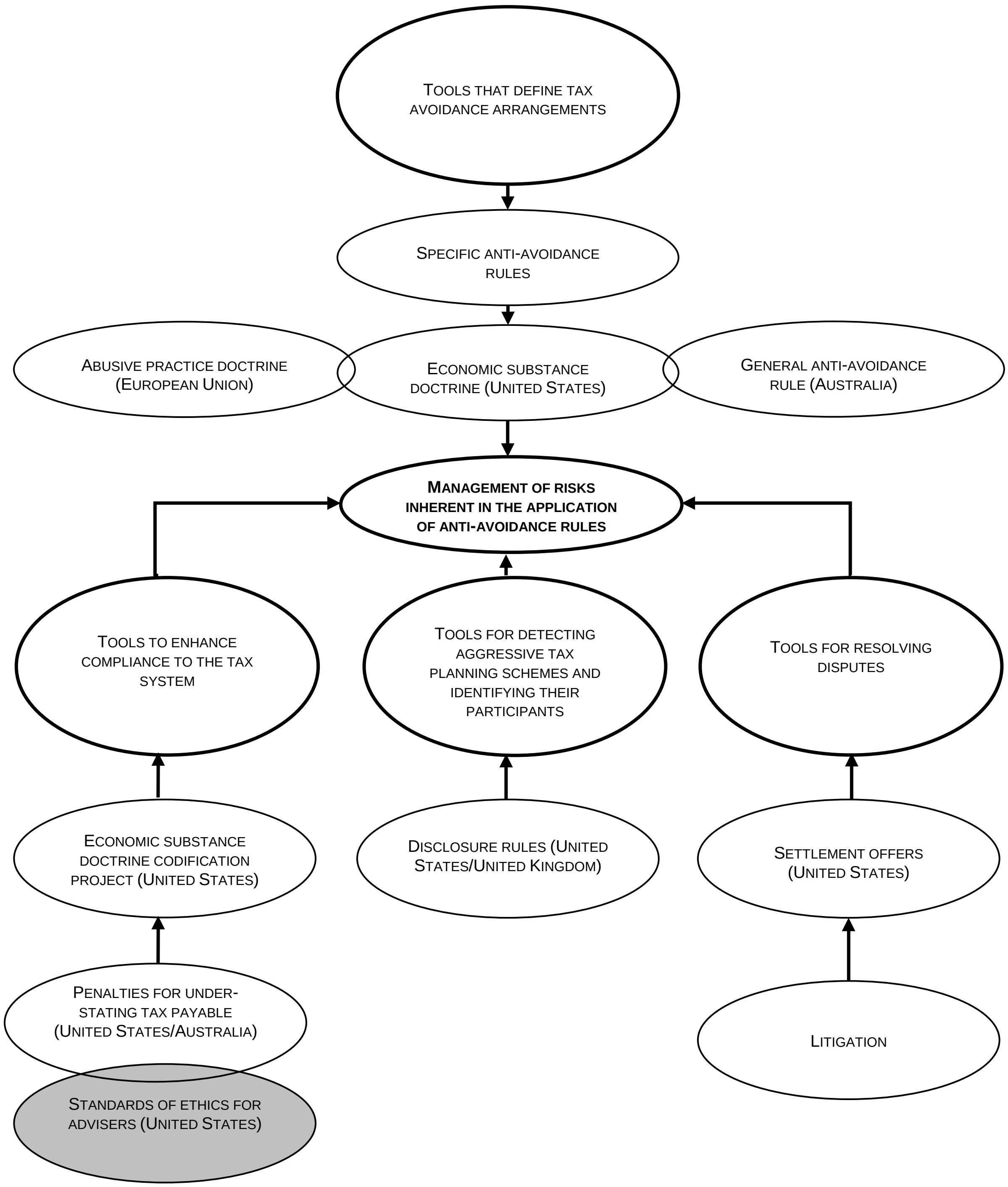
Context of the Ethical Standards

As discussed in Instalment 1, "Study Framework," there are a number of tools available to the tax administration to better curb tax avoidance arrangements and increase the risk for aggressive taxpayers and advisers. These tools can be divided into the following spheres of intervention of the tax administration:

- tools that define tax avoidance arrangements;
- tools to enhance compliance to the tax system;
- tools designed to detect aggressive tax planning schemes and identify their participants;
- tools that focus on resolving disputes.

Chart 1.1 on the following page provides a concise illustration of the relation between these spheres of intervention in managing the risks inherent in aggressive tax planning. Each sphere of intervention is shown in the chart using a bold border. The foreign tools selected for the purposes of the study are inserted into the appropriate spheres of intervention. The tool considered in this instalment, i.e. ethical standards, is indicated by a grey background to situate its role in the tax administration's management of the risks inherent in aggressive tax planning.

CHART 1.1
SPHERES OF INTERVENTION OF THE TAX ADMINISTRATION REGARDING AGGRESSIVE TAX PLANNING: SELECTED TOOLS USED BY SOME OF OUR TRADING PARTNERS - ROLE OF AMERICAN ETHICAL STANDARDS



Our Chart.

Taxpayers are responsible for estimating their tax payable according to the rules stipulated in the *Internal Revenue Code*.[2] Certain taxpayers may organize their affairs to minimize their tax payable in accordance with the law. Others may implement a planning scheme that seeks to take advantage of grey areas in the application of the law in order to claim tax benefits. Moreover, the most aggressive taxpayers might take into consideration the limited risk of detection or the possibility of reaching a settlement with the tax administration in the event of litigation with the latter.

When the tax administration audits taxpayers' income tax returns, it may conclude that the taxpayers have under-stated their tax payable. In the field of aggressive tax planning, the tax administration withdraws the tax benefits that the taxpayers have claimed by applying specific anti-avoidance rules and invoking the jurisprudence that it deems to be relevant. In particular, by relying on the economic substance doctrine elaborated by the courts, the tax administration will rescind the tax benefits that taxpayers have claimed on the grounds that the planning scheme that they have carried out was devoid of economic substance and was not intended to achieve a genuine purpose.

In Instalment 6 of this study, entitled "Economic Substance Doctrine," we examined the uncertainty surrounding the application of the economic substance doctrine in the United States. We showed how taxpayers manage risks related to the application by the tax administration and the courts of the economic substance doctrine and the penalty for under-stating tax payable. We refer the reader to Instalment 6 for a more detailed discussion of this doctrine and penalty. For the purposes of this instalment, we succinctly summarize in section 4.3 the concepts and issues of the economic substance doctrine from the standpoint of the ethical standards.

The tax administration may apply to taxpayers a penalty corresponding to 20% of the amount of tax under-stated, as determined by the tax administration according to its interpretation of the tax law and the jurisprudence. However, taxpayers may avoid the penalty if they establish that they have acted in good faith and have displayed due diligence to ensure that they have claimed tax benefits in accordance with the tax law. When the under-statement of the tax payable stems from transactions a significant purpose of which is tax avoidance, the taxpayers

[2] *Internal Revenue Code*, 26 U.S.C.

must, however, be able to prove that they could reasonably believe that, according to the balance of probabilities, the tax benefits were obtained in compliance with the tax law and the jurisprudence.

Facing the risk of being subject to a penalty for under-stating tax payable, taxpayers may seek the opinion of tax advisers. A taxpayer may display due diligence if, in particular, he relies on the conclusions of an impartial tax adviser who has concluded that, according to the balance of probabilities, tax benefits could be claimed in compliance with the tax law and the jurisprudence in force at the time that he claimed them, taking into account the weight of each of the recognized legal or administrative interpretive sources.[3]

The courts might confirm the withdrawal by the US tax administration of the tax benefits claimed by the taxpayers, notwithstanding the opinion of their advisers. If need be, the courts must determine whether the levying by the tax administration of a penalty for under-stating tax payable is warranted under the circumstances, taking into account the opinion of the taxpayer's advisers.

In the past, the US tax administration voiced concerns about the possibility for taxpayers of avoiding a penalty for under-stating tax payable by relying on tax opinions that were not sufficiently thorough.

In 1984, the US tax administration prescribed ethical standards to which tax advisers had to comply, in particular when they formulated to taxpayers a tax opinion on aggressive tax planning schemes.[4] These standards were intended to specifically regulate the opinions of tax advisers concerning the compliance level of an aggressive tax planning scheme which was covered by a prospectus or any other document to be used for public solicitation. Briefly, pursuant to these standards, the advisers had to:

- verify the accuracy of all relevant facts to the planning scheme covered by the document;

3 26 U.S.C. § 6662 and 26 C.F.R. § 1.6662; 26 U.S.C. § 6664 and 26 C.F.R. § 1.6664.

4 31 C.F.R. Part 10. The tax administration was empowered to regulate presentations made by tax advisers before it: 31 U.S.C. § 330. More specifically, it may adopt ethical standards governing advisers who formulate to their clients a written opinion on transactions that, in its opinion, present risks of tax avoidance: see 31 U.S.C. § 330(d).

- accurately and fully describe all of the important facts;
- clearly and fully indicate all of the facts that might possibly arise;
- apply the tax law to the facts underlying the planning scheme;
- analyse all the tax questions;
- conclude whether the taxpayers could more likely than not claim the tax benefits with respect to each question for which the tax administration might reasonably have won its case before the courts in the event of a challenge;
- conclude whether the taxpayers could more likely than not claim substantially more than half of all the tax benefits.[5]

The US tax administration had prescribed these standards in response to the proliferation of aggressive tax planning schemes during the 1970s and 1980s.[6] However, in the late 1990s, the tax administration and various professional organizations were of the opinion that aggressive taxpayers could avoid a penalty for under-stating tax payable by relying on opinions that did not necessarily cover all of the relevant facts. In their view, the advisers could not truly and properly determine the application of the tax law or the economic substance doctrine to an aggressive tax planning scheme.[7] Moreover, these standards only covered planning schemes subject to solicitations by tax advisers.

In 2005, the US tax administration amended the ethical standards, in particular by adopting additional standards to which both tax advisers and consulting firms are subject. Unlike the standards that applied solely to opinions focusing on planning schemes subject to solicitations, the tax administration may prescribe by regulation ethical standards to regulate the issuing by tax advisers of any written opinion focusing on transactions that, in its opinion, present risks of

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5 See 31 C.F.R. §10.33, as in force prior to June 21, 2005; U.S., Department of Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (July 1999) [Treasury, *Corporate Tax Shelters*], pages 70-72.

6 These standards were based on those of the American Bar Association in 1982. For a cursory overview of these ethical standards, see Treasury, *Corporate Tax Shelters*, *supra* note 5, pages 85-93.

7 Treasury, *Corporate Tax Shelters*, *ibid.* See also Meah Rothman Tell, “Circular 230: Beware the Jabberwock!” (2006) 80:1 Fla. B.J. 39, which refers to the tax opinions rendered by advisers to *Enron* which contained a conclusion that the tax treatments claimed should comply to the law based on the taxpayer’s claim to the effect that it was pursuing a genuine business purpose. See also the settlement of class action suits in the *Simon* v. *KPMG LLP and Sidley Austin Brown & Wood LLP* cases (June 2, 2006), Civ. 05-CV-03189 (D. N. J.), *infra,* and *Denney* v. *Jenkens & Gilchrist* (February 18, 2005), Opinion & Order 03 Civ. 5460 (SAS) (S. D. N.Y.), *infra*, in which taxpayers were denied tax benefits stemming from transactions that the US tax administration publicly declared to be aggressive (listed transactions) although the taxpayers relied on tax opinions that concluded that these transactions complied with the law according to the balance of probabilities. These opinions appeared to have a limited scope regarding the possible application of the economic substance doctrine in respect of the facts taken as a whole.

avoidance.[8] These additional standards have been in force since June 21, 2005.[9] The tax administration is of the opinion that it had to prescribe them to restore, maintain and promote public trust in the integrity of tax advisers when they formulate tax opinions to their clients:

> Tax advisors play a critical role in the Federal tax system which is founded on principles of compliance and voluntary self-assessment. The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice. To restore, promote, and maintain the public's confidence in those individuals and firms, these final regulations set forth best practices applicable to all tax advisors. These regulations also provide mandatory requirements for practitioners who provide covered opinions. The scope of these regulations is limited to practice before the IRS. These regulations do not alter or supplant other ethical standards applicable to practitioners.[10]
>
> [our extracts]

Generally speaking, tax advisers must practise their profession diligently to confirm the accuracy of the information in the documents and oral or written communications that they transmit to their clients and to the tax administration. This requirement applies both to the documents and the oral or written communications that are submitted to the US tax administration, inasmuch as they deal with any aspect whose application falls under the tax administration's jurisdiction, especially matters that affect the tax benefits stemming from an element prescribed by the tax administration.[11]

These standards can be divided mainly into four broad levels:

- best practices;
- standards with respect to tax returns and documents, affidavits and other papers;
- requirements for written advice other than covered opinions;
- standards for covered opinions.

Specific standards deal precisely with tax opinions rendered in respect of three categories of transactions in which the taxpayers seek to achieve a tax purpose. The advisers must generally

8 31 U.S.C. § 330(d).

