ARTICLES

TAXPAYER CIVIL PENALTY PROTECTION: *LONG TERM CAPITAL HOLDINGS* AND ITS WAKE

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The civil penalty protection provisions of the Internal Revenue Code are a taxpayer's last line of defense when the Internal Revenue Service seeks to punish the taxpayer. This Article examines the evolution of legislative, administrative, and judicial attitudes toward penalizing taxpayers and predicts that, if current trends continue unabated, the penalty protection that taxpayers now receive from relying on the advice of their tax advisors will be effectively eliminated in many cases. Because the district court's decision to impose substantial penalties on the taxpayers in Long Term Capital Holdings v. United States was well publicized and came at a critical juncture in that evolution, the case and its wake provide a useful framework for understanding those legislative, administrative, and judicial trends and evaluating their potential future impact. Although the district court's opinion of the aggressive tax planning employed in that case was ultimately approved on appeal, several of the bases for its decision to deny penalty protection represented significant departures from pre-existing, taxpayer-friendly case law in this area, were arguably misguided, and could discourage taxpayers considering less controversial tax planning. Fortunately, those bases have not been widely adopted in subsequent cases. Nevertheless, the persistence of pro-penalty legislative and administrative trends in Long Term Capital Holdings' wake suggests that many taxpayers may ultimately be prevented from relying on outside tax advisors for protection from penalties when their attempts to properly apply our increasingly intricate tax laws to complicated business transactions go awry.

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I. INTRODUCTION

A small boat finding itself behind a fast-moving larger one occasionally gets capsized in the latter's wake. For much of Long Term Capital Holdings' brief existence it was a behemoth ship that sailed the seas of high finance with a swashbuckling derring-do reminiscent of the Crimson Permanent Assurance,[1] leaving overturned competitors strewn out in its wake.[2] But in the tax world there is only one behemoth—the Internal Revenue Service (the "IRS")—and it was Long Term Capital Holdings' turn to capsize on August 27, 2004 when the United States District Court for the District of Connecticut issued its opinion in *Long Term Capital Holdings v. United States*.[3] Judge Arterton upheld the IRS's denial of a $106,058,228 capital loss[4] and its alternative impositions of a forty

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1. As any Monty Python fan knows, the Crimson Permanent Assurance was the staid British assurance firm that appeared in "The Crimson Permanent Assurance," a short film about that company's turn to piracy after it was acquired by inhumane corporate overlords. After pillaging the corporate headquarters of the Very Big Corporation of America, the members of Crimson Permanent Assurance sailed the "wide accountant-sea" in search of other bloated multinational conglomerates to prey upon. MONTY PYTHON'S THE MEANING OF LIFE (Universal Pictures 1983) (featuring short introductory film "The Crimson Permanent Assurance"); *see also* Wikipedia, The Crimson Permanent Assurance, http://en.wikipedia.org/wiki/The_Crimson_Permanent_Assurance (last visited June 3, 2009). The short film can be viewed online at The Crimson Permanent Assurance, http://video.google.com/videoplay?docid=2498206364209961454 (last visited June 3, 2009).

2. The story of Long Term Capital Holdings' (also known as Long-Term Capital Management) infamous meltdown is told in ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000). During its four-year existence, Long Term Capital Holdings' equity and assets skyrocketed to $4.7 billon and more than $100 billion, respectively, before the fund's dramatic failure in the fall of 1998 resulted in a $3.65 billion Federal Reserve-orchestrated bailout by a consortium of private banks. *Id.* at xix–xx, 218. For a shorter version of the story, see generally Jeremy Bernstein, *The Einsteins of Wall Street*, COMMENT., Sept. 2004, at 64.

3. 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd sub nom.* Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40 (2d Cir. 2005). The plaintiffs in *Long Term Capital Holdings* immediately announced their intention to appeal the district court's holding to the Court of Appeals for the Second Circuit. *Long-Term Capital Management: Hedge Fund Will Appeal Ruling On Tax Shelter by U.S. Judge*, WALL ST. J., Oct. 26, 2004, at C4. When the appeal came, it was limited to the penalty aspects of the district court's holding. Brief for Plaintiffs-Appellants at 2, *Long-Term Capital Holdings, LP*, 150 F. App'x 40 (No. 04–5687).

4. *Long Term Capital Holdings*, 330 F. Supp. 2d at 128. The court found that either the

percent penalty for gross valuation misstatement and a twenty percent penalty for substantial understatement.[5] Not surprisingly, the Commissioner of the Internal Revenue hailed *Long Term Capital Holdings* as an "important victory in [the government's] ongoing battle against abusive tax shelters."[6] The IRS Chief Counsel echoed those sentiments and observed that "the judge's decision recognizes a legal opinion is not a free pass from facing penalties."[7] Just over one year later, the United States Court of Appeals for the Second Circuit affirmed the district court's decision in an unpublished opinion.[8]

Long Term Capital Holdings was decided at an important juncture in the evolution of taxpayer civil penalty protection standards. After reviewing the decision to impose civil penalties in *Long Term Capital Holdings*, this Article traces that evolution through the years immediately preceding the case, places its holding in historical context, and analyzes the impact of it and its wake on the availability of civil penalty protection to taxpayers in the future. Part II of this Article outlines the general parameters of the civil accuracy-related penalties, and the avenues for avoiding them, before summarizing the *Long Term Capital Holdings* case, with particular emphasis on the case's penalty protection aspects.

Part III examines the evolving attitudes of Congress, the IRS, and the courts toward taxpayer civil penalty protection, and analyzes different aspects of Judge Arterton's penalty protection conclusions in light of the positions taken by Congress, the IRS, and other courts. Although the district court's holding regarding the civil penalties imposed by the IRS in response to the aggressive tax planning in that case was ultimately approved on appeal, several of the bases for the court's decision to deny penalty protection represented significant departures from pre-existing, taxpayer-friendly case law, were arguably misguided, and could discourage less controversial tax planning in the future.

Part III ends with an examination of *Long Term Capital Holdings*' wake for deviations from the earlier identified legislative, administrative, and judicial trends regarding taxpayer civil penalty protection. This Article concludes in Part IV with the observation that the logical culmination of those trends could ultimately prevent many taxpayers from relying on the advice of their tax advisors when their attempts to properly apply our increasingly intricate tax laws to complicated business transactions go awry. Such a result is not desirable because it would discourage taxpayers from engaging in the reasonable

transactions leading to the taxpayer's capital loss must be disregarded under the economic substance doctrine or they must be consolidated under the step transaction doctrine. *Id.* Each conclusion resulted in the disallowance of the taxpayer's $106 million capital loss. *Id.*

5. *Id.* at 196.

6. *Everson Says IRS "Pleased" with Decision in Long-Term Capital Holdings Case*, TAX NOTES TODAY, Aug. 30, 2004, 2004 TNT 169-23 (LEXIS) (publishing statements released by IRS Commissioner Mark W. Emerson and IRS Chief Counsel Don Korb).

7. *Id.* For an economic perspective on the deterrence effect of penalties like the one assessed in *Long Term Capital Holdings*, see generally Yoram Keinan, *Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of* Long Term Capital Holdings v. United States, 3 BERKELEY BUS. L.J. 381 (2006).

8. *Long-Term Capital Holdings, LP*, 150 F. App'x at 42.

disagreements with the IRS that ultimately clarify the uncertain regions of our complex tax laws.[9] It would also create significant fairness concerns by penalizing taxpayers regardless of whether they make a reasonable, good faith attempt to comply with that law.

II. *LONG TERM CAPITAL HOLDINGS V. UNITED STATES*

Because the statutory and regulatory provisions governing the accuracy-related civil penalties are intricate, the court's opinion is difficult to understand without a working knowledge of the basic nature of those provisions as they existed in 2004 when the district court decided the case.[10] Accordingly, the relevant accuracy-related civil penalty provisions are briefly summarized before turning to an overview of Judge Arterton's opinion in *Long Term Capital Holdings*.

A. An Accuracy-Related Civil Penalty Primer

From 1989, when Congress overhauled the Internal Revenue Code's civil penalty provisions, through October 2004, all of the accuracy-related civil penalties were consolidated in I.R.C. § 6662.[11] Similarly, in 1989 Congress recodified the associated penalty defenses into I.R.C. § 6664.[12]

The main accuracy-related penalty imposes a twenty percent addition to the tax already due upon "any portion of an underpayment of tax"[13] that results from any of the following: "(1) [n]egligence or disregard of rules or regulations[,]

9. *See, e.g.*, Gitlitz v. Comm'r, 531 U.S. 206, 218 (2001) (requiring S corporation shareholders to increase their bases in their company stock by amount of company's discharged indebtedness even though they were not required to include that debt discharge in their taxable income). Congress quickly stepped in to prevent future S corporation shareholders from getting the basis increase. *See* Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 402(a), 116 Stat. 21, 40 (codified at I.R.C § 108(d)(7)(A) (2006)) (providing that excluded cancellation of indebtedness income of S corporation will not result in adjustment to basis of shareholder's stock).

10. See *infra* Part III.C.1 for a discussion of the post-*Long Term Capital Holdings* revisions to the accuracy-related civil penalty provisions.

11. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(a), 103 Stat. 2106, 2395–99 (codified as amended at I.R.C. §§ 6662–65). Congress undertook this consolidation because it believed "that the number of different penalties that relate to accuracy of a tax return, as well as the potential for overlapping among many of these penalties, causes confusion among taxpayers and leads to difficulties in administering these penalties by the IRS." H.R. REP. NO. 101-247, at 1388 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2858. Thus, it hoped to "improve the fairness, comprehensibility, and administrability of [the accuracy-related civil] penalties." *Id.* In October 2004, Congress created I.R.C. § 6662A, which imposes increased accuracy-related civil penalties on reportable transaction understatements. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 812(a), 118 Stat. 1418, 1577–78 (codified as amended at I.R.C. § 6662A).

12. Omnibus Budget Reconciliation Act of 1989 § 7721(a). Ease of taxpayer understanding and administration, both by the IRS and the courts, motivated Congress to create this "unified exception criterion." H.R. REP. NO. 101-247, at 1392–93. Congress supplemented the existing penalty protection statute with special rules for reportable transaction understatements in October 2004. American Jobs Creation Act of 2004 § 812(c) (codified at I.R.C. § 6664(d)).

13. I.R.C. § 6662(a).

(2) [a]ny substantial understatement of income tax[,] (3) [a]ny substantial valuation misstatement under chapter 1[,] (4) [a]ny substantial overpayment of pension liabilities[, or] (5) [a]ny substantial estate or gift tax valuation understatement."[14] In the case of a "gross valuation misstatement," as opposed to one that is merely "substantial," the addition to tax already due is increased from twenty percent to forty percent of the underpayment.[15] Because a single penalty applies to "the portion of any underpayment which is attributable to 1 or more"[16] of the enumerated errors, a taxpayer engaged in multiple different types of misconduct leading to the same understatement (e.g., negligence that leads to a substantial understatement of income tax) is not subjected to penalty stacking.[17] However, when one of the types of misconduct with respect to a portion of the underpayment is a gross valuation misstatement, the forty percent penalty imposed by I.R.C. § 6662(h)(1) trumps the twenty percent penalty resulting from the other misconduct.[18]

The substantial understatement of income tax penalty does not require any taxpayer culpability before it can be imposed.[19] Instead, for individual taxpayers like the partners in *Long Term Capital Holdings*, all that is generally required is that the tax amount due on the tax return be less than the actual amount due by more than the greater of $5,000 or ten percent of the actual tax due.[20] Because this penalty's mechanical nature has the potential to punish honest taxpayers

14. *Id.* § 6662(b)(1)–(5). Chapter 1 of Title 26 includes income taxes. *See, e.g.*, *id.* §§ 1(a)–(d), 11(a) (imposing income taxes on individuals and corporations). Because the latter two accuracy-related penalties do not apply to income taxes, they are beyond the scope of this Article and are not discussed further. The negligence or disregard of rules or regulations penalty is also not discussed in detail because, while the IRS did assert that penalty against Long Term Capital Holdings, the district court deemed it unnecessary to consider its application once the other two penalties were found to apply. Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 196 (D. Conn. 2004), *aff'd sub nom*. Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40 (2d Cir. 2005).

15. I.R.C. § 6662(h)(1).

16. *Id.* § 6662(b).

17. Treas. Reg. § 1.6662-2(c) (as amended in 2003); *see also* H.R. REP. NO. 101-386, at 652 (1989) (Conf. Rep.), *reprinted in* 1989 U.S.C.C.A.N. 3018, 3255 (declaring Congress's intention to "reorganize[] the accuracy penalties into a new structure that operates to eliminate any stacking of the penalties"). Likewise, the accuracy-related civil penalties do not apply when the taxpayer's underpayment is subject to the civil fraud penalty found in I.R.C. § 6663. I.R.C. § 6662(b). Of course, a single taxpayer can still be subjected to accuracy-related penalties on multiple grounds if the taxpayer's various types of misconduct result in different underpayments of tax. *Id.*

18. Treas. Reg. § 1.6662-2(c).

19. *Compare* I.R.C. § 6662(d)(1)(A), (2)(A) (containing mechanical formula for determining whether "substantial understatement" occurred), *with* I.R.C. § 6662(c) (focusing on taxpayer's unreasonableness, carelessness, recklessness, or intentional acts). Congress originally adopted the substantial understatement penalty in 1982 to discourage taxpayers from "playing the 'audit lottery'" without significant exposure to the negligence penalty because they had obtained advice from a tax professional. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 216 (Comm. Print 1982).

20. I.R.C. § 6662(d)(1)(A), (2)(A).

who are trying to comply with the tax laws but whom happen to reasonably disagree with the IRS, it has its own safe harbor, which is discussed below.[21]

Finally, the substantial and gross valuation misstatement penalties apply when a property's value or adjusted basis is excessively overstated on an income tax return and causes a tax underpayment.[22] When *Long Term Capital Holdings* was decided, a 200% overstatement was "substantial" and a 400% overstatement was "gross."[23] Although tax underpayments of $5,000 or less resulting from valuation misstatements by individuals are excluded,[24] above that threshold the valuation misstatement penalties were originally intended to be essentially "no fault" provisions.[25]

Taxpayers may avoid accuracy-related penalties on tax underpayments by qualifying for the general and penalty-specific protections found in I.R.C. §§ 6662 and 6664. While specific defenses are available for the substantial understatement penalty,[26] no specific defenses exist for the valuation misstatement penalties.[27] In addition, a taxpayer who qualifies for the "reasonable cause exception" found in I.R.C. § 6664(c) avoids all accuracy-related penalties in I.R.C. § 6662.[28]

Two specific protection provisions apply to the substantial understatement penalty.[29] The first protection alternative is available if the taxpayer had a reasonable basis for the disallowed position and that position was properly disclosed on the taxpayer's return.[30] The second protection alternative requires

21. *See id.* § 6662(d)(2)(B) (providing safe harbor for taxpayers who relied on substantial authority or who had reasonable basis for tax treatment); STAFF OF JOINT COMM. ON TAXATION, *supra* note 19, at 216–17 (describing penalty limits for taxpayers reasonably relying on relevant circumstantial facts involving taxable item).

22. I.R.C. § 6662(e)(1)(A), (h)(1). The valuation understatement penalties contain special rules for violations of I.R.C. § 482, which deals with property and service transfers between related entities. *Id.* § 6662(e)(1)(B).

23. *Id.* § 6662(e)(1)(A), (h)(2)(A)(i). The current thresholds are 150% and 200%, respectively. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(a)(1)(A), (2)(A), 120 Stat. 780, 1083 (codified at I.R.C. § 6662(e)(1)(A), (h)(2)(A)(i)–(ii)).

