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TAX LAW UNCERTAINTY AND THE ROLE OF TAX INSURANCE

Kyle D. Logue*

In the broadest sense, this is an article about legal or regulatory uncertainty and the role that private and public insurance can play in managing it. More narrowly, the article is about tax law enforcement and the familiar if ill-defined distinctions between tax evasion, tax avoidance, and abusive tax avoidance. Most specifically, the article is about a new type of tax risk insurance policy, sometimes called tax indemnity insurance or transactional tax risk insurance that provides coverage against the risk that the Internal Revenue Service (Service) will disallow a taxpayer-insured’s tax treatment of a particular transaction. The question is whether this type of insurance coverage increases incentives for illegitimate tax avoidance or, alternatively, provides needed certainty to taxpayers — certainty that the Service is not able or willing to provide. Should tax insurance be banned? Encouraged? Ignored? To what extent should the government, instead of commercial insurance companies, provide such legal uncertainty insurance directly, either by increasing the use of private rulings or by selling the equivalent of tax indemnity insurance policies? On the question of commercially provided tax indemnity insurance, the article concludes that the appropriate regulatory response is probably (a) to allow the purchase of policies (and perhaps in some situations to subsidize their purchase) but (b) to compel taxpayers who purchase

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such policies to disclose this fact to the Service. Such a response allows
the use of tax risk insurance as a supplement to private letter rulings
while at the same time minimizing the possibility that the insurance will
be sold to cover pure “detection risk.”

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I. INTRODUCTION

Consider the following hypothetical transactions and the tax law uncertainty that each contains:1

Example One: Ms. A is contemplating making a sizeable investment in an existing partnership. In the course of her due diligence investigation, Ms. A discovers a large potential tax issue. Ms. A's tax advisor tells her that if the Service detects and raises the issue on audit, she would probably prevail in court, but that a favorable outcome is not certain. The law in question is not crystal clear in its application to the particular circumstances of this partnership, and thus there is some significant possibility of losing on the merits if it comes to that. Moreover, if the issue is detected and raised by the Service, the cost of litigating the question will be substantial. Because of these uncertain contingencies, Ms. A is reluctant to proceed.

Example Two: B Corp, a publicly traded corporation, would like to spin off its subsidiary C to B's shareholders for nontax business reasons. However, C is a very valuable company, and B's basis in C's stock is low; therefore, B would, if possible, like to structure the transaction to qualify as a tax-free spin-off under Internal Revenue Code (Code) section 355. The problem is that there is some risk the Service (and in turn a court) will conclude that the transaction was not in fact motivated primarily by a nontax business purpose but was rather a mere device for avoiding taxes and will thus disallow the tax-free treatment. If that were to happen, B would incur a huge tax liability from the capital gain on the transaction. To resolve this legal uncertainty, B sought a private letter ruling from the Service that the spin-off would qualify under section 355, but the Service refused to issue the requested ruling because the question of whether B has a nontax business purpose for the spin-off is too "fact intensive." B's outside tax counsel has provided a legal opinion confirming that the transaction should qualify for tax-

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1 The first four hypotheticals are taken from an article about tax indemnity insurance by a tax practitioner. See generally Richard A. Wolfe, Tax Indemnity Insurance: A Valuable and Evolving Tool for Managing Tax Risks, 598 PLI/TAX 595, 604-16 (2003).
free treatment; this opinion reduces almost to zero the likelihood of penalties should the Service disagree. However, given the magnitude of the corporate-level gain involved, B is nevertheless reluctant to go forward with the deal.

Example Three: D Corp is a holding company that owns a number of subsidiary corporations, including T Corp, which happens to be D’s only profitable operation at the moment. D is in dire financial straits and needs to raise capital to survive. Accordingly, D decides to sell T to the highest bidder. P is interested in buying T from D; in the course of conducting its due diligence, however, P discovers that D has a significant potential federal income tax issue unrelated to T, an issue that involves hundreds of millions of federal tax dollars that has not yet been detected by the Service. Although P’s tax counsel is of the view that D’s position with respect to this tax issue is probably correct on the merits, there is considerable uncertainty on this point, and the Service (and a court) might well take a less favorable view. P is concerned that (i) the issue may well be detected and D’s reporting position will be rejected by the Service; (ii) if detected, there is some nontrivial possibility that the government will prevail; and (iii) if the government were to prevail, D, because of its dire financial position, might not be able to satisfy the taxes that would arise, potentially leaving T on the hook for the taxes under the consolidated return regulations.²

Example Four: E Corp is a publicly traded corporation that is currently being audited by the Service. Indeed, like many large corporations, E is virtually under constant audit. The Service agents have indicated to E that they are considering issuing a thirty-day letter with respect to a significant tax issue involving E’s return. E believes the agents’ position has limited merit, but E is aware that if the agents issue the thirty-day letter, because of the magnitude of the potential tax, E will have to publicly disclose that fact and establish an accounting reserve for the potential tax liability. P is concerned that this disclosure will adversely affect its share price.

These examples represent a much larger phenomenon: sophisticated taxpayers who are considering engaging in some sort of business transaction but face substantial uncertainty as to how the tax laws will be applied to their particular transaction. It is easy to understand how such uncertainty might deter a risk-averse taxpayer from engaging in welfare-enhancing, wealth-creating transactions, which would obviously be a bad thing, especially if the uncertainty in question could feasibly be eliminated or reduced. One might surmise that the natural solution to the problem of tax law uncertainty would be for the government — either Congress or the Treasury Department — to clarify the law in advance so that such uncertainty does not exist. It simply is not possible, however, to eliminate substantive tax law uncertainty for every conceivable business transaction. No matter how long and detailed the tax laws become (and they presently span over 10,000 pages of code and regulations), there will always be gaps; there will always be transactions or activities whose proper tax treatment is uncertain. Another solution might be to have the government on a case-by-case basis provide insurance against tax law uncertainty in the form of private letter rulings issued directly to taxpayers — in effect, guaranteeing with some limitations a particular tax treatment for a particular transaction. As it turns out, however, the Service is not always willing or able to provide such individualized assurance.

A final alternative is the one on which this Article focuses: privately provided tax risk insurance.³ In recent years, insurance companies have begun to offer tax risk insurance policies — also called tax indemnity insurance policies (TIIPs) or transactional tax risk insurance — that provide taxpayers with coverage against the risk that the Service will reject a taxpayer’s characterization of a particular transaction. These policies usually provide full indemnification for all tax-related losses, including back taxes, interest, and penalties. What sorts of tax risks can be insured against? Situations like the examples mentioned above have each been the basis of a tax risk insurance policy, as have many others.⁴ More importantly, the theoretical scope of tax risk insurance is large as is the potential market for regulatory uncertainty insurance more generally. For insurance markets to operate there need only be a significant amount of money at stake coupled with a significant amount of uncertainty. Thus, although tax

³ Tax insurance goes by various names: tax liability insurance, tax indemnity insurance, and tax risk transactional insurance, to name a few.

⁴ See Wolfe, supra note 1, at 604–06.
risk insurance is a recent development and is still only a niche market compared with the enormous market for commercial general liability insurance or professional malpractice insurance, and although it has not yet spread to other, nontax areas of regulatory uncertainty, it is not surprising to hear that there are reports that the tax indemnity insurance market is growing rapidly. It is only a matter of time before insurers begin considering nontax applications of regulatory uncertainty insurance.

Interestingly, a decent argument can be made that there is nothing special, and nothing especially troublesome, about privately provided tax liability insurance, or regulatory uncertainty insurance more generally. The type of risk-shifting that occurs through a tax risk insurance policy is merely a natural extension of a type of contractual risk-shifting that has existed for a long time without much controversy: tax indemnity or tax allocation agreements between contracting parties. Such agreements, which are frequently, if not always, a part of corporate merger and acquisition transactions, regularly serve to allocate uncertain tax liabilities between or among the parties. For example, a tax indemnity agreement might shift a potential tax liability from a purchaser to a seller or vice versa. These indemnity agreements presumably shift the relevant legal risks to the less risk-averse party to the transaction. In any event, since tax indemnity agreements have existed for a while, the introduction of tax risk insurance marks a sort of natural evolution of tax indemnity agreements. With the introduction of this new insurance market, if one of the parties is risk-averse with respect to a tax law contingency involved in the deal, instead of just shifting the tax law uncertainty from buyer to seller or vice versa, that legal uncertainty can be moved from the contracting parties to a third-party insurance company whose business is assessing and distributing risks and who can therefore do so relatively efficiently. Viewed this way, tax risk insurance would seem to be neither more nor less objectionable than any other form of commercial liability insurance and should be left alone, or perhaps even encouraged in some way.

There is, however, a less optimistic way to view tax risk insurance. To see this concern, imagine a final hypothetical:

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Example Five: F Corp is a public corporation that is currently highly profitable but faces intense competition. F's chief executive officer (CEO) is continually under extreme pressure from shareholders, and from the capital markets generally, to increase after-tax earnings, and the pressure travels downstream. Every department in the corporation, including (somewhat counterintuitively) the tax department, is being urged to "deliver greater profits." For the past several years, F has paid large amounts of federal income tax to the government, to the chagrin of the CEO and shareholders. F's tax manager is feeling the heat and wondering whether his job with the company is secure. Then he is approached by XYZ Firm, an accounting/law firm that specializes in developing, marketing, implementing, and ultimately defending highly sophisticated tax shelter products. XYZ says it has a new shelter to offer F that relies on an ingeniously counterintuitive but literally plausible reading of several different provisions of the Code. According to XYZ, merely by engaging in a series of complicated transactions that have little real (i.e., nontax) economic significance and that involve an accommodating foreign corporation that is not subject to U.S. tax laws but is willing to assist for a price, F can in effect manufacture paper losses that will substantially reduce the company's U.S. corporate income tax liability. The catch is that, if this shelter is detected by the Service on audit, which is unlikely given the complexity of the transaction but nevertheless possible, the Service will certainly regard the transaction as a sham or as lacking significant nontax economic substance. Although a court may be persuaded to overturn the Service's determination and side with the taxpayer, the more likely outcome is that a court would side with the government given that the shelter in question relies on an interpretation of the law that is clearly contrary to congressional intent. In any event, the cost of litigating the case would be immense. Moreover, because of the aggressive nature of the tax position being recommended, large tax penalties are a possibility, despite the presence of a "more likely than not" opinion from a reputable tax counsel, assuming such an opinion can be secured. Given all of these uncertainties, F is reluctant to purchase the shelter product.

This hypothetical should be familiar to the readers of this journal and to anyone who has followed the problem of corporate tax shelters
in the tax and business presses. As has been well documented, sophisticated taxpayers confront powerful incentives to engage in what are sometimes called “abusive tax shelter” transactions. Indeed, the prevalence of abusive tax shelters, with the associated costs in terms of behavioral distortions and distributional inequities, is widely considered one of the most serious problems facing the administration of the income tax laws and is certainly one of the most written about topics in all of tax scholarship. The tax shelter problem will, in all likelihood, never go away entirely. So long as (i) there is a low probability that abusive shelters will be detected on audit, which seems likely always to be true; (ii) sophisticated taxpayers have the ability to avoid paying penalties by simply purchasing an appropriate opinion letter, or “penalty insurance,” from a willing tax lawyer; and (iii) the penalties that are assessed in those cases in which the opinion letters are unavailing are relatively small, as has always been true, there will likely be a healthy market for tax shelters. If we add to this equation the possibility that even the small residual risk of incurring tax penalties might be entirely eliminated through the purchase of a tax risk insurance policy, a dramatically larger tax compliance problem potentially emerges.