9 For an overview of changes over the years to the ethical standards and the reasons why the US tax administration made them, see Isaac J. Roang, "To Disclaim or Not To Disclaim: IRS Circular 230 Requirements for Written Advice" (2006) 19:3 Geo. J. Legal Ethics 937 [Roang, "Circular 230"], pages 947-948.

10 U.S., Department of Treasury (Office of the Secretary), *Regulations Governing Practice Before the Internal Revenue Service*, TD 9165, RIN 1545-BA70 (December 20, 2004), 69:243 Fed. Reg. 75839 (2004) [Treasury, *Regulations Governing Practice (2004)*], page 75840.

11 31 C.F.R. §10.22. When a tax adviser collaborates with other tax advisers, he will be assumed to have acted diligently if he has taken reasonable steps to ensure that those advisers have also performed their work diligently.

exercise a specific degree of diligence concerning the veracity of the facts underlying these transactions and with regard to the application of the tax law and the economic substance doctrine.

The US tax administration may reprimand tax advisers. It may also suspend or disbar them from making presentations before it when, briefly, the advisers display reprehensible conduct, recklessness or gross incompetence regarding the application of the ethical standards. It may also levy a monetary penalty on the advisers and on the consulting firms in which they practice.

This instalment focuses essentially on the standards for covered opinions, since they are currently at the centre of debate between tax advisers and the tax administration in the United States. To better grasp the context surrounding these standards, we will successively and succinctly describe the different levels of ethical standards, starting with best practices and concluding with the covered opinions standards. We will then formulate observations on the specific standards.

3 Description

3.1 Reporting advisers

Briefly, reporting advisers must be accredited by the US tax administration and adhere to the prescribed professional standards in order to represent taxpayers before the tax administration.[12] The acts covered include any presentation made to the tax administration concerning the rights, privileges, debts or liabilities of a taxpayer pursuant to the tax laws and regulations, including the issuing of a tax opinion on an aggressive tax planning scheme:

> Practice before the Internal Revenue Service comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion, and representing a client at conferences, hearings and meetings[13].
>
> [our extracts]

3.2 Best practices

Generally speaking, accredited advisers must represent taxpayers in accordance with best practices. Advisers must act with integrity when they represent taxpayers before the tax administration. To do so, they must:

- clearly and precisely define with the client the terms of the mandate;
- establish the facts and measure their degree of relevance;
- assess the reasonable nature of the facts submitted to them and the assumptions that must be postulated;
- draw a conclusion on the application of the tax law (including the jurisprudence) to the relevant facts;

[12] 31 C.F.R. § 10.3. to 10.8. Advisers who are subject to the ethical standards are lawyers, chartered accountants, advisers on employee plans, actuaries, assessors, and any other individual accredited by the US tax administration: see 31 C.F.R. §§ 10.0, 10.3 and 10.4.

[13] 31 C.F.R. § 10.2(a)(4) as amended by U.S., Department of Treasury, *Regulations Governing Practice Before the Internal Revenue Service*, RIN-1545-BA72, TD 9359 (September 26, 2007) [Treasury, *Final Regulations (September 26, 2007)*].

- advise the taxpayer on the use to which the latter may put the opinion formulated, in particular as regards the likelihood that the taxpayer may avoid a penalty for understating tax payable by relying on the opinion;
- in the case of the directors of consulting firms, take reasonable steps to ensure that all of the firm's advisers practice their profession in accordance with these best practices.[14]

These best practices are not restrictive. Unlike the standards described below, tax advisers who do not practice their profession according to these principles are not subject to any penalty. These principles nonetheless underlie the other standards to which sanctions are attached.

3.3 Standards with respect to tax returns and documents, affidavits and other papers

Tax advisers must conform to prescribed standards when they produce a taxpayer's income tax return. If need be, they must apply these standards when they produce a tax return or an information return on behalf of a taxpayer according to the degree of likelihood that each position adopted in a return complies with the tax law.

The US tax administration has changed these standards over the years in order to better protect the integrity of the tax system for some categories of aggressive tax planning schemes, while seeking to mitigate these standards when such planning schemes are not reflected in a taxpayer's income tax return.

Prior to the changes that the US tax administration made before 2007, a tax adviser could produce the tax return of a taxpayer who claimed a particular tax treatment or recommend to a client that he could claim such a treatment only if, in his opinion, this treatment satisfied either of the following criteria:

- there is a realistic possibility that such treatment conforms to the tax law. A treatment is deemed to be realistic if the likelihood of its complying with the tax law is equivalent to or greater than one chance in three according to a reasonable analysis of the facets and the tax law conducted by an individual possessing the appropriate tax knowledge;
- the tax treatment is not frivolous under the tax law and is properly disclosed in the tax return (a patently improper treatment is deemed to be frivolous).[15]

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14 31 C.F.R. §10.33.

15 31 C.F.R. §10.34(a). However, that provision is subject to a proposed regulation that amends the probability thresholds and the standards that income tax return preparers must follow to determine this threshold: see U.S.,

A change to the ethical standards that the tax administration proposed in 2007 stipulates that the tax adviser had to reasonably believe that the tax treatment of each item more likely than not complied with the tax law or, if the item is properly disclosed in an information return, have reasonable arguments to support the item's compliance with the tax law (reasonable basis). The proposed change sought to better harmonize the ethical standards with the penalties stipulated in the *US Internal Revenue Code*, i.e. the penalty for under-stating tax payable to which taxpayers are subject, and the penalty for income tax return preparers.[16]

According to the same proposed change, advisers may in good faith rely on the information provided by their clients in order to carry out the mandate that the latter have entrusted to them, without having in principle to thoroughly verify such information. The advisers must nonetheless diligently analyse the information submitted to them or which they have otherwise obtained. Moreover, they must ensure the accuracy of the information if it differs from important information or a factual hypothesis formulated in executing the mandate.[17] The adviser must inform the taxpayer of the penalties that might be imposed on him in respect of the tax treatment claimed and apprise him of the possibility of avoiding the penalty by properly disclosing the details of this tax treatment.[18]

Because of the changes adopted in 2008 to the penalty applicable to income tax return preparers, the US tax administration intends to publish new directives concerning the ethical standards in such a way as to reflect the changes made in 2008 to that penalty.[19] In 2008, the US tax administration raised the degree of diligence of income tax return preparers for the purposes of the aforementioned penalty.[20] Pursuant to these changes, preparers are usually subject to the substantial authority criterion (arguments must be probable, i.e. meet a 40%

Department of Treasury, *Regulations Governing Practice Before the Internal Revenue Service*, REG-138637-07, RIN 1545-BH01 (September 19, 2007) [Treasury, *Final Regulations (September 19, 2007)*]; Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13.

16 Treasury, *Final Regulations (September 19, 2007)*, *ibid*.

17 See 31 C.F.R. §10.34(d), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 15.

18 31 C.F.R. §10.34(c), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 15.

19 Jeremiah Coder, "Treasury Says Parts of Preparer Penalties Regs Will Be Finalized," 2008 TNT 196-3 (October 8, 2008).

20 See *Emergency Economic Stabilization Act of 2008*, Pub. L. No. 110-343, Division A, § 506, October 3, 2008.

probability threshold) in respect of positions that are not properly disclosed in an income tax return. However, they continue to be subject to the more-likely-than-not criterion if a tax return reflects a tax shelter (that is, a transaction a significant purpose of which is tax avoidance), a transaction that the US tax administration has declared to be aggressive for the purposes of the disclosure rules (listed transactions) as well as transactions that are reportable under those rules a significant purpose of which is tax avoidance.

3.4 Written opinions, other than covered opinions

Tax advisers must comply with these general standards when they issue a written opinion concerning the tax treatment of a transaction. Briefly, tax advisers must not formulate a written opinion:

- by relying on factual or legal hypotheses that are unreasonable (in this respect, they must ascertain the likelihood that facts might possibly occur);
- by relying unreasonably on statements or presentations made by the taxpayer or any other person;
- without taking into consideration all the relevant facts that were brought to their attention or the facts that they should know;
- by taking into consideration the likelihood that the tax administration will not audit the taxpayer's tax return, that it will not take issue with an item during an audit or, as the case may be, that the taxpayer will reach a settlement with the tax administration.[21]

However, tax advisers must adhere to another set of ethical standards if they issue a prescribed written opinion (covered opinion).

3.5 Covered opinions

Advisers who formulate a conclusion to a taxpayer that is favourable to the latter in a written tax opinion concerning a transaction that is part of one of the following three categories of prescribed transactions are subject to an array of specific standards.

[21] 31 C.F.R. §10.37.

3.5.1 Prescribed transactions

3.5.1.1 Category 1: Transactions declared to be aggressive pursuant to the disclosure rules (listed transactions)

Advisers must apply the covered opinions standards when they formulate an opinion in respect of transactions that the US tax administration declares to be aggressive for the purposes of the disclosure rules.[22] The tax administration prescribes disclosure obligations for taxpayers and advisers in respect of transactions that, in its opinion, display risks of avoidance. The tax administration might determine whether such transactions are abusive and identify the taxpayers who carried them out based on the information submitted.

These transactions include transactions that the US tax administration has declared to be aggressive on an *ad hoc* basis and by way of public information bulletins. Taxpayers and tax advisers must produce information on a transaction that is identical or substantially similar to one of the transactions that the tax administration has declared to be aggressive (listed transactions). As of June 2006, the tax administration had declared 31 planning schemes to be aggressive for the purposes of the disclosure rules.[23] This figure had risen to 34 by March 1, 2008. Briefly, these transactions appear to be devoid of economic substance and are apparently intended solely to allow the taxpayers to deduct amounts in computing their income.[24]

3.5.1.2 Category 2: A transaction whose principal purpose can be seen as avoidance

For the purposes of the standards for covered opinions, tax avoidance is the principal purpose of a transaction when the purpose of a tax nature exceeds any other purpose. However, the tax purpose will not be considered the principal purpose of the transaction if the taxpayer claims tax benefits in accordance with the purposes of the tax law.[25]

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22 31 C.F.R. § 10.35(b)(2)(i)(A).

23 David M. Walker (Comptroller General of the United States), testimony, "Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting," given at a public hearing before the US Senate Committee on Finance (GAO-06-85IT) Washington, DC, United States Government Printing Office, June 13, 2006, page 11.

24 See Joe Walsh, "Circular 230 Sets Stringent Requirements for Written Advice," (2005) 75:4 Practical Tax Strategies 196 [Walsh, "Circular 230 and Written Advice"], pages 200-201.

25 31 C.F.R. § 10.35(b)(2)(i)(B); (b)(10).

3.5.1.3 Category 3: A transaction a significant purpose of which can be seen as avoidance if the tax opinion satisfies one of the prescribed criteria

This category of transactions includes transactions a significant purpose of which can be seen as avoidance and in respect of which the tax opinion satisfies one of the following prescribed criteria:

- the opinion concludes that the taxpayer's fiscal status more likely than not complies with the tax law (a reliance opinion);
- the opinion is likely to be used to engage in solicitation to encourage individuals to implement a transaction (a marketed opinion that can be applied generally);
- the opinion is issued to a taxpayer in confidence;
- the opinion contains contractual protection clauses governing the reimbursement to the taxpayer of the fees that he has paid the advisers if the tax benefits fail to materialize or setting up fees that are conditional to the obtaining of the tax benefits.[26]

3.5.2 Applicable standards

Advisers who formulate a covered opinion must comply with the standards indicated below.

3.5.2.1 Due diligence of a taxpayer's business purposes in a planning scheme

Advisers must take reasonable steps to ensure that they take into consideration all of the relevant facts and ensure their accuracy. In particular, they must ascertain the existence of a genuine business purpose and the possibility for the taxpayer to anticipate a profit according to credible information. In the case of a possible transaction, they must take into consideration the likelihood that other facts may arise. They may not postulate unreasonable factual assumptions.[27]

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[26] 31 C.F.R. § 10.35(b)(2)(i)(C). It should be emphasized that advisers may not generally reach conditional fee agreements with their clients: 31 C.F.R. § 10.27(b)(1), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13. However, for fee agreements concluded after March 26, 2008, the tax administration will grant the advisers the right to be remunerated by fees that are calculated according to the value of the tax benefits claimed by their clients, but solely when they represent their client during a tax administration's audit, during litigation between these parties, or when the penalties and applicable interest are revised: see 31 C.F.R. § 10.27(b)(2), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13.

[27] 31 C.F.R. § 10.35(c)(1).