24. I.R.C. § 6662(e)(2).

25. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 19, at 216 (describing Congress's enactment of valuation misstatement penalties in its summary of prior law).

26. *See* I.R.C. § 6662(d)(2)(B) (providing for substantial authority and adequate disclosure defenses against substantial understatement of income tax penalty).

27. See *supra* note 25 and accompanying text, noting that Congress intended the valuation misstatement penalties to be "no fault" provisions.

28. I.R.C. § 6664(c)(1); Treas. Reg. § 1.6664-4(a) (as amended in 2003). Although not applicable to the taxpayers in *Long Term Capital Holdings*, I.R.C. § 6664(d) contains a special "reasonable cause exception" that applies to the reportable transaction accuracy-related penalty found in I.R.C. § 6662A. I.R.C. § 6664(d).

29. I.R.C. § 6662(d)(2)(B)(i)–(ii).

30. *Id.* § 6662(d)(2)(B)(ii); *see also* Treas. Reg. § 1.6662-4(e)(1)–(2)(i) (as amended in 2003) (stating that adequately disclosed items having reasonable basis do not contribute to penalized understatement because they are treated as if they had been correctly shown on original tax return). A tax return position has a "reasonable basis" when the taxpayer has a more than colorable claim that the position was reasonably based on suitable legal authorities, such as the Internal Revenue Code,

that the taxpayer have had "substantial authority" for the rejected tax treatment when the return was filed.[31] "Substantial authority" is an objective standard that is met when the "weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment," but does not require that the supporting authorities outweigh the contrary authorities.[32] Although neither protection provision is currently available for tax shelter participants,[33] when the *Long Term Capital Holdings* returns were filed, noncorporate tax shelter participants like the individual partners of that case could still obtain penalty protection if, in addition to having substantial authority for the discredited position, they had a reasonable belief that the position was more likely than not correct.[34] If either protection provision applies, then the associated understatement does not contribute to the penalized underpayment.[35]

The "reasonable cause exception" found in I.R.C. § 6664(c) is the broadest accuracy-related civil penalty protection provision.[36] Under that exception, "[n]o penalty shall be imposed under section 6662 . . . with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."[37] There is

the Treasury regulations, court cases, and revenue rulings and procedures issued by the IRS. Treas. Reg. § 1.6662-3(b)(3) (as amended in 2003); *see also id.* § 1.6662-4(d)(2) (as amended in 2003) (providing list of acceptable authorities).

31. I.R.C. § 6662(d)(2)(B)(i); *see also* Treas. Reg. § 1.6662-4(d)(3)(iv)(C) (as amended in 2003) (setting appropriate time frame for substantial authority evaluation).

32. Treas. Reg. § 1.6662-4(d)(3)(i) (as amended in 2003). It is even possible to have substantial authority for opposing positions. *See id.* ("There may be substantial authority for more than one position with respect to the same item."). The substantial authority standard lies above the reasonable basis standard and below the "more likely than not" standard, which requires a "greater than 50-percent likelihood of the position being upheld." *Id.* § 1.6662-4(d)(2). The array of standards and corresponding percentages are bewildering. *See* BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE § 207.1.1 (6th ed. 2004) (providing continuum chart of various standards and approximate percentages); Sheldon I. Banoff, *Penalty Percentages Prognosticators Perplex Practitioner*, TAX NOTES TODAY, Dec. 6, 1993, 93 TNT 249–56 (LEXIS) (making tongue-in-cheek suggestion that "substantial authority" should exist when there is 37.5% chance of success, which is like batter getting "three hits out of eight at-bats," while lamenting use of mathematically precise percentages when evaluating inherently imprecise strength of tax positions).

33. *See* I.R.C. § 6662(d)(2)(C)(i) (stating "substantial authority" and "reasonable basis" exceptions do not apply to tax shelters). For this purpose, "the term 'tax shelter' means—(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." *Id.* § 6662(d)(2)(C)(ii).

34. Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 200 (D. Conn. 2004), *aff'd sub nom*. Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40 (2d Cir. 2005); *see also* Treas. Reg. § 1.6662-4(g)(1)(i) (as amended in 2003) (explaining now-obsolete substantial authority protection provision for noncorporate tax shelter participants).

35. I.R.C. § 6662(d)(2)(B).

36. *Compare id.* § 6664(c)(1) (providing penalty protection from all penalties within I.R.C. §§ 6662 and 6663), *with* Treas. Reg. § 1.6662-3(b)(1) (as amended in 2003) (creating exception solely for I.R.C. § 6662 negligence penalty), *and* I.R.C. § 6662(d)(2)(B) (establishing specific exception for I.R.C. § 6662 substantial understatement penalty).

37. I.R.C. § 6664(c)(1).

no set, objective means of qualifying for this exception because it is a facts and circumstances test that focuses on "the extent of the taxpayer's effort to assess the taxpayer's proper tax liability."[38] Even acquiring and relying on an opinion from a professional tax advisor does not automatically meet this exception's requirements if such reliance was unreasonable in light of "the taxpayer's education, sophistication and business experience."[39] At bare minimum, the tax professional must base the relied-upon opinion on "all pertinent facts and circumstances and the law as it relates to those facts and circumstances,"[40] and the opinion "must not be based on unreasonable factual or legal assumptions."[41] Obviously, the opinion does not have to be correct for a taxpayer to reasonably rely on it because the only time a taxpayer needs to show reasonable reliance is when the IRS or a court has determined that the opinion was incorrect and the IRS has imposed a penalty on the taxpayer.[42]

B. The Case in the District Court

Long Term Capital Holdings and its related entities (collectively referred to as "Long Term") are parts of a hedge fund investment structure.[43] The owners of Long Term—including two former Nobel Prize winning economists, Robert Merton and Myron Scholes[44]—arranged for Long Term to undertake a series of

38. Treas. Reg. § 1.6664-4(b)(1) (as amended in 2003).

39. *Id.* § 1.6664-4(c)(1) (as amended in 2003). For example, the taxpayer's business experience may indicate that the taxpayer reasonably should have known that the opinion was based on erroneous facts or factual assumptions, or the taxpayer may have sufficient tax knowledge to reasonably know that the tax professional was not competent. *See id.* (explaining that such factors may indicate to taxpayer that advisor did not have necessary knowledge to give advice).

40. *Id.* § 1.6664-4(c)(1)(i).

41. *Id.* § 1.6664-4(c)(1)(ii).

42. *See* Treas. Reg. § 1.6664-4(c)(1) (as amended in 2003) (requiring consideration of many factors when evaluating reasonable reliance, but not of whether opinion was ultimately correct). In fact, reasonable reliance under I.R.C. § 6664(c) can only become relevant after a penalty has been assessed under I.R.C. §§ 6662 or 6663. I.R.C. § 6664(c)(1). Those provisions are only implicated after a determination that the taxpayer underpaid its tax liability. *Id.* §§ 6662(a), 6663(a). Logically, if the taxpayer relied on the opinion to determine its proper tax liability, then the existence of an underpayment must signify that that opinion was incorrect on the point resulting in the tax underpayment. *See, e.g.*, Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 149, 172, 200–01 (D. Conn. 2004) (assessing accuracy-related penalties after rejecting conclusions in King & Spalding tax opinion relied on by taxpayer), *aff'd sub nom.* Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40 (2d Cir. 2005).

43. *Long Term Capital Holdings*, 330 F. Supp. 2d at 127 n.1. The district court's description of a hedge fund is apt:

> A hedge fund is an investment vehicle in which sophisticated institutions and individuals of high net worth pool investments. Because of the level of sophistication required to invest in a hedge fund and other requirements, such funds are not subject to extensive regulation and are permitted to pursue a wide range of investment strategies. The core business of the hedge fund is to earn high returns for investors.

Id. at 128 n.5. The owners viewed things a little more grandiosely—"'We're not just a fund. We're a financial technology company.'" Leah Nathans Spiro, *Dream Team*, BUS. WK., Aug. 29, 1994, at 50, 56 (quoting Myron Scholes).

44. *Long Term Capital Holdings*, 330 F. Supp. 2d at 128 & n.4, 129 & n.6. Merton and Scholes

transactions that purportedly resulted in $106,058,228 of capital losses during its 1997 tax year.[45] Long Term's capital losses were allocated to its direct and indirect partners, who presumably used them to offset other capital gains recognized during that tax year.[46] What follows is a condensed description of the transactions producing the losses, intended to provide sufficient understanding of the court's holding on the merits and the resulting civil penalty issues.[47]

Long Term's loss-producing transaction began on August 1, 1996 when Onslow Trading and Commercial LLC ("OTC") purportedly became a limited partner in Long Term Capital Partners L.P. ("LTCP"), a U.S. partnership that owned part of Long Term's hedge fund.[48] OTC was a Turks and Caicos Islands corporation whose purpose was to facilitate tax planning structures.[49] Part of OTC's contribution upon becoming a partner was preferred stock in Rorer International Corporation ("Rorer").[50] On November 1, 1996, OTC made an additional contribution to Long Term's hedge fund of preferred stock in Quest & Associates, Inc. ("Quest").[51] In October of 1997, OTC sold its LTCP interests to Long Term Capital Management L.P. ("LTCM"), the entity that managed Long Term and that was owned by Merton, Scholes, and the other creators of

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won the 1997 Nobel Prize in economics for their groundbreaking development of the "Black-Scholes Model," which is used in derivative and option pricing. *Id.* at 128 n.4, 129 n.6. Both men have been professors at numerous prestigious business schools, including Harvard Business School, Massachusetts Institute of Technology's Sloan School of Management, and the University of Chicago. *Id.* Scholes was the most knowledgeable of the Long Term partners on tax matters. "[H]e regarded taxes as a vast intellectual game" and would go to great lengths to avoid paying them. LOWENSTEIN, *supra* note 2, at 35. In addition to his involvement in the planning discussed in this Article, Scholes constructed a warrant to convert the partners' prospective income to lower-taxed capital gain and "spearhead[ed] a clever plan that let the partners defer their cut of the profits for up to ten years in order to put off paying taxes." *Id.* That latter planning backfired disastrously when Long Term went belly up, taking their deferred income with it. *See id.* at 219–20 (detailing owners' financial situations immediately after fund's collapse). Scholes' bad experiences with tax planning evidently soured his view of aggressive tax planning. After the district court's opinion, when Scholes was asked whether exploiting tax loopholes for gain was acceptable he responded, "No, it is not. And, it is costly to do so. But, sometimes what is thought to be ethical in one time period, is deemed not to be so later on." Lynnley Browning, *Tax Ruling Casts a Long Shadow*, N.Y. TIMES, Aug. 30, 2004, at C1 (quoting email from Scholes).

45. *Long Term Capital Holdings*, 330 F. Supp. 2d at 139.

46. *Id.*

47. The actual transactions involved were horribly complex. *See* Richard M. Lipton, *Reliance on Tax Opinions: The World Changes Due to* Long Term Capital Holdings *and the AJCA*, 101 J. TAX'N 344, 345–48 (2004) (describing these complex transactions in greater detail); Lee A. Sheppard, *LTCM Case: What They Won't Do for Money, Part 2*, 104 TAX NOTES 1006, 1007–09 (2004) (same); Alvin C. Warren, Jr., *Understanding* Long Term Capital, 106 TAX NOTES 681, 681–86 (2005) (same).

48. *Long Term Capital Holdings*, 330 F. Supp. 2d at 127 n.1, 136. LTCP's apparent purpose was to segregate the assets of U.S. investors from those of foreign investors. *Id.* at 130.

49. *Id.* at 132.

50. *Id.* at 136. OTC also contributed $2,833,451 to LTCP, which it borrowed from another Long Term entity. *Id.* at 136–37.

51. *Long Term Capital Holdings*, 330 F. Supp. 2d at 137. As before, OTC borrowed cash from another Long Term entity and made an additional $3,356,497 contribution to LTCP. *Id.*

Long Term.[52] Shortly thereafter, Long Term's hedge fund sold the shares of Rorer and Quest preferred stock for their fair market values.[53] The Rorer and Quest preferred stock sales resulted in the challenged capital losses because Long Term took the position that OTC's precontribution activities involving the stock had resulted in a basis that greatly exceeded the stock's fair market value and that LTCM succeeded to the loss resulting from that basis under the rules governing the allocation of pre-existing losses among the partners.[54]

On audit, the IRS disallowed the $106,058,228 capital loss resulting from the Rorer and Quest preferred stock sales.[55] The district court upheld that disallowance because it found that the transactions resulting in those losses lacked economic substance[56] and that they could be recast to eliminate the purported losses under the step transaction doctrine.[57] That result meant that LTCM's basis in the preferred stock was either zero, because they lacked economic substance,[58] or the value that LTCM paid for the stock in the recast

52. *Id.* at 127 n.1, 138. The named petitioner, Long Term Capital Holdings, was the general partner of LTCM in 1997. *Id.* at 127 n.1.

53. *Id.* at 138.

54. *Long Term Capital Holdings*, 330 F. Supp. 2d at 139. OTC received the Rorer and Quest preferred stock while participating in a set of cross-border leasing transactions that were conceptually similar to each other and were nicknamed CHIPS and TRIPS. *Id.* at 132–35. In the TRIPS structure, OTC leased long-haul truck tractors and subleased them to Wal-Mart Stores, Inc. *Id.* at 128. Wal-Mart Stores, Inc. then prepaid 92.5% of the present value of the rents due under the sublease. *Id.* OTC took the position that the rent prepayment was not taxable under U.S. tax law or the tax law of the United Kingdom, where OTC was formed, but that it did increase OTC's total basis in its TRIPS-related assets. *Id.* at 135–36. OTC then contributed its interests in all TRIPS-related assets and obligations to Rorer in exchange for the Rorer preferred stock. *Long Term Capital Holdings*, 330 F. Supp. 2d at 135. As a result, OTC claimed a basis in its Rorer preferred stock that greatly exceeded its fair market value. *Id.* at 136. Rorer, in turn, did not report any income from the rent prepayment proceeds received from OTC but did deduct future rent payments due under the master lease agreement. *Id.* Thus, Rorer obtained considerable tax deductions from its participation in TRIPS without incurring the associated economic outlay. *See id.* (explaining savings rate of forty million dollars for every several million dollars expended).

55. *Id.* at 127.

56. The basis for the court's lack of economic substance holding was its conclusion that Long Term "had no business purpose for engaging in the transaction other than tax avoidance and the transaction itself did not have economic substance beyond the creation of tax benefits." *Long Term Capital Holdings*, 330 F. Supp. 2d at 172. The court's analysis is extensive, but not relevant to this Article. *See id.* at 171–90 (providing court's economic substance analysis).

57. *Id.* at 128. The step transaction doctrine "treats the 'steps' in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked. Rather than viewing each step as an isolated incident, the steps are viewed together as components of an overall plan." Greene v. United States, 13 F.3d 577, 583 (2d Cir. 1994) (citation omitted). One variant of the doctrine is the "end result test," which "will be invoked if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result." *Id.* In the step transaction portion of its opinion, the district court applied the "end result test" to determine that "OTC's contribution of preferred stock to LTCP followed by the sale of the received partnership interest to LTCM was in substance a sale of the preferred stock" to LTCM. *Long Term Capital Holdings*, 330 F. Supp. 2d at 191.

58. *Long Term Capital Holdings*, 330 F. Supp. 2d at 199 n.99.

transactions, an amount far less than the basis claimed.[59] In either case, the Rorer and Quest preferred stock sales did not result in a capital loss.