To see this point, imagine what would happen if XYZ Firm in Example Five above were to offer the following option with its new shelter product: If F Corp would agree to purchase and implement XYZ’s newest shelter, XYZ would broker a deal with InsureCo to underwrite F’s risk of having to pay back taxes, interest, and penalties in the event the shelter is discovered and rejected. Moreover, InsureCo would also agree to cover the litigation costs to defend the shelter against the Service. F would need only to pay the insurance premium and agree to the terms in the contract. If such insurance

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6 The term “abusive tax shelter” is notoriously difficult to define. Unless otherwise specified, I use the term loosely to mean transactions that are primarily tax-motivated and that rely for their tax advantages on a reading of the tax laws that is (a) technically legal (that is, not obviously illegal) but (b) more likely than not to be rejected by a court if examined on the merits. Many other definitions of tax shelters have been offered, some broader and some narrower than the one just stated. Some of these other definitions are mentioned below.

were available, it would almost certainly be socially undesirable. Unlike insurance against legitimate legal uncertainty (that is, uncertainty as to how the law will be applied to particular situations), this would be insurance against pure detection risk — that is, the risk of being caught — since the legal position being taken here is almost certainly not legal. The last thing we need is a new financial product that enables highly aggressive taxpayers to shift their risk of being detected to a risk-neutral insurer. Thus, although the tax indemnity insurance market may currently be a small scale operation in contrast to some other types of insurance, and may even presently be limited to transactions that do involve significant legal uncertainty, the market could expand or mutate to produce insurance policies that cover tax shelter transactions as well, thereby making an already difficult tax compliance problem far worse. This concern is not purely academic. There has already been some regulatory scrutiny directed at tax insurance arrangements precisely because of the concern about shelter insurance. For example, the Treasury Department considered but ultimately rejected making the purchase of a tax indemnity insurance policy sufficient grounds for triggering the tax shelter reporting requirement, which would have brought enhanced Service scrutiny on insured tax positions.9

So which picture of tax risk insurance — the optimistic or the pessimistic one — is more accurate? Is tax insurance good or bad? It turns out that the best answer is that it depends. Under certain assumptions, a surprisingly strong case can be made for allowing —

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8 Another term for substantive legal uncertainty in the tax context is “merits risk,” as in the risk of losing the issue “on the merits” in the event that it is examined by a court.

9 Treas. Reg. § 1.6011-4(b)(4) (2004) (defining one class of “reportable transactions” — i.e., transactions that trigger special reporting requirements for the taxpayer — as those with “contractual protection” regarding the tax position in question, where “contractual protection” includes transactions with respect to which the taxpayer has secured a tax insurance policy). This language in the temporary regulations caused a stir among insurance companies who were concerned that making the purchase of tax insurance a trigger for tax-shelter reporting would prevent this fledgling insurance market from ever getting off the ground. See, e.g., David S. De Berry, Insurance Group Comments on Tax Shelter Reporting Regs, Tax Notes Today (Jan. 6, 2003) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2003 TNT 3-57) [hereinafter Insurance Group Comments] (comments of Dave De Berry of The Hartford Company, urging the Treasury Department to change proposed regulations to exclude the purchase of tax insurance as sufficient to trigger shelter-reporting requirements). The temporary regulation was superseded by a final set of regulations in T.D. 9046, 2003-1 C.B. 614, which still contains the contractual protection category of reportable transactions, but which omits any mention of tax insurance.
even encouraging — tax insurance, which as a form of insurance has much in common with run-of-the-mill liability or legal risk insurance. There is no denying, however, the danger inherent in this type of insurance. It is possible that the sort of tax indemnity insurance for run-of-the-mill corporate transactions, which we see now, could evolve into something else, something more like insurance against abusive tax positions or overly aggressive interpretations of the tax laws. Therefore, the interesting questions are how likely is that possibility, what can be done to prevent it, and whether, on balance, tax risk insurance ought to be considered a socially beneficial — or at least benign — development, or whether it should be discouraged or banned altogether. This Article addresses these questions. A related question, which will not be the focus of this Article but which the analysis of this Article raises, is whether there might be a legitimate role for private insurance in other contexts of regulatory legal uncertainty.

Part II begins with a description of the general problem of tax law enforcement; the blurry distinction between tax evasion and tax avoidance; and the link between those concepts, the rules/standards debate, the concept of legal uncertainty, and the market for tax risk insurance. Part III then describes what I call the “old markets” in tax insurance, which consist of (a) the use of tax indemnity agreements in corporate merger and acquisition transactions and (b) the widespread and uncontroversial phenomenon of warranties or guarantees issued by tax preparation firms to individual and small business taxpayers. Part III also briefly discusses what I call tax advisor warranties that turn out to have essentially the same structure as contingent fee arrangements for tax advice and, in the view of the Treasury Department, do raise enforcement concerns. Part IV, the meat of the Article, provides a somewhat more detailed description of the new tax indemnity insurance market and the factors that seem to give rise to it. Part IV also gives fuller voice to the worries that one might have concerning a market for tax insurance given the already serious deterrence problems in the area of corporate tax enforcement. This Part also explains in greater detail the somewhat surprising case in favor of allowing or even subsidizing the use of tax insurance in certain settings and explores whether there is any significant difference between tax indemnity insurance and commercial liability insurance such that the former ought to be restricted or banned whereas the latter is not only allowed but encouraged. It also outlines a possible disclosure solution that tax policymakers might adopt to minimize the dangers and maximize the advantages of tax indemnity
insurance — that is, to minimize the possibility that it will be used to cover only detection risk. Finally, Part IV briefly considers an alternative to commercially provided legal uncertainty insurance: government provided legal uncertainty insurance — either through the increased use of private letter rulings or, more interestingly, the introduction of government provided tax liability insurance. Either approach has advantages and disadvantages, which I discuss below.

II. EVASION AND AVOIDANCE, RULES AND STANDARDS, AND THE PROBLEM OF LEGAL UNCERTAINTY

A. An Introductory Note on Tax Noncompliance

There is a sense in which tax compliance is a permanent problem. As with the enforcement of any law that imposes burdens on individuals for the collective good, there will always be incentives for free riding. What this means in the tax context is that taxpayers, individual and corporate, will always have an incentive to minimize their own tax liabilities while continuing to take full advantage of the benefits of government expenditures. A corollary of this fact is that in the absence of government imposed penalties for noncompliance, our practice of funding government expenditures through tax revenues would be highly problematic. At the heart of this conventional view is the classical deterrence model of tax law, which

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10 The so-called “tax gap” is the Service’s effort to estimate the overall shortfall in federal tax dollars due to noncompliance. That is, the tax gap measures the difference between how much in federal taxes ought to have been paid for a particular tax year and how much was actually paid. The first number has historically been calculated using a complicated set of formulas and inputting data from the old Taxpayer Compliance Measurement Program (TCMP), which was carried throughout the 1970s and 1980s but which ended in 1995. The latter number is taken from estimated and actual tax collections. See generally Joel Slemrod & Jon Bakija, Taxing Ourselves: A Citizen’s Guide to the Debate over Taxes 174–76 (3d ed. 2004) (explaining the tax gap calculation). Since 2001, tax gap data have been gathered under the new, less ambitious, but less intrusive National Research Program. But those data have not yet been analyzed. The tax gap consists of three components: underreporting of income (e.g., excessive deductions, underreported income, and the like), nonfiling, and underpayment of stated liabilities. It is the underreporting figure that constitutes the lion’s share of the tax gap and that presents the largest tax compliance problem. According to TCMP data from the 1970s and 1980s extrapolated to the 2001 tax year, underreporting is estimated to be around 13.8 percent for individual taxpayers and 17.4 percent for corporations. Joel Slemrod, The Economics of Corporate Tax Selfishness (Nat’l Bureau of Econ. Research, Working Paper No. 10858, 2004), available at http://www.nber.org/papers/w10858.
says that taxpayers rationally respond to incentives including formal tax penalties.\(^\text{11}\) This is not to say, of course, that informal sanctions such as social norms play no role in encouraging tax compliance, nor that tax compliance would be nonexistent in the absence of sanctions. To the contrary, there is evidence that taxpayers, at least corporate and self-employed taxpayers, voluntarily pay more in taxes than formal deterrence models would predict.\(^\text{12}\) In fact, given how many individuals and firms do pay their taxes, it seems reasonable to assume either that there is some degree of cognitive failure, such as overestimation of the likelihood of detection, or perhaps altruism/patriotism on the part of taxpayers. Perhaps the informal sanctions taxpayers face, such as the reputational costs of being labeled a “tax cheat,” are a more significant deterrent than one might initially think.\(^\text{13}\) Still, few doubt that the traditional deterrence factors

\(^{11}\) The seminal statement of this Becker-esque view of tax law is found in Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323 (1972). Under the Allingham/Sandmo model, taxpayers seek to minimize their tax payment, taking into account only the obvious deterrence variables such as the probability of detection, size of the penalty, tax rate, actual income, and the like.

\(^{12}\) This phenomenon has inspired some scholars to assert that U.S. taxpayers are “pathologically honest,” in the sense that they pay more in taxes than the standard deterrence (Allingham/Sandmo) model would suggest. It is almost as if taxpayers are, in effect, making a “gift” to the government. Joel Slemrod, *Trust in Public Finance* (Nat'l Bureau of Econ. Research, Working Paper No. 9187, 2002), available at http://www.nber.org/papers/w9187. As Joel Slemrod points out, however, this argument is often overstated, insofar as it fails to recognize that, with many individual taxpayers, especially those whose primary source of income is in the form of wages, the level of compliance is very high, just as the traditional deterrence model would predict. This fact seems to be due, in large part, to the role of information returns, which the Service can easily cross-reference with tax returns. *Id.* Still, with respect to the corporate income tax, as well as with respect to some forms of individual income, such as self-employment income, the well-documented opportunities for undetectable evasion are so plentiful that the traditional model, narrowly construed, clearly does not provide the full explanation.

\(^{13}\) See generally *Why People Pay Taxes: Tax Compliance and Enforcement* (Joel Slemrod ed., 1992) (containing empirical studies of the role of social norms and morality on compliance); James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance*, 36 J. ECON. LIT. 818, 850 (1998) (discussing literature on the effect of morality and social norms on tax compliance). It is also possible that, with respect to some taxpayers and some types of tax compliance, formal and informal sanctions, or extrinsic and intrinsic sanctions, work not as complements to but as substitutes for each other, such that increasing the formal penalties for tax noncompliance could actually reduce compliance by “crowding out” intrinsic or moral motivations to comply. See Bruno S. Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, 107 ECON. J. 1043 (1997). There is some experimental evidence that
the probability of detection and the magnitude of the formal penalty — remain tremendously important in the compliance equation for many taxpayers. This seems especially true for most if not all sophisticated taxpayers, by which I mean taxpayers — corporations and wealthy individuals, as well as partnerships and trusts through which wealthy individuals often invest — who hire expert tax advisors to help them arrange their financial affairs so as to minimize their taxes, or more precisely to maximize their after-tax returns on various investments. 14

An important question then, given the interrelated effects of formal and informal sanctions as well as extrinsic and intrinsic motivations, is whether the traditional deterrence variables are currently set at socially optimal levels. Many tax experts think not. As mentioned in the Introduction, 15 there is a widely held view among tax academics and practitioners that a large and increasing number of corporations and wealthy individuals are engaging in highly aggressive tax avoidance transactions, often referred to as tax shelters, 16 that lack any significant economic substance, have no discernible nontax business purpose, and, although based on literal interpretations of the Code, produce tax outcomes that any reasonable person would agree are inconsistent with sound tax principles. Many tax experts view the solution to the problem as one of deterrence. That is, many would agree that to address the tax shelter problem, we need to increase the

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14 Below I draw a distinction between “tax advisors” and “tax return preparers.” I use the former term to describe tax experts who help taxpayers plan their transactions in advance so as to maximize after-tax returns. I use the latter term for tax experts who help taxpayers fill out and file their returns. Tax preparers therefore are, for the most part, working with transactions that have already taken place. The line between advisors and preparers can obviously be blurred; sophisticated taxpayers may have the same firm that assisted them in setting up various tax-advantaged transactions prepare their returns. But even then, it would likely be a different person within the firm. In any event, the distinction holds up in many instances.