3.5.2.2 Application of the tax law and the jurisprudence to all of the facts pertaining to the planning scheme

The advisers must express and support their conclusion about the application of the tax law to the facts, taking into account the jurisprudence. They may not postulate unreasonable legal assumptions, nor may they postulate the assumption that any uncertainty concerning the application of the law and jurisprudence will be resolved in the taxpayers' favour. The opinion must not contain inconsistent analyses or conclusions.[28]

3.5.2.3 Conclusion according to the balance of probabilities that is clearly and expressly stated in the opinion

The advisers must expressly express a conclusion about the likelihood that the taxpayer may claim the tax benefits attributable to each significant issue of a transaction under the tax law and the jurisprudence and such conclusion must be visible in the opinion.[29] Briefly, a significant issue is an item of income or a deduction in the calculation of income, a capital gain or loss, a tax credit or the value of a property, in respect of which the tax administration has a reasonable basis for a successful challenge before the courts, and the resolution of that issue might significantly affect the tax treatment of the overall planning scheme.[30]

If need be, the advisers must expressly state in the opinion that they have been unable to formulate a favourable conclusion to the taxpayer according to the balance of probabilities in respect of a significant issue and that the taxpayer may not rely on this conclusion to avoid a penalty for under-stating tax payable as regards that issue.[31]

The advisers must also expressly draft a conclusion concerning the likelihood that the taxpayer may claim all of the tax benefits stemming from a planning scheme, provide the reasons behind this conclusion and visibly integrate it in the opinion. In the case of marketed opinions that fall

[28] 31 C.F.R. § 10.35(c)(2).
[29] 31 C.F.R. § 10.35(c)(3)(ii).
[30] 31 C.F.R. § 10.35(b)(3).
[31] 31 C.F.R. § 10.35(e)(4).

under category 3, the advisers must formulate this conclusion according to the balance of probabilities.[32]

3.5.2.4 Express and visible mention of the opinion's limitations for the taxpayer with respect to the penalty for under-stating tax payable

The advisers must also draft a notice stipulating that the taxpayer may not rely on the opinion to avoid a penalty for under-stating tax payable in respect of the tax treatment of a significant issue if the opinion concludes according to the balance of probabilities that he may not claim the tax benefits pertaining to that issue. The advisers must expressly and visibly draft such notice in the opinion.[33]

If need be, the advisers must:

- mention in the opinion the financial or business relationship that the adviser maintains with other individuals that are linked to the transaction covered by the opinion and describe the fees that he receives from them; or
- visibly indicate that the opinion is provided in conjunction with a solicitation and that the taxpayer should obtain the opinion of an impartial adviser in light of these circumstances.[34]

3.5.3 Relaxation of the standards in respect of transactions in category 3

The covered opinions standards include exceptions in respect of opinions focusing on transactions in category 3, i.e. transactions a significant purpose of which is tax avoidance. In those cases, advisers may deliver an opinion without necessarily applying each of the specific standards.

3.5.3.1 Limited scope opinions on a transaction a significant purpose of which is avoidance

First, advisers may formulate a limited scope opinion in respect of a transaction in category 3 (but not for an opinion that is likely to be used for solicitation purposes). The advisers must then prominently present in the opinion the following assertions:

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[32] 31 C.F.R. § 10.35(c)(4).
[33] 31 C.F.R. § 10.35(e)(4).
[34] 31 C.F.R. § 10.35(e)(1) and (2).

- the opinion only deals with a limited number of significant issues;
- additional questions might arise concerning the tax treatment of other issues pertaining to the transaction analysed;
- the opinion does not contain any conclusion on these other issues;
- the taxpayer may not rely on this opinion to avoid a penalty for under-stating tax payable in respect of issues not covered by a conclusion.[35]

Second, advisers who formulate an opinion concluding that the taxpayer's fiscal status concerning one or more significant issues more likely than not conforms to the tax law, may expressly mention therein that the client may not rely on the opinion to avoid a penalty for under-stating tax payable.[36] Such an opinion will not be considered an opinion that falls under category 3.

3.5.3.2 Standardized opinions for solicitation purposes

Advisers who formulate an opinion for solicitation fulfil their duties under the specific standards if the opinion states, in particular, that:

- the advisers did not draft the opinion to allow a taxpayer to avoid any penalty that the US tax administration might levy, including a penalty for under-stating tax payable;
- the opinion was formulated for solicitation purposes;
- a taxpayer should obtain the opinion of an impartial adviser concerning the transaction's level of compliance with the tax law, in light of his situation.[37]

3.6 Sanctions

Advisers who fail to comply with the ethical standards are liable to sanctions the consequences of which vary according to the nature of the non-compliance. The advisers are subject to a higher degree of diligence with respect to the covered opinions standards than in respect of the general standards.

[35] 31 C.F.R. §10.35(e)(3).
[36] 31 C.F.R. § 10.35(b)(4).
[37] 31 C.F.R. §10.35(b)(5).

3.6.1 Non-compliance caused by recklessness or gross incompetence

Generally speaking, and except for best practices standards, advisers are liable to any of the sanctions stipulated if they knowingly breach the ethical standards. In the case of standards governing the production of income tax returns and documents, standards pertaining to written opinions and the standards for covered opinions, tax advisers are also liable to a penalty for non-compliance stemming from recklessness or gross incompetence.[38]

Recklessness means a highly unreasonable presentation by the adviser of the tax law and the facts, including any omission of these elements, in comparison with the presentation that an adviser displaying due diligence would make of such elements were he placed in the same circumstances.[39]

Gross incompetence displayed by an adviser is equivalent, in particular, to gross indifference towards compliance with the tax law or in the representation of a client's affairs, and constant failure to fulfil his obligations towards his client.[40]

3.6.2 Reprimand, suspension or disbarment of the adviser's right to represent taxpayers before the tax administration

Briefly, advisers who fail to comply with the ethical standards (except for best practices) may be subject to a reprimand, a suspension or disbarment in respect of their right to represent taxpayers before the US tax administration.

A private reprimand is conveyed in a letter from the Office of Professional Responsibility (OPRC)[41] transmitted solely to the adviser informing him that his conduct is in breach of the

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38 31 C.F.R. §10.52(a), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 19.

39 31 C.F.R. §10.51(a)(13), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 18.

40 31 C.F.R. § 10.51(a)(13), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 18.

41 Briefly, this division of the US tax administration is responsible for elaborating and applying the ethical standards to which tax advisers must adhere in the practice of their profession when they represent taxpayers before the tax administration. Additional information is available on the IRS Website: <http://www.irs.gov/irs/article/0,,id=175512,00.html>.

ethical standards. The adviser may continue to represent taxpayers before the tax administration despite a private reprimand.[42]

On the other hand, the decision to publicly reprimand an adviser, suspend or disbar him will be handed down either following an agreement between the tax administration and the adviser[43] or by an administrative tribunal.[44] Unlike a suspension or disbarment, the adviser subject to a public reprimand maintains his right to represent taxpayers before the tax administration.[45]

3.6.3 Monetary penalty

In addition to the penalties noted earlier, the US tax administration may impose a monetary penalty on advisers and on tax consulting firms in which they practice. The amount of the penalty may not exceed the value of the gross income that these advisers or firms may derive from conduct in breach of the applicable standards.[46] The tax administration may either levy a monetary penalty alone or impose this penalty in addition to the sanctions mentioned earlier.[47]

The tax administration may impose a penalty in an amount that can be lower than the maximum amount prescribed according to:

- the degree of culpability of the advisers or the advisers' consulting firm;
- their breach of a duty to advise a client or any other duty towards the latter;
- the measures that they have adopted to promptly remedy that breach;
- the damages that a client, the general public or the tax administration has sustained or might sustain.[48]

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42 31 C.F.R. § 10.79(c).

43 31 C.F.R. § 10.61, as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 22.

44 31 C.F.R. § 10.76, as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 32.

45 31 C.F.R. § 10.79.

46 31 C.F.R. §10.50(c), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 17. The corporations might be subject to a monetary penalty if they should reasonably have been aware of the conduct of any of their advisers.

47 31 C.F.R. § 330(b); 31 C.F.R. §10.50(c)(3), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 17.

48 The tax administration published these directives on the application of the monetary penalty in U.S., Internal Revenue Service, Notice 2007-39, "Disciplinary Actions under Section 822 of the American Jobs Creation Act of 2004," 2007-20 I.R.B. 1243 (April 22, 2007). Here is the extract concerning the final element mentioned in the list to which this note is appended: "In general, the Service will not impose monetary penalties in cases of minor

3.6.4 A penalty applied by an administrative tribunal failing agreement between the adviser and the tax administration

In the case of a public reprimand or a suspension lasting less than six months, the administrative tribunal will give a decision on the penalty if the tax administration proves its allegations of recklessness or gross incompetence on the part of the adviser according to the balance of probabilities.[49]

In the case of a suspension lasting six months or more or disbarment, the tax administration must establish, based on clear, convincing proof, its allegations of recklessness and gross incompetence.[50]

3.6.5 Sanction applicable within five years of non-compliance

The US tax administration may apply any sanction within five years of the day on which the adviser breached the ethical standards. It may suspend or disbar an adviser if the latter has been subject to a penalty imposed by his professional board in the five-year period preceding the day on which he was subject to an ethical complaint for non-compliance with the ethical standards prescribed by the tax administration.[51]

3.7 Appeal rights regarding a decision of the administrative tribunal

When the sanction is subject to a decision of an administrative tribunal, the Office of Professional Responsibility and the adviser may appeal this decision before another instance of the US tax administration, i.e. the Secretary of Treasury and, subsequently, before a federal

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technical violations, when there is little or no injury to a client, the public, or tax administration, and there is little likelihood of repeated similar misconduct."

49 31 C.F.R. § 10.76(b), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 32.

50 *Ibid*.

51 31 C.F.R. § 10.82, as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 35.

court. Briefly, the Secretary of Treasury will only overturn a ruling if the appellant proves that the ruling is clearly erroneous in light of evidentiary elements or that the ruling is ill founded in law.[52]

At the adviser's request, the director of the Office of Professional Responsibility may rescind any sanction imposed. If the director assents to this request, he may set the conditions with which the adviser must comply during a specified period according to the nature of the sanctioned conduct if, in the director's opinion, they foster the adviser's adherence to the ethical standards.[53] In the case of an adviser subject to disbarment, the lifting of that sanction must not run counter to the public interest.[54]

3.8 Publication of a decision that sanctions an adviser

The US tax administration publishes the decision confirming the suspension or disbarment of an adviser when it becomes final, i.e. once appeal rights to an administrative tribunal and the Secretary of Treasury have been exhausted.[55]

3.9 Interlocutory injunction

The US tax administration may file a request with a court for an interlocutory injunction to enjoin advisers or tax consulting firms to comply with any of the ethical standards.[56]

3.10 Limited scope of a covered opinion in respect of a penalty for under-stating tax payable

Despite the compliance of an opinion to the standards for covered opinions, the taxpayer must, in order to avoid a penalty for under-stating tax payable, establish his good faith and the

[52] 26 C.F.R. §10.78, as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 34. For a cursory explanation of the adviser's rights of appeal, see Jeremiah Coder, "OPR Director Chesman Details Office to Allay Practitioner Mistrust," 2007 TNT 191-5 (October 2, 2007) [Coder, "OPR Director Allay Practitioner Mistrust"].

[53] 31 C.F.R. § 10.79(d).

[54] 31 C.F.R. § 10.81.

[55] 31 C.F.R. § 10.72(d), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, paragraph 30.

[56] 26 U.S.C. § 7408(b).

transaction's level of compliance with the tax law and the jurisprudence in light of the applicable tax rules.[57]

[57] 31 C.F.R. §10.35(f).

4

Observations

The US tax administration and professional organizations share the same concerns regarding the transparency and integrity of tax advisers in the practice of their profession. However, the opinions of groups of stakeholders differ on the scope and details of the ethical standards that the advisers must apply in the realm of taxation.

The US tax administration is constantly assessing the ethical standards to ensure their effectiveness.[58] It acknowledges that the covered opinions standards are imperfect, especially as regards standardized opinions used for solicitation purposes and those focusing on transactions a significant purpose of which is avoidance. The tax administration periodically evaluates the appropriateness of adopting an approach that would be based on general standards of diligence rather than the approach that underlies the covered opinions standards.

Inasmuch as the tax administration believes that the covered opinions standards are necessary to protect the integrity of the tax system, professional organizations have recommended that they be simplified or applied solely to transactions that display the highest risks of avoidance. The main questions inherent in the ethical standards include:

- the overlapping of the fields of jurisdiction of professional boards and the tax administration on ethics;
- the difficulties that tax advisers encounter in presenting an accurate picture of the risks linked to an aggressive tax planning scheme because of the multiplicity and vagueness of the indicators adopted to apply the economic substance doctrine;
- the uncertainty for the taxpayer regarding the possibility of avoiding a penalty for under-stating tax payable if he relies on the opinion of an adviser, even though the opinion conforms to the standards for covered opinions;
- the tax advisers' professional liability towards their clients;

[58] U.S., Internal Revenue Service, *IRS Strategic Plan 2005-2009* (Publication 3744), Rev. 6-2004 [IRS, *Strategic Plan*], page 22.

- the tax administration's appearance of partiality because of the broad and nebulous scope of the covered opinions standards and the procedures leading to the application of a sanction.

4.1 For the sake of simplicity and fairness, the tax administration should collaborate with boards to implement standards of care in the realm of taxation

A self-assessment taxation system centres, first and foremost, on the taxpayer's duty to estimate his tax payable and the tax administration's duty to ascertain whether the taxpayer has discharged his obligation according to the tax law. Taxpayers may seek the services of tax advisers who practice their profession pursuant to the ethnical standards of their respective professional boards, which have a mandate to assure the public that their members practice their profession diligently.[59]

Through the ethical standards, the US tax administration regulates the practice of tax advisers and their relations with taxpayers and is of the opinion that tax advisers play a key role in ensuring a proper operation of a self-assessment taxation system. To this effect, such standards seek to restore the trust of all taxpayers in the tax advisers' honesty and integrity,[60] probably in light of the financial scandals that have occurred in the United States in recent years. These standards round out those adopted by professional boards.