The IRS also imposed, in the alternative, a forty percent gross valuation misstatement penalty, a twenty percent substantial understatement penalty, and a twenty percent negligence or disregard of rules or regulations penalty.[60] The district court found that, absent a successful penalty defense by Long Term, either a forty percent gross valuation misstatement penalty[61] or a twenty percent substantial understatement penalty[62] on the full amount of Long Term's tax underpayment was appropriate.[63] With the IRS's positions supporting penalty imposition firmly established, the court turned to Long Term's penalty protection claims.

Long Term asserted that it qualified for a reduction of the twenty percent substantial underpayment penalty under I.R.C. § 6662(d)(2)(B) and for relief from both the forty percent gross valuation misstatement penalty and the twenty percent substantial underpayment penalty under the reasonable cause exception found in I.R.C. § 6664(c).[64] Before entering into the transactions that resulted in the capital losses, Long Term had engaged the law firms of Shearman & Sterling

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59. *Id.* at 191.

60. *Id.* at 196. The court did not address the third alternative—the twenty percent negligence or disregard of rules or regulations penalty—because it became moot once the first two penalties were found to apply. *Id.* See *supra* Part II.A for an explanation of statutory requirements of these accuracy-related civil penalties and their interrelation.

61. *Long Term Capital Holdings*, 330 F. Supp. 2d at 199. The court found that Long Term had underpaid its tax due to its claim that it had a $107,136,628 adjusted basis in the Rorer and Quest preferred stock when, under the court's step transaction analysis, the correct adjusted basis was actually around $1 million. *Id.* Therefore, Long Term's claimed basis was "well in excess of 400 percent of the amount determined to be the correct adjusted basis" required for a "gross valuation misstatement" under I.R.C. § 6662(e) and (h). *Id.* Somewhat paradoxically, the court implied, but did not hold, that under its economic substance analysis the claimed adjusted basis in the stock would be *infinitely* greater than the correct adjusted basis because the stock was never acquired for tax purposes and could only have a correct basis amount of zero. *Id.* at 199 n.99. The IRS could not be troubled with such philosophical musings when it considered this type of situation; it simply declared that "[t]he value or adjusted basis . . . of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount." Treas. Reg. § 1.6662-5(g) (as amended in 1992).

62. The court had already concluded that Long Term had underpaid its tax and that Long Term had understated the amount of tax due on its return. *Long Term Capital Holdings*, 330 F. Supp. 2d at 128. Because the amount of the understatement easily exceeded ten percent of the correct tax liability, the court held that, absent a successful defense by Long Term, the understatement was substantial and the twenty percent substantial underpayment penalty applied to the entire amount of the understatement. *Id.* at 200–01.

63. The court did not determine the actual dollar amount of the penalty because the penalty would be assessed on Long Term's partners, rather than on the partnership itself. *Id.* at 200 n.100. Partnerships are flow-through entities that pass income and loss items on to their partners instead of paying federal income tax at the entity level. I.R.C. § 701 (2006). For the sake of clarity, at times this Article refers to Long Term "underpaying" its tax, but in fact Long Term's treatment of the Rorer and Quest preferred stock sales caused its partners to underpay their taxes. *See Long Term Capital Holdings*, 330 F. Supp. 2d at 200 n.100 (explaining that underpayment was attributable to partner).

64. *Long Term Capital Holdings*, 330 F. Supp. 2d at 128, 200, 205. See *supra* Part II.A for further explanation of these penalty protection provisions.

("Shearman") and King & Spalding ("K&S") to opine on various aspects of those transactions, and their opinions formed the basis of Long Term's penalty protection claims.[65] Shearman issued "should" level opinions on OTC's bases in the Rorer and Quest preferred stock just before contribution to LTCP.[66] K&S's opinion was also a "should" opinion and dealt with Long Term's tax consequences after the Rorer and Quest preferred stock was contributed to LTCP.[67]

Judge Arterton rejected each of Long Term's defenses.[68] Long Term's penalty reduction claim failed because the court concluded that there was not substantial authority supporting Long Term's treatment of the Rorer and Quest preferred stock sales and because it found that Long Term did not reasonably and in good faith rely on the "should" level opinions[69] that it obtained from Shearman and K&S.[70] With respect to the substantial authority requirement, the court rejected each legal authority cited by Long Term in support of its position because the court found that, although each authority was potentially applicable to the facts as argued by Long Term, each was materially distinguishable when applied to the facts as determined by the court.[71] The court's determination regarding Long Term's reliance on its tax opinions is explained in the reasonable cause exception discussion that follows.

In order to successfully avoid the penalties at issue by using the reasonable cause exception found in I.R.C. § 6664(c), Long Term needed to show reasonable and good faith reliance on the advice from Shearman and K&S.[72]

65. *Long Term Capital Holdings*, 330 F. Supp. 2d at 145, 147, 196. Long Term paid Shearman and K&S over $513,300 and $525,650, respectively, for their opinions. *Id.* at 175.

66. *Id.* at 145–47. According to the court, a "'should' level opinion evinces a fairly high level of comfort on the part of the tax practitioner that the legal conclusions follow as a matter of law from the factual representations and assumptions." *Id.* at 145 n.34.

67. *Id.* at 148–49.

68. *Long Term Capital Holdings*, 330 F. Supp. 2d at 128.

69. See *supra* note 66 for the district court's description of a "should" level opinion.

70. *Long Term Capital Holdings*, 330 F. Supp. 2d at 204–05. The penalty reduction standard applied by the court is the standard for "tax shelters" because the court concluded that the sole purpose of the transactions undertaken by Long Term was to avoid tax. *Id.* at 200–01; *see also* I.R.C. § 6662(d)(2)(C)(ii) (2006) (defining "tax shelter" in this context as "a partnership . . . if a significant purpose of such partnership . . . is the avoidance or evasion of Federal income tax"). In the absence of such a conclusion, Long Term would have only needed to show either "substantial authority" or, if the "relevant facts" resulting in the claimed tax treatment were adequately disclosed on the return, a "reasonable basis" for the adopted treatment. I.R.C. § 6662(d)(2)(B)(i), (ii).

71. *Long Term Capital Holdings*, 330 F. Supp. 2d at 203–05. In short, the court held that when a court decides that a taxpayer's understanding of the facts is materially incorrect, any legal authorities relied on by the taxpayer for penalty protection are useless. *See* Lipton, *supra* note 47, at 353 (recognizing that court's position required Long Term to cite cases "supporting 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 in which the sole motivation was tax avoidance"). Thus, the court's lack of economic substance holding precluded Long Term from succeeding in its penalty reduction argument. *Long Term Capital Holdings*, 330 F. Supp. 2d at 203–05.

72. *Long Term Capital Holdings*, 330 F. Supp. 2d at 206.

The court did not address the Shearman opinions, but stated four reasons why Long Term failed to qualify with respect to the K&S opinion.[73] First, the court concluded that Long Term did not receive the allegedly relied-upon opinion prior to the time that it filed its 1997 tax return.[74] K&S did not issue its written opinion until January 27, 1999, well after Long Term filed its tax return on April 15, 1998.[75] Long Term's only prefiling documentation of K&S's advice was an April 14, 1998 memorandum written by its in-house tax counsel outlining the intended tax treatment and stating that "[K&S], on this date, has orally confirmed that [it] will issue an opinion that the [tax treatment], as described above, should be sustained . . . . [and] that this opinion will be rendered in accordance with the requirements of Treasury Regulation sections 1.6662-4(d), 1.6662-4(g), and 1.6664-4(c)."[76] Although both the April 14, 1998 memorandum and the K&S opinion itself indicated that some prefiling oral advice was given, the court held that Long Term failed to establish that the oral advice provided a basis for the positions taken on its tax return.[77]

Second, Long Term failed to show that the K&S opinion was "based on all pertinent facts and circumstances" because the court felt that K&S unreasonably relied on Long Term's unsupported representations regarding its pretax profit expectations and its motives for entering into the transaction, and that K&S should have done more analysis on the transaction's nontax economic merits.[78] The K&S attorney responsible for the opinion did testify about the analysis performed to support those representations,[79] but the court found no contemporaneous evidence indicating that such an analysis was performed prior to the opinion's issuance.[80]

Third, Long Term failed to show that the K&S opinion was based on "the law related to the . . . transaction."[81] In particular, the court seemed to think that the lack of discussion of case law from the Court of Appeals for the Second Circuit, which was the applicable appellate court for the district court, was telling and that the legal analysis was simply incorrect.[82] Presumably, failure to cite case

73. *Id.*

74. *Id.* at 208.

75. *Id.* at 147–48.

76. *Id.* at 148. The Treasury regulations listed relate to protection from accuracy-related civil penalties. See *supra* Part II.A for a discussion of the basic structure of Treasury regulations related to protection from accuracy-related civil penalties, including the Treasury regulations referred to in the memorandum.

77. *Long Term Capital Holdings*, 330 F. Supp. 2d at 208.

78. *Id.* at 209.

79. *Id.* at 149–51.

80. *Id.* at 152–53. Given K&S's heavy involvement in planning the transactions, it is unlikely that Long Term would have proceeded with the transactions, much less filed a tax return reflecting them, without K&S's assurances that a favorable opinion on the critical tax issues would be forthcoming. Presumably, K&S's work prior to giving those assurances would have included analyzing Long Term's motives.

81. *Id.* at 209.

82. *Long Term Capital Holdings*, 330 F. Supp. 2d at 209–11 ("[K&S]'s effort is insufficient to carry Long Term's burden to demonstrate that the legal advice satisfies the threshold requirements of

law from the Second Circuit was also a shortcoming of the Shearman opinions because they merely outlined the facts and assumptions analyzed and stated conclusions without discussing the legal analysis performed in reaching those conclusions.[83]

Finally, Long Term's "apparent steps to conceal the tax losses from the sale of the Rorer and Quest stock on the tax returns" evidenced a lack of good faith that precluded application of the reasonable cause exception.[84] Here, the court emphasized that Long Term's tax return, prepared by its accountant Price Waterhouse and confirmed on this point by Coopers & Lybrand, apparently netted the Rorer and Quest stock losses with other gains and labeled the resulting amount "Net Unrealized Gains."[85]

C. *The Second Circuit's Perspective*

Long Term's appeal did not challenge the district court's disallowance of the $106 million capital loss.[86] Instead, it focused on reducing its penalty exposure.[87]

Long Term argued that the forty percent gross misstatement penalty should not apply because the additional tax liability resulted from the district court's legal characterization of Long Term's transaction, not from an actual, factual valuation misstatement by Long Term.[88] Relying on the legislative history accompanying Congress's decision to enact the gross valuation misstatement penalty, Long Term asserted that the penalty's scope should be limited to "taxpayers misstating the value of their property to achieve a tax benefit"[89] and

reasonable good faith reliance on advice of counsel."). However, the Second Circuit was not the only appellate court open to the taxpayer. Long Term could have filed suit in the Court of Federal Claims, from which appeal to the Federal Circuit would have been possible. When K&S's opinion was prepared, the court of appeal whose case law would be binding on the taxpayer was not known for certain. The opinion did cite one case from the Court of Claims, which was the Federal Circuit's predecessor, and a number of cases from other circuit courts of appeal. Petitioners' Exhibit 357 at 38–39, *Long Term Capital Holdings*, 330 F. Supp. 2d 122 (Civ. Nos. 3:01CV1290, 3:01CV1291, 3:01CV1711, 3:01CV1713, 3:01CV1714 (JBA)).

83. *See Long Term Capital Holdings*, 330 F. Supp. 2d at 146 (finding Shearman opinions "contain[ed] no legal reasoning or analysis"). Technically, Long Term did not need the actual legal analysis because it should be entitled to rely on Shearman's ultimate opinions. *See* Treas. Reg. § 1.6664-4(c)(1) (as amended in 2003) (requiring taxpayer to make sure that advisor has relevant facts and circumstances surrounding transactions and that advisor is not making erroneous factual or legal assumptions, but not requiring taxpayer to review advisor's legal analysis). Regardless, the legal analysis was in a separate file memorandum. *Long Term Capital Holdings*, 330 F. Supp. 2d at 146.

84. *Long Term Capital Holdings*, 330 F. Supp. 2d at 211–12.

85. *Id.* One wonders what more should be required of a taxpayer when it consults with not one, but two, of the six major public accounting firms on the proper manner of reporting of an item on its tax return and its effort still is not considered sufficient.

86. Brief for Plaintiffs-Appellants, *supra* note 3, at 2. Long Term did contest Judge Arterton's application of the step transaction doctrine, but only as a means of undermining her application of the forty percent gross valuation misstatement penalty. *Id.*

87. *Id.*

88. *Id.* at 43–44.

89. *Id.* at 44.

that the penalty "is directed only at discrepancies attributable to factual misstatements, not to legal disputes over how to compute basis."[90] The Second Circuit affirmed the penalty after disagreeing that the penalty should only apply to an overstated basis arising from an erroneous valuation because the statute itself "does not differentiate between factual and legal determinations."[91]

Long Term challenged each of the district court's four bases for rejecting Long Term's reasonable cause defense.[92] The Second Circuit characterized three of those four bases—(1) K&S's failure to render an opinion before Long Term filed its tax return, (2) Long Term's failure to show that that opinion did not unreasonably rely on assumptions that Long Term knew to be false, and (3) Long Term's lack of good faith in its presentation of the capital loss on its tax return—as questions of fact subject to review for clear error.[93] In each case, the court found that the record sufficiently supported the district court's holdings.[94]

The Second Circuit did not directly address Judge Arterton's final reason—the deficiency of K&S's legal opinion—for rejecting Long Term's reasonable cause defense.[95] Instead, the court minimized that holding's importance by relegating it to a footnote and by recharacterizing its purpose.[96] According to the Second Circuit, the district court

> criticized K&S's limited and unimpressive use of law not because it expected Long-Term to engage in sophisticated questioning of its expert's advice but because the inadequacy of the legal analysis showed that K&S's advice amounted to "general superficial

90. Brief for Plaintiffs-Appellants, *supra* note 3, at 47. See *infra* Part III.A.1 for a brief discussion of the legislative history that Long Term relied on in its brief.

91. Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40, 44 (2d Cir. 2005). The court also noted that it had approved application of the gross valuation misstatement penalty to a tax shelter lacking economic substance in *Gilman v. Commissioner*, 933 F.2d 143 (2d Cir. 1991), in which it affirmed a penalty on shammed sale and leaseback of computer equipment, *Long-Term Capital Holdings, LP*, 150 F. App'x at 44. The courts do not universally agree with *Gilman* on that point. *See* Heasley v. Comm'r, 902 F.2d 380, 383 (5th Cir. 1990) ("Whenever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit. In such a case, the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit."); Gainer v. Comm'r, 893 F.2d 225, 227 (9th Cir. 1990) (finding IRS could not impose valuation misstatement penalty when it had already disallowed deductions and credits impacted by misstatement); Todd v. Comm'r, 862 F.2d 540, 543 (5th Cir. 1988) (concluding that no valuation misstatement had occurred because "the deductions and credits . . . were inappropriate altogether, the Todds' valuation of the property supposedly generating the tax benefits had no impact whatsoever on the amount of tax actually owed"); Klamath Strategic Inv. Fund, LLC v. United States, 472 F. Supp. 2d 885, 899–900 (E.D. Tex. 2007) (relying on *Heasley* to reject gross valuation overstatement penalty when IRS disregards transaction because of economic substance doctrine), *aff'd in part, vacated in part*, 568 F.3d 537 (5th Cir. 2009).