15 See supra text accompanying notes 6–7.

16 As I have already mentioned, “tax shelter” has no settled meaning, and there is much dispute over what qualifies as a shelter and what does not. See supra note 6.
probability that shelters will be detected by the Service, by either increasing the frequency and thoroughness of audits — which means significantly increasing the Service’s budget — or increasing disclosure requirements. In addition, we need to increase substantially the penalties actually imposed for tax underpayments by either increasing the size of the penalties on the books or, alternatively, by taking steps to insure that the penalties that already exist get imposed in appropriate cases. Other commentators contend that unless the Service and the courts do a better job of defining what constitutes an abusive tax shelter, increasing audit rates and penalty assessments will have little effect. In addition, some tax experts also worry that the highly publicized spread of sophisticated tax avoidance on the part of corporate and wealthy taxpayers undermines the average taxpayer’s respect for the system and thus can lead to increased noncompliance at every level.

B. Introducing Legal Uncertainty and the Tax Compliance Continuum

I have been speaking of the terms “compliance” and “noncompliance” as if they have self-evident meanings. They do not. In fact, one of the central problems of tax law enforcement is that these terms are not self-defining, but often mean different things to


19 U.S. DEPT. OF THE TREASURY, supra note 7, at 3:

Corporate tax shelters breed disrespect for the tax system — both by the people who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a “race to the bottom.” If unabated, this will have long-term consequences to our voluntary tax system far more important than the revenue losses we currently are experiencing in the corporate tax base.
different people, a fact that has consequences for designing an optimal
tax-enforcement regime as well as for the issue of tax law uncertainty.
So what is usually meant by the term “noncompliance?” For starters,
a distinction is often made between “evasion” and “avoidance,”
although the distinction is, to tax experts, notoriously fuzzy. In simple
terms, “evasion” means a clear violation of an unambiguous tax rule.
With tax evasion, then, the taxpayer has no plausible argument that
her position is consistent with the law. In addition, the concept of tax
evasion is often understood to include some element of intentionality
on the part of the taxpayer. That is, a tax evader is thought to be
someone who knowingly breaks the tax laws and who, in fact, takes
steps to cover up the crime, and thus evade detection. On this view,
a quintessential example of tax evasion would be the intentional
failure to report items of income. Thus, it is tax evasion when a self­
employed individual knowingly and intentionally does not report
income that was received during the relevant tax period. Likewise,
when an individual or taxable entity deducts expenses that are clearly
not deductible according to the Code, or takes deductions for entirely
fictional expenses, the individual or entity commits tax evasion. In

20 The American Heritage Dictionary defines tax evasion as the “[j]ntentional
avoidance of tax payment usually by inaccurately declaring taxable income.” THE
Webster’s Dictionary of Law adds the following gloss in its main entry for tax evasion:
a willful and esp. criminal attempt to evade the imposition or payment of a tax.”
MERRIAM WEBSTER’S DICTIONARY OF LAW (1996), available at

21 Of course, the old “ignorance of the law” adage applies to taxes as well. Thus,
having a sincere subjective believe that an activity is legal under the tax laws is not an
excuse for tax evasion. In practice, however, it seems likely that unsophisticated
taxpayers will be able to avoid a criminal conviction if they can demonstrate good
faith, albeit mistaken, beliefs in the positions they took or good faith reliance on their
tax advisors. There are some tax positions, however, that likely will get you criminally
punished irrespective of your subjective intent. This is because these positions are so
obviously contrary to established law and have been struck down so many times
before that claims of good faith reliance are not credible. Examples of this would be
such standard tax-protestor arguments as the claim that the filing of federal income
tax returns is “voluntary,” understood to mean optional. For a statement and
refutation of this position, see Internal Revenue Serv., Anti-Tax Law Evasion
Schemes — Law and Arguments (Section 1), available at http://www.irs.gov/
businesses/small/article/0,,id=106502,00.html.

22 Tax evaders often facilitate such off-the-books transactions by insisting on
payment in cash only. See Joseph Bankman, Tax Enforcement: Tax Shelters, the Cash
Economy, and Compliance Costs, 104 TAX NOTES 185, 188 (July 12, 2004).
addition, if a wealthy individual hides income in a foreign bank account in a manner that is clearly not allowed by U.S. tax law, that taxpayer clearly is a tax evader. A conviction for tax evasion under this definition, because it is a criminal offense, can result in the perpetrator's not only having to pay back taxes, interest, as well as civil and criminal penalties, but also having to spend some time in jail. As I discuss more fully in Part IV below, no tax insurance policies cover tax evasion defined this way.

If tax evasion is defined as the clear (and usually intentional) violation of the tax laws in order to reduce one's tax liability, what is tax avoidance? An obvious possibility suggests itself: Why not define tax avoidance as arranging your affairs to minimize your taxes in a manner that is consistent with the tax laws? Or as doing everything within the law to reduce your tax liability? This definition would set up a nice dichotomy between tax evasion (illegal) and tax avoidance (legal) and would greatly simplify the job of the tax enforcer, not to mention the scholar. Moreover, just as there are obvious examples...

23 The maximum penalty for noncriminal (nonfraudulent) underpayment of taxes is twenty percent of the tax understatement. I.R.C. § 6662(a). The penalty for civil fraud is seventy-five percent of the understatement. Id. § 6663(a). If a party is convicted of criminal tax evasion, under the higher standards of proof found in the criminal system, the maximum penalty for an individual is up to $100,000 and five years in prison for criminal evasion and $25,000 and/or one year in prison for criminal failure to file. Id. §§ 7201, 7203.

24 See, e.g., DAVID L. SCOTT, WALL STREET WORDS: AN ESSENTIAL A TO Z GUIDE FOR TODAY'S INVESTOR 379 (1997) (stating definition of tax avoidance as "[t]he reduction of a tax liability by legal means. For example, high-income individuals avoid significant federal income taxes by purchasing and holding municipal bonds.").


Tax avoidance is the legal exploitation of the tax regime to one's own advantage, to attempt to reduce the amount of tax that is payable by means that are within the law whilst making a full disclosure of the material information to the tax authorities. Examples of tax avoidance involve using tax deductions, changing one's tax status through incorporation or establishing an offshore company in a tax haven.

By contrast tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade the payment of taxes by illegal means. Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such
of tax evasion, there are obvious examples of legal tax avoidance as well. For instance, it is clearly legal avoidance when a taxpayer takes advantage of a so-called tax-expenditure provision in a straightforward way. Tax expenditures are Code provisions intended by Congress to provide subsidies for certain types of activities or transactions.26 Thus, whether it is investing in tax-exempt bonds or investing in property subject to accelerated depreciation, the term "legal avoidance" would fit. Even if you are offended by tax expenditures as a policy matter, when a taxpayer takes advantage of them, even if the transaction is primarily tax motivated, the behavior is clearly legal. Clearly legal avoidance, however, is not limited to tax expenditures. It might also include some — though, as I will point out below, not all — investments that exploit the tax advantages inherent in the structure of the tax laws. An example of this would be a simple purchase of growth stock in order to get the benefit of the realization doctrine, as well as the preferential capital gains rate.27 Moreover, to use the economist's capacious understanding of the term, "tax avoidance" would include an individual's decision to reduce work hours in response to the existence of the income tax or an increase in tax rates, another example of obviously legal behavior. In any event, what unifies all of these examples is that whether or not one considers the tax provision in question to be good or bad tax policy, and there is much debate on that question, there can be no doubt that many of the

as underdeclaring income, profits or gains, or overstating deductions).

Tax avoidance may be considered as either the amoral dodging of one's duties to society, part of a strategy of not supporting violent government activities or just the right of every citizen to find all the legal ways to avoid paying too much tax. Tax evasion, on the other hand, is a crime in almost all countries and subjects the guilty party to fines or even imprisonment. Switzerland is one notable exception: tax fraud (forging documents, for example) is considered a crime, tax evasion (like underdeclaring assets) is not.

(emphasis omitted).

26 This is not to say, of course, that illegal tax avoidance cannot involve tax expenditure provisions. Combining a tax expenditure provision with some structural aspect of the Code to create arbitrage opportunities has been a common way of achieving questionably legal avoidance. My only point here is that there are some easy cases of legal avoidance, such as the straightforward use of tax expenditure provisions.

27 Abusive tax shelters can also involve exploitation of certain structural elements in the Code, such as the realization doctrine or the distinction between debt and equity. The point here is that some of the tax savings due to the structure of the Code are clearly legal, in the sense that they were intended by Congress.
transactions that exploit these provisions were intended by Congress and are undoubtedly legal.

Unfortunately, the neat dichotomy between illegal evasion and legal avoidance does not encompass all the interesting possibilities. That we can identify clear examples of illegal evasion and legal avoidance does not mean that all of the tax law is clear-cut. To the contrary, as every tax practitioner and tax commentator knows — and as many law students in the introductory federal income tax course struggle to understand — there are many situations in which the tax law is unclear and thus distinguishing between what is legal and illegal, what is permissible and impermissible, can be extremely difficult. To put the point more precisely, with respect to many provisions in the tax code, taxpayers face significant uncertainty ex ante as to how those provisions will be applied by the Service and by the courts to particular situations that taxpayers confront. Given this uncertainty, a taxpayer who wishes to comply with the tax laws, either because of moral compunction or because of a desire to avoid formal or informal sanctions, but who does not wish to donate money to the federal government — that is, does not want to pay more than the law in fact requires — faces the difficulty of making choices based on rough probability estimates as to what the law “is” at any given time. And what this means conceptually and, in terms of determining whether or not the taxpayer will be assessed penalties, what it means in practice, is that the taxpayer must make an educated guess as to what some ex post adjudicator will determine the law “is,” or, more precisely, what the law was when the taxpayer engaged in the transaction or activity in question.

Thinking of tax compliance, and legal compliance more generally, in these probabilistic terms is on one level obviously unrealistic. We are accustomed to viewing taxpayers, at least sophisticated taxpayers, as rational — even hyper-rational — actors. Indeed, it is well known that some taxpayers are motivated to take especially aggressive, even illegal, positions on their tax returns precisely because they have rationally calculated their probability of detection as being very low. But it is quite a different matter to imagine the average individual taxpayer doing a probabilistic calculation not to determine whether to comply with a clear legal rule, but to decipher what the tax law is in the first place. And yet, at least for sophisticated taxpayers with expert legal advisors to help them minimize their tax payments while avoiding penalties, such probabilistic estimates are a part of the
Indeed, the tax laws and regulations make the application of tax penalties for noncompliance depend on such probabilistic assessments. That is, if the Service and the courts determine ex post that a particular position taken by a taxpayer is wrong — that the taxpayer underpaid its taxes — then whether the taxpayer must pay penalties as well will depend on the Service’s and ultimately a court’s ex post assessment of the taxpayer’s ex ante probability of success on the merits. For example, the twenty percent “substantial understatement” penalty, which is assessed to taxpayers found to have understated their tax liability by the lesser of $5000 ($10,000 for corporations) or ten percent of the overall liability, can be avoided if it can be shown that with respect to the tax issue in question the taxpayer had “substantial authority.” Substantial authority has been interpreted by the Service to mean something less than a fifty percent chance of prevailing on the merits of the issue, assuming the issue is detected on audit. With respect to tax shelters, the probability of prevailing on the merits must be greater to avoid penalties, which makes sense given that shelters are a class of transactions that by definition have relatively weak support in the law. Specifically, if the taxpayer can show that (a) the tax position at issue was disclosed to the Service, and (b) the position had a “reasonable basis” in the law. I.R.C. § 6662(d)(2)(B).