As we noted in subsection 3.6.5, the US tax administration may rely on the penalties imposed by professional boards to suspend an adviser. The penalties that such boards impose might serve as a precedent for the purposes of the tax ethical standards insofar as their standards apply to situations similar to aggressive tax planning schemes. Such harmonization allows for the reconciliation of the principles of simplicity and fairness. In our opinion, professional boards are in the best position to impartially judge whether the advisers that they govern have practised their profession diligently according to their field of expertise in light of the circumstances without encumbering the management of the tax system. Inasmuch as it is desirable for a tax administration to decree distinct ethical standards, the Chair is of the opinion that it must

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59 We refer the reader to Instalment of this project, which discusses the ethical duties that tax advisers must assume when they formulate a tax opinion to their clients.

60 See the preamble to the proposed Treasury regulation, *Regulations Governing Practice (2004)*, *supra* note 10 preceding the final adoption of the ethical standards.

elaborate and apply them coherently with the standards of professional boards to which the adviser in question belongs.

4.2 Regardless of who elaborates the standards for covered opinions, taxpayers may obtain an accurate picture of the risks inherent in an aggressive tax planning scheme if the advisers apply them

The US tax administration may rescind the tax benefits claimed by taxpayers by applying the specific anti-avoidance rules and the economic substance doctrine. It may also levy a penalty for under-stating tax payable. Taxpayers must display a higher degree of diligence given the risk that the tax administration will withdraw the tax benefits pursuant to the economic substance doctrine and apply the penalty.

In this context, the US tax administration imposes requirements on tax advisers to enable taxpayers to make an enlightened decision based on an accurate assessment of the risks inherent in an aggressive tax planning scheme. Among other things, the tax administration has observed that taxpayers had not been informed by their advisers that they could not rely on a standardized opinion formulated for the purposes of solicitation in order to claim tax benefits stemming from a planning scheme.[61]

4.2.1 The advisers are subject to duties of care similar to those of taxpayers for the purposes of the penalty for under-stating tax payable

To avoid the penalty, taxpayers may rely on the opinion of an impartial tax adviser who concludes according to the balance of probabilities that the tax benefits could be obtained according to the tax law in force at the time that they were claimed and to the economic substance doctrine, bearing in mind the weight of each of the recognized legal or administrative interpretive sources in the realm of tax law.[62] The taxpayer must disclose to the tax advisers all of the relevant facts in order to avoid the penalty and communicate all of the facts to enable his

[61] See the observations made by representatives of the tax administration during round tables organized by the Section of Taxation of the American Bar Association and presented by Lee A. Sheppard, "News Analysis: Shelter Penalties: Or Else What ? Part 3," 2007 TNT 30-5 (February 15, 2005).

[62] 26 U.S.C. §6662 and 26 C.F.R. §1.6662; 26 U.S.C. §6664 and 26 C.F.R. §1.6664.

adviser to ascertain whether a planning scheme allows him to achieve a significant business purpose and whether the value of the tax benefits claimed seem reasonable in light of his investment.[63]

Pursuant to the standards for covered opinions, advisers are subject to a duty of care similar to that assumed by taxpayers. They must exercise a higher degree of diligence to verify the accuracy of the facts that a taxpayer or other advisers submit to them concerning any significant issue in the planning scheme that the taxpayer is contemplating. From tax administration's standpoint, the covered opinions rules are intended to heighten the advisers' degree of diligence since the latter must also ensure that the taxpayer seeks to achieve a genuine purpose rather than simply obtain a tax benefit before issuing a favourable opinion.[64] More specifically, the following duties are imposed on tax advisers:

- the tax advisers may not unreasonably postulate factual assumptions concerning the true purpose that the taxpayer is pursuing. The advisers must, in particular, verify whether the business purpose stated by the taxpayer is genuine if they knew or should have known that the taxpayer or any other person submitted to them incomplete or inaccurate facts in this respect;[65]
- the tax advisers may not postulate the assumption that the taxpayer is seeking to achieve a commercial purpose through the implementation of a transaction if they knew or should have known that the taxpayer could not anticipate a profit notwithstanding the tax benefits.[66]

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[63] 26 U.S.C. §6664 and 26 C.F.R. §1.6664(f). Otherwise, taxpayers might not be able to establish that they have displayed due diligence by simply relying on a tax opinion in which, for all useful purposes, their adviser could not have analysed all financial or commercial aspects of the transaction. For an illustration of the degree of diligence that taxpayers should display when they communicate information to their advisers in order to be able to avoid a penalty for under-stating tax payable, see *InterTan, Inc.* v. *Commissioner of Internal Revenue Service*, T.C. Memo 2004-1 (January 5, 2004), a ruling upheld on appeal by *InterTan, Inc.* v. *Commissioner of Internal Revenue* (December 8, 2004), Decision No. 04-60225 (5th Cir. 2004). For a brief discussion of the scope of application of this ruling, see Burgess Raby and William Raby, "How Taxpayers Can Void Their Penalty Protection," 2004 TNT 14-7 (January 22, 2004).

[64] U.S., Treasury Inspector General for Tax Administration, *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* (March 2006) 2006-10-066) [TIGTA, *Office of Professional Responsibility*].

[65] 31 C.F.R. § 10.35(c)(1)(ii) et (iii). In this respect, the taxpayer's statements about the purposes pursued in a transaction should be described specifically and be included under a separate heading in the opinion.

[66] 31 C.F.R. § 10.35(c)(i)(1)(ii). In this respect, the tax advisers may rely on a financial projection or an evaluation of an asset conducted by another adviser, except if they knew or should have known that the projection or the evaluation was incomplete or erroneous or if the individual who conducted them did not possess the requisite expertise.

In the end, advisers must exercise this degree of diligence as soon as a taxpayer claims a tax benefit in an aggressive tax planning scheme. Pursuant to the covered opinions standards, the adviser must determine the likelihood of the tax administration's and the taxpayer's success before the courts in respect of any "significant issue."[67] Briefly, a significant issue consists in income or a deduction in the calculation of income, a capital gain or loss, a tax credit or the value of an asset in respect of which the tax administration has a reasonable position that could be upheld by the courts and in respect of which the tax treatment could significantly affect the tax treatment of the planning scheme overall.[68]

The covered opinions rules do not define to what extent the tax administration's position is reasonable. It nonetheless appears that its position might be considered reasonable if there is more than a roughly 20% chance that the courts will confirm it.[69] From the standpoint of the tax administration, a low probability threshold allows it to raise the degree of diligence of taxpayers and advisers who are planning to carry out an aggressive tax planning scheme.[70] In this way, a taxpayer will be aware of the risk of the tax administration's withdrawing the tax benefits, even if his adviser perceives this risk to be relatively limited.

4.2.2 A conclusion according to the balance of probabilities allows the taxpayer to better grasp the risk of the courts' rescinding the tax benefits and maintaining a penalty

Pursuant to the covered opinions standards, taxpayers may obtain an accurate picture of the likelihood of their being able to claim tax benefits through a planning scheme in a manner that complies with the tax law and the jurisprudence.

According to these standards, the advisers must formulate a conclusion on the likelihood that the taxpayer may claim the tax benefits stemming from a transaction according to the tax law and the jurisprudence. If the advisers are unable to formulate a conclusion favourable to the

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67 31 C.F.R. §10.35(b)(3), (c). From the tax administration's standpoint, the adoption of a low probability threshold allows it to raise the degree of diligence of taxpayers and advisers who are seeking to implement an aggressive tax planning scheme: see David T. Moldenhauer, *Circular 230 Opinion Standards, Legal Ethics and First Amendment Limitations on the Regulation of Professional Speech by Lawyers* (The Berkeley Electronic Press, ExpressO Preprint Series, Paper 963: 2006) [Moldenhauer, *Circular 230 and Legal Ethics*], pages 23-25.

68 31 C.F.R. §10.35(b)(3), (c).

69 See Robert A. Rizzi, "Circular 230 and Current Opinion Practice: Two Years Later," (2007) 34:1 Corp. Tax'n 3 [Rizzi, "Current Opinion Practice"], page 7.

70 See Moldenhauer, *Circular 230 and Legal Ethics*, *supra* note 67, pages 23-25.

taxpayer according to the balance of probabilities, they must expressly conclude that the taxpayer may not rely on their written opinion to avoid a penalty for under-stating tax payable. The balance of probabilities threshold corresponds to the threshold to which taxpayers are subject to avoid a penalty in the case of a transaction a significant purpose of which is avoidance. This threshold also corresponds to that adopted by the courts to determine whether the taxpayer may claim the tax benefits in a manner that complies with the tax law and the jurisprudence.[71]

Consequently, an opinion that includes a clearly supported conclusion that is formulated according to the balance of probabilities allows taxpayers to better determine the degree of risk inherent in an aggressive tax planning scheme. The obligation for the advisers to formulate a conclusion with such a degree of diligence minimizes the risk of the advisers' recommending to the taxpayers that they play the "audit lottery." In this respect, the standards expressly prescribe that an adviser may not formulate an opinion by taking into consideration the likelihood that the taxpayer will not be subject to an audit, that the auditors will not examine the tax treatment claimed or that the taxpayer will be able to settle any dispute with the tax administration. Despite these latter requirements, the Chair is of the opinion that an aggressive taxpayer will always be able to engage in a planning scheme by speculating on the chances that the tax administration will not detect a risky scheme during an audit.

4.2.3 Diligent verification by advisers of the application of the economic substance doctrine allows the taxpayer to fully grasp the risks inherent in an aggressive tax planning scheme

A taxpayer who relies on a covered opinion in order to engage in an aggressive tax planning scheme nonetheless runs the risk of being subject to a penalty for under-stating tax payable.[72] The court that rescinds the tax benefits in pursuance of the tax rules or the economic substance doctrine will evaluate the taxpayer's good faith according to his level of expertise in tax matters

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[71] Moreover, investors might be unable to obtain the most accurate picture of a company's financial statements over the long term because of the disparity over the scope of this criterion for the purposes of the application of the penalty and the purposes of securities regulations: see Philip D. Morrisson, "The Multiple Meanings of 'More Likely Than Not,'" (2006) 35:10 Tax Management International Journal 524.

[72] The US tax administration announced its intention to modify the rules governing the application of the penalty for under-stating tax payable in order to expressly stipulate that taxpayers may not in any way whatsoever rely on an opinion rendered by advisers pursuant to the specific standards which contains a conclusion that is unfavourable to the taxpayers. To our knowledge, the tax administration has still not made these changes. This clarification has nonetheless been made in the specific standards: see subsection 3.10.

and the soundness of the opinion formulated by his tax advisers.[73] The courts might give preponderant weight to an opinion rendered in accordance with the applicable ethical standards and, consequently, cancel a penalty for under-stating tax payable applied by the tax administration.[74]

Taxpayers will only obtain an accurate picture of the risks inherent in an aggressive tax planning scheme if the advisers put forward an unequivocal opinion concerning all of the relevant facts and if they ascertain the likelihood that the tax rules, the economic substance doctrine and the penalty for under-stating tax payable may apply. The taxpayer can obtain this accurate picture if the advisers apply the standards for covered opinions. Pursuant to these standards, the advisers may not unreasonably postulate factual assumptions concerning the true purpose of the taxpayer or his anticipation of a profit in respect of the transactions in which the tax purpose is either one of the significant purposes of the taxpayer, its main purpose or even its sole purpose.

In our opinion, the *Long Term Capital Holdings* case[75] illustrates the degree of diligence to which the advisers might be subject under the covered opinions standards. In this case, the district court and the court of appeals maintained the application of the economic substance doctrine and the penalty for under-stating tax payable in respect of the taxpayer. According to the courts, the tax opinion on which the taxpayer relied was formulated in light of assumptions that the taxpayer submitted about the economic substance of the planning scheme. The

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[73] 31 C.F.R. §10.35(f). See Walsh, “Circular 230 and Written Advice,” *supra* note 24, pages 199-200.

[74] See *Klamath Strategic Investment Fund LLC* v. *United States*, 472 F. Supp.2d 885 (E.D. Tex. 2007); (January 31, 2007), Civil Action No. 5:04-CV-278 (E.D. Tex.) [*Klamath*]. However, as discussed in subsection 4.3.2, the tax administration and the tax advisers may express differing opinions on the degree of diligence that the tax advisers must display, especially as regards the genuineness of the purposes that the taxpayer claims to achieve in an aggressive tax planning scheme.