92. Brief for Plaintiffs-Appellants, *supra* note 3, at 23–42.

93. *Long-Term Capital Holdings, LP*, 150 F. App'x at 42–43.

94. *Id.*

95. *See id.* at 43 n.1 (acknowledging, but not analyzing, Judge Arterton's final reason for rejecting Long Term's defense).

96. *Id.*

> pronouncements" based almost entirely on the flawed and outcome-determinative assumptions Long-Term asked it to make."[97]

III. UNDERSTANDING *LONG TERM CAPITAL HOLDINGS* AND ITS WAKE

The *Long Term Capital Holdings* opinions were issued at a pivotal point in the evolution of Congress's and the IRS's attitudes toward taxpayer civil penalty protection. Although both had gravitated toward more stringent protection standards for a number of years, their response to *Long Term Capital Holdings* and other similar cases from the late 1990s and early 2000s accelerated their trend toward almost strict liability penalties on complicated business transactions accompanied by significant tax benefits. Throughout, the courts provided an important counterbalance, rejecting the IRS's penalty positions when those positions compromised a taxpayer's ability to protect him or herself from penalties by acquiring and relying on professional tax advice too much. Judge Arterton's opinion was significant because it suggested that the courts might become more receptive to curtailing that protection in the future. However, two of the most controversial aspects of her opinion—the substantial authority analysis and the requirement that Long Term heavily scrutinize the quality of the legal advice it received from K&S—are inconsistent with prior case law and arguably misguided. Later courts have not widely adopted these two arguments.[98]

A. *Evolving Attitudes Toward Penalty Protection*

To fully appreciate the significance of *Long Term Capital Holdings* and its wake, it must be placed in context, which requires an appreciation of what came before. Accordingly, this Part examines the attitudes of Congress, the IRS, and the courts toward taxpayer civil penalty protection before critiquing Judge Arterton's application of accuracy-related civil penalties in *Long Term Capital Holdings*.

1. Congress

Since the early 1980s, Congress has generally adopted an increasingly pro-penalty attitude, particularly with respect to tax shelter transactions. In 1981, Congress increased the already-existing negligence or disregard of rules or regulations penalty,[99] and supplemented it by adding a valuation overstatement

97. *Id.*

98. See *infra* notes 200–06 and accompanying text for a discussion of the problems inherent in Judge Arterton's use of the substantial authority analysis and her requirement that the taxpayer scrutinize the legal advice received.

99. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 722(b)(1), 95 Stat. 172, 342–43 (repealed 1989) (adding penalty equal to fifty percent of interest due on tax underpayment resulting from negligence).

penalty whose rate increased with increasing overstatements.[100] Congress felt that these modifications were necessary to discourage taxpayers from intentionally overvaluing hard-to-value property in the hope that the IRS would "divid[e] the difference" with them, and from unnecessarily prolonging disputes with the IRS to take advantage of tax interest rates that were below the prevailing cost of borrowing.[101]

The following year, Congress gave the IRS another weapon in its burgeoning compliance enforcement arsenal—the substantial understatement of liability penalty.[102] Except for the fact that the penalty rate was only ten percent, this penalty's form was quite similar to the current version found in I.R.C. § 6662.[103] As with the valuation overstatement penalty the year before, Congress's purpose in creating the new penalty was to improve taxpayer compliance by discouraging taxpayers from taking questionable return positions to "play[] the 'audit lottery'" without significant exposure to penalties.[104] Congress also singled out tax shelter investors for special penalty treatment by making protection from the new penalty more difficult for them because "if the principal purpose of a transaction is the reduction of tax, it is not unreasonable to hold participants to a higher standard than ordinary taxpayers."[105] Apparently, the original substantial understatement penalty was too weak to accomplish its purpose because four years later Congress ratcheted it up from ten percent to twenty percent.[106]

After establishing all these accuracy-related civil penalties, Congress emphasized its dedication to the new penalty regime by chastising the IRS for failing to use the negligence penalty when it was "fully justified" and by urging it to "assert, without hesitancy in appropriate circumstances, the penalties that the Congress has provided."[107] The message must have gotten through to the IRS

100. Economic Recovery Tax Act of 1981 § 722(a). The graduated rates were a precursor to the current substantial/gross system, but were not as severe because the maximum rate was only thirty percent. *See id.* (listing maximum valuation overstatement penalty rate as thirty percent).

101. H.R. REP. NO. 97-201, at 243 (1981).

102. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 323, 96 Stat. 324, 613–15 (repealed 1989).

103. *See id.* (listing penalty rate as ten percent of amount of underpayment attributable to substantial understatement of income tax for taxable year).

104. STAFF OF JOINT COMM. ON TAXATION, *supra* note 19, at 216. Taxpayers often escaped the negligence penalty by obtaining advice from a tax professional before proceeding. *Id.*

105. H.R. REP. NO. 97-760, at 576 (1982) (Conf. Rep.), *reprinted in* 1982 U.S.C.C.A.N. 1190, 1348.

106. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1504, 100 Stat. 2085, 2743 (repealed 1989); *see also* S. REP. NO. 99-313, at 183 (1986) (characterizing current ten percent penalty as "an insufficient deterrent").

107. H.R. REP. NO. 98-861, at 985–86 (1984) (Conf. Rep.), *reprinted in* 1984 U.S.C.C.A.N. 1445, 1673. Congress went out of its way to deliver this message to the IRS—the provision of the public law that the quoted conference report addressed did not even deal with accuracy-related penalties. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 144, 98 Stat. 494, 682–84 (repealed 1989) (increasing interest rate on substantial underpayments attributable to tax-motivated transactions). Somewhat humorously, Congress also praised the IRS for no longer routinely settling tax shelter cases by allowing investors to deduct out-of-pocket expenses because such a taxpayer "should not expect to be able to deduct out of pocket expenses regardless of the circumstances of his case." H.R. REP. NO.

because by 1989 Congress actually expressed "concern[] that the present-law accuracy-related penalties (particularly the penalty for substantial understatements of tax liability) have been determined too routinely and automatically by the IRS," and encouraged the courts to regulate the application of civil penalties in an effort to promote "greater fairness of the penalty structure and [to] minimize inappropriate determinations of [the accuracy-related] penalties."[108] That year, Congress actually reduced taxpayer exposure to the accuracy-related civil penalties by eliminating the cumulative stacking of multiple accuracy-related penalties onto a single tax underpayment.[109]

From 1989 to 2004, Congress resumed emphasizing the accuracy-related penalties' noncompliance deterrence effects and steadily strengthening them by making minor revisions to target certain specific abuses[110] and by slowly restricting taxpayer access to protection from the substantial understatement penalty.[111]

In between the district court's opinion in *Long Term Capital Holdings* and its affirmation by the Second Circuit, Congress passed major tax legislation—the American Jobs Creation Act of 2004—that emphasized its growing attitude toward accuracy-related civil penalties.[112] In that Act, Congress created a new

98-861, at 985. The IRS continues to make such settlement offers. *See, e.g.*, I.R.S. Announcement 2005–80, 2005–2 C.B. 967, 968–69 (announcing new settlement initiative for participants in twenty-one tax shelters that permits them to deduct their out-of-pocket costs); I.R.S. Announcement 2004–46, 2004–1 C.B. 964, 964–65 (offering same settlement for participants in "Son of BOSS" tax shelters). Indeed, shortly after *Long Term Capital Holdings* was decided in the district court, the IRS Chief Counsel expressed his belief that that kind of settlement would remain common in the future. Allen Kenney, *Son-Of-BOSS Settlement: Enforcement Wave of the Future?*, 106 TAX NOTES 43, 43 (2005).

108. H.R. REP. NO. 101-247, at 1393 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2863.

109. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(a), 103 Stat. 2106, 2395–99 (codified as amended at I.R.C. §§ 6662–65 (2006)); H.R. REP. NO. 101-386, at 652 (1989) (Conf. Rep.), *reprinted in* 1989 U.S.C.C.A.N. 3018, 3255 (declaring Congress's intention to "reorganize[] the accuracy penalties into a new structure that operates to eliminate any stacking of the penalties"). The Omnibus Budget Reconciliation Act of 1989 also established the current general structure of the accuracy-related civil penalty provisions when it consolidated the penalties discussed above into I.R.C. § 6662. Omnibus Budget Reconciliation Act of 1989 § 7721(a).

110. *See, e.g.*, Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11312, 104 Stat. 1388, 1388-454 to 1388-455 (codified as amended at I.R.C. § 6662(e)) (amending existing civil penalty provision statute to assist IRS in applying it to transfer pricing transactions governed by I.R.C. § 482).

111. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1028(c), 111 Stat. 788, 928 (codified as amended at I.R.C. § 6662(d)(2)) (preventing corporations in multiparty financing arrangements from availing themselves of adequate disclosure exception to substantial understatement penalty and lowering threshold for being treated as tax shelter under that penalty from having "principal purpose" of avoiding taxes to merely "significant purpose"); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13251, 107 Stat. 312, 531 (codified at I.R.C. § 6662(d)(2)(B)(ii)) (requiring reasonable basis to escape substantial understatement penalty through adequate disclosure on taxpayer's tax return). Congress undertook these modifications to "improve compliance by discouraging taxpayers from entering into questionable transactions" (i.e., tax shelters). S. REP. NO. 105-33, at 148 (1997).

112. American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 811–20, 118 Stat. 1418, 1575–85 (codified as amended in scattered sections of I.R.C). The accuracy-related penalty provisions were part of an array of tax shelter related penalties designed to curb future taxpayer noncompliance via abusive tax shelters. *See* H.R. REP. NO. 108-548, pt. 1, at 261 (2004) (explaining that combating tax

accuracy-related penalty covering understatements due to reportable transactions (the "reportable transactions penalty").[113] The new penalty applies to a "listed transaction" and to any other "reportable transaction . . . if a significant purpose of such transaction is the avoidance or evasion of Federal income tax."[114] A listed transaction is "a transaction that is the same as or substantially similar to one of the types of transactions that the [IRS] has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."[115] Other reportable transactions have one of five other specified characteristics (e.g., a "loss transaction," which includes a transaction resulting in a $2 million or more partnership loss in a single tax year).[116] The reportable transactions penalty is twenty percent of the tax understatement if the transaction was adequately disclosed on the taxpayer's tax return and thirty percent if it was not.[117] A restricted version of the I.R.C. § 6664 reasonable cause exception applies to the new penalty and is only available if: (1) the transaction was adequately disclosed,

shelters is rationale for new penalty applicable to any taxpayer who fails to report required information). Although not relevant to individuals like the taxpayers in *Long Term Capital Holdings*, for publicly traded corporate taxpayers the most significant "penalty" may be the reputational damage that accompanies public disclosure of certain monetary penalties to the SEC. *See* Elaine Church et al., *Penalties Put Teeth in Tax Shelter Disclosure Requirements*, 105 TAX NOTES 827, 830 (2004) (speculating that fear of this disclosure requirement, and SEC prompting, may cause companies to monitor tax shelter issues more closely).

113. American Jobs Creation Act of 2004 § 812(a) (codified as amended at I.R.C. § 6662A). For a discussion of the numerous open issues created for taxpayers by the new penalty provisions, see generally Howard Berman et al., *The Uncertainties of Accuracy with the New Accuracy-Related Penalty*, 111 TAX NOTES 437 (2006).

114. American Jobs Creation Act § 812(a). The terms "listed transaction" and "reportable transaction" are defined elsewhere in the Act, *id.* §§ 811(a), 812(a) (codified as amended at I.R.C. §§ 6662A, 6707A), but that definition merely defers to the Treasury regulations under I.R.C. § 6011, *id.* § 811(a).

115. Treas. Reg. § 1.6011-4(b)(2) (as amended in 2004). To assist taxpayers in keeping track of the various listed transactions, the IRS periodically publishes a comprehensive list, *e.g.*, I.R.S. Notice 2004–67, 2004–2 C.B. 600, and maintains a real-time version on its website, Recognized Abusive and Listed Transactions – LMSB Tier 1 Issues, http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html (last visited June 14, 2009). The IRS's online list also includes the IRS's "Transactions of Interest," which the IRS has not finished analyzing but which it believes have "the potential for tax avoidance or evasion." Recognized Abusive and Listed Transactions, *supra*.

116. Treas. Reg. § 1.6011-4(b)(1), (5)(i)(B) (as amended in 2004). The other four types of reportable transactions are "[c]onfidential transactions," "[t]ransactions with contractual protection," "[t]ransactions with a significant book-tax difference," and "[t]ransactions involving a brief asset holding period." *Id.* § 1.6011-4(b)(3), (4), (6), (7).

117. American Jobs Creation Act of 2004 § 812(a). Even if the transaction is adequately disclosed, the new penalty may exceed the substantial understatement of income tax penalty in I.R.C. § 6662 because the new penalty's underpayment calculation automatically assumes that the offending taxpayer is in the highest marginal tax bracket. *Compare* I.R.C. § 6662A(b)(1)(A)(i)–(ii) (defining "reportable transaction understatement" as difference between increase that results from proper tax treatment of an item and highest imposed tax rate), *with* I.R.C. § 6662(d)(2)(A)(i)–(ii) (defining "understatement" as excess between amount that should have been shown for taxable year and amount that is shown). If both penalties apply to the same understatement, the reportable transaction penalty trumps the substantial understatement penalty. American Jobs Creation Act of 2004 § 812(a).

(2) substantial authority existed for the adopted tax treatment, and (3) the taxpayer reasonably believed that the adopted tax treatment was more likely than not the correct treatment.[118] Furthermore, the taxpayer may not rely on a tax opinion from an advisor who has a financial interest in the transaction or is connected with its promotion.[119] Even if the tax advisor is acceptable, the opinion will still be disregarded if it relies on unreasonable assumptions or taxpayer representations, or if it does not address all relevant facts.[120] However, if an opinion meets those requirements and is based on existing law, a taxpayer can avoid the reportable transaction penalty by relying on it in good faith.[121]

Congress also tightened up the pre-existing substantial understatement penalty in two ways. First, it completely denied tax shelter participants access to the substantial authority protection.[122] Second, it modified the definition of a substantial understatement for corporate taxpayers to ensure that understatements in excess of $10 million would be subject to penalty.[123]

By the time the Second Circuit decided *Long Term Capital Holdings*, Congress's trend toward increased reliance on accuracy-related civil penalties to encourage taxpayer compliance was unmistakable. With the exception of its activities in 1989, it had repeatedly encouraged the IRS and the courts to apply already available penalties and had created new ones to address both specific and general taxpayer compliance problems. With respect to participants in tax shelter transactions that were determined to be improper, Congress appeared to be gradually approaching a strict liability understatement penalty. Not surprisingly, Congress's pro-penalty attitude influenced the IRS and the courts.

2. The Internal Revenue Service

From 1992 through 2004, the IRS's general policy statement on penalties was:

> Penalties are used to enhance voluntary compliance: Penalties constitute one important tool of the Internal Revenue Service in pursuing its mission of collecting the proper amount of tax revenue at the least cost. Penalties support the Service's mission only if penalties enhance voluntary compliance. Even though other results such as raising of revenue, punishment, or reimbursement of the costs of enforcement may also arise when penalties are asserted, the Service will design, administer and evaluate penalty programs solely on the

118. American Jobs Creation Act of 2004 § 812(c) (codified at I.R.C. § 6664(d)).

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.* § 812(d) (codified at I.R.C. § 6662(d)(2)(C)).