I do not mean to suggest that there is a large class of taxpayers who are constantly doing probability calculations to determine what the law is with regard to every tax provision. However, with respect to the tax law provisions (a) that are uncertain in application and (b) that can have a significant effect on tax liabilities, many sophisticated taxpayers in fact do such probabilistic calculations — assessing what the Service and a court will likely say the law is — explicitly or implicitly. Of course, they also take into account the probability of detection and the likelihood of penalties, among other factors. Also, it seems obvious that, in contrast to sophisticated taxpayers, average individual taxpayers, almost by definition, spend far less time and resources thinking about such things, if they consider them at all. Even for those taxpayers, however, insofar as they use paid tax preparers who are tax law experts, the result can wind up being the same: decisions based on probabilistic estimates of how an ex post adjudicator will assess the merits of a claim.

Alternatively, the substantial understatement penalty can be avoided if the taxpayer can show that (a) the tax position at issue was disclosed to the Service, and (b) the position had a “reasonable basis” in the law. I.R.C. § 6662(d)(2)(B). Trea. Reg. § 1.6662-4(d)(2) (2003). How much less stringent is the substantial authority standard than the more-likely-than-not standard? That is not clear, though it is apparently more stringent than the reasonable basis standard. Reasonable basis, in turn, is a higher standard than “not frivolous” or “not patently improper.” Id. § 1.6662-3(b)(3).

The Code defines tax shelters as “(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.” I.R.C. § 6662(d)(2)(C)(iii). This definition is obviously less pejorative than my loose operational definition, which includes an
taxpayer can prove to the Service or a court that the position in question was ex ante "more likely than not" to succeed on the merits if it were detected, then the taxpayer can avoid the penalties for tax understatements with respect to positions that meet the Code's definition of a tax shelter. 32 If all these probabilistic standards were

assumption that position in question would like not survive judicial scrutiny. See supra note 6.

32 I.R.C. § 6662(d)(2). The penalty is higher in certain situations. For example, if a taxpayer engages in a reportable transaction, which is an even more narrowly defined set of shelter-type transactions (described in section 6011) but fails to satisfy special tax shelter reporting requirements, the understatement penalty rises to thirty percent. I.R.C. § 6662A(c). Also, the understatement penalty is forty percent rather than twenty percent for "gross valuation misstatements." Id. § 6662(h)(1). Finally, a seventy-five percent penalty can be imposed for fraudulent understatements, although this penalty is rarely handed out. Id. § 6663. The penalty rules for tax shelters have recently changed as a result of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418. Prior to that Act, a distinction was drawn between corporate and noncorporate taxpayers engaged in shelter transactions. For noncorporate taxpayers, the normal substantial understatement penalty for tax shelters could be avoided only if (a) there is substantial authority for the position, and (b) the taxpayer reasonably believed that there was a greater than fifty percent chance of prevailing on the merits. I.R.C. § 6662(d)(2)(C) (amended 2004). And for purposes of former Code section 6662(d)(2)(C), and thus for tax years ending before October 22, 2004, this reasonable belief could be established based on a good faith reliance on a tax advisor's more-likely-than-not opinion, assuming the advice was based on all the relevant facts and the advisor was qualified. Treas. Reg. § 1.6662-4(g)(4)(ii) (2003). This reduction in the substantial understatement penalty, again, was not available to corporate taxpayers. The 2004 Act eliminated this option for noncorporate taxpayers. See I.R.C. § 6662(d)(2)(C). However, the understatement penalties generally can be abated, for corporate and noncorporate taxpayers, if a taxpayer can demonstrate that it acted with "reasonable cause" and in "good faith" in reporting the position in question. Id. § 6664(c). The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on the opinion of a professional tax advisor... [who] unambiguously concludes [on the basis of the pertinent facts and authorities] that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the" Service. Treas. Reg. §§ 1.6662-4(g)(4)(i)(B), 1.6664-4(c) (2003). The 2004 Act, however, changed the reasonable cause abatement provision as well by implementing, in effect, a strict liability standard for understatements attributable to so-called "listed" or "reportable transactions," which, as defined under Code section 6011, are transactions that the Service has identified as special categories of tax shelters or potential tax shelters. I.R.C. § 6664(c). If a transaction falls under these new rules, which also apply to tax years ending after October 22, 2004, there is a stricter set of reasonable cause and good faith standards that must be satisfied to avoid the penalty. Even these stricter standards, however, require the taxpayer to show, among other things, that it reasonably believed that the position in question had a better-than-fifty-percent chance of prevailing on the merits if detected. Thus, quantifiable merits risk
not enough, there is also the "realistic possibility of success" standard, which governs certain tax preparer penalties and is quantified as at least a 33 percent chance of winning on the merits, again, assuming detection.33

In sum, the penalty provisions in the Code force taxpayers to think about tax law in probabilistic terms. At least with respect to Code provisions whose application is uncertain, or uncertain in some contexts, taxpayers who want to avoid penalties must assess the chances that a particular interpretation will be upheld or rejected. One way of thinking of the choice confronted by the taxpayer under these conditions of substantive legal uncertainty is to imagine any given interpretation of the tax laws falling somewhere on a continuum. What the continuum measures is the ex ante probability that a court will decide that the particular tax law interpretation the taxpayer has chosen or is relying upon is the correct one, assuming the position is detected and evaluated by a court — that is, assuming detection risk to be 100 percent. If the interpretation were to fall on one end of the continuum, that position would be considered outright tax evasion, since it would have a zero probability of being sustained on the merits if examined by a court. If the interpretation were to fall on the other end of the spectrum, it would be considered unambiguously legal, which means here that the probability that the position would be upheld on the merits by a court if examined is 100 percent. Moreover, we can conceive of movement along the continuum as representing a change in the probability that a court will accept the taxpayer's position on the merits.34 For all practical

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34 Thinking of the tax-compliance question in terms of a continuum is not new. Daniel Shaviro, for example, has pointed out the continuous nature of these distinctions:

Aggressive paper shuffling to minimize tax liability is not identical to cheating if its being impermissible under the existing state of the law is not clear-cut. But there is an issue of degree here, and a slippery slope. Taking self-interested but reasonable reporting positions slides over into taking positions that are more and more unlikely to be sustained and, therefore, deliberately kept secret, converting the entire enterprise into one of playing
purposes, at least for sophisticated taxpayers engaged in tax planning, the most important part of the continuum lies somewhere in the middle.\footnote{35}

All of this can be illustrated in a simple schematic.

**FIGURE 1. TAX COMPLIANCE CONTINUUM**

![Diagram of tax compliance continuum with labels A, B, C, and D showing different levels of risk and probability of winning on the merits.]

-the "audit lottery" rather than taking a position that one believes is actually reasonable under the law. At a certain point, although it is hard to say exactly where, aggressive planning merges into outright cheating. Even before that point is reached, the former starts to have many of the same bad effects on general compliance as the latter.

**Daniel N. Shaviro, Corporate Tax Shelters in a Global Economy: Why They Are a Problem and What We Can Do About It** 25 (2004).

\footnote{35} According to some corporate tax practitioners, tax planning is when a taxpayer wants to engage in a transaction primarily for nontax business reasons, but wishes to structure the transaction so as to minimize its tax liability consistent with the tax laws — or consistent with how Congress intended the tax laws to be applied. Thus, most practitioners, and some academics, would recognize tax planning as a type of legal and legitimate tax avoidance. See, e.g., Schler, *Ten More Truths, supra* note 18, at 384 ("Tax planning is not all bad."). Others, however, regard most tax planning activity as being questionably legal, under a sound conception of economic performance, and consider most, if not all, tax planning as socially undesirable. See, e.g., Weisbach, *Ten Truths, supra* note 18, at 222 ("There is no social benefit to tax planning.").
On the left side of the continuum, the merits risk — i.e., the chance of losing on the merits if detected — at some point reaches 100 percent; or, conversely, the probability of winning on the merits reaches zero. This point is represented in Figure 1 by Point A. Thus, all tax positions or interpretations of the Code to the left of A are clearly illegal and constitute tax evasion. By contrast, on the right end of the continuum lies a point beyond which the merits risk is zero, and hence the chance of winning on the merits is 100 percent. B marks that point: the beginning of the domain of clearly legal avoidance. Although there can be interesting questions around Points A and B, and determining on which side of those points a particular tax position will fall can be difficult, the most interesting questions in tax enforcement, at least for most sophisticated taxpayers, lie in the middle part of the continuum between points A and B. This is true for several reasons. First, virtually all sophisticated taxpayers want to avoid even the appearance of outright evasion since the consequences in terms of formal and informal penalties would be catastrophic. Thus, they will keep their interpretations comfortably to the right of Point A. At the same time, many sophisticated taxpayers will be induced to push their interpretations of the Code to the left of Point B to ensure that they pay no more in taxes than they actually owe.

This conclusion suggests that where the action is on the continuum is the region clustering around the midpoint between A and B. Where this region begins and ends is impossible to say. It is also impossible to say with any certainty whether this region is, in the real world, centered on something like Point C in a natural bell curve formation of sorts, or whether instead it would be skewed to one side or the other. The answer to those questions would depend on the balancing of a number of forces including the competitive market pressures to minimize taxes paid; the role of more-likely-than-not opinions tax shelter opinions as an effective form of penalty insurance; the probability of detection; and the size of the formal and informal penalties. For example, some commentators contend that corporate managers desperately want to avoid getting hit with tax penalties, which could be a career ending event for them. This fact could push

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36 Obviously there are also disputes about whether a particular tax position constitutes criminal evasion or whether it falls just on the noncriminal side of the line. Indeed, both points (A and B) have their own problems of “fuzziness,” but those areas are not as interesting, or as problematic, as the large grey area in the middle region.

37 See Bankman, supra note 7, at 1792 (“In the past, at least, imposition of a 20 percent penalty was seen as a career-ending event for the responsible official in a
taxpayers towards interpretations or transaction to the right of C. Pushing in the other direction, however, is the very low probability of detection and the very low penalties for getting the law wrong as well as the existence of tax penalty insurance that is provided by tax advisors in the form of more-likely-than-not shelter opinions. These are legal opinions provided by tax advisors that analyze the tax position being considered and almost inevitably conclude that the position is more likely than not to be sustained on the merits if detected on audit and ultimately evaluated by a court. In other words, these opinions in effect conclude that the reporting position falls to the right of Point C. It is generally believed that having a more-likely-than-not opinion effectively eliminates the risk of a substantial understatement penalty for a tax shelter position as courts tend to be deferential to such opinions when it comes to assessing penalties.\(^{38}\) Again, anecdotal evidence and conventional wisdom among tax experts suggest that something of the sort is in fact happening; hence the recent hubbub about tax shelter activity and the role of tax shelter opinions.\(^{39}\)

We shall return to the idea of the tax compliance continuum and the problem of aggressive avoidance below. For now, the important idea to take from this discussion is the general one: that the tax law can be characterized by significant substantive uncertainty and thus can be viewed probabilistically from an ex ante perspective. What will become clear below is that this fact can have serious consequences in terms of overall social welfare.