[75] See *Long Term Capital Holdings* v. *United States*, 330 F. Supp. 2d.122, 2004 U.S. Dist. LEXIS 17159 (D. Conn. 2004) [*Long Term Capital Holdings* (D. Conn.)], a decision upheld on appeal by 150 Fed. Appx. 40, U.S. App. LEXIS 20988 (2nd Cir. 2005) [*Long Term Capital Holdings* (2nd Cir.)]. For a comment on the degree of diligence of the tax advisers in this case, see Alvin C. Warren Jr., “Understanding *Long Term Capital,*” 2005 TNT 25-48 (February 7, 2005).

advisers could have concluded that certain of those assumptions were unreasonable by diligently verifying the facts:

> The substance of the King & Spalding opinion does not provide a basis for concluding that the advice rendered to Long Term was based on all pertinent facts and circumstances or does not unreasonably rely on unreasonable factual assumptions. While the opinion states that it relies on assumptions and representations expressly made by Long Term, including that Long Term entered the OTC transaction for business purposes other than tax avoidance and reasonably expected to derive a material pretax profit from it and that there was no preexisting agreement on the part of OTC to sell its partnership interest to LTCM, it makes no effort to demonstrate, factually or analytically, why it was reasonable to rely on those assumptions and representations. Moreover, there is no evidence, such as internal King & Spalding memoranda, revealing King & Spalding' analysis of the claimed non-existence of an agreement on the part of OTC to exercise its put option or any breakout of Long Term's claimed expectation of profit or business purpose. As seen in the Court's discussion above, particularly the existence of evidence clearly contrary to certain representations regarding the settlement payment to Turlington, see supra Part III.B.4.c., a reasonably diligent analysis of all facts and circumstances would have revealed at least some of those assumptions to be unreasonable and unsupportable.[76]
>
> [our extracts]

4.2.4 Taxpayers may make a more informed decision if they are aware of the factors that undermine the tax adviser's impartiality

Advisers must bring to the attention of the taxpayer certain facts that might lead the latter to question the confidence level that he should give to their tax opinion. An opinion that mentions the factors that undermine the advisers' impartiality in accordance with the covered opinions standards allows taxpayers to better determine the degree of risk of being subject to a penalty for under-stating tax payable. In fact, to avoid such a penalty, a taxpayer should not generally rely on the tax opinion of the promoter of an aggressive tax planning scheme or on an adviser who is subject to a conflict of interest. Similarly, taxpayers might find it impossible to establish their good faith if they rely on a tax opinion put forward by advisers whose fees depend on the value of the tax benefits claimed or that is issued in confidence.[77]

76 *Long Term Capital Holdings* (D. Conn.), *ibid*.

77 Instalment 6 of Part II of this project examines in greater detail the penalty for under-stating tax payable.

4.3 Heightened diligence by advisers in respect of the economic substance doctrine fosters compliance by taxpayers with the tax system

Advisers must weigh the likelihood that the taxpayer's and the tax administration's position be upheld by the courts according to the application of:

- the tax rules;
- the economic substance doctrine;
- the penalty for under-stating tax payable.

Opinions may differ among groups of stakeholders about a transaction's level of compliance with the law when the transaction appears to conform to the tax rules but not to the economic substance doctrine.

- Advisers and taxpayers will give preponderant weight to compliance with the tax rules pursuant to a technical interpretation to the detriment of the economic substance doctrine;
- The tax administration will give preponderant weight to the purposes of the tax law and the economic substance doctrine to the detriment of a literal interpretation of the law.

The courts may confirm the taxpayer's interpretation and application of the tax rules but rescind the tax benefits by applying the economic substance doctrine. In such a case, the courts must cancel or uphold the application by the tax administration of a penalty for under-stating tax payable, according to the weight attributed to a technical interpretation of the tax rules and to the economic substance doctrine.

4.3.1 Advisers could put forward an opinion favourable to taxpayers if the tax rules do not clearly and coherently reflect the purposes of the tax law

The covered opinions standards require that advisers possess knowledge of all of the relevant tax rules in a transaction covered by the opinion that they must formulate. In light of the tax rules, the jurisprudence and documents from the tax administration pertaining to the interpretation and application of the law, advisers must assess the likelihood that the tax administration's and the taxpayers' can be upheld by the courts in the event of a dispute:

- Taxpayers will give preponderant weight to the transaction's compliance according to the terms of the tax rules;
- The tax administration will give preponderant weight to the purposes of the tax law in light of an interpretation of the tax rules taken as a whole and the objects stipulated in documents extrinsic to the law when the rules were adopted.

In recent years, courts' decisions have highlighted the disparities between the terminology in the tax rules and the purposes of the tax law, as illustrated by the rulings in the *Black & Decker*[78]*,* *Coltec*[79] and *Klamath* cases.[80] Such disparities are attributable, on the one hand, to the ambiguity and inconsistency of the tax rules and, on the other hand, to inconsistencies between their scope and the situations that the tax administration initially targeted when adopting them. In those rulings, the courts have emphasized an interpretation of the tax rules that allowed taxpayers to claim tax benefits stemming from a transaction that did not in all respects conform to the description of the type of transaction that was targeted in documents extrinsic to the law – however, those transactions were subject to the application of the economic substance doctrine.

In a context that would be similar to that found in the cases mentioned earlier, it strikes us that the advisers might conclude that the likelihood that the tax administration's position be upheld by the courts falls below the balance of probabilities if the tax administration relies essentially on the purposes of the tax rules spelled out in the extrinsic documents.[81] Accordingly, advisers might then conclude on the balance of probabilities that a taxpayer may claim tax benefits by applying the tax rules taken literally even if the nature of the planning scheme is not similar to a situation mentioned in explanatory notes.

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[78] *Black & Decker Corp.* v. *United States*, 436 F. 3d 431 (4th Cir. 2006).

[79] *Coltec Industries, Inc.* v. *United States*, 454 F. 3d 1340 (Fed. Cir. 2006), cert. denied by the US Supreme Court 127 S. Ct. 1261 (2007).

[80] *Supra* note 74.

[81] The conclusions handed down by the courts in the *Coltec* and *Black & Decker* cases concerning disparities between the tax rules and the purposes pursued by the tax law are similar to those handed down by the Supreme Court of Canada in *Canada Trustco Mortgage Co.* v. *Canada,* [2005] 2 R.C.S. 601, in pursuance of the general anti-avoidance rule. We refer the reader to Instalment 6 focusing on the economic substance doctrine.

4.3.2 Advisers must pay close attention to the taxpayers' purposes and verify the planning scheme's compliance with the economic substance doctrine

The likelihood that the tax administration wins in courts is greater under the economic substance doctrine in light of recent favourable decisions. In this respect, advisers that issue a covered opinion must display greater diligence in respect of the application of this doctrine.

Briefly, pursuant to this doctrine, a taxpayer who claims tax benefits stemming from a transaction must establish that he wished to achieve a legitimate non-tax purpose and that his economic position has changed or is likely to change. By virtue of the standards for covered opinions, tax advisers may not unreasonably postulate factual assumptions on the true purpose pursued by the taxpayer. In particular, they must verify the genuineness of the business purpose stated by the taxpayer if they know or should have known that the taxpayer or any other individual submitted to them incomplete or inaccurate facts.[82] They may not postulate the assumption that the taxpayer is seeking to achieve a business purpose if they know or should have known that the taxpayer cannot reasonably expect a profit in the planning scheme notwithstanding the tax benefits.[83]

However, advisers must come to terms with an economic substance doctrine whose criteria are numerous and vague in the jurisprudence. The courts have applied this doctrine under three different approaches. They have also applied a range of criteria to describe and measure the weight of different purposes found in a planning scheme and to ascertain the degree of change in the taxpayer's economic position. What is more, the courts have described both objectively and subjectively the taxpayers' purposes in a transaction.[84]

Advisers must, therefore, determine the likelihood that the taxpayers will win their cases by postulating, on the one hand, the application by the courts of the economic substance doctrine

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[82] 31 C.F.R. §10.35(c)(i)(1)(ii) and (iii). In this respect, the taxpayer's statements concerning the purposes pursued in a transaction should be described specifically under a separate heading.

[83] 31 C.F.R. §10.35(c)(i)(1)(ii). In this respect, the tax advisers may rely on a fiscal projection or an evaluation of an asset conducted by an individual, except if the advisers knew or should have known that the projection or the evaluation was incomplete or erroneous, or if the individual who conducted them did not possess the requisite expertise.

[84] Instalment 6 contextualizes the economic substance doctrine, its criteria and questions related to it as regards different groups of stakeholders.

under either one of the approaches mentioned earlier and, on the other hand, the application of each of the criteria that the courts or the tax administration have adopted in the past in applying this doctrine. In such context, the degree of diligence required by the covered opinions standards is challenging for tax advisers. They must act carefully and diligently and possess the appropriate expertise on the tax rules applicable to a planning scheme.

Moreover, under those standards, an adviser must issue an opinion on the application of the economic substance doctrine in light of the facts provided both by the taxpayer and his other advisers about, in particular, the purposes of the taxpayer and his anticipation of a profit. According to these standards, tax advisers may rely on a fiscal projection or an evaluation of an asset conducted by another party unless they know or should have known that the projection or evaluation is incomplete or erroneous, or that the individual who conducted them does not possess the requisite expertise.

Such a requirement implies that the adviser must diligently check the competence of another adviser or even conduct a second assessment of the other adviser's opinion. We think that, under a self-assessment regime, it is incumbent upon the taxpayer to seek the appropriate expertise to evaluate the anticipation of a profit or to confirm the legitimacy of the purposes pursued by the transaction. The tax administration should only apply this requirement in respect of advisers possessing expertise to ascertain the taxpayer's anticipation of a profit. Thus, an adviser who reaches a conclusion by relying on the opinion of an adviser accredited by the tax administration in the realm of financial and economic evaluation should not be subject to penalties if the latter opinion proves to be erroneous.

The *Klamath* case[85] illustrates the degree of diligence that tax advisers should display in respect of the information submitted to them concerning a planning scheme that the taxpayer wishes to carry out. This ruling does not focus directly on the application of the ethical standards but we believe that it clearly illustrates the scope of the taxpayers' and tax advisers' duties of care.

In that case, the court concluded that the taxpayers could claim the tax benefits stemming from an aggressive tax planning scheme in compliance with the tax rules. However, the court

[85] *Supra* note 74.

rescinded the tax benefits claimed by applying the economic substance doctrine, although it did not maintain the application of the penalty for under-stating tax payable. The court was of the opinion that the taxpayers could claim in good faith the tax benefits from the standpoint of the law, according to the balance of probabilities.[86]

The court reached that conclusion in light, among other things, of its technical interpretation of the tax rules and the expert report submitted by the taxpayers on the level of analysis of their tax advisers. In particular, the court concurred with the conclusions in the expert report whereby the advisers had issued a tax opinion that conformed to the ethical standards then applicable in tax matters. The tax advisers had concluded, according to the balance of probabilities, that the taxpayers could claim the tax benefits according to the tax rules and the jurisprudence that were applicable when the opinion issued. According to the expert report, the advisers could reasonably rely on the financial advisers' representations of the planning scheme carried out without conducting a second assessment. However, the planning scheme was not carried out in accordance with those presentations since their financial advisers had agreed to carry out the transaction otherwise.[87]

4.3.3 The courts tend to give preponderant weight to the economic substance doctrine in relation to a technical interpretation of the tax rules

In recent years, the courts have confirmed the tax administration's application of the economic substance doctrine to withdraw tax benefits claimed by taxpayers. More specifically, the courts in the *Long-Term Capital Holdings,*[88] *Santa Monica Pictures,*[89] *Dow Chemical,*[90] *Black & Decker,*[91] *Coltec,*[92] *Castle Harbour*[93] and *Klamath* cases[94] ruled that the taxpayers could claim

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86 See *Klamath*, *supra* note 74, pages 24-27.

87 For a criticism of the ruling handed down in the *Klamath* case, see Lee A. Sheppard, "What Does IRS BLIPS Victory Mean," 2007 TNT 30-5 (February 12, 2007).

88 *Supra* note 75.

89 *Santa Monica Pictures, LLC et al.* v. *Commissioner*, T.C. Memo 2005-104, ruling appealed by the taxpayer before the United States Court of Appeals for the Second Circuit, No. 05-4491-ag (2nd Cir., August 16, 2005).

90 *Dow Chem. Co.* v. *United States*, 435 F. 3d 594 (6th Cir. 2006), cert. denied by the United States Supreme Court on February 20, 2007, 127 S. Ct. 1251 (2007).

91 *Supra* note 78.

92 *Supra* note 79.

93 *TIFD III-E, Inc.* v. *United States*, 459 F.3d 220 (2nd Cir. 2006), reversing the ruling of the court of first instance in favour of the taxpayer in *TIFD III-E, Inc.* v. *United States*, 342 F. Supp. 2d 94 (D. Conn. 2004). These rulings are

the tax benefits according to a technical interpretation of the tax rules but that these benefits must be rescinded under the economic substance doctrine.

In light of those rulings, the likelihood that the courts uphold the tax administration's position on economic substance doctrine seems to outweigh the balance of probabilities. The probabilities nonetheless depend on the facts underlying each planning scheme.

4.4 Advisers who put forward a limited scope opinion run the risk of being penalized by the tax administration because the dividing line between a significant purpose and a main purpose seems vague

The absence of defined, precise criteria to measure the relative weight of the purposes of an aggressive tax planning scheme engender significant consequences for tax advisers as regards the degree of diligence that they must exercise when they put forward a tax opinion. The advisers must give an opinion on the economic substance doctrine and the penalty for under-stating tax payable. Both the doctrine and the penalty centre on the weight of a tax goal in a transaction. Uncertainty persists about how to pinpoint a tax goal in a transaction and ascertain its relative weight for the purposes of this doctrine. Uncertainty surrounding the application details of this doctrine engenders other uncertainty concerning the application of the penalty for under-stating tax payable and the covered opinions standards. Neither those standards, the tax law nor the jurisprudence define precise, uniform criteria to describe a tax purpose in a transaction and to measure its weight. Consequently, the advisers could possibly be subject to a disciplinary penalty pursuant to the ethical standards depending on the criteria that the tax administration decides to apply to measure the weight of the different goals in a planning scheme.

commonly known under the name of the limited liability company of which the taxpayer was a member (Castle Harbour Limited Liability Company).