123. American Jobs Creation Act of 2004 § 819(a) (codified at I.R.C. § 6662(d)(1)(B)). This modification was aimed at larger corporate taxpayers who often avoided the substantial understatement penalty on sizable understatements in absolute terms because those understatements were less than ten percent of their correct taxable income. H.R. REP. NO. 108-548, pt. 1, at 274 (2004).

basis of whether they do the best possible job of encouraging compliant conduct.[124]

To that end, the IRS "use[d] penalties to encourage voluntary compliance by: (1) helping taxpayers understand that compliant conduct is appropriate and that noncompliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer."[125] The IRS periodically made regulatory changes to more effectively promote its voluntary compliance goal.[126] Following Congress's lead, the IRS increasingly adopted a pro-penalty posture in its regulatory activities.[127]

Much of the IRS's rulemaking in this area simply elaborated on the legislative changes discussed above.[128] However, glimpses of the IRS's evolving viewpoint on penalty protection can be derived from its responses to commentator suggestions during the notice and comment rulemaking process.[129] For example, the IRS specifically rejected commentator suggestions that penalty protection safe harbors should be created and that "reliance on professional advice limited to the conclusion that there is substantial authority for a position should qualify for the reasonable cause and good faith exception."[130] The IRS's rejection was premised on its belief that its penalty administration would be most effective when it used a flexible, fact-specific penalty analysis, which was inconsistent with the proposed bright-line penalty protection rules.[131]

124. I.R.S. Policy Statement P-1-18 (Apr. 27, 1992), *reprinted in* 1 INTERNAL REVENUE MANUAL (Administration) (CCH) § 1.2.1.2.3(1) (Mar. 2001). For a more exhaustive discussion of the IRS's philosophy on penalties when the Policy Statement was adopted, see generally EXECUTIVE TASK FORCE, INTERNAL REVENUE SERVICE, COMMISSIONER'S PENALTY STUDY, REPORT ON CIVIL TAX PENALTIES, *reprinted in* TAX NOTES TODAY (1989), and Dennis J. Ventry Jr., *IRS Penalty Study: A Call For Objective Standards*, 112 TAX NOTES 1183 (2006) (summarizing 402-page report while looking back on results of IRS's mammoth effort nearly twenty years later).

125. I.R.S. Policy Statement P-1-18.

126. *Id.*

127. However, IRS rulemaking often moves forward slowly. *See, e.g.*, T.D. 9174, 2005-1 C.B. 629 (removing long-obsolete substantial understatement of liability regulations promulgated under I.R.C. § 6661, which was repealed by Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(2), 103 Stat. 2106, 2399).

128. *See, e.g.*, T.D. 8381, 1992-1 C.B. 374, 374 (fleshing out rules for negligence or disregard of rules or regulations penalty, substantial understatement penalty, and substantial (or gross) valuation misstatement penalty under new penalty regime created by Omnibus Budget Reconciliation Act of 1989 § 7721(a) (codified as amended at I.R.C. §§ 6662–65)). See *supra* Part III.A.1 for a discussion of Congress's legislative efforts during this period. The IRS also made itself useful by issuing pronouncements aimed at helping taxpayers comply with the law and avoid substantial underpayment penalties through adequate disclosure on their tax returns. *See, e.g.*, Rev. Proc. 2004-73, 2004-51 I.R.B. 999 (listing adequate disclosure procedures for everything from medical expenses to investment credits).

129. *See* 5 U.S.C. § 553(c) (2006) (requiring agency to "give interested persons an opportunity to participate in the rule making," and, "[a]fter consideration of the relevant matter presented, . . . incorporate in the rules adopted a concise general statement of their basis and purpose").

130. T.D. 8381, 1992-1 C.B. 374, 379.

131. *Id.*

Four years later, the IRS rejected two additional requests for taxpayer-friendly penalty protection rules regarding reliance on professional tax advice.[132] First, the IRS refused to remove proposed language requiring a taxpayer to reasonably conclude that the tax advisor was qualified to render tax advice.[133] Second, the IRS did not adopt a suggestion that the relied-on tax advice be excused from taking into account the taxpayer's purposes for conducting a transaction in a particular manner because it felt that those purposes shed light on "whether the taxpayer acted in good faith in its tax return treatment of items from the transaction."[134]

In 2003, the IRS briefly took the lead from Congress in limiting taxpayer access to penalty protection.[135] The IRS issued regulations that came close to rendering a tax advisor's opinion worthless for penalty protection purposes if the challenged transaction was a "reportable transaction"[136] and the taxpayer did not adequately disclose it.[137] The IRS took this aggressive step because "early identification of potentially abusive tax avoidance transactions [was] a high priority" and because it "believe[d] that taxpayers [were] improperly rel[ying] on opinions or advice issued by tax advisors to establish reasonable cause and good faith as a basis for avoiding the accuracy-related penalty, even when the

132. T.D. 8617, 1995-2 C.B. 274, 275. The IRS did make one concession in this area when it agreed to allow reliance on tax advice that was "based upon all *pertinent* facts and circumstances" rather than on "all *material* facts" because taxpayers cannot be expected to know which facts are material to the advisor's legal conclusions. *Id.* (emphasis added).

133. *Id.* The IRS did not appear to go as far as Judge Arterton did in this respect. *See* Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 209–10 (D. Conn. 2004), *aff'd sub nom*. Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40 (2d Cir. 2005) (requiring taxpayer to evaluate quality of tax lawyer's advice, including whether it was sufficiently well grounded in decisions of applicable appellate court).

134. T.D. 8617, 1995-2 C.B. 274, 275. Given that many of the critical common law anti-abuse doctrines (e.g., the economic substance doctrine) turn in part on taxpayer intent, it is hard to see how the commentator who suggested this position expected the IRS to agree. *See* Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 781–82 (5th Cir. 2001) (denying application of economic substance doctrine to Compaq's transaction because Compaq had business purpose other than acquisition of tax benefits for entering into transaction); Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91–92 (4th Cir. 1985) (adopting two-prong sham transaction doctrine inquiry that included whether "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction"). *But see* Boulware v. United States, 128 S. Ct. 1168, 1182 (2008) (holding that criminal tax defendant was not required to show contemporaneous intention to treat corporate distribution as nontaxable return of capital prior to arguing that such treatment would eliminate alleged tax underpayment).

135. *See* T.D. 9109, 2004-1 C.B. 519 (limiting applicability of reasonable cause exception). Congress caught up when it created I.R.C. §§ 6662A and 6664(d) in the American Jobs Creation Act of 2004. See *supra* notes 112–23 and accompanying text for a description of those provisions.

136. See *supra* notes 114–115 and accompanying text for a brief discussion of "reportable transactions."

137. T.D. 9109, 2004-1 C.B. 519, 520 (explaining that "a taxpayer's failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith, which would bar relief under section 6664(c)"). Because the regulation devalued an attorney's advice for penalty protection purposes, at least one commentator accused the IRS of interfering with the attorney-client relationship and of deterring clients from relying on attorneys for advice. Beckett G. Cantley, *The New Tax Shelter Opinion Letter Regulations: Cutting Back on a Client's Ability to Rely on the Advice of His Counsel*, 18 AKRON TAX J. 47, 73 (2003).

opinion[s] or advice relate[d] to a reportable transaction that the taxpayer should have, but did not, disclose."[138] Congress caught up to the IRS in this area when it created I.R.C. §§ 6662A and 6664(d) in the American Jobs Creation Act of 2004.[139]

While the rulemaking branch of the IRS steadily tightened the penalty provisions in its regulations, the IRS's enforcement wing adopted various disclosure amnesty programs and settlement initiatives that traded away penalty protection when doing so hastened payment of the actual tax liability.[140] The most extensive of these initiatives was I.R.S. Announcement 2002–2, which proclaimed

> a disclosure initiative to encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. If a taxpayer discloses any item . . . the IRS will waive the accuracy-related penalty under § 6662(b)(1), (2), (3), and (4) for any underpayment of tax attributable to that item.[141]

The district court's opinion in *Long Term Capital Holdings* had a marked effect on the IRS's attitude toward bartering away penalties.

After Judge Arterton released the *Long Term Capital Holdings* opinion, the IRS quickly responded by trumpeting its victory and by stressing the fact that "a legal opinion is not a free pass from facing penalties."[142] Policy changes followed shortly thereafter. Almost immediately, the IRS Appeals Division "reassessed and tightened" its settlement offers to taxpayers who had participated in certain abusive transactions.[143] The announced settlement terms were revised to include a taxpayer concession to the imposition of fifty percent of the potentially applicable accuracy-related penalty.[144] According to the IRS Chief of Appeals, "'[m]odifying [the IRS's] settlement guidelines was appropriate in light of *Long Term Capital Holdings*'" because "'[t]he court's

138. Establishing Defenses to the Imposition of the Accuracy-Related Penalty, 67 Fed. Reg. 79,894, 79,895 (proposed Dec. 31, 2002).

139. See *supra* notes 112–121 and accompanying text for a discussion outlining recently enacted reportable transaction penalty provisions.

140. *See, e.g.*, I.R.S. Announcement 2004-46, 2004-1 C.B. 964, 964 (announcing new settlement initiative for participants in "Son of BOSS" tax shelters that permitted them to limit their penalties to ten percent if they had not participated in another listed transaction). *But see* Rev. Proc. 2003-11, 2003-1 C.B. 311 (offering civil fraud penalty protection to taxpayers who disclosed having "used offshore payment cards or offshore financial arrangements to avoid United States income taxes" and paid their taxes, but reserving right to impose accuracy-related civil penalties).

141. I.R.S. Announcement 2002-2, 2002-1 C.B. 304, 304.

142. *Everson Says IRS "Pleased" with Decision in Long-Term Capital Holdings Case*, *supra* note 6.

143. I.R.S. News Release IR-2004-128 (Oct. 20, 2004), *available at* http://www.irs.gov/newsroom/article/0,,id=130347,00.html.

144. *Id.* If the IRS had asserted both the forty percent gross valuation understatement penalty and the twenty percent substantial understatement penalty, then the taxpayer had to concede a twenty percent penalty. *Id.*

careful analysis was a compelling reason to incorporate the case in [the IRS's] assessment of the litigating hazards for [the affected] cases.'"[145]

Concurrently, the IRS Office of Chief Counsel revised its position regarding penalties when advising other IRS employees during examinations and when litigating tax cases.[146] After stressing the importance of penalties in "promoting sound tax administration by increasing the economic costs of noncompliance," the Chief Counsel declared that IRS representatives would no longer automatically settle cases by waiving penalties in exchange for a concession of some or all of the underlying tax deficiency.[147] Citing the *Long Term Capital Holdings* case twice, the Chief Counsel explained that a "hazards of litigation" analysis for penalty imposition must be performed separately from the deficiency analysis because, as demonstrated by that case, a taxpayer often fails to carry the burden of proof on penalty protection issues.[148]

Thus, after *Long Term Capital Holdings* the IRS stood poised to carry out the voluntary compliance mission outlined in its long-standing penalty policy statement by "ratchet[ing] up the pressure on those entering into abusive transactions"[149] because "[c]onceding penalties . . . risks undercutting efficient tax administration by reducing the deterrent effect of penalties."[150] In doing so, the IRS would challenge taxpayer penalty protection defenses in court and would put pressure on the courts to sustain its penalty determinations.[151] Victory in the Second Circuit only served to harden the IRS's resolve.[152]

3. The Courts

While the courts have been only too willing to affirm the IRS's penalties where appropriate,[153] they have acted as an important safeguard against

145. *Id.* (quoting David Robison, IRS Chief of Appeals).

146. I.R.S. Office of Chief Counsel Notice CC-2004-036 (Sept. 22, 2004), *available at* www.irs.gov/pub/irs-ccdm/cc-2004-036.pdf.

147. *Id.* at 1–2. *See generally* Sheryl Stratton & Allen Kenney, *Appeals Tightens Screws on Shelter Investors*, 105 TAX NOTES 487 (2004) (discussing IRS's settlement guidelines announcement).

148. I.R.S. Office of Chief Counsel Notice CC-2004-036 at 1.

149. I.R.S. News Release IR-2004-128 (Oct. 20, 2004), *available at* http://www.irs.gov/newsroom/article/0,,id=130347,00.html.

150. I.R.S. Office of Chief Counsel Notice CC-2004-036 at 1.

151. *See id.* at 2 (stating proper application and development of penalties should be examined when deciding whether to litigate, examining possible defenses, and noting burden is on taxpayer to prove defense); I.R.S. News Release IR-2004-128 (announcing that IRS Commissioner Everson believes that "'[b]oth Congress and the courts are supporting [the IRS] in this effort'").

152. *See* Sheryl Stratton, *Government, Practitioners Look at Attacking Tax Shelters from Both Sides*, TAX NOTES TODAY, Sept. 30, 2005, 2005 TNT 189-3 (LEXIS) (discussing both IRS and practitioner viewpoints on penalties shortly after Second Circuit's ruling and quoting assistant attorney general for Justice Department's Tax Division attributing IRS's victory to "brilliant" litigation team).

153. *See, e.g.*, Estate of True v. Comm'r, 390 F.3d 1210, 1245–47 (10th Cir. 2004) (affirming Tax Court's determination that accuracy-related penalty for substantial estate tax valuation understatement was warranted); Horwath v. Comm'r, T.C.M. (RIA) 2004-213 (2004) (imposing negligence accuracy-related penalty); Peete v. Comm'r, 87 T.C.M. (CCH) 951, 953 (2004) (finding that substantial underpayment accuracy-related penalty applied).

excessive IRS zeal. Of course, because of the highly fact-specific nature of the penalty analysis and the myriad judges involved, the courts, unlike Congress and the IRS, do not speak with a single voice on these issues.[154] Therefore, what follows is a discussion of the principal case law touching the two significant penalty protection aspects of *Long Term Capital Holdings*: (1) whether factual evidence can be included in the "substantial authority" analysis necessary to avoid the substantial understatement penalty under I.R.C. § 6662(d)(2)(B)(i) and Treasury Regulation § 1.6662-4(b)(4)(ii)(A), and (2) to what extent must a taxpayer scrutinize professional tax advice before he or she can safely rely on it for protection under the I.R.C. § 6664(c) reasonable cause exception.[155]

Whether factual evidence can be included in the "substantial authority" analysis becomes critical when the underlying tax issue turns completely on a single factual determination and there is evidence pointing in both directions.[156] The principal appellate cases addressing whether the "substantial authority" analysis encompasses consideration of discredited factual evidence are *Osteen v. Commissioner*,[157] *Streber v. Commissioner*,[158] and *Estate of Kluener v. Commissioner*.[159] Although each court held that the discredited factual evidence could be considered in the substantial authority analysis and that the taxpayer was not liable for an accuracy-related penalty because substantial authority existed, the courts differed on the amount of factual evidence necessary to establish substantial authority.

In *Osteen*, the IRS and the Tax Court agreed that the Osteens could not deduct certain losses from their farming and horse breeding operation because they did not engage in it for profit.[160] The Eleventh Circuit concurred with that conclusion, but not with the accompanying substantial understatement penalty, because it found that the Osteens had substantial authority for their deductions.[161] After noting that the underlying tax issue turned entirely on the factual determination of profit motive, and that not even the IRS argued that

154. Indeed, it is possible for two judges on the same court to reach opposite conclusions in parallel cases involving essentially the same set of facts. *See* Richard J. Wood, *Accuracy-Related Penalties: A Question of Values*, 76 IOWA L. REV. 309, 325–26 (1991) (complaining that in *Todd v. Comm'r*, 89 T.C. 912 (1987), *aff'd*, 862 F.2d 540 (5th Cir. 1988), and *Noonan v. Comm'r*, 52 T.C.M. (CCH) 534 (1986), Tax Court reached opposite conclusions on same penalty issue for two sets of taxpayers that had participated in exact same tax shelter).