\(^{38}\) *Id.* at 1779 ("In theory, such opinions ought not to serve as protection from the substantial understatement penalty. In practice, any run-of-the-mill opinion letter is thought to insulate the taxpayer from the substantial understatement penalty . . . ").

\(^{39}\) Indeed, this concern about the increase in tax shelter activity and the role of more-likely-than-not opinions led to the recently finalized revisions to Circular 230, which were designed to increase the standards of practitioners issuing tax opinions on transactions whose principle (or even significant) purpose is tax evasion or avoidance. Regulations Governing Practice Before the Internal Revenue Service, 69 Fed. Reg. 75,839 (Dec. 20, 2004) (to be codified at 31 C.F.R. §§ 10.33, 10.35 to .38, 10.52, and 10.93). For a discussion of the new tax opinion standards in Circular 230, see Arthur L. Baily & Alexis MacIvor, *New Circular 230 Regulations Impose Strict Standards for Tax Practitioners*, 107 TAX NOTES 341 (Apr. 18, 2005).
C. Sources of Legal Uncertainty: Rules and Standards in Tax Law

Before we address the consequences of tax law uncertainty, there is more to be said about the sources. That there can be significant substantive legal uncertainty in the tax laws may come as a surprise to nonexperts in the field. After all, the tax system is the quintessential rule-based, as opposed to a standards-based, legal regime. Almost by definition there is supposed to be less substantive legal uncertainty with a system of rules than with a system of standards. Although the tax system is primarily a system of rules, it is inevitably a system of standards as well, as some scholars have recently begun to emphasize. This is because, even in a system with highly complex rules — in fact, perhaps especially in such a system — there can be difficult questions of how the rules are to be applied to complex transactions.

The rules/standards distinction in law is well known. With a rule, the relevant lawmaker (whether it be Congress or some agency acting as rule-promulgator) determines ex ante — that is, before the conduct being regulated takes place — relatively precisely what conduct is permitted or compelled under what particular circumstances. With a standard, by contrast, the ex ante lawmaker provides relatively few details regarding the regulated conduct, leaving more of the content of the command to be provided ex post. Thus, with rules, the ex ante lawmakers, be they part of a legislature or agency, must provide most of the normative content of the rule; while ex post adjudicators, be they judges, jurors, or agency officials, are responsible primarily only for applying law to facts. With standards, the job of the ex ante lawmaker is somewhat easier, but the ex post adjudicator must both provide content to the law and apply the law to the facts at hand. The classic illustration of the rules/standards distinction involves traffic safety laws. A traffic safety rule might be that drivers may not
exceed fifty-five miles per hour on the highway. The only issue for the ex post adjudicator then is whether a particular driver exceeded the speed limit.\textsuperscript{43} A traffic safety standard, by contrast, might require that drivers always drive reasonably under the circumstances, leaving the ex post adjudicator to determine not only the speed at which the driver was traveling but also whether that speed was reasonable. Common sense would suggest that for the driver trying to decide how to drive consistently with the laws, the relatively vague standard would present significantly greater legal uncertainty than would the relatively clear speed limit rule. Indeed, some have even suggested that the differing degrees of legal uncertainty provide one essential way of distinguishing rules from standards.\textsuperscript{44}

What does all this have to do with taxes? Is the federal income tax system the quintessential system of rules, or is it not?\textsuperscript{45} It is certainly true that the federal tax system has one of the most complex and comprehensive set of rules of any area of American law. Even though a good case can probably be made for simplifying the existing tax code, as most tax experts recommend,\textsuperscript{46} such simplification would not eliminate the need for many detailed and complex rules. In other words, it almost certainly makes sense that the tax system should have a lot of detailed rules, even if not as many rules as we currently have.\textsuperscript{47}

\textsuperscript{43} Obviously a rule of this sort could be more complex than this, providing different speed limits for different situations.

\textsuperscript{44} Louis Kaplow, \textit{General Characteristics of Rules, in 5 ENCYCLOPEDIA OF LAW AND ECONOMICS: THE ECONOMICS OF CRIME AND LITIGATION} 502, 513 (Boudewijn Bouckaert \& Gerrit De Geest eds., 2000) (“Indeed, if rules are defined as the extent to which legal commands are given content \textit{ex ante} and thus the ease with which private parties can predict how the law will apply to their conduct, legal uncertainty might be viewed as simply a measure of the extent to which a legal command is standard-like.”). As I argue below, \textit{see infra} text accompanying notes 59–60, however, uncertainty can arise precisely because of the complexity of rules and hence the difficulty of determining how such complex rules will be applied in specific settings.

\textsuperscript{45} Weisbach, \textit{ supra} note 42, at 860 (“The tax law is the paradigmatic system of rules.”). Weisbach then goes on to explain why lawmakers have begun to introduce standards into the tax law’s predominantly rule-based approach. \textit{Id}.

\textsuperscript{46} William G. Gale, \textit{Tax Simplification: Issues and Options, Testimony before House Ways and Means Committee, July 17, 2001} (“The notion that taxes should be simpler is one of the very few propositions in tax policy that generates universal agreement.”) , \textit{available at} \url{http://www.brookings.edu/views/testimony/gale/20010717.pdf}.

\textsuperscript{47} Noël B. Cunningham \& James R. Repetti, \textit{Textualism and Tax Shelters}, 24 \textit{VA. TAX REV.} 1, 56 (2004) (“The Code (including subchapter K) has been, and undoubtedly will continue to be, primarily a rule-based statute. It is important that the ‘millions of taxpayers who engage in billions of transactions’ be able to file annual
Why is this so? According to the orthodox legal theory of rules and standards, relatively detailed rules are generally preferable when the cost of determining ex ante what the permissible or required conduct should be for a given situation is low relative to an ex post determination, and when the frequency of application of the rule is likely to be high.\textsuperscript{48} By contrast, standards are to be preferred when an ex ante determination of the optimal conduct is relatively costly and when the norm in question will be applied by the ex post adjudicator relatively infrequently.\textsuperscript{49} This is why it could make sense in a tort system to have a general, somewhat vague reasonableness standard regulating the conduct of, say, drivers,\textsuperscript{50} but it is difficult even to conceive of a tax system composed entirely of standards to be adjudicated ex post. Consider the silliness, for example, of a hypothetical tax system that had no detailed rules but merely required all taxpayers to remit to the government each year a reasonable amount under the circumstances. The current compliance problems would pale by comparison to those inherent in such a system. In sum, any comprehensive tax regime will need to have detailed and complex rules.\textsuperscript{51}

However, just as the tax system cannot rely solely on standards, neither can it rely exclusively on rules. Thus, as with presumably every area of law, the tax system is a mixed one; and although rules predominate in the U.S. tax system, the use of standards is growing. The reasons for this trend are simple. First, a pure rule-based approach simply is not feasible; neither Congress nor the Treasury could tax returns with some degree of certainty without incurring huge compliance costs.

\textsuperscript{48} Kaplow, supra note 41, at 562.

\textsuperscript{49} Id.

\textsuperscript{50} It also makes sense to have some traffic rules, given that it is fairly easy to determine that driving over the speed limit (or, even more obviously, driving on the wrong side of the road) is almost always a bad idea.

\textsuperscript{51} That is, we should expect the tax system to be relatively more rules-based than, say, the general tort system. This is not to deny, of course, that a plausible tax regime might rely substantially less on detailed rules than the U.S. system does. It should also be noted that even a legal regime that seems to be primarily standards-based can develop into a more rules-based regime over time as, for example, when court decisions interpreting and applying the standard to various factual situations begin to accumulate. See Kaplow, supra note 41, at 577–78 (discussing way in which precedential value of ex post decisions by courts and other adjudicators can make standards more rule-like).
Department can possibly anticipate all of the conceivable transactions that will be affected by the tax laws, nor would they want to. The Code is too long as it is, and, in any event, there comes a point at which the cost of ex ante rule-making, including that of the added complexity to the system, becomes prohibitive. Second, and more important, whatever tax rules are adopted, no matter how specific or detailed or comprehensive they are, sophisticated taxpayers with fancy tax lawyers and accountants will always find opportunities for aggressive or abusive tax avoidance. Put differently, it simply is not possible to write tax laws that are devoid of all unintended loopholes. These loopholes in turn are exploited by smart tax advisors seeking zealously to represent their corporate, and increasingly their wealthy individual, clients. Thus, competition induces tax advisors to compete to provide the most aggressive, tax-minimizing interpretations of the tax laws possible, constrained only by the threat of taxpayer penalties, which, given the more likely than not opinions discussed above, is often empty.\(^{52}\) As a result, what was a potentially small loophole with relevance to only a few transactions, and thus not worth worrying about, becomes a large loophole as enterprising tax advisors funnel money and clients through such gaps.\(^{53}\) The problem with such opportunistic and aggressive exploitation of unintended loopholes (or discontinuities) in the tax system, of course, is that they produce both distributive unfairness in the short run, as not all taxpayers are equally able to avail themselves of these techniques, and inefficiency in the long run, as taxpayers shift into the fields that have the most, or are best able to exploit, tax loopholes, pushing down the pre-tax rate of return in those fields but artificially increasing the number of investors or participants in those fields. The point here is that, under a pure rule-based approach to generating tax law (that is, assuming there were no background anti-avoidance standards to deter abusive avoidance — no economic substance, business purpose, or sham transaction doctrines), and if neither Congress nor the Treasury Department did anything to stop it, the harm to the tax system would

\(^{52}\) See supra text accompanying notes 28–35.

\(^{53}\) As David Weisbach puts this point, the problem with a rules-based tax system generally is that the uncommon transaction — the one that it is, by definition, not cost effective to handle with an ex ante rule — can become a common transaction, as clever tax advisors identify such loopholes and then market them to high-income individuals and corporations. Weisbach, supra note 42, at 868–70. As Weisbach points out, this inherent vulnerability of rule-based systems may exist in other areas of law as well, but seems to be especially problematic in the tax area, for a number of reasons, including a pervasive culture of tax law manipulation. Id. at 870–71.
be catastrophic. Under these assumptions, there would be no mechanism for closing loopholes. The tax system would either collapse or become something very different from what it now is, as only the unsophisticated or altruistic would pay any income taxes at all.

Of course, neither Congress nor the Treasury would let the tax system collapse. The question is how Congress and the Treasury should respond to such inevitable gaps in the law. Consider the pure rule-based approach, which would work something like this: When a new loophole is discovered, a new rule would have to be adopted to close it, either by Congress or by the Treasury acting as rule promulgator. These new loophole-closing rules would likely be made prospective in application. At least that is how things have worked historically. What “prospectivity” means here is that the new rules would apply for the most part only to future tax years. These new loophole-closing rules would then be followed by another round of tax shelter “innovation” on the part of tax advisors, who would either find gaps in the new rules or elsewhere in the tax laws. Congress or the Treasury would eventually respond with another round of prospective loophole-closing legislation or rulemaking, and the cycle would continue. The result of such a purely rule-based approach, as University of Chicago Law Professor David Weisbach has noted, would be an enormous and costly increase in the complexity of the tax laws. Contrast this scenario with a mixed tax system of mostly rules,

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54 This sort of nominally prospective rule change can of course have retroactive effects, insofar as taxpayers made investments in reliance on the previous rules and expected to benefit from the old rule for a number of future tax years. See generally Michael J. Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. PA. L. REV. 47, 49–50 (1977) (defining “nominal prospectivity” and “nominal retroactivity”). In some cases, taxpayers in these circumstances are able to get even greater transition relief by way of a grandfather rule of some sort.