94 *Supra* note 80.

4.4.1 Relaxation of the covered opinions standards solely in respect of transactions a significant purpose of which falls within the province of avoidance

The tax administration is of the opinion that the three categories of transactions subject to the covered opinions standards present risks of avoidance depending on the weight of the tax purpose in the transaction:

- in category 1, the transactions declared to be aggressive pursuant to the disclosure rules apparently seek, generally speaking, to allow taxpayers solely to carry out a tax goal;[95]
- transactions whose main purpose falls within the province of avoidance are included in category 2;
- transactions a significant purpose of which is avoidance are included in category 3.

In principle, the advisers may neither formulate hypotheses in respect of the goals pursued by the taxpayer nor the reasonable nature of his anticipation of a profit. In this particular instance, these standards afford the advisers the possibility of formulating hypotheses in respect of these facts in the case of transactions a significant purpose of which is avoidance. They may either put forward an opinion focusing on a limited number of significant tax elements or avoid formulating any opinion on the nature and the weight of the different goals pursued by their client in a transaction, or put forward an opinion mentioning that the taxpayer may not use the opinion to avoid a penalty for under-stating tax payable.

The Chair is of the opinion that such a possibility appears to strike a reasonable balance between the simplicity of the taxation system and the duties of tax advisers. In order to avoid a penalty for under-stating tax payable in respect of such a transaction, a taxpayer must establish that he could reasonably believe according to the balance of probabilities that the transaction complied with the tax law and the jurisprudence, even though the courts ultimately rescind the tax benefits stemming from the transaction.

However, the tax administration neither accords this possibility to advisers in respect of transactions whose main purpose falls within the province of avoidance nor in respect of

[95] Essentially, the sole purpose of these transactions, which are devoid of economic substance, appears to be the deduction of tax losses or other amounts: See Walsh, "Circular 230 and Written Advice," *supra* note 24, pages 200-201.

transactions declared to be aggressive for the purposes of the disclosure rules. In such transactions, the advisers must satisfy each of the conditions stipulated by the covered opinions standards. They must put forward an opinion with the requisite degree of diligence in respect of all of the facts submitted by the client and the application to these facts of the law and the jurisprudence.[96]

Neither the tax rules, nor the ethical standards nor even the courts succeed in clearly distinguishing a significant purpose from a main purpose in a transaction. This vague distinction considerably mitigates the flexibility that the covered opinions standards seek to confer on tax advisers.

4.4.2 The criterion of the goal pursued by the tax law seeks to establish a distinction between a main purpose and a significant purpose, but this distinction is vague

Tax advisers are concerned by the possibility that the tax administration might apply a penalty because the advisers have failed to fulfil their duties prescribed for covered opinions when the distinction between a main purpose and a significant purpose in a planning scheme is vague.[97]

For the purposes of the ethical standards, a main purpose means a purpose that dominates any other in a planning scheme. However, these standards do not define the scope of the expression “significant purpose.” At best, they stipulate that a transaction may include a significant tax purpose without such a purpose being the main purpose. In principle, the weight of a significant purpose in a transaction is less important than the weight of the main purpose. In the absence of precise criteria, this distinction is vague to say the least.

However, the tax administration delineates the scope of the expression “main purpose” for the purposes of the covered opinions standards. It expressly takes into consideration the goals of the tax law to determine whether the main purpose in a transaction can be seen as avoidance. Thus, a main purpose of a tax nature in a transaction is not considered to be avoidance if the

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96 See Arthur L. Bailey and Alexis A. MacIvor, “Circular 230: Is the Hysteria Over?” (2006) 58:1 The Tax Executive 55.

97 See Roang, “Circular 230,” *supra* note 9, pages 946-947; Walsh, “Circular 230 and Written Advice,” *supra* note 24, pages 201-202.

taxpayer claims tax benefit in accordance with the goals pursued by the tax law.[98] However, these standards neither prescribe such a criterion in respect of transactions declared to be aggressive pursuant to the disclosure rules (listed transactions) nor as regards transactions a significant purpose of which is avoidance.[99]

The effectiveness of the criterion of abuse of the purposes of the tax law is closely linked to the manner in which those purposes are expressed in the tax rules. As the US jurisprudence illustrates, in particular the *Coltec*[100] and *Black & Decker* cases,[101] the purposes of the law are not always clearly and coherently expressed either in the tax rules or documents extrinsic to the law. In such a context, the application of the criterion of the abuse of the purposes of the law does not always establish a clear distinction between a main purpose and a significant purpose in a planning scheme. In our opinion, to determine the weight of tax purpose in a transaction, the taxpayer's planning scheme must be compared with a transaction that would have allowed him to achieve his true purposes in accordance with the business standards applicable under the circumstances.

4.4.3 Opinions differ among groups of stakeholders on how to describe and measure the relative weight of the purposes of a planning scheme because of disparities in the application by the courts of the economic substance doctrine

The courts have voiced differing opinions on how to pinpoint the purposes of a transaction from the standpoint of the application of the economic substance doctrine. They have analysed both objectively and subjectively the purposes of a transaction. They have also developed numerous criteria to measure the weight of the different purposes of a transaction and to ascertain the extent to which the taxpayer's economic position changes. The courts have not uniformly delineated the requisite weight of a tax purpose in a transaction that triggers the application of this doctrine.

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98 31 C.F.R. § 10.35(b)(10).

99 The application rules governing the disclosure rules nonetheless provide general indicators to determine whether one of the significant purposes in a transaction is tax avoidance. Pursuant to 31 C.F.R. § 301.6111-2(b)(3), a transaction will have no significant purposes of a tax nature if it is carried out in accordance with current business practices and obtaining tax benefits may be deemed to comply with the tax law. See John C. Gardener *et al*., "Amendments to Circular 230 (Part I)," (2006) 37:1 The Tax Adviser 24, 27-31.

100 *Supra* note 79.

101 *Supra* note 78.

Because of uncertainty surrounding the application details of the economic substance doctrine and other doctrines, opinions will differ among groups of stakeholders on the weight of a tax goal in an aggressive tax planning scheme. Such uncertainty will likely engender disputes over the facts that the advisers knew or should have known in relation to the economic substance of a given transaction for the purposes of applying the covered opinions standards.

In light of the *Long Term Capital Holdings* case,[102] the advisers should rigorously analyse all of the jurisprudence dealing with the economic substance doctrine or any other anti-avoidance doctrine, including decisions that might be unfavourable to the taxpayer. They must also weight their conclusion in light of the application of the jurisprudence to the circumstances surrounding the planning scheme. The following extracts from the ruling of the court of first instance in this case illustrate the degree of diligence to which the tax advisers might be subject under the covered opinions standards:

> *Since the Court has found that the OTC transaction is devoid of objective economic substance and subjective business purpose, Long Term has not and cannot cite authority, much less substantial authority, for the proposition that a taxpayer may claim losses from a transaction in which the taxpayer intentionally expends far more than could reasonably be expected to be recouped through non-tax economic returns in a transaction the sole motivation for which is tax avoidance*. The cases relied on by Long Term, principally Frank Lyon, Newman, and UPS are not authority supporting the OTC transaction as having genuine economic substance but are "materially distinguishable," Treas. Reg. § 1.6662-4(d)(3)(ii), from it. By contrast, the clear and pre-existing on-point authority of Goldstein and Gilman preclude Long Term's tax treatment of the sale of the Rorer and Quest stock. Similarly, with respect to the Court's application of the step transaction doctrine, there is no authority for claiming losses on the sale of the Rorer and Quest stock approximately 100 times in excess of the cost basis to Long Term. The "authority" offered on this point by Long Term was based on the rejected factual claim that no agreement or understanding existed between OTC and Long Term prior to OTC's contributions that OTC would sell its partnership interest to LTCM, the rejected legal contentions that the independent economic substance of LTCP and Portfolio and their valid and substantial business purposes precluded operation of the step transaction doctrine under Vest, Weikel, and Dewitt, and that Grove and Greene precluded the Court's recast of the OTC transaction.
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> …
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> *The King & Spalding written opinion also fails to demonstrate that its advice was based on the law related to the OTC transaction and not based on unreasonable legal assumptions.* There is no citation to Second Circuit authority in the opinion, notwithstanding Long Term's continual residence in the Second Circuit and the obvious, central applicability of Goldstein, Gilman, Grove, Blake, and Greene. Furthermore, *there is little, if any, of what could be characterized as legal analysis of the economic substance of the OTC transaction. What little there is essentially quotes a sentence from Frank Lyon, observes that the subjective*

102 *Supra* note 75.

> *business purpose/objective economic substance test emerged from that decision, and concludes that the OTC transaction passes muster because Long Term "instructed [King & Spalding] to assume" that both OTC and Long Term had business purpose for and a reasonable expectation of material pre-tax profit from the transaction. See Pet.'s Ex. 357 at 45-46. As set forth above, however, the Supreme Court's decision in Frank Lyon is highly fact sensitive and cannot simply be applied to just any set of facts.*
>
> …
>
> *The King & Spalding written opinion further contains minimal legal analysis of the application of the end result test for purposes of step transaction analysis*. […] After some discussion of authorities, the opinion concludes that "where the new corporation was found to have independent economic significance or a valid business purpose, the form of the transactions has been respected […] As discussed above, even if this assumption were factually correct, application of the end result test would not be legally precluded […] This assumption that the end result test would not be properly applied is a paradigmatic example of an unreasonable legal assumption within the meaning of Treas. Reg. § 1.6664-4(c)(1)(ii). […]
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> …
>
> *Finally, no other evidence such as companion memoranda discussing the application of the Second Circuit's decisions in Goldstein, Gilman, Grove, Blake, and Grove, or the Tenth Circuit's decision in Associated to the actual facts of the OTC transaction was offered to show research for King & Spalding's legal analysis and opinions. Such background research does not involve obscure or inaccessible caselaw references, is basic to a sound legal product*, especially for "should" level opinion and a premium of $400,000. With hourly billing totals exceeding $100,000 there could not have been research time constraints.
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> *In essence, the testimony and evidence offered by Long Term regarding the advice received from King & Spalding amounted to general superficial pronouncements asking the Court to "trust us; we looked into all pertinent facts; we were involved; we researched all applicable authorities; we made no unreasonable assumptions; Long Term gave us all information." The Court's role as factfinder is more searching and with specifics, analysis, and explanations in such short supply, the King & Spalding effort is insufficient to carry Long Term's burden to demonstrate that the legal advice satisfies the threshold requirements of reasonable good faith reliance on advice of counsel*.
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> [our extracts and italics]

4.4.4 The advisers should have the possibility of putting forward limited scope opinions regardless of the weight accorded the tax goal of a planning scheme

Given the ambiguity of the covered opinions standards, various professional organizations proposed that they be simplified. The key proposals included:

- the application of those standards solely to transactions a significant purpose of which is avoidance. This proposal has the advantage of harmonizing ethical standards with the penalty for under-stating tax payable;[103]

[103] See the analysis of, and recommendations for, Circular 230 of the American College of Trust and Estate Counsel in *Comments on Circular 230 Regulations* and the April 6, 2005 press release to the American tax administration

- the relaxation of the standards so that advisers may formulate limited scope opinions or stipulate that the client may not rely on the opinion to avoid a penalty for under-stating tax payable, regardless of the weight of the tax goal in a transaction;[104]

- exclusion from the field of application of those standards in respect of opinions dealing with transactions that comply with the goals pursued by the tax law, regardless of the weight of the tax goal in the transaction.[105]

The Chair believes that the second proposal strikes a reasonable balance between the respective duties of taxpayers and advisers in complying with the taxation system, especially when the advisers are asked solely for specific expertise. In our opinion, the advisers must be able to formulate an opinion within the limits of their field of expertise and, ultimately, to determine their level of responsibility to their client should the latter be denied the tax benefits and have to pay a penalty for under-stating tax payable.

By way of illustration, professional organizations are suggesting that the covered opinions standards be relaxed to allow advisers to put forward an opinion without fully analysing the facts, the tax law and the jurisprudence from the standpoint of transactions declared to be aggressive by the tax administration for the purposes of the disclosure rules.[106] Given the complexity of these transactions, the advisers might find it impossible to verify all of these facts according to the degree of diligence required for covered opinions. In the opinion of the advisers, they should be able to put forward in respect of such transactions a limited scope opinion or an opinion that stipulates that the taxpayer may not use it to avoid a penalty for under-stating tax payable. The tax administration might otherwise levy on the advisers a penalty for failing to comply to the letter of the covered opinions standards.[107]

[ACTEC, *Comments on Circular 230 (2005)*], page 15. This organization suggests that only the “significant purpose” criterion be maintained.

104 See New York State Bar Association, *Report on Circular 230 Regulations*, Report No. 1081 (March 3, 2005) [NYSBA, *Report 1081 on Circular 230*], pages 24-28.