155. See *supra* Part II.B for an analysis of the roles these issues played in *Long Term Capital Holdings*.

156. Merrill Glenn Jones II, Note, Osteen v. Commissioner*: In Search of a Workable Test for Substantial Authority in "All Or Nothing" Substantial Understatement Penalty Tax Cases*, 31 WAKE FOREST L. REV. 1185, 1207 (1996) (explaining that, although whether substantial authority exists is legal question, it can become question of fact in these circumstances). This problem is exacerbated when the factual question at issue is one of taxpayer intent. *See* Estate of Kluener v. Comm'r, 154 F.3d 630, 638 (6th Cir. 1998) (discussing use of factual evidence to show intent).

157. 62 F.3d 356 (11th Cir. 1995).

158. 138 F.3d 216 (5th Cir. 1998).

159. 154 F.3d 630 (6th Cir. 1998).

160. *Osteen*, 62 F.3d at 357.

161. *Id.* at 358.

losing that factual issue meant that the taxpayers automatically lost the legal substantial authority issue, the Eleventh Circuit applied the "clearly erroneous" standard of review to determine that "there is substantial authority from a factual standpoint for the taxpayer's position."[162] Alternatively, the court found that the facts before it were similar enough to those in cases where taxpayers had successfully established a profit motive that the Osteens could use those cases for substantial authority.[163]

The Fifth Circuit agreed with *Osteen* when it confronted the same issue in *Streber*.[164] It held that factual evidence could contribute to substantial authority and that the clearly erroneous standard was the appropriate test for substantial authority from a factual standpoint.[165] As in *Osteen*, the IRS did not argue that factual authority was not a component of substantial authority.[166] That position, however, was championed by Judge King in a vigorous dissent.[167] Judge King supported her position by observing that the Treasury regulation defining "substantial authority" listed only legal authorities and that Congress could not have intended that the clearly erroneous standard apply to determine factual substantial authority because that standard effectively eviscerated the substantial understatement penalty.[168]

Although the Sixth Circuit was not prepared to adopt Judge King's dissent, it did take a step in that direction in *Estate of Kluener*.[169] After examining the Treasury regulations dealing with the substantial authority defense, the court decided that it could consider factual evidence because those regulations "command us to examine relevant facts, whereas nothing explicitly precludes us from examining them."[170] However, it agreed with Judge King that the clearly erroneous standard applied by the *Osteen* and *Streber* courts was too weak because that standard was inconsistent with the regulatory requirement that

162. *Id.* at 359. In other words, "[o]nly if there was a record upon which the Government could obtain a reversal under the clearly erroneous standard could it be argued that from an evidentiary standpoint, there was not substantial authority for the taxpayer's position." *Id.*

163. *Id.* at 360.

164. Streber v. Comm'r, 138 F.3d 216, 223 (5th Cir. 1998).

165. *Id.*

166. *Id.* at 223 n.14. The Tax Court did not base its holding that the taxpayers lack substantial authority on that position either. *Id.*

167. *Id.* at 228–29 (King, J., dissenting) ("[T]he majority proceeds to heap one legal error onto another by promulgating in dicta a construction of the substantial authority standard that fails to comport with the treasury regulations interpreting § 6661 and that robs the statute of much of its value as a deterrent of taxpayer misconduct.").

168. *Streber*, 138 F.3d at 228 (King, J., dissenting). Judge King also commented that the clearly erroneous standard would encourage taxpayers to litigate, rather than settle, disputes with the IRS when a substantial understatement penalty had been asserted because the taxpayers could easily avoid that penalty by creating a fact issue. *Id.* at 228 n.3.

169. Estate of Kluener v. Comm'r, 154 F.3d 630, 638–39 (6th Cir. 1998). Unlike *Osteen* and *Streber*, which were decided under the old substantial understatement penalty in I.R.C. § 6661, *Estate of Kluener* dealt with I.R.C. § 6662. *Id.* at 637.

170. *Id.* at 638. The court also expressed concern over adopting a policy that would encourage courts to assess a penalty while ignoring the facts. *Id.*

"substantial authority" exceed the reasonable basis standard.[171] Instead the court held that "'substantial authority' requires a taxpayer to present considerable or ample authority, whereas *Osteen* requires him to present only some evidence."[172] The lone dissenter in *Estate of Kluener*, Judge Wellford, agreed that factual evidence could be considered, but only to determine which legal authorities applied.[173] Thus, under Judge Wellford's formulation of the substantial authority standard, the taxpayer is penalized immediately upon losing the underlying tax deficiency issue.[174]

Given the dearth of Tax Court cases citing *Osteen*, *Streber*, and *Estate of Kluener* for the proposition that factual evidence is part of the substantial authority analysis, it seems likely that the Tax Court was ignoring those cases on that point.[175] Apparently, even for cases within the Eleventh Circuit, the Tax Court ignored *Osteen* and continued to impose substantial understatement penalties in "all or nothing" cases with little or no explanation.[176] Nevertheless, despite the Tax Court's passive resistance and vocal dissenters like Judge King, the majority opinions in *Osteen*, *Streber*, and *Estate of Kluener* were the applicable law when Judge Arterton decided *Long Term Capital Holdings*.[177]

The case law dealing with the second penalty protection issue—to what extent must a taxpayer scrutinize professional tax advice before he or she can safely rely on it for protection under the I.R.C. § 6664(c) reasonable cause

171. *Id.* at 639. The current reasonable basis standard requires more than a frivolous or merely colorable claim. Treas. Reg. § 1.6662-3(b)(3) (as amended in 2003).

172. *Estate of Kluener*, 154 F.3d at 639. In dicta, the court suggested that the "substantial evidence" test for reviewing adjudicative administrative decisions, which requires a "degree of evidence that could satisfy a reasonable factfinder," might be an appropriate standard of review. *Id.* at 639 n.2.

173. *See id.* at 640 (Wellford, J., concurring in part and dissenting in part) (recognizing that substantial legal authority existed for taxpayer's position, but that using it presupposes taxpayer's version of facts).

174. *Id.*

175. The only Tax Court case found that favorably cited one of these cases for this proposition prior to the *Long Term Capital Holdings* decisions was *Calarco v. Commissioner*, No. 1530-03S, 2004 WL 1616387, at *10 (T.C. July 20, 2004) ("We take this factual documentation into account in weighing whether a taxpayer should be subject to section 6662 penalties." (citing *Kluener*, 154 F.3d at 637–38)). Because *Calarco* is a Tax Court Summary Opinion, it may not even be cited as precedent in other cases. *Id.* at *1 n.1; *see also* I.R.C. § 7463(b) (2006) (stating that Tax Court decisions "shall not be treated as a precedent for any other case").

176. *See* Appellant's Opening Brief at 53–54 & nn.33–34, United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014 (11th Cir. 2001) (No. 00-12720-EE) (complaining that Tax Court ignored *Osteen* despite fact that appellant explicitly cited that case to court). The Tax Court's disregard is surprising given its view that "better judicial administration. . . . requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone." Golsen v. Comm'r, 54 T.C. 742, 757 (1970) (footnote omitted), *aff'd*, 445 F.2d 985 (10th Cir. 1971). The Eleventh Circuit did not address the Tax Court's noncompliance with *Osteen* because it held that United Parcel Service's tax treatment was proper, making the penalty issue moot. *United Parcel Serv. of Am., Inc.*, 254 F.3d at 1020.

177. *See* Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 201–04 (D. Conn. 2004) *aff'd sub nom*. Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40 (2d Cir. 2005) (discussing, and disagreeing with, only those three cases on this point of law).

exception—is sparse.[178] The seminal case in this area, the Supreme Court's decision in *United States v. Boyle*,[179] did not even deal directly with accuracy-related penalties.[180] The relevant *Boyle* dictum follows:

> When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the [Internal Revenue] Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.[181]

Thus, *Boyle* suggests that a taxpayer need not scrutinize the advisor's legal advice once he or she is satisfied with the competency of the "presumed expert."[182] This interpretation is consistent with the Treasury regulation directive that "reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of *Federal tax law*."[183] It is also consistent with the Fifth Circuit's holding in *Srivastava v. Commissioner*[184] that denied penalty protection to a taxpayer who attempted to rely on an attorney who was not a tax lawyer.[185]

178. Notably, that portion of the *Long Term Capital Holdings* opinion cites no cases on this point. *Id.* at 208–11.

179. 469 U.S. 241 (1985).

180. *See Boyle*, 469 U.S. at 245–51 (analyzing reasonable cause exception to late-filing penalty found in I.R.C. § 6651(a)(1)).

181. *Id.* at 251. Courts have utilized various portions of this passage when evaluating whether a taxpayer satisfies the I.R.C. § 6664(c) reasonable cause exception. *See, e.g.*, Stanford v. Comm'r, 152 F.3d 450, 461 (5th Cir. 1998) (finding taxpayer's reliance on advice from accountant and attorney was reasonable based on rationale in *Boyle*); Heasley v. Comm'r, 902 F.2d 380, 384 (5th Cir. 1990) (relying on *Boyle* to evaluate whether taxpayer had exercised due care sufficient to avoid negligence penalty); Peete v. Comm'r, 87 T.C.M. (CCH) 951, 952 (2004) (employing *Boyle* to find taxpayer did not reasonably rely on competent tax professional advice). A businessman's right to rely on the advice of counsel is not limited to tax matters. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 881 n.22 (Del. 1985) ("[W]e are satisfied that in an appropriate factual context a proper exercise of business judgment may include, as one of its aspects, reasonable reliance upon the advice of counsel."), *overruled on other grounds by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

182. *Boyle*, 469 U.S. at 251; *see also* Mauerman v. Comm'r, 22 F.3d 1001, 1006 (10th Cir. 1994) (finding reasonable reliance when taxpayer used his own independent attorneys and accountants to advise him on an investment because "it is not reasonable to expect that Mauerman could monitor his independent advisors to make sure they had done sufficient research to give knowledgeable advice. It is for exactly this reason that many intelligent investors hire independent, educated experts to advise them.").

183. Treas. Reg. § 1.6664-4(c)(1) (as amended in 2003) (emphasis added). According to the IRS when it issued that regulation, "[i]n most situations it will generally be reasonable for a taxpayer to conclude that an attorney, an accountant, or an enrolled agent is qualified to give advice on Federal tax law." T.D. 8617, 1995-2 C.B. 274, 275.

184. 220 F.3d 353 (5th Cir. 2000).

185. *Srivastava*, 220 F.3d at 367. To make matters worse for the taxpayers in *Srivastava*, the attorney testified that he told the taxpayers to "seek out a tax lawyer for tax advice." *Id.*

Similarly, tax advice from an insurance agent is insufficient to establish reasonable reliance.[186]

However, simply having "[t]he participation of highly paid [tax] professionals" does not automatically provide a taxpayer with "protection, excuse, justification, or immunity from . . . penalties."[187] In particular, relying on an advisor who is also promoting the investment that is the advice's subject is not reasonable because of the advisor's inherent conflict.[188]

In short, while courts have found a taxpayer's reliance unreasonable when the expert is not a tax expert or is conflicted, it appears that, prior to *Long Term Capital Holdings*, courts did not deny penalty protection to a taxpayer simply because the quality of the legal advice provided to the taxpayer by a tax expert was inadequate or wrong.[189] Thus, while the courts were quite prepared to deny penalty protection to taxpayers, they were more lenient than the IRS with respect to each of the issues discussed above.

B. The District Court's Opinion in Context

Judge Arterton's hard line on the penalty and penalty protection issues is consistent with Congress's general trend toward increased reliance on accuracy-related penalties to encourage taxpayer compliance and its gradual move toward creation of a strict liability underpayment penalty for abusive tax shelters. In addition, although the district court's opinion in *Long Term Capital Holdings* preceded enactment of the American Jobs Creation Act of 2004 by several months, its holdings were compatible with that legislation in several ways.

First, the court's close scrutiny and ultimate denial of Long Term's request for substantial understatement penalty reduction under I.R.C. § 6662(d)(2)(B)—because Long Term's transaction was found to be a tax shelter—foreshadowed Congress's complete disallowance of that section's potential penalty protection for tax shelter participants.[190]

186. Neonatology Assocs., P.A. v. Comm'r, 115 T.C. 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

187. Nicole Rose Corp. v. Comm'r, 117 T.C. 328, 341 (2001), *aff'd per curiam*, 320 F.3d 282 (2d Cir. 2003).

188. Goldman v. Comm'r, 39 F.3d 402, 408 (2d Cir. 1994); Edwards v. Comm'r, 84 T.C.M. (CCH) 24, 34–35 (2002).

189. The closest case was *Jones v. Commissioner*, 74 T.C.M. (CCH) 473 (1997). In *Jones*, the Tax Court stated that the taxpayer's reliance on his accountants was unreasonable because "the accountants unreasonably relied on uncorroborated journal entries" when preparing the taxpayer's tax return. *Id.* at 491. However, the erroneous journal entries were intentionally prepared at the taxpayer's direction, so it is not clear that the accountants' lack of diligence, rather than the taxpayer's subterfuge, prevented reasonable reliance. *See id.* (noting that petitioner's failure to provide necessary information was relevant in finding that petitioner did not act in good faith). Furthermore, this appears to be a factual error, not a legal error, on the accountants' part. *See id.* (indicating accountant failed to verify journal entries with bank statements, canceled checks, or other external sources).

190. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 812(d), 118 Stat. 1418, 1580 (codified at I.R.C. § 6662(d)(2)(C) (2006)) (stating that statutory provision reducing understatement penalty in certain circumstances does not apply to tax shelters).

Second, had Congress's new reportable transaction penalty applied to the tax years at issue in *Long Term Capital Holdings*, it would have compelled the same result that the court reached. Because Long Term claimed a $106,058,228 capital loss on its tax return from the transaction, that loss transaction would have been a reportable transaction potentially subject to the new twenty percent penalty under I.R.C. § 6662A.[191] Furthermore, because Long Term failed to adequately disclose the loss on its tax return, it would be denied an opportunity to avail itself of the reasonable cause exception in I.R.C. § 6664 under the new law.[192]

Finally, the court's suspicion of the K&S opinion during its reasonable cause exception analysis is consistent with the provisions in the new law that forbid reliance on opinions by material advisors and on opinions that rely on unreasonable factual assumptions.[193] Those provisions would have applied because K&S received over $500,000 of compensation and was involved in the structuring of the transaction, and because the court found that K&S did not sufficiently examine Long Term's purported reasons for undertaking the transactions in question.[194]

Similarly, and not surprisingly because the court agreed with the IRS's arguments in the case, *Long Term Capital Holdings* fits nicely with the IRS's penalty and penalty-protection views. As discussed above, the IRS has steadily pushed for tough and flexible reasonable reliance requirements, and has attempted to restrict penalty protection where it believes that a taxpayer's purpose for entering into a potentially abusive tax shelter is improper.[195] Likewise, Judge Arterton's penalty protection analysis was stringent and fact-intensive, and focused in part on Long Term's reasons for transacting with OTC.[196] Perhaps most importantly, given the IRS's recent emphasis on fighting tax shelters by forced adequate disclosure of reportable transactions, the court lambasted Long Term for its failure to properly report the transactions resulting in its claimed losses on its return and used that failure as an alternative reason

191. See *supra* notes 113–16 and accompanying text for an explanation of the various statutory and regulatory provisions that would cause loss transactions like the one in *Long Term Capital Holdings* to fall under the reportable transaction penalty.