55 Weisbach, supra note 42, at 861. Note that if a rule-based response to tax loopholes were made nominally retroactive, which they almost never are, it would be comparable to a standard-based response to aggressive tax avoidance, since ex post anti-avoidance determinations by courts are always applied retroactively. The only difference is that with a retroactive rule-based approach, the ex post decision is made by Congress or the Treasury Department in their rulemaking capacities. Under such a retroactive rule-based approach, it is not entirely clear that there would be an increase in complexity as compared with a standard-based approach that relies principally on courts as ex post adjudicators. Either way, taxpayers would be deterred from looking for loopholes in the first place if they knew they would eventually be shut down retroactively. This sort of retroactive repeal, however, is very difficult to accomplish as a political matter. Moreover, at least as far as Congress is concerned, there may be public choice reasons why such loophole-closing legislation would be
but with a background anti-avoidance standard. Under such a mixed system, which is not terribly different from what we have today, the anti-avoidance standard provides deterrence relatively cheaply by closing loopholes retroactively; but it does so without producing nearly as much overall complexity as does the prospective rule-based approach.56 Again, this is because an anti-avoidance standard need not specify in advance every conceivable example of abusive avoidance — every unintended tax loophole — that will be struck down. It need only state that transactions that fail to satisfy the standard, whether economic substance, business purpose, or something else, will be disallowed, in which case the taxpayer will owe back taxes plus interest and, if the interpretation of the Code was too aggressive, penalties as well. It is the tax law equivalent of the negligence doctrine in torts. Professor Daniel Shaviro of NYU Law School describes benefits of anti-avoidance standards in tax as follows:

One key reason for using a standard is that the IRS and the courts can apply it across the board, without raising issues of undue retroactivity, even if the government failed to anticipate a particular trick and state in advance that it does not work. There are simply too many fault lines in the existing income tax and too many clever people laboring behind closed doors to find new ways to exploit these fault lines for after-the-fact prospective responses to be adequate.57

D. The Consequences of Legal Uncertainty

It is conventional wisdom that with the use of legal standards comes a degree of substantive legal uncertainty. In fact, Harvard Law School Professor Louis Kaplow has put the relationship between

slow in coming, thus making reliance solely on a rule-based response aggressive avoidance impractical.

56 See Weisbach, supra note 42, at 861; cf. Kaplow, supra note 41, at 593–96 (challenging the assumption that standards tend to be more complex than rules). This view seems correct as far as it goes. When we introduce the possibility of uncertainty and the purchase of liability insurance for the consequences of uncertain legal standards, however, the use of a standard-based approach to tax law or any other area of law, if accompanied by the purchase of liability insurance, would not necessarily reduce overall complexity, though it might. The question is whether insurers in underwriting their policies would simply replace the complexity of detailed tax rules with the complexity of detailed insurance policies. The point is that the comparative complexity of the two approaches is not entirely clear.

57 SHAVIRO, supra note 34, at 23.
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standards and uncertainty this way:

[I]f rules are defined as the extent to which legal commands are given content ex ante and thus the ease with which private parties can predict how the law will apply to their conduct, legal uncertainty might be viewed as simply a measure of the extent to which a legal command is standard-like.58

Thus, on this view, when a standard is used in lieu of a system of rules, there is a tradeoff between the benefits of reduced complexity and the costs of increased uncertainty. To see this point, go back to the traffic-safety example, where the roads are governed by a general negligence standard requiring reasonable driving. In that example, when I am deciding how carefully to drive my car or whether to drive at all, I face the possibility that in the event of an accident my driving will be deemed to have been unreasonable under the circumstances, thus making me liable for the accident costs. The threat of such ex post liability can give me an incentive to drive carefully; that incentive is the deterrence value of a tort standard. But that threat also creates legal uncertainty for me. Indeed, the possibility that my driving will be considered by a court ex post to have been unreasonable, and the cause of someone else's harm, is just the sort of legal uncertainty that can motivate me to purchase auto liability insurance. A similar story can be told for any situation in which a liability standard is used; and thus a similar story can be told with respect to the use of anti-avoidance standards in the tax field. Because an anti-avoidance standard necessarily leaves open the precise definition of what constitutes impermissible tax avoidance, taxpayers engaged in tax planning must face a degree of legal uncertainty, uncertainty as to what the law is and how it will be applied to a given factual situation.

It must also be said, however, that a system that consists almost entirely of complex rules also can produce a type of legal uncertainty. This fact, which typically gets overlooked in discussions of rules and standards, becomes evident when one considers the plight of the average individual taxpayer attempting to fill out his tax return. The Code is so detailed and complex and just plain long that most individual taxpayers who attempt to do their own returns can have little certainty on April 15 that they have fully complied with the law. Indeed, this is why so many individual taxpayers now use tax return preparers or tax preparation software, both of which serve as a sort of insurance against the uncertainties of the tax laws. Indeed, as

58 Kaplow, supra note 44, at 513.
discussed below, tax return preparers and tax software companies often provide warranties with their services, which literally serve as insurance for taxpayers against the risk that the return preparer will make a mistake on some detail of the law.\textsuperscript{59} Finally, in addition to the uncertainties regarding what the appropriate application of the legal rule or standard is, there is also the uncertainty associated with the possibility of erroneous decisions on the part of the law enforcers. That is, the Service and the court may mistakenly determine that the taxpayer has violated the law. That possibility is an element of substantive legal uncertainty that taxpayers must also take into account.\textsuperscript{60}

So what is the big deal with a little uncertainty? The world is full of uncertainties, and yet life seems to go on. Get over it. Most of us are not generally paralyzed by the existence of the uncertainty around us. True enough. That does not mean, however, that uncertainty is per se good. For starters, people do not like uncertainty; at least many people do not like many types of uncertainty. This is what economists mean when they say that an individual is risk-averse. To put the point somewhat technically, a risk-averse individual is someone who, when comparing a certain dollar amount with an uncertain prospect of the same expected value, prefers the former. In other words, those who are risk-averse are willing to pay something — at least an actuarially fair insurance premium (a premium equal to the weighted probability of the loss multiplied by the magnitude) — to shift a risk of loss to an insurance company. Although there is plenty of evidence of risk-preferring behavior out there as well, from organized gambling to bungee jumping, it is generally assumed that many individuals are risk-averse with respect to many types of risks that involve a small likelihood of a large potential loss.\textsuperscript{61} Substantive legal risk or uncertainty can fall into this category as well.\textsuperscript{62} What this means is that legal risk is something that most people would pay to avoid, which in turn means that social welfare would be enhanced if legal risk could be reduced or eliminated at a cost less than what

\textsuperscript{59} See infra Part III (discussing tax preparer services).

\textsuperscript{60} John E. Calfee & Richard Craswell, Some Effects of Uncertainty on Compliance with Legal Standards, 70 Va. L. Rev. 965, 968 (1984).

\textsuperscript{61} In one of the all time great examples of circular reasoning, the assumption that individuals are in fact risk-averse derives largely from the observation that individuals behave as if risk-averse — such as by purchasing insurance.

\textsuperscript{62} I use the terms “risk” and “uncertainty” interchangeably here. Their technical meanings, as the terms are used by economists and insurance experts, are in fact different, but that difference is not important for current purposes.
people are willing to pay to shed it.

That, in a nutshell, is why legal risk or legal uncertainty can be a bad thing from the perspective of individual consumers or taxpayers. This same explanation would apply to any corporate taxpayer that is privately owned and to any partnership arrangement in which the partners are individuals. It is a little harder to understand, however, why a corporation whose stock is publicly traded would be averse to legal uncertainty. In theory, most if not all of the shareholders of a public corporation are diversified, meaning they own shares in enough companies and in enough industries whose risks are not correlated with each other that they — the shareholders — are actually indifferent as to the risks that affect any individual company. In other words, a fully diversified shareholder is concerned only with economy-wide risks and how the stocks in their portfolios respond to economy-wide fluctuations, not with any firm-specific risk. The uncertainty as to how the laws, including the tax laws, will be applied to a particular corporation's circumstances, such as to a particular transaction, is one such firm-specific risk. Given this fact, if managers of public corporations were acting as loyal agents for their diversified shareholders, they should likewise behave as if they are risk-neutral with respect to firm-specific risks, including legal risks — including, even more specifically, tax law risks. And yet public corporations buy liability insurance all the time. Moreover, many of the tax risk insurance policies that have been sold were purchased by public corporations. Why would that happen if shareholders are in fact risk-neutral?

There are a number of possible explanations. First, even if corporate shareholders are risk-neutral, corporate managers, including tax managers, may well be risk-averse with respect to certain types of catastrophic, potentially bankrupting, liabilities. This might be so, for example, if managers have nondiversifiable human capital at risk in their respective companies. Moreover, even if the potential legal risks do not threaten to bankrupt the company, a negative, uninsured legal outcome may end the careers of corporate managers,

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63 Although one might reasonably assume that entrepreneurs are less risk-averse than the average individual, it might still be the case that such investors or business people prefer to limit or eliminate some types of risk — that is, even risk neutral or risk seeking entrepreneurs often want to limit the domain of their risk taking behavior, and this can be done through the purchase of insurance.

64 For a list of explanations for the corporate demand for insurance, see David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. Bus. 281 (1982).
a prospect that would certainly be enough to make corporate managers risk-averse with respect to such liabilities. And, indeed, this is thought to be the case with the risk of a tax penalty assessment.\footnote{See Bankman, \textit{supra} note 7, at 1784.}

Second, the purchase of insurance by a corporation might be thought of as a means of securing reliable, bonded advice regarding how to minimize losses. That is, insurers may be seen as experts in risk management, and by selling an insurance policy to the corporation, the insurer has also agreed in effect to give the insured corporation the benefit of its expertise in reducing insured risks. Moreover, the advice is bonded, in the sense that the insurer has agreed to be on the hook for the resulting losses if its risk-reduction advice is followed.\footnote{See Mayers & Smith, \textit{supra} note 64, at 288–89.}

As will be discussed more fully below, a case can be made that tax risk insurance serves this bonded-advice function as well. Finally, if we take at face value the explanations that corporate managers of large corporations often provide to justify their purchases of corporate insurance, and if we take seriously the pitch that insurance brokers use to market insurance policies to corporate risk managers, the best explanations for the purchase of insurance — including tax risk insurance — by public corporations may depend on the assumption that there is some level of risk-aversion, or perhaps some level of residual irrationality, among investors. A simplified version of this story goes as follows: Management is worried that, if there is a large unforeseen liability in a particular year, whether a tort judgment or a tax deficiency, will cause a “shock” to, or a surprise downward movement in, reported earnings. The catch is that such a shock to earning can cause investors to overreact, leading to a drop in share price, which even if temporary can have consequences for the company by raising the cost of capital.\footnote{It can also have consequences for management compensation, which might itself produce risk-aversion among managers.}

Thus, if a corporation discovers a new potential liability and books a reserve for it on its financial statements, such a reserve, if large, can affect share price and in turn the cost of capital. Insurance provides a means of eliminating such shocks. Instead of waiting for the large loss to occur and expensing it then, and instead of booking a reserve in anticipation of the loss’s occurrence, the corporation can simply pay a premium to an insurance company and shift the risk to the insurer. Such an insurance transaction in effect removes the liability from the insured-corporation’s balance sheet. In any event, however one describes this capital-market-shock theory, it amounts to a type of risk-aversion on
the part of corporate investors, even supposedly diversified ones.