105 See ACTEC, *Comments on Circular 230 (2005*), *supra* note 103, page 21.

106 At present, the advisers may only formulate a favourable or unfavourable opinion to their clients after analysing their purposes and the likelihood of the clients’ anticipating a profit from a transaction in pursuance of the economic substance doctrine.

107 See Walsh, “Circular 230 and Written Advice,” *supra* note 24, pages 200-201; NYSBA, *Report 1081 on Circular 230*, *supra* note 104, pages 29-30.

Similarly, professional organizations are concerned by the risk of the advisers' being penalized when they are only providing an informal opinion on the application of the law (advice similar to a technical interpretation) instead of an opinion dealing with a transaction to be implemented by the taxpayer.[108] In the course of practising their profession, advisers are often asked by their clients to provide an interpretation of the law in respect of the hypothetical facts that the clients submit. Like these organizations, we are of the opinion that the advisers must be able to formulate informal technical interpretations without running the risk of being subject to an ethical penalty, all the more so as the taxpayer could not truly rely on such interpretations to avoid a penalty for under-stating tax payable.

Since it is the taxpayers who must ultimately decide whether or not they carry out an aggressive tax planning scheme, the advisers must heighten their awareness of the relative scope of the opinions voiced, especially those who do not possess the appropriate fiscal expertise. Given the general scope of the parameters and the penalties that they may sustain, the advisers will usually include an exclusion clause in their written opinions. One example could read as follows:

> *In light of the requirements imposed in Circular 230, please be forewarned that any tax advice in this communication (or any attachments or other communications related thereto) is neither intended nor written to be used, and cannot be used, to (i) avoid penalties under the Internal Revenue Code or (ii) promote, market or recommend to another party any transaction or other matter addressed therein, unless we expressly state otherwise in this communication or any attachments or other communications related thereto*..[109]

4.5 Advisers commit their professional liability towards their clients if they fail to depict an accurate picture of an aggressive tax planning scheme in accordance with standards of care

Tax advisers commit their professional liability towards their clients if the latter are denied the tax benefits claimed and are subject to a penalty for under-stating tax payable, despite their reliance on the advisers' tax opinion. The advisers' professional liability plan may encourage them to heighten their diligence in the realm of aggressive tax planning schemes if the terms of the coverage are harmonized with the criteria of the penalty for under-stating tax payable or the

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[108] In the Canadian context, these opinions might be compared with an advance ruling by the tax administration concerning a transaction to be implemented by the taxpayer.

[109] This clause is an adaptation by the authors of the sample legend excerpted from Jeffrey H. Paravano and Melinda L. Reynolds, "The New Circular 230 Regulations – Best Practices or Scarlet Letters," BNA Tax Management Memorandum (August 22, 2005).

ethical standards. However, disputes will arise concerning the insurable nature of the tax advisers' actions and the amount covered by the insurance policy.[110]

The settlements reached between taxpayers and their tax advisers in the *KPMG LLP and Sidley Austin Brown & Wood LLP*[111] and *Jenkens & Gilchrist* case[112] under class actions illustrate the issues pertaining to the tax advisers' duties to depict to the taxpayer an accurate assessment of the risks inherent in an aggressive tax planning scheme. The courts confirmed these settlements.

Briefly, the taxpayers launched a civil action against their tax advisers to claim financial damages since the planning schemes that the advisers elaborated and that the taxpayers carried out following their recommendation were akin to an abusive scheme. From the taxpayers' standpoint, the key questions included:

- the lack of disclosure by their tax advisers of the ties that the latter maintained with other advisers participating in the planning scheme;
- the advisers' opinion that the transaction complied with the law according to the balance of probabilities.

The courts had to determine whether the tax advisers knew or should have known that the transaction was abusive since it was devoid of economic substance. In the advisers' opinion, the conclusion that the transaction complied with the tax law according to the balance of probabilities was rendered diligently but offered the taxpayers no guarantee and the latter were duly informed and were fully aware of the risks inherent in the planning scheme. The taxpayers

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110 For an observation in this respect, see Rizzi, "Current Opinion Practice," *supra* note 69, page 4. For an illustration of the disputes that may arise concerning the terms and conditions of professional insurance policies in the realm of aggressive tax planning, see the settlement reached between taxpayers and tax advisers approved by the courts in *Denney* v. *Jenkens & Gilchrist*, (February 18, 2005), Opinion & Order 03 Civ. 5460 (SAS) (S. D. of New York) [*Jenkens & Gilchrist*], and *Denney* v. *Jenkens & Gilchrist*, No 03 Civ. 5460 (SAS), Joint Brief In Support of Motion for Preliminary Class Certification and Settlement Approval, April 28, 2004 (S. D. of New York) [*Jenkens & Gilchrist* (Joint Brief)].

111 *Simon* v. *KPMG LLP and Sidley Austin Brown & Wood LLP*, Civ. 05-CV-03189 (D. N. J., June 2, 2006).

112 *Jenkens & Gilchrist*, *supra* note 110. For additional information on the allegations of the taxpayers and the law firm, see *Jenkens & Gilchrist* (Joint Brief), *supra* note 110.

alleged, among other things, that their advisers did not inform them of all of the relevant facts pertaining to the aggressive tax planning scheme.[113]

The courts had to apportion the taxpayers' and the advisers' responsibilities according to the degree of diligence displayed by the advisers in informing the taxpayers of the risks inherent in the planning scheme. In order to approve an agreement, the courts must determine its equitable nature taking into account litigation risks, without having to opine on the advisers' actions. The courts will, in particular, take into consideration the following factors taken as a whole:[114]

- the complexity of a lawsuit, bearing in mind the costs that the participants are likely to incur and its duration;
- the participants' level of satisfaction with the terms of the agreement;
- the extent of the participants' analysis of the documents that are relevant to the lawsuit when the settlement offer was made;
- the difficulty of apportioning each party's responsibility;
- the difficulty of ascertaining the damages sustained by the parties;
- the reasonable nature of the amount agreed upon to compensate the participants, bearing in mind the advisers' financial capacity to pay an amount greater than that agreed upon and the risks inherent in a lawsuit.

In both cases, the courts approved the agreements ratified by a large number of the eligible taxpayers and by the tax advisers because of the complexity of the planning scheme and the tax rules in question, the high cost of pursuing the lawsuit, and the possible insolvency of the advisers' consulting . In the *Jenkens* case, the court opined that the advisers must practise their profession in accordance with the standards of care applicable to their professional field. In this instance, the tax advisers should have complied, among other things, with the ethical standards in tax matters.

The amount of insurance coverage could nonetheless prove to be significantly lower than the financial damages sustained by their clients. In the *Jenkens* case, the taxpayers claimed several hundred million dollars in damages and interest, well beyond the limit of the law firm's insurance coverage. The agreement stood at roughly US$85 million, of which the law firm paid US$5.25

[113] See Sheryl Stratton, "Jenkens Settlement Info Reveals Wealth of Shelter Advisers" 2004 TNT 197-3 (October 12, 2004). The specific standards for covered opinions were not applicable when the tax advisers acted.

[114] See Jenkens & Gilchrist, *supra* note 110. The court lists the reasons on page 26 and then discusses them in greater detail elsewhere in its ruling.

million, the insurer, US$70 million, and the other defendants, the remainder. Pursuant to the court approved agreement, the tax advisers had to establish a financial reserve to deal with recourse from taxpayers who did not approve the agreement. Moreover, the participating taxpayers could launch proceedings against other advisers who were not part of the agreement.

4.6 For the sake of fairness, the tax administration must reasonably, not strictly, apply the covered opinions standards

4.6.1 The tax administration is seeking to dispel the advisers' fears by stating that it intends to apply the covered opinions standards solely to the most blatant non-compliance cases

Professional organizations are concerned about the risk of advisers' being liable to a penalty because of the rigidity and ambiguity of the covered opinions standards.[115]

In response to these concerns, the US tax administration intends to judiciously and fairly apply the ethical standards.[116] The Office of Professional Responsibility will make the most appropriate decision in light of the nature of the alleged misconduct of the adviser and the need to maintain a sound administration of the tax system. According to members of the tax administration, the covered opinions standards will be applied in a reasonable manner. More specifically, it will apply these standards to advisers who blatantly fail to display the requisite degree of diligence. Advisers who display isolated acts of negligence or make mistakes in good faith would not be liable to penalties.[117]

The tax administration intends to seek suspension or disbarment solely in the event of recklessness or gross incompetence. Similarly, it intends to request the levying of a monetary penalty solely in the case of extremely serious misconduct by an adviser.[118] The tax

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115 For an overview of the observations expressed by professional organizations, see Rizzi, "Current Opinion Practice," *supra* note 69.

116 IRS *Strategic Plan*, *supra* note 58, pages 21-25.

117 See Dustin Stamper, "OPR Not Interested in Punishing "Foot Faults", Officials Say," 2007 TNT 201-4 (October 17, 2007); Walsh, "Circular 230 and Written Advice," *supra* note 24, page 209.

118 See the comments concerning the application of a monetary penalty made by the director of the Office of Professional Responsibility in the article by Sheryl Stratton entitled "Monetary Penalty Guidance Due Out Soon," in 2007 TNT 15-7 (January 23, 2007). The tax administration recently published directives concerning the

administration is of the opinion that the application of such penalties solely in these circumstances should dispel the concerns of diligent advisers.

Given the tax administration's concern for protecting the public, we wonder about the possibility that, instead of requesting the application of the most stringent sanctions in such cases, it will request their application as soon as the nature and value of the tax benefits claimed by a taxpayer in a given situation present a risk of revenue loss for the State. Similarly, the tax administration might decide to apply sanctions when the nature of the adviser's activities presents a potential risk for taxpayers, e.g. solicitations, without conducting a full analysis of the circumstances surrounding the issuing of an opinion by the tax advisers. Application by the tax administration of ethical standards regardless of the application of the tax law to the facts and circumstances of each planning scheme would undermine the long-term effectiveness of the ethical standards.

To our knowledge, the Office of Professional Responsibility has obtained the application of penalties pursuant to the general standards but has not yet obtained the application of penalties to advisers or consulting firms pursuant to the covered opinions standards.[119] Past rulings might shed light on the application of the ethical standards by the tax administration. Because of the scope of the penalties and uncertainty surrounding the application of those standards, greater transparency on the part of the OPR in its decisions or administrative policies would allow advisers to comply more extensively with the ethical standards.[120] Pursuant to a change made on September 26, 2007 to the ethical standards, the US tax administration will henceforth publish the final decisions handed down on the application of the ethical standards.[121] To our knowledge, no decision has yet been handed down on the application of the covered opinions standards.

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application of the monetary penalty: Internal Revenue Service, Notice 2007-39, *Disciplinary Actions under Section 822 of the American Jobs Creation Act of 2004* (April 2007).

[119] Kevin E. Thorn, "A Rare Look Inside the IRS's Office of Professional Responsibility" (April-May 2006) *Journal of Tax Practice and Procedure* 37 [Thorn, "Inside OPR"] page 37.

[120] Thorn, "Inside OPR," *supra* note 119, page 41. The author notes that failure by advisers to practice their profession diligently and their participation in tax scams and schemes were among the types of conduct of which they were accused by the tax administration in the past.

[121] 31 C.F.R. § 10.72(d)(1). See the IRS Website: <http://www.irs.gov/taxpros/agents/article/0,,id=177688,00.html>.

As we emphasized in subsection 4.1, the US tax administration may rely on the penalties imposed by professional boards to suspend an adviser under the tax standards. The penalties imposed by those boards can set a precedent if their standards apply to situations similar to aggressive tax planning schemes, although this possibility is uncertain.

The Office of Professional Responsibility is, in all likelihood, focusing its attention on aggressive tax planning schemes. Although the OPR has not produced an accurate breakdown of the cases examined and the resources devoted to them, the tax administration identified 80 aggressive tax planning scheme files that were transmitted to the OPR in 2005 and the latter had identified 36 on-going files as of December 31, 2005.[122] The OPR conducts audits based solely on information provided by the members of the tax administration or professional boards. It should be noted that the tax administration's auditors may notify the OPR that, in their opinion, advisers should be subject to examination pursuant to the ethical standards when their clients have been subject to a penalty for under-stating tax payable.[123] However, the OPR does not maintain adequate communications procedures with other divisions of the tax administration or with professional boards to ensure a sound handling of the files.[124]

Given the ambiguity of the covered opinions standards, the tax administration and tax advisers might reach out-of-court settlements to resolve disputes more flexibly than by means of an administrative procedure. The tax administration recently announced that a settlement was reached with two attorneys who, it alleges, failed to comply with various general ethical standards when they formulated a tax opinion on issuances of municipal bonds. These advisers agreed to adhere to the standards of care of their consulting firm. The advisers approved the settlement without admitting their liability. They also had to authorize the tax administration to publicly announce the approval of the settlement and reveal their identity.[125]

[122] TIGTA, *Office of Professional Responsibility*, *supra* note 64.

[123] See U.S., Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 22, 2002 [JCT, *Tax Shelters (2002)*], page 43.

[124] TIGTA, *Office of Professional Responsibility*, *supra* note 64.