192. See *supra* notes 118–20 and accompanying text for a description of how Congress limited the reasonable cause exception's applicability to the new reportable transactions penalty.

193. *See* I.R.C. § 664(d)(3)(B) (stating that certain opinions, including those from specific types of tax advisors, cannot be basis for reasonable belief regarding tax treatments).

194. Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 147, 175, 209 (D. Conn. 2004), *aff'd sub nom*. Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40 (2d Cir. 2005); *see also* Lipton, *supra* note 47, at 358 (speculating that Shearman and K&S would have been "material advisors" under American Jobs Creation Act such that their opinions would have been worthless).

195. See *supra* notes 129–34 and accompanying text for a detailed discussion of the IRS's steadfast refusal during its rulemaking process to adopt taxpayer requests to provide penalty protection safe harbors.

196. *Long Term Capital Holdings*, 330 F. Supp. 2d at 209.

for denying penalty protection.[197] From the IRS's perspective, "'[t]he court decision validated the IRS position on penalties.'"[198]

Unlike Congress and the IRS, prior penalty protection rulings by the courts are not completely harmonious with *Long Term Capital Holdings*. The court's legal bases for denying penalty protection—that Long Term failed to prove reliance on K&S's advice when it submitted its tax return and that Long Term's actions evidenced a lack of good faith—are not particularly controversial.[199] However, Judge Arterton's substantial authority analysis and her requirement that Long Term heavily scrutinize the quality of the legal advice it received from K&S represent a departure from prior case law.

Although the court cited and discussed the three principal appellate cases deciding whether facts can constitute "substantial authority" for penalty protection purposes,[200] it rejected the majority opinions in each case in favor of Judge King's dissenting opinion in *Streber*.[201] That rejection placed Long Term in an untenable, and arguably unfair, position, because it forced Long Term to show substantial legal support for its tax return positions based on the facts as found by the court, not as reasonably understood by Long Term when it filed its return. As a result, Long Term was effectively denied an opportunity for penalty relief under I.R.C. § 6662(d)(2)(B) once the court reshaped the actual transactions that occurred into something materially different by using either the step transaction doctrine or the economic substance doctrine. Long Term's only possible penalty defense under the court's approach would have been to anticipate that the IRS and the court would apply a judicial doctrine like the step transaction doctrine or the economic substance doctrine, guess how the revised transactions would appear, and file its tax returns accordingly.[202] This result is precisely the "all or nothing" situation properly decried by the Eleventh Circuit in *Osteen*.[203]

The court's conclusion, that Long Term could not reasonably and in good faith rely upon the K&S opinion because that opinion did not meet the court's stringent standards (e.g., citing enough Second Circuit case law and undertaking a sufficiently in-depth analysis of the cases cited in support of Long Term's

197. *Id.* at 211–12.

198. I.R.S. News Release IR-2004-128 (Oct. 20, 2004), *available at* http://www.irs.gov/newsroom/article/0,,id=130347,00.html (quoting Deborah M. Nolan, Commissioner, IRS Large and Mid-Size Business Division).

199. Although the legal bases for these holdings are on fairly solid ground, Judge Arterton's factual findings are not above question. See *supra* notes 80 and 82 for thoughts on the plausibility of these factual findings and whether the court was asking for an unreasonable effort from Long Term.

200. *Long Term Capital Holdings*, 330 F. Supp. 2d at 201–05. See *supra* notes 157–74 and accompanying text for a discussion of the principal cases holding that factual evidence can be considered in the substantial authority analysis.

201. *Long Term Capital Holdings*, 330 F. Supp. 2d at 204.

202. However, even if Long Term reported their transaction in anticipation of the judicial doctrine applied by the court, it might not have had substantial authority to ignore the normally applicable provisions of the Code and Regulations. Lipton, *supra* note 47, at 352–53.

203. Osteen v. Comm'r, 62 F.3d 356, 359–60 (11th Cir. 1995).

positions), was also in error.[204] *Boyle*, its progeny, and Treasury Regulation § 1.6664-4 make clear that a taxpayer's duty in this respect extends no further than assuring himself or herself that the prospective advisor is knowledgeable of federal tax law and is not laboring under a conflict of interest.[205] In contrast, the court's standard would force a taxpayer who desires penalty protection to become a prognosticating tax expert who can anticipate whether the court will find his or her attorney's advice sufficiently well grounded in the applicable law.[206] Clearly, that standard places too high a burden on taxpayers and could make tax counsel's advice practically useless in the very transactions where penalty protection might be necessary.

C. The Wake

1. Congress Resumes Its March Toward Stricter Penalties

After passing the American Jobs Creation Act of 2004, Congress rested on its laurels for a time. But, beginning in 2006, perceived taxpayer abuse and need for revenue pushed Congress to continue strengthening the accuracy-related penalty provisions. That year, as part of a general crackdown on charitable deduction abuse, Congress reduced the gross and substantial valuation misstatement penalty thresholds from 400% and 200% to 200% and 150%, respectively.[207] At the same time, it eliminated the reasonable cause exception for gross valuation misstatement penalties arising from income tax charitable deductions.[208]

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204. Both the government and the Second Circuit seemed to recognize that Judge Arterton was on weak footing here and attempted to mitigate the consequences of her mistake. *Compare* Final Brief for the Appellee at 39–44, Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40 (2d Cir. 2005) (No. 04-5687-cv) (twisting Judge Arterton's questionable statements so that they supported more acceptable bases for denying penalty protection (e.g., Long Term's knowledge that K&S opinion relied on unreasonable legal assumptions)), *with Long-Term Capital Holdings, LP*, 150 F. App'x at 43 n.1 (accepting government's recharacterization of district court's opinion). Notwithstanding the subsequent spin, the lower court's interpretation of the relevant authorities required Long Term to second-guess K&S's work. *See Long Term Capital Holdings*, 330 F. Supp. 2d at 211 (finding that poor quality of reasoning in K&S opinion did not permit Long Term to meet requirement of "reasonable good faith reliance on advice of counsel"); Stobie Creek Invs., LLC v. Comm'r, 82 Fed. Cl. 636, 720 (2008) (contrasting taxpayer's opinion with K&S opinion in *Long Term Capital Holdings*, which "[stood] accused of providing 'minimal legal analysis'").

205. See *supra* notes 179–88 and accompanying text for coverage of applicable case law in this area.

206. *See Long Term Capital Holdings*, 330 F. Supp. 2d at 209–11 (finding K&S opinion to be "shallow" and "superficial"). The court concluded its disparagement of the K&S opinion by stating, "The Court's role as factfinder is more searching and with specifics, analysis, and explanations in such short supply, the [K&S] 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." *Id.* at 211.

207. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(a)(1)(A), (a)(2)(A), 120 Stat. 780, 1083 (codified at I.R.C. § 6662(e)(1)(A), (h)(2)(A)(i)–(ii) (2006)).

208. *Id.* § 1219(a)(3) (codified at I.R.C. § 6664(c)(2)).

In 2007, Congress introduced a new accuracy-related penalty in I.R.C. § 6676 that applies to excessive refund claims.[209] The penalty amount equals twenty percent of the denied portion of the refund claim unless the taxpayer had a reasonable basis for making the denied claim.[210] Although the legislative history is sparse,[211] presumably Congress felt that taxpayers were using refund claims to take questionable tax positions without exposure to the accuracy-related penalty provisions discussed in this Article.[212]

By 2008, Congress was considering two revisions that would effectively convert the accuracy-related civil penalties into strict liability penalties for certain taxpayers. The first revision would codify the economic substance doctrine and create a new twenty percent accuracy-related penalty for "noneconomic substance transactions" that would increase to forty percent if the transactions are not adequately disclosed.[213] In addition, the I.R.C. § 6664(c) reasonable cause exception would not apply to (1) noneconomic substance transactions, whether disclosed or not; (2) tax shelters; and (3) large corporations with gross receipts in excess of $100 million during the relevant taxable year.[214] Large corporations would also be denied a substantial understatement reduction

209. Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, § 8247(a), 121 Stat. 190, 204 (codified at I.R.C. § 6676 (Supp. I 2007)).

210. *Id.*

211. The Joint Committee on Taxation issued an explanation of this provision in an earlier version of the legislation, but did not explain Congress's reasons for enacting it. *See* STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., TECHNICAL EXPLANATION OF THE "SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007" AND PENSION RELATED PROVISIONS CONTAINED IN H.R. 2206 AS CONSIDERED BY THE HOUSE OF REPRESENTATIVES ON MAY 24, 2007, at 36 (Comm. Print 2007) (explaining section 8247 of proposed legislation).

212. The IRS has unofficially speculated that

> (i) numerous frivolous or "bad" refund claims; (ii) limited IRS resources to review refund claims; and (iii) the IRS' timing disadvantage *vis-à-vis* the taxpayer on a refund claim if, in reviewing the refund claim, the IRS finds erroneous items (unrelated to the refund claim) on the return that are not assessable because the period of limitations has expired

may have caused Congress to enact I.R.C. § 6676. SHARYN M. FISK & HEATHER K. LEE, TAXATION PROCEDURE & LITIG. COMMS. OF THE TAXATION SECTIONS OF THE STATE BAR OF CAL. AND THE L.A. COUNTY BAR ASS'N, SECTION 6676 ERRONEOUS CLAIM FOR REFUND OR CREDIT PENALTY: THE PENALTY HAS NO REASONABLE BASIS 5 (2008), *available at* 2008 TNT 109-40 (LEXIS).

213. Universal Homeowner Tax Cut Act of 2008, H.R. 5790, 110th Cong. §§ 211(a), 212(a) (2008). These penalties would also apply to refund claims. *Id.* § 212(c). Congress has considered this type of provision for several years and often uses it as a revenue raiser or spending offset that is otherwise unrelated to the main contents of the bill. *See, e.g.*, Healthcare for Hybrids Act, H.R. 1920, 110th Cong. § 202(a) (2007) (listing new economic substance penalty under "Title II—Offsets"); Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2005, H.R. 2625, 109th Cong. (2005) (proposing to codify economic substance doctrine and create new penalty to accompany it). Ironically, given the forty percent valuation penalty imposed by the court in *Long Term Capital Holdings*, some of these revenue-raising provisions do not even propose a forty percent penalty on nondisclosed noneconomic substance transactions. *See* Food and Energy Security Act of 2007, H.R. 2419, 110th Cong. § 12522(a) (as amended and passed by Senate, Dec. 14, 2007) (imposing thirty percent penalty on nondisclosed transactions and twenty percent penalty on adequately disclosed ones).

214. H.R. 5790, § 212(b)(3), (d)(1).

under I.R.C. § 6662(d) without "a reasonable belief that the tax treatment of such item by the taxpayer is more likely than not the proper tax treatment of such item."[215] Presumably, certain members of Congress believe that these taxpayers do not deserve mercy, because the first two groups have played with fire and members of the last group have the wherewithal to purchase top-notch tax advice so they have no excuse for not getting their tax positions right. Although Congress has adopted this approach for taxpayers that it believed were too aggressive in the past,[216] extending it to large corporations would break new ground by denying penalty protection based on a taxpayer's nature or identity rather than its actions. The introduction of this legislation signals a new willingness to consider strict liability civil penalties for taxpayers attempting to properly calculate their taxes when the appropriate treatment is unclear.

The second revision under current consideration targets hedge fund managers who use partnership structures to convert management fees into capital gains.[217] The applicable penalty would be forty percent for tax underpayments resulting from a hedge fund manager's failure to report income from a "disqualified interest" (e.g., equity, convertible debt, or an option) as ordinary income, and the reasonable cause exception would not be an available defense.[218]

Congress's enacted and proposed legislation since *Long Term Capital Holdings* shows an increasing willingness to impose "no fault" accuracy-related penalties. Although in most cases those penalties are employed to curb specific taxpayer abuses, the proposed elimination of reasonable cause penalty protection for large corporations is particularly troubling because that denial is triggered by the taxpayer's identity, not its behavior. Should Congress continue moving in that direction, strict liability penalties may become the norm, not the exception.

2. No Compromise by the Internal Revenue Service

The IRS's rulemaking branch has not been particularly active on taxpayer penalties since the conclusion of *Long Term Capital Holdings*.[219] Shortly after

215. *Id.* § 212(d)(1).

216. See *supra* note 105 and accompanying text for a discussion of Congress's decision to make penalty protection more difficult for taxpayers who engaged in transactions where the principal purpose was the reduction of tax.

217. Responsible Expansion of the State Children's Health Insurance Program Act of 2008, S. 2936, 110th Cong. § 202(c) (2008). Although hedge fund managers trying to convert management fees into capital gains are not new, see *supra* note 44 for a discussion of Scholes' plan to accomplish that goal for Long Term in the mid-1990s, that strategy has received considerable unfavorable media attention in recent years, *see, e.g.*, Alan S. Blinder, *The Under-Taxed Kings of Private Equity*, N.Y. TIMES, July 29, 2007, at B4 (describing how favorable tax treatment accorded to Blackstone Group, a hedge fund going through initial public offering, "left some members of Congress agape at how little tax the Internal Revenue Service would collect on a multibillion-dollar deal").

218. S. 2936, § 202(a), (c).

219. The IRS's rulemakers were also busy revising the Circular 230 professional standards applicable to tax practitioners who might consider providing penalty protection to their clients. T.D.

Congress passed the American Jobs Creation Act of 2004, the IRS did issue interim guidance to taxpayers on the new statutory penalty provisions.[220] However, this guidance primarily outlined the types of tax advisor activities and compensatory arrangements that the IRS considered suspect without elaborating on the IRS's enforcement position in this area.[221] The IRS has also announced its intention to publish new regulations implementing the new taxpayer penalty provisions in the 2004 Act.[222] Taxpayers are still waiting.[223]

On the enforcement side, the IRS has been more successful in putting out timely internal guidance expressing its commitment to deterring inaccurate reporting via penalties.[224] That guidance has continued the IRS's marked trend toward adopting stronger penalty positions, which began immediately after the district court's ruling in *Long Term Capital Holdings*.[225] First, even though the IRS admonished auditors not to "use penalties as a bargaining point," it now requires them to develop and document a case for imposing accuracy-related penalties for potential tax shelter transactions.[226] That documentation effort can be quite substantial, involving answers to more than one hundred questions.[227]

9165, 2005-1 C.B. 357. That effort may turn out to be as effective as increasing taxpayer penalties. *See* Burgess J.W. Raby & William L. Raby, *Penalty Protection for the Taxpayer: Circular 230 and the Code*, TAX NOTES TODAY, June 2, 2005, 2005 TNT 105-65 (LEXIS) (noting that new Circular 230 both represents and promotes change in tax practitioner's role as source of penalty protection). Perhaps the IRS's rulemakers were simply admiring their handiwork and watching to see whether more was needed.

220. I.R.S. Notice 2005-12, 2005-1 C.B. 494.

221. *Id.*

222. *Id.*

223. *See* IRS, 2008-2009 Priority Guidance Plan (Sept. 10, 2008), at 21, http://www.irs.gov/pub/irs-utl/2008-2009_gpl.pdf (including in list of new items regulations dealing with accuracy-related penalties for understatements under §§ 6662, 6662A, and 6664).

224. *See, e.g.*, IRS, ACCURACY-RELATED PENALTIES FOR TAXPAYERS INVOLVED IN TAX SHELTER TRANSACTIONS: AUDIT TECHNIQUE GUIDE 1 [hereinafter IRS, AUDIT TECHNIQUE GUIDE] ("The consideration and assertion of penalties in audits involving tax shelters is vital to the Service's efforts in addressing the proliferation of tax shelters."); *IRS Issues Audit Technique Guide on Abusive Tax Shelters, Transactions*, TAX NOTES TODAY, May 24, 2005, 2005 TNT 102-14 (LEXIS) (noting that use of *Audit Technique Guide* emphasizes IRS's commitment to addressing problem of tax shelters). The IRS "obsoleted" this Audit Technique Guide in July 2008 because it was incorporated into Part 20 of the Internal Revenue Manual. IRS, Audit Techniques Guides (ATGs), http://www.irs.gov/businesses/small/article/0,,id=108149,00.html (last visited June 8, 2009).

225. See *supra* notes 142–52 for a description of the IRS's immediate response to the district court's opinion in *Long Term Capital Holdings*.

226. IRS, INTERNAL REVENUE MANUAL § 20.1.5.1, *available at* http://www.irs.gov/irm/part20/irm_20-001-005.html. Indeed, for some transactions, the auditing agent is required to prepare a separate report solely addressing the case for imposing accuracy-related penalties. *See* Large & Mid-Size Bus. Div., Internal Revenue Serv., Coordinated Issue—All Industries—Redemption Bogus Optional Basis Tax Shelter (Jan. 31, 2006), http://www.irs.gov/businesses/corporations/article/0,,id=154246,00.html (containing guidelines for reviewing certain partnership transactions involving improper basis increases obtained under I.R.C. §§ 754 and 743).

227. *See* IRS, AUDIT TECHNIQUE GUIDE, *supra* note 224, at 24–31 (listing questions that IRS auditors typically consider when developing accuracy-related penalty).

Second, for certain types of transactions, the IRS now advises appeals officers to assume that accuracy-related penalties should apply.[228]

Finally, in I.R.S. Announcement 2005-80, the IRS announced a settlement initiative that covered twenty-one types of transactions, most of which had already been identified as abusive, and extended to all transaction participants except the promoter, those connected to the promoter, those accused of fraud or under criminal investigation, and those whose cases had already been designated for litigation or were being litigated.[229] Taxpayers wishing to utilize the initiative had to accept the IRS's treatment of the transaction, pay all resulting taxes, and consent to a civil accuracy-related penalty under I.R.C. § 6662.[230] The only two permitted penalty exceptions were (1) prior proper disclosure under I.R.S. Announcement 2002-2,[231] and (2) reliance on a written tax opinion that the taxpayer received prior to filing the tax return and that reaches a "more likely than not" confidence level on all significant federal tax issues after considering all the relevant facts and without assuming any unreasonable facts.[232] In addition, the opinion must be from a tax advisor who was not connected to the transaction's promoter or preparing the taxpayer's opinion under a contingent fee tied to "the successful sustention of all or part of the intended tax benefit."[233] Thus, the IRS's only major settlement initiative after *Long Term Capital Holdings* delivered on the post-trial promises by the IRS Chief of Appeals and IRS Chief Counsel not to compromise anymore on penalties.[234]

3. The Courts' Tepid Response

Subsequent case law has not said much about either controversial aspect of Judge Arterton's penalty protection conclusions. With respect to her consideration of the K&S opinion's legal shortcomings, that absence may be explained by the Second Circuit's minimization and recharacterization of her discussion on that point.[235] In its opinion, the Second Circuit relegated this issue to a footnote and explained that Judge Arterton

228. *See, e.g.*, IRS, SETTLEMENT POSITION: NOTIONAL PRINCIPAL CONTRACTS (CONTINGENT DEFERRED SWAPS) 61 (2006), *available at* http://www.irs.gov/pub/irs-utl/asg_npc__2005-04-20_redacted.pdf ("Appeals believes the penalty for substantial understatement and negligence and disregard of rules and regulations will apply in the typical case.").

229. I.R.S. Announcement 2005-80, 2005-2 C.B. 967, 967–69. The settlement initiative expired on January 23, 2006. *Id.* at 967.

230. *Id.* at 970.

231. See *supra* text accompanying note 141 for the disclosure provisions in I.R.S. Announcement 2002-2.

232. I.R.S. Announcement 2005-80, 2005-2 C.B. 967, 970.

233. *Id.*

234. See *supra* notes 143–48 and accompanying text for a more detailed discussion of the IRS's change in settlement and penalty policies.

235. *See* Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40, 43 n.1 (2d Cir. 2005) (commenting that Judge Arterton's criticism of K&S's legal analysis was not result of any expectation that Long Term second-guess that advice).

> criticized K&S's limited and unimpressive use of law not because [she] expected Long-Term to engage in sophisticated questioning of its expert's advice but because the inadequacy of the legal analysis showed that K&S's advice amounted to "general superficial pronouncements" based almost entirely on the flawed and outcome-determinative assumptions Long-Term asked it to make.[236]

After such a careful sanitation by the Second Circuit, it's no surprise that other courts have not viewed *Long Term Capital Holdings* as establishing a new penalty protection paradigm. Instead, they continue to examine whether the taxpayer's expert is sufficiently qualified in the relevant subject matter to justify the taxpayer's reliance,[237] but do not require second guessing of the expert's actual work product.[238] In one case, *Santa Monica Pictures, LLC v. Commissioner*,[239] the Tax Court appears to have held that an absence of legal analysis in a lawyer's written opinion can prevent it from providing penalty protection to a taxpayer.[240] However, an absence of legal analysis differs from erroneous legal analysis in one important respect—the former is much easier for a taxpayer to recognize than the latter. For that reason, the Tax Court's criticism of the legal opinion in *Santa Monica Pictures* does not necessarily mean that the Tax Court agrees with Judge Arterton on this point. Furthermore, it is not clear whether the lack of legal analysis alone would have been sufficient to make the taxpayer's reliance on the opinion unreasonable, because the court also found that the opinion was "grounded on erroneous factual assumptions that [the taxpayer] knew were untrue."[241] Notwithstanding the *Santa Monica Pictures* case, there is little evidence to suggest that the courts will follow Judge Arterton's lead on this point.

With respect to the district court's position that transactions that have been disregarded under the economic substance doctrine must be excluded from the substantial understatement penalty's "substantial authority" protection analysis,

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236. *Id.* (quoting Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 211 (D. Conn. 2004)). Not everyone bought it. *See* Stobie Creek Invs., LLC v. United States, 82 Fed. Cl. 636, 720 (2008) (noting that K&S's opinion was "accused of providing 'minimal legal analysis'" by the district court (quoting *Long Term Capital Holdings*, 330 F. Supp. 2d at 210)).

237. Thompson v. Comm'r, 499 F.3d 129, 134–36 (2d Cir. 2007) (remanding to Tax Court for determination of whether reliance on two appraisers was reasonable in light of their lack of relevant experience and qualifications).

238. Allison v. United States, 80 Fed. Cl. 568, 583–84 (2008) (observing that under *Boyle* "[t]he negligence of a tax adviser . . . is not imputed to the taxpayer when [tax] technicalities are at issue" but that "if the negligence . . . is the ignoring of a law, the negligence is imputed to the taxpayer if the statute is unambiguous").

239. 89 T.C.M. (CCH) 1157 (2005).

240. *Santa Monica Pictures*, 89 T.C.M. (CCH) at 1236 (describing how opinion "reache[d its] conclusions without any legal analysis or citation to the Code, the regulations, or caselaw"). This basis for refusing to accept reliance on an opinion could be applied to Long Term's reliance on the Shearman opinions. See *supra* note 83 and accompanying text for a description of how the Shearman opinions given to Long Term discussed that firm's conclusions without providing the underlying legal analysis, which was contained in a separate document that was not provided to Long Term.

241. *Santa Monica Pictures*, 89 T.C.M. (CCH) at 1236.

the lower courts are divided.[242] The only court to directly address the conflict between *Osteen*, *Streber*, and *Estate of Kluener* and *Long Term Capital Holdings* on this issue merely noted the dispute's existence before concluding that "there is a general agreement that the courts will consider only legal authorities with similar fact patterns."[243] Unfortunately, the court did not identify which fact pattern—the taxpayer's or the court's—was the relevant one.[244]

Three different courts implicitly took sides in this dispute while deciding whether to impose a substantial understatement penalty on a taxpayer whose transaction had been disregarded under the economic substance doctrine.[245] None of them cited *Osteen*, *Streber*, *Estate of Kluener*, or *Long Term Capital Holdings* on this issue in their substantial understatement penalty analyses. The U.S. Tax Court simply refused to consider authorities that were relevant under the taxpayer's formulation of the facts.[246] The U.S. Court of Federal Claims seemed more willing to consider the taxpayer's authorities, but eventually concluded that, because of the Federal Circuit's repeated application of the economic substance doctrine over the years, "the fictional nature of the transaction and its lack of economic reality outweigh [the taxpayer's applicable authorities] in the substantial authority assessment."[247] Finally, the U.S. District

242. As noted above, the courts of appeal that have addressed this issue all agree that factual evidence must be considered in such cases. See *supra* notes 157–74 and accompanying text for further discussion of *Osteen*, *Streber*, and *Estate of Kleuner*.

243. *In re* Hillsborough Holdings Corp., 346 B.R. 877, 880 (Bankr. M.D. Fla. 2006).

244. *Id.*

245. Klamath Strategic Inv. Fund, LLC v. United States, 472 F. Supp. 2d 885, 900–01 (E.D. Tex. 2007), *aff'd in part, vacated in part*, 568 F.3d 537 (5th Cir. 2009); Stobie Creek Invs., LLC v. United States, 82 Fed. Cl. 636, 706–07 (2008); Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 57–59 (2007); *Santa Monica Pictures*, 89 T.C.M. (CCH) at 1228–29. Like the courts in *Long Term Capital Holdings*, each of these courts also considered a variant of this "all or nothing" issue—whether a forty percent gross valuation misstatement penalty should automatically apply to the tax due on a loss that was disallowed under the economic substance doctrine because the transaction creating that loss was disregarded. See *supra* notes 86–94 and accompanying text for a description of how the Second Circuit addressed this issue in *Long Term Capital Holdings*, as well as a discussion about the related disagreement between the circuit courts on this point. As in *Long Term Capital Holdings*, the courts that concluded that a taxpayer's substantial authority penalty protection evaporated when the taxpayer was found to owe more tax because of the economic substance doctrine also held that the gross valuation misstatement penalty should apply. *See Stobie Creek Invs., LLC*, 82 Fed. Cl. at 704 (applying penalty); *Jade Trading, LLC*, 80 Fed. Cl. at 54 (same); *Santa Monica Pictures*, 89 T.C.M. (CCH) at 1227 (same). *But see Klamath Strategic Inv. Fund, LLC*, 472 F. Supp. 2d at 899 (refusing to apply penalty where economic substance doctrine resulted in transaction being disregarded).

246. *Santa Monica Pictures*, 89 T.C.M. (CCH) at 1229 ("Although these transfers were accomplished using the partnership basis rules, it seems evident that Congress did not envision these rules' being used merely as a vehicle to transfer built-in losses from a tax-indifferent party to an interested purchaser pursuant to a prearranged plan. As relevant to these circumstances, the authorities are clear and firmly established: a transaction that lacks economic substance is not recognized for Federal tax purposes.").

247. *Jade Trading, LLC*, 80 Fed. Cl. at 58; *see also Stobie Creek Invs., LLC*, 82 Fed. Cl. at 707 n.65 (concluding that Tax Court opinion relied on by taxpayers for substantial authority under their version of facts "did not displace the primacy of economic substance"). The *Stobie Creek Invs., LLC* court's analysis also noted that "the factual contentions underlying [the] opinion were not supported." 82 Fed. Cl. at 706. However, the *Jade Trading, LLC* taxpayers appealed both the tax and penalty

Court for the Eastern District of Texas took into account the substantial authority supporting the taxpayer's treatment of the actual transactions that had occurred, even though the court disregarded those transactions when determining the taxpayer's tax liability, to conclude that the taxpayer qualified for protection from the substantial understatement penalty.[248] Clearly, the courts with an opportunity to address—explicitly or implicitly—either of Judge Arterton's controversial penalty protection conclusions have not unanimously, or even strongly, endorsed them.

IV. CONCLUSION

Because the IRS may impose several of the accuracy-related penalties almost automatically once a tax underpayment is found,[249] the Internal Revenue Code's civil penalty protection provisions are often a taxpayer's only defense when the IRS seeks to punish that taxpayer. Preserving viable penalty protections is important because they encourage reasonable disagreements between taxpayers and the IRS that can help to clarify the ambiguous areas of our complex tax laws. Maintaining viable penalty protections also helps avoid the perception that our tax system is inherently unfair, by distinguishing between taxpayers who make reasonable, good faith attempts to comply with that law and those that do not.

The *Long Term Capital Holdings* opinions arrived at a critical juncture in the evolution of the taxpayer civil penalty protection standards. In the years immediately preceding those decisions, some commentators had begun to fret that taxpayers would be prevented from relying on the advice of their tax advisors when they engaged in complex tax planning.[250] Certainly, the attitudes of Congress and the IRS were both trending strongly in that direction before *Long Term Capital Holdings* and they have continued to do so in its wake. Indeed, the commentators' concerns might have been fully justified if Judge Arterton's opinion had been one of the first steps taken by the courts to reverse their established taxpayer-friendly positions relating to factual substantial authority and to a taxpayer's need to heavily scrutinize the legal sufficiency of advice received from his or her tax advisor. Such a reversal truly would have signaled the end of penalty protection for taxpayers engaging in complex tax planning, but it has not yet come to pass. Some courts have not followed Judge Arterton's arguably misguided departure from prior case law on the former

holdings. Brief of Plaintiff-Appellant Jade Trading, LLC, Jade Trading, LLC v. United States, No. 2008-5045 (Fed. Cir. Aug. 1, 2008), *available at* 2008 WL 3974193.

248. *Klamath Strategic Inv. Fund, LLC*, 472 F. Supp. 2d at 901. Although the IRS appealed the district court's refusal to assess penalties on jurisdictional grounds, the taxpayer prevailed on that point. Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 547–48 (5th Cir. 2009).

249. See *supra* notes 19–25 and accompanying text for a description of the mechanical nature of the substantial understatement of income tax penalty and Congress's intention that valuation misstatement penalties be "no fault."

250. *See, e.g.*, Cantley, *supra* note 137, at 75–76 (explaining how recently issued regulations could undermine client reliance on an attorney's tax advice).

issue, and the Second Circuit effectively emasculated her position on the latter one.

So, for the time being at least, a taxpayer considering whether to engage in complex tax planning, or merely trying to apply our increasingly intricate tax laws to complicated business transactions, can still take into account the possibility of penalty protection from a tax advisor's opinion if the taxpayer's positions are later deemed too aggressive.[251] However, the legislative and administrative trends discussed in this Article should not be ignored. If those trends progress to their logical culmination, they could ultimately eliminate taxpayer civil penalty protection for many taxpayers, and those taxpayers will join Long Term, overturned and adrift in the IRS's wake.

251. Of course, that possibility will be of small comfort if the protection fails in the end. In the words of Myron Scholes, one of Long Term's partners, shortly after the district court's opinion in *Long Term Capital Holdings*, "'No, [exploiting tax loopholes for gain] is not [acceptable]. And, it is costly to do so. But, sometimes what is thought to be ethical in one time period, is deemed not to be so later on.'" Browning, *supra* note 44 (quoting email from Scholes).