The foregoing is an account of why individuals and corporations purchase insurance; thus, in a sense it is an account of the costs of uncertainty, including tax law uncertainty. Besides this general cost of risk-bearing associated with legal uncertainty, there is another cost as well. Legal uncertainty can induce taxpayers, especially risk-averse taxpayers, to over-comply with the law in various ways. Taxpayers could manifest over-compliance in a number of ways, such as changing the structure of their transactions, deciding not to engage in the transaction in question, or engaging the transaction as planned but without taking advantage of the more favorable tax treatment to which they are arguably — though by assumption not certainly — entitled. One way of understanding this sort of over-compliance is to refer back to the tax compliance continuum. Over-compliance, for example, might mean that taxpayers would tend to avoid taking positions that approached the more-likely-than-not threshold — that is, they would stay comfortably to the right of Point C — by avoiding even remotely questionable transactions or reporting positions. All of these types of over-compliance constitute social waste and can even produce distributional inequities insofar as the effects of the legal uncertainty and differential risk-bearing are unfairly distributed across taxpayers.\footnote{Note that the existence of substantive legal uncertainty can cause distortions in taxpayer behavior even if taxpayers are neutral with respect to risk. Calfee & Craswell, \textit{supra} note 60, at 1002–03. This can occur, for example, if the legal standard being applied takes a form similar to a negligence rule, under which the individual or firm can avoid the entire penalty if they merely, and only barely, satisfy a threshold standard of care. The intuition behind this somewhat counter-intuitive point can be illustrated in an example from tort law. Imagine that a product-safety standard says merely that product manufacturers should make their products reasonably safe, with “reasonably safe” meaning “cost-justifiably safe,” taking into account the full social costs of accidents caused by the product. Assume further that what this means ideally is that, for example, a maker of $200 lawnmowers should invest $25 per mower to install the latest foot protection technology. Anything less than that investment would be considered negligent in a tort case in the event of an injury; anything more than that would be unnecessary and inefficient, because it would force consumers to purchase a safer product than is necessary under the circumstances. If the legal standard is uncertain, and the manufacturer cannot determine ex ante precisely what the cost-effective safety device is, and if the penalty for noncompliance is large enough, the manufacturer may have an incentive to install, say, a $27 (or $30 or $35) foot protector instead of the efficient $25 one in order to eliminate the threat of potential liability — which disappears entirely when the threshold of reasonable care has been met. This theoretical possibility of over-compliance, which again applies even in the absence of risk-aversion on the part of the regulated party, though risk-}
Given the nature of tax law, with its mixture of complex, sometimes inscrutable rules and background anti-avoidance standards, it is inevitable that there will be some measure of substantive legal uncertainty. The existence of such uncertainty can lead to behavioral distortions, inefficient risk bearing, and both under- and over-compliance with the tax laws. What if anything should be done about this? One answer is: nothing. Perhaps since the current penalties for tax noncompliance and the probability of detection are so low — too low to produce optimal compliance incentives — a case can be made for using tax law uncertainty as a second-best form of deterrence. That is, given the existing incentives to under-comply with the tax laws, maybe the deterrence value of a little legal uncertainty will at least help to even things out. Indeed, the only thing preventing some taxpayers from being more aggressive in their tax planning may be the residual level of uncertainty within the tax laws. And this might even be Congress's intent; lawmakers may have left some uncertainties in the tax laws with the hope in mind that taxpayers, seeking to avoid uncertainty, would err on the side of caution. That is possible. But if that were Congress's intent, it has not done a good job of saying so. Moreover, using such legal uncertainty in this way is a fairly imprecise tool for deterring aggressive tax

aversion exacerbates the effect, has been demonstrated in the context of tort standards. Id. at 990. It would also apply to the context of tax enforcement. Thus, for example, a taxpayer facing uncertainty as to how the IRS or a court will apply, say, the economic substance or business purpose doctrines to the taxpayer's particular transaction might decide to over-comply with the law by building into the transaction an excessive amount of nontax business risk, just to ensure compliance with the standards and thus avoid underpayment penalties, even though such additional risk is pure economic waste. Of course, an anti-avoidance standard that ends up inducing some taxpayers to structure some transactions with some amount of real economic risk or substantive business investment that they would not have otherwise, in the absence of the standard, can be optimal overall. One of the ways that anti-avoidance standards work is to create such "frictions" that hinder or limit the extent to which taxpayers can achieve both (a) the economic substance they are seeking and (b) that tax treatment they are seeking. Daniel N. Shaviro, Economic Substance, Corporate Tax Shelters, and the Compaq Case, 88 TAX NOTES 221 (July 10, 2000) (explaining that a function of the economic substance doctrine is to impose frictions on aggressive tax planning). My point is that uncertainty in the tax laws can produce excessive friction which may alter or inhibit transactions that are welfare enhancing.

For a formal analysis of the effects of tax law and tax enforcement uncertainty on reported income and on aggregate social welfare, see Suzanne Scotchmer & Joel Slemrod, Randomness in Tax Enforcement, 38 J. PUB. ECON. 17 (1989). The authors do not argue that behavioral effects of tax law uncertainty will precisely offset the behavioral effects of insufficient penalties. They do note, however, that the two can act as substitutes for each other.
planning, since some taxpayers will be induced to over-comply and others, the less risk-averse, will be inclined to take a chance and exploit the ambiguity. In addition, there are better responses to tax under-compliance than the use of legal uncertainty. For example, the best response to suboptimal penalties or suboptimal detection rates is to increase one or the other, or both.\textsuperscript{70} Thus, maybe we should radically increase tax understatement penalties or spend more money on auditors, hiring more of them and training them better.\textsuperscript{71} If we take either of those steps, however, we would be right back where we started with the problem of legal uncertainty and the accompanying distortions and inequities due to potential over-compliance. Even if we fix the problem of under-deterrence by choosing the optimal balance of detection risk and penalties, we will still need to deal with the problem of legal uncertainty. What I want to explore in the remainder of this Article is a particular response to substantive legal uncertainty, a form of private insurance that has in recent years come into use by mostly sophisticated corporate taxpayers. In particular, I explore in some detail the benefits and costs of tax transaction insurance, and I compare it with the most obvious alternative: government provided legal uncertainty insurance. As we will see, insofar as tax insurance operates purely as coverage for substantive legal uncertainty or coverage for merits risk, it appears to be socially desirable. However, insofar as it operates as insurance against pure detection risk — i.e., if taxpayers were to buy coverage for tax positions that they knew were contrary to prevailing law — tax insurance may be problematic and perhaps should be limited or banned.

Before I get to these arguments, however, let us review some of the facts about the existing market in tax insurance. First, I will take a brief detour to describe what might be called the old markets in tax insurance, which still thrive today, and then I will survey the new market, which is much smaller in scope at this point but is in many ways more interesting for its potential.

\textsuperscript{70} Scotchmer and Slemrod demonstrate, however, that, under certain restrictive assumptions, the socially optimal level of tax law uncertainty is greater than zero. The intuition behind this point is that a marginal increase in tax law uncertainty can have the same deterrent effect on taxpayer reporting behavior as a more expensive investment in increased detection. \textit{Id.} at 24–25. They would presumably agree, however, that there is a ceiling to the optimal amount of tax law uncertainty.

\textsuperscript{71} My own view is that we should do both.
III. THE OLD MARKET IN TAX INSURANCE: TAX PREPARER (AND TAX ADVISOR) WARRANTIES AND TAX INDEMNITY AGREEMENTS

This Part discusses three forerunners of tax transaction insurance: tax preparer warranties; tax advisor warranties, or contingent fee arrangements; and tax indemnity agreements. The first is discussed at some length, the latter two only briefly. Although these warranties differ from each other and from tax risk insurance, each involves some degree of shifting of tax law uncertainty from one party to another and thus can be understood as a form of tax insurance. What is especially interesting is that from the perspective of the Treasury Department, preparer warranties and indemnity agreements present no tax law enforcement concerns, whereas advisor warranties do. Why this is so is a question explored below.\(^72\)

A. Tax Preparer Warranties

Long before there were tax indemnity insurance policies, there was a type of tax insurance that is still sold to millions of individual taxpayers today. These are the warranties provided by tax return preparers for their clients.\(^73\) Although the content of these warranties varies from one tax preparer to another, there is a considerable degree of overlap.\(^74\) The typical preparer warranty provides that if the

\(^72\) See infra text accompanying notes 85–89.

\(^73\) Under state insurance laws, the regulatory definition of the term “insurance” does not typically encompass service or product warranties. See, e.g., State ex rel. Duffy v. W. Auto Supply Co., 16 N.E.2d 256, 259 (Ohio 1938) (“A warranty promises indemnity against defects in the article sold, while insurance indemnifies against loss or damage resulting from perils outside of and unrelated to defects in the article itself.”). This means that those companies issuing warranties need not qualify as insurance companies or meet all of the requirements, including solvency requirements, imposed on such companies by state law. I have found one instance, however, in which a state insurance regulator treated a particular tax preparer warranty as insurance for state insurance regulatory purposes. Office of Gen. Counsel, State of N.Y. Ins. Dept., Treatment of Tax Preparer's Warranty (2000), available at http://www.ins.state.ny.us/rg003281.htm (concluding that any tax preparer warranty that covered losses beyond those caused by preparer errors would constitute insurance for regulatory purposes.)

\(^74\) For the purposes of this study, I have focused on the warranties provided by H&R Block and Jackson Hewitt that are publicly available on their respective web sites. H&R Block, Professional Services, http://www.hrblock.com/taxes/products/product.jsp?productId=43&otpPartnerId=2054&PartnerId=2054 (describing H&R Block's “Peace of Mind” warranty); Jackson Hewitt, Tax Liability Protection, http://www.jacksonhewitt.com/products_gold.asp (describing Jackson Hewitt's “Gold
preparer makes a mistake in preparing the taxpayer's return and that
error results in the Service's assessing interest and penalty charges
against the taxpayer, the preparer will cover those additional costs.
Most preparers further narrow the standard coverage by specifying
that the coverage is triggered only by calculation errors on the
preparer's part; some preparers, however, are less specific about
precisely what sort of error will trigger coverage.

In any event, the standard tax preparer warranty typically limits
coverage to preparer errors of some kind and thus leaves taxpayers
themselves responsible for any interest or penalties caused by their
own mistakes or malfeasance. For example, if a taxpayer fails to tell
the tax preparer of some item of gross income that she received in a
given year and the preparer leaves that item off the taxpayer's return,
or if the taxpayer simply provides incorrect numbers with respect to
some item of income or deduction, any resulting penalties and interest
would be the responsibility of the taxpayer. If the preparer commits
an error, however, the standard warranty covers any resulting penalty
and interest. This standard warranty is provided by most tax
preparation firms and most tax preparation web sites and software
companies; and the price for this coverage is typically included in the
basic cost of the service.\footnote{For example, Turbo Tax provides the following standard warranty with its online product: "We are so confident in the accuracy of TurboTax for the Web that it's 100% Guaranteed Accurate. Rest assured, if you ever have to pay an IRS or state penalty or interest because of a TurboTax calculations error, we'll pay you the penalty and interest." TurboTax – Guaranteed 100% Accurate, http://www.turbotax.com/tax_products/turbotax_advantages/guaranteed_accurate_online_tax_prep.html (last visited Oct. 5, 2005).}

Conspicuously absent from the standard tax preparer warranty is
coverage for underpaid taxes. That is, they cover penalties and
interest but not the underpaid taxes themselves. This is not to say that
tax underpayment warranties are never offered. They are, but they

\footnote{According to one source, H&R Block and Jackson Hewitt
together handle roughly sixteen percent of all individual federal income tax returns
filed with the Service. ALAN BERUBE ET AL., CTR. ON URBAN & METRO. POLICY, THE
BROOKINGS INSTITUTION & THE PROGRESSIVE POLICY INST., THE PRICE OF PAYING
TAXES: HOW TAX PREPARATION AND REFUND LOAN FEES ERODE THE BENEFITS OF
the H&R Block and Jackson Hewitt examples, I have spoken with several
accountants, as well as with others familiar with the tax preparation industry, about
the use and typical content of tax preparer warranties.}

Guarantee" warranty).
are generally offered separately as a "rider" to the basic warranty. Furthermore, although tax deficiency coverage is offered by some preparers, it would not be surprising if taxpayers rarely opted to buy it. It is not that tax deficiencies are never large and unpredictable enough to motivate a demand for insurance. Indeed, as will be discussed in the next Part, it is the risk of a large unexpected tax deficiency, rather than the risk of penalties, that seems to generate most of the recent demand for tax indemnity insurance. The biggest difference between the tax indemnity or tax transaction insurance market and the market for tax preparation warranties is the relative magnitude of the risks. For most individual taxpayers who have a return preparer do their returns, as compared to the corporate taxpayers who are purchasing tax indemnity policies, the amount of the potential tax deficiency is relatively small, not only in absolute terms but relative to the overall tax liability. A major reason for this is that most individual taxpayers — and certainly the ones who have hired tax return preparers to file their returns — are not likely to be engaged in some sort of aggressive shelter transaction, which by definition puts substantial tax dollars at risk. Rather, they have decided to use a professional preparer or tax preparation software because they find the tax laws to be too complex to manage on their own. Such taxpayers typically do not go to return preparers for tax shelter advice, but only for help in preparing their returns. Moreover, individual taxpayers who decide to take aggressive positions on their returns may do so regardless of the advice of their preparers. This suggests another reason why return preparation firms would be reluctant to provide coverage against tax deficiencies. That

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76 Both H&R Block and Jackson Hewitt, for example, offer special extended warranties that, for an additional fee, provide coverage for underpaid taxes. In both cases, however, the amount of coverage for underpaid taxes is capped — $5,000 for H&R Block and $6,000 for Jackson Hewitt. Also, in both cases, coverage is triggered by the preparer’s error. Thus, combining both the standard and the extended warranties, if an H&R Block or Jackson Hewitt tax return preparer makes an error on a return, either a computational error or an error in interpreting the law, and the Service catches this mistake and issues a deficiency notice to the taxpayer requiring additional taxes plus interest and penalties, the company will pay all of the penalties and interest, as under the standard warranty, plus up to the policy limits in back taxes.

77 Few, if any, of the types of transactions that have been the subject of tax transaction insurance are of the sort that would be likely to give rise to penalties.

78 This conclusion, which is my own educated guess, does not mean that the use of return preparers overall necessarily enhances the accuracy of tax filings. There is, in fact, literature on this question, and the answer is that it depends. See infra note 80 and accompanying text.
is, if the risks are large, tax preparation firms may simply not be willing to take on the extra risk. Put differently, just as most product manufacturers would prefer not to become insurers for the consequential harms associated with their products and thus typically attempt to disclaim such warranties, it is possible that many tax return preparers simply do not wish to become the insurers of their customers' overall tax liability. In addition, even if the tax preparation firms were willing to take on the additional risk, they may not wish to take on the extra regulatory burdens, including licensure and solvency requirements, associated with being "engaged in the business of insurance" for state regulatory purposes. Such regulatory burdens would be more likely if the return preparer sold tax-deficiency coverage in addition to the basic warranties.79

A final observation about tax preparer warranties is that they also typically include a modest commitment to assist the taxpayer in the event of an audit. This guarantee entails a promise to help the taxpayer in the event of an audit to answer basic questions regarding how his or her return was prepared and how the various numbers were calculated. The guarantee, however, specifically declines to promise full-fledged legal representation; to the contrary, it expressly disclaims that obligation. Interestingly, tax preparers also sometimes guarantee that if the taxpayer overpays his or her taxes and does so as a result of the preparer's error (typically, only if it is a calculation error), the preparer will assist in filing an amended return to recover the excess taxes paid and will reimburse the taxpayer for any interest on that amount. Thus, tax insurance against errors on the part of tax preparers, which again has been in existence for some time, can be symmetrical, covering calculation errors in both directions.

The foregoing is a rough picture of the market for tax preparation warranties. In their current form, these warranties have certain characteristics that are common to other service and product warranties, characteristics that suggest the contracts are harmless and perhaps even socially beneficial. However, under certain conditions, one can imagine that these warranties, like other "small print" language in standard form contracts, might present consumer-protection issues. That is, if the consumers who purchase the warranties are asymmetrically uninformed or systematically misperceive the risks being insured, government regulation may be appropriate. The case for such intervention would be no different from that for other consumer product warranties. This sort of

79 See Office of Gen. Counsel, State of N.Y. Ins. Dep't., supra note 73.
regulation is typically done at the state level either by state attorneys general enforcing state consumer protection laws or by state insurance regulators if the warranties happen to qualify as insurance.

The more pertinent question for the purposes of this Article is whether tax preparation warranties — at least the ones comparable to those offered by the large tax preparation firms — present any tax law enforcement or compliance concerns. The answer seems to be that, although the use of tax preparers may have some negative effects on taxpayer compliance (as well as some positive effects), there is no obvious compliance cost or benefit associated with the warranties per se. That is, the existence of these warranties probably does not by itself create an incentive for insured taxpayers to take overly aggressive positions on their tax returns. Whether an individual taxpayer’s use of expert assistance in preparing a tax return leads to increased or reduced compliance is a question that has been studied by economists. Within that literature, one of the more interesting hypotheses is that tax return preparers, and perhaps tax advisors more generally, (a) tend to increase compliance with complex but clear legal rules but (b) tend to reduce compliance or increase noncompliance with rules that are more ambiguous or uncertain. Put differently, tax preparers are “rule enforcers” and “ambiguity exploiters.”80 With respect to clear but complex rules, individual, presumably unsophisticated taxpayers may inadvertently fail to comply simply from lack of understanding. In those cases, hired tax experts, who are able to decipher these complex rules and wish to avoid tax preparer penalties, will tend to correct such inadvertent clear errors, producing greater overall compliance with such provisions. For this optimistic conclusion to follow, it must be assumed that (a) return preparers are better able to understand such complex provisions than can the taxpayers who hire them, and (b) although the rules are complex they are clear, giving tax experts an incentive to counsel in favor of compliance. This latter assumption would hold because noncompliance in this context would in effect amount to evasion, which would subject not only the taxpayer but the preparer to near-certain, potentially severe penalties in the event of audit. By contrast, where the legal requirements are more ambiguous — or, to use the language from the previous Part, more standard-like — the overall

effect on compliance rates of using a preparer may cut in the opposite direction. This would be true if unsophisticated individual taxpayers tend to react to ambiguity by over-complying — if, for example, they do not take deductions to which they are not sure they are entitled. On the other hand, sophisticated tax preparers react to the same ambiguity less risk-aversely and are willing to take calculated risk. In terms of the tax compliance continuum in Figure 1 above, many unsophisticated, risk-averse individual taxpayers may tend to stay relatively close to Point B. By contrast, return preparers, better able to make the probabilistic calculations necessary to avoid penalties due to their superior tax expertise, may be more likely to take positions closer to Point C. There is at least some evidence to suggest that these conditions do hold in some settings and that the rule-enforcer/ambiguity-exploiter hypothesis may have some real world validity, although the evidence is not beyond dispute and the policy implications are not clear.

In any event, whatever the outcome of that debate, it does not bear directly on the question of warranties or insurance. Whether paid preparers on balance have good, bad, or no effects on taxpayer compliance decisions overall, the fact that preparers tend to provide warranties for their work by itself does not yet seem to present a large tax compliance problem. Indeed, the Treasury Department has completely ignored these tax preparer warranties, presumably on the assumption that they pose no serious threat to the fisc.\footnote{As we shall see in a moment, however, the Treasury Department has not been as sanguine about what I call tax advisor warranties. See infra text accompanying notes 82–89.} The one way in which such warranties might present a problem would be if the promise of tax penalty insurance/warranties induced taxpayers to take more aggressive positions or to allow their return preparers to take more aggressive positions on their behalf. This is certainly possible. Just as aggressive tax planning can be in the self-interest of both sophisticated taxpayers and their advisors, it can also be in the self-interest of average individual taxpayers and their return preparers to be aggressive; and the use of warranties could conceivably encourage this sort of behavior. However, it is unlikely that this would become a significant tax compliance problem for middle or lower income taxpayers who use the large return preparation firms. These are not taxpayers with the resources or incentives to engage in complex quasi-legal tax shelter transactions of the sort that would appeal to wealthy or corporate taxpayers who (a) have more absolute tax dollars and a
higher percentage of their income at stake in the tax avoidance game and (b) can hire expensive tax lawyers and accountants to help them with their tax planning. Moreover, given the nature of the wholesale tax preparation business, tax return preparation firms are simply not in a position to provide this sort of complicated tax shelter planning advice.

In sum, a case can be made that tax preparer warranties efficiently allocate the risk of tax preparer mistake to the obvious cheapest-cost-avoider and best insurer, the tax preparer. Moreover, at least with respect to the large retail tax preparation firms, there seem to be relatively few tax compliance problems associated with the use of warranties, although whether the use of tax return preparers itself increases or decreases compliance is an open question.

B. Tax Advisor Warranties (a.k.a. Contingent Fee Arrangements)

Tax return preparers are not the only tax professionals providing implicit or explicit service warranties. Based on my conversations with tax attorneys and accountants, a type of warranty is also sometimes provided by tax advisors who provide taxpayers with expert opinions as to the appropriate or likely tax treatment of particular transactions. By “tax advisor” here I mean someone who advises a taxpayer regarding (a) how to structure a given transaction so as to minimize taxes, and then (b) how to report that transaction on the taxpayer's return. The advisor therefore is providing expertise on the tax law as it applies to a particular situation and is involved in so-called tax planning. By “tax return preparer” I mean someone who fills out the tax return itself. Obviously, the preparer may give some legal advice on how to report certain issues; thus, the distinction does not always hold up. One can still usefully distinguish, however, between the H&R Blocks of the world and the lawyers and accountants that give more specialized transactional advice on specific issues, usually to corporate or wealthy individual taxpayers.

These warranties have some attributes in common with return preparation warranties and some attributes in common with tax transaction insurance, although they are different in important respects as well. Like tax transaction insurance, these warranties apply to specific opinions offered by the advisor with respect to particular tax issues; they do not apply to the taxpayer's entire tax return. Tax preparer warranties by contrast apply to the entire return, as the preparation of the entire return is the service being warranted. Like tax preparer warranties, however, tax advisor warranties offer less-than-full indemnity for losses. That is, unlike tax indemnity or tax transaction insurance policies, tax advisor warranties do not cover taxpayers against the possibility