[125] U.S., Internal Revenue Service, Notice 2007-197, "IRS Announces Groundbreaking OPR Settlement with Attorneys" (December 6, 2007). These standards include those pertaining to the production of an income tax return. For a cursory description of these standards, see subsection 3.3. The other standards deal with the degree of diligence that the advisers must generally display in tax matters. However, the tax administration has not provided additional details on the nature of the acts of which the advisers were accused.

Such a settlement allows the advisers to avoid the possibility of being subject to a stringent sanction by an administrative tribunal. From the tax administration's standpoint, the public announcement of such a settlement may encourage broader compliance by advisers to the ethical standards.[126] However, for the sake of fairness, the tax administration must ensure that auditors do not abusively apply the prescribed sanctions, including monetary penalties,[127] which would compel the advisers to accept a settlement that would be unfavourable to them.

4.6.2 An appearance of partiality of the tax administration can undermine the integrity of the ethical standards

Advisers are concerned about the appearance of partiality of the tax administration in applying ethical standards. The tax administration believes that internal procedures allow it to determine as fairly as possible whether an adviser should be sanctioned. The adviser is given an opportunity to submit his viewpoints to the tax administration regarding his complying with these standards. Moreover, several attorneys in the tax administration's Office of Professional Responsibility examine the file before referring it to an administrative tribunal, as the case may be.[128]

The integrity of the ethical standards in tax matters centres on the impartiality of the person responsible for reviewing the decision of the tax administration to sanction an adviser. An administrative tribunal will decide whether a penalty must be applied after it has heard the adviser and the tax administration. Given that this tribunal operates within the tax administration, legislative measures have been adopted to ensure its impartiality.[129] Advisers have nonetheless voiced concerns about the lack of fiscal expertise of the administrative tribunals called upon to settle disputes on the application of the covered opinions standards, and in respect of the tax

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126 See Jeremiah Coder, "OPR Settlement Announcement Could Be First of Many," 2007 TNT 236-4 (December 7, 2007).

127 Dustin Stamper, "OPR Not Interested in Punishing 'Foot Faults,' Officials Say," 2007 TNT 201-4 (October 17, 2007). See also the comments of the tax section of the American Bar Association concerning the monetary penalties under the ethical standards, *Comments in Response to IRS Notice 2007-39, 2007-20 I.R.B. 1243 (April 23, 2007), on the Application of Monetary Penalties in Disciplinary Procedures under Section 822 of the American Jobs Creation Act of 2004* (October 5, 2007), page 4, online on the ABA Website: <http://www.abanet.org/tax/pubpolicy/2007/071005commentsirsnotice200739sec822americanjobscreationact2004.pdf>.

128 See Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, pages 14-15. See also Coder, "OPR Director Allay Practitioner Mistrust," *supra* note 52.

129 For a cursory explanation of the role that the administrative tribunals play in the United States and the measures aimed at ensuring their impartiality within the US government, see <http://www.oalj.dol.gov/EDUCTION.HTM> (Website consulted by the authors on May 25, 2007).

administration's attorneys who are responsible for applying the ethical standards.[130] In their opinion, the procedures governing the hearing of the parties regarding a sanction sought by the tax administration do not guarantee an impartial review of a disciplinary case, unlike the procedures adopted by the professional boards.[131]

4.6.3 The tax administration should apply the covered opinions standards solely to the most aggressive tax planning schemes

Inasmuch as the tax administration believes that the covered opinions standards should be maintained, professional organizations are of the opinion that their scope should be restricted to the transactions that present the highest risk of avoidance without being applied to the opinions formulated by advisers to their clients in the normal course of the clients' business. Some professional organizations share the tax administration's concerns regarding the transactions indicated below.

4.6.3.1 Transactions declared to be aggressive pursuant to the disclosure rules (listed transactions)

With respect to these transactions, the advisers might generally conclude according to the balance of probabilities that a taxpayer may not claim tax benefits stemming from such transactions considering their circumstances, the tax law and the economic substance doctrine.[132]

4.6.3.2 Transactions a significant purpose of which is tax avoidance and that are subject to a standardized tax opinion used for solicitation purposes

Professional organizations share the tax administration's concerns regarding aggressive tax planning schemes that are subject to solicitation by advisers among investors and that rely on a

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130 See Dustin Stamper, "IRS Names OPR Director" 2007 TNT 41-2 (March 1, 2007). This concern among advisers regarding the fiscal expertise of the administrative tribunals arises because the tribunals are usually asked to hear disputes in the realm of labour relations. The tax administration is of the opinion that these tribunals are nonetheless capable of hearing disputes on the application of the ethical standards since such disputes centre, by and large, on an evaluation of the degree of diligence displayed by advisers and not, strictly speaking, on the application of the tax rules, as such: see Jeremiah Coder, "OPR Director Says Future Guidance Will Be More Practical," 2007 TNT 215-6 (November 6, 2007) [Coder, "Guidance More Practical"].

131 See Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13, pages 14-15.

132 See Walsh, "Circular 230 and Written Advice," *supra* note 24, pages 200-201.

standardized opinion.[133] Some organizations have nonetheless expressed concerned over the scope of the expression “solicitation.” They suggest better targeting this expression in order to strike a balance between the duties of tax advisers and the integrity of the tax system regarding activities that present genuine tax avoidance risks.

First, it might be impossible for advisers to reasonably anticipate the use to which other persons might put the opinion that they formulated. Moreover, some advisers are of the opinion that they must adhere to the covered opinions standards even though the opinion that they issue to their client is strictly used by other parties to a transaction or by related persons such as enterprises in the same corporate group and has not been put forward in a public solicitation of investors.[134]

Next, the covered opinions standards on standardized opinions for solicitation purposes would not cover, in the opinion of some professional organizations, opinions elaborated by advisers' firms to solicit their clients, who use the opinions solely for their own purposes. The definition of a standardized opinion for solicitation purposes would not cover these situations although they present the highest tax avoidance risks.[135]

4.6.4 The tax administration must publish in a timely manner guidelines on the application of the ethical standards to enhance their predictability

Tax advisers and the US tax administration will express differing views on the application of the covered opinions standards, mainly because of the standards' ambiguity. For the sake of predictability and fairness, the tax administration must publish guidelines to specify the circumstances under which it will apply those standards. However, as of October 2, 2007, the tax administration was still finalizing an initial series of guidelines regarding the application of the covered opinions standards.[136] Its objective was to elaborate guidelines according to

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133 Pursuant to the specific standards for covered opinions, a standardized opinion is defined as an opinion whose author knew or should have known that it would be used by another person (other than an associate of the adviser or an employee) to solicit potential investors.

134 See NYSBA, *Report 1081 on Circular 230*, *supra* note 104, pages 17-20.

135 *Ibid*.

136 See Jeremiah Coder, “IRS, Treasury Officials Offer Background on Circular 230 Changes” (October 2, 2007), 2007 TNT 191-1. The tax administration was also elaborating guidelines governing the application of the standards in respect of the production of an income tax return.

realistic situations that tax advisers commonly face in order to draw a clearer distinction between reprehensible conduct and honest mistakes.[137]

While the publication of guidelines mitigates the uncertainty surrounding the application of the ethical standards, we believe that the distinction between reprehensible conduct and honest mistakes ultimately rests upon the distinction that the tax law establishes between legitimate transactions and those that are abusive. As we noted in Instalment 6 of Part II of this study, the distinction between those types of transactions is vague and unpredictable. In order for any guidelines to achieve their objective, the tax administration must formulate concrete illustrations of the degree of diligence that the advisers must display in light of the multiplicity of approaches and criteria that the courts have adopted in applying the economic substance doctrine.

4.6.5 A ruling by the tax administration sanctioning an adviser should only be published when it is final

An adviser who has been sanctioned may appeal to the Secretary of Treasury a ruling of the administrative tribunal confirming the sanction imposed by the tax administration. Some advisers have voiced concerns about the possibility of the publication of the ruling before the Secretary of Treasury has reviewed it. Premature publication of the tribunal's ruling may unduly undermine the adviser's concern. In this respect, the tax administration has changed the ethical standards such that no ruling may be published before it becomes final.[138] A decision becomes final within 30 days of the date of the ruling of the administrative tribunal or, if this ruling is appealed, the date of the decision reached by the Secretary of Treasury.[139]

[137] See Coder, "Guidance More Practical," *supra* note 130.

[138] See 31 C.F.R. § 10.72(d), as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13: see the tax administration's explanations, pages 14-15.

[139] See 31 C.F.R. §10.76, §10.77 and §10.78, as amended by Treasury, *Final Regulations (September 26, 2007)*, *supra* note 13. The Secretary of Treasury must hand down its ruling within 180 days of the filing of the appeal of a decision of the administrative tribunal.

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Conclusion

Tax advisers play a twofold role by advising their clients and ensuring compliance with the tax law. Viewed in isolation, the ethical standards, including those for covered opinions, seem to be a useful tool to better protect the integrity of the tax system. If advisers comply with these standards, taxpayers are able to make an enlightened decision on the likelihood that the tax treatment claimed complies with the tax law and the economic substance doctrine, bearing in mind the possibility that the tax administration may levy on the taxpayer a penalty for under-stating tax payable.

The integrity of the tax system is enhanced to the extent that advisers exercise a rigorous degree of diligence in respect of the taxpayers' purposes in a planning scheme. We are nonetheless of the opinion that it is incumbent, first, upon taxpayers to ascertain the risks that they are facing if they carry out a transaction without disclosing to their advisers all of the underlying facts. The taxpayers are in a better position than any other stakeholder to be aware of the entire array of relevant facts to describe their purposes in a transaction. Aggressive taxpayers who carry out a planning scheme without relying on a thorough tax opinion are taking high financial risks.

More specifically, we believe that a penalty for under-stating tax payable and the attendant rules directly affect the degree of diligence to which both taxpayers and their advisers are subject. If advisers fail to display due diligence in the execution of the mandate assigned to them by their clients, we believe that it is incumbent, first, on the latter, to obtain damages from their advisers or insurers because of negligence or misrepresentation of the facts or the tax law, in particular as regards the economic substance doctrine and the penalty for under-stating tax payable.

However, the presence of a penalty for under-stating tax payable seems insufficient to contain solicitation activities led by some advisers. We believe that advisers must expressly reveal to the taxpayers the factors that are likely to undermine the impartiality of their opinion and the maximum amount that each taxpayer may claim under the advisers' liability insurance policy.

Under these circumstances, any ethical standards imposing such obligations on advisers enhance the integrity of the tax system and, by the same token, protect taxpayers who do not possess the necessary tax expertise to grasp the subtleties of tax advisers' solicitation activities. Furthermore, we are of the opinion that the disclosure rules are a more appropriate tool than the ethical standards to contain tax advisers' solicitations.

For the sake of fairness, the tax administration could elaborate, with professional boards, coercive ethical standards pertaining to aggressive tax planning schemes. Together, they could define the degree of diligence that tax advisers must display in respect of aggressive tax planning schemes in order to more clearly apportion responsibility between themselves and their clients in complying with the tax rules, including the economic substance doctrine and the penalty for under-stating tax payable. Advisers could be liable to an ethical sanction to be imposed by an impartial administrative tribunal which jurisdiction lies outside the tax administration when, within the advisers' field of expertise, they conclude in a clearly unreasonable manner that their client's planning scheme complies with the economic substance doctrine. Moreover, the administrative tribunal could apply a stringent sanction on advisers who act outside their field of expertise.

In our opinion, a procedure that allows tax advisers to fulfil their duty of care by leaving it up to them to commit their professional liability towards their clients in respect of the facts that the latter reveal makes it possible to strike a reasonable balance between:

- simplicity in the administration of the taxation system for all stakeholders;
- the duty of care of taxpayers and tax advisers in a self-assessment system.

It should be emphasized that, according to the former director of the Office of Professional Responsibility, the standards pertaining to covered opinions achieved their objective of heightening awareness among tax advisers of the importance of due diligence as regards aggressive tax planning schemes. However, the tax administration may encounter difficulties in applying them. It believes that the standards of care usually applicable to accredited advisers combined with those governing culpable conduct and false statements would allow the tax administration to protect the integrity of the tax system.

Whether the ethical standards are expressed in general or specific terms, advisers are likely to experience difficulty in fulfilling the responsibility that is attributed to them by the tax administration as long as opinions differ among the courts on the criteria of the economic substance doctrine. The uncertainty inherent in this doctrine engenders significant consequences for the professional liability of tax advisers in respect of aggressive tax planning schemes. For all useful purposes, the codification of this doctrine would enable advisers to better fulfil their responsibilities both in respect of their clients and the tax administration.

To conclude, we believe that making tax advisers subject to other tools such as disclosure rules allows the tax administration to manage the risks inherent in aggressive tax planning schemes in a simpler, more targeted manner as opposed to ethical standards. In our view, the key objective of the tax administration is to accelerate the detection of aggressive tax planning schemes elaborated by tax advisers and carried out by taxpayers. Subject to the taxpayers' privilege of confidential communication, the tax administration may collect the relevant information to determine whether the transactions are abusive and to identify the taxpayers and advisers participating in them. In respect of the advisers, the tax administration could transmit to professional boards any ethical issue so that they protect the public in accordance with the role that is usually entrusted to them.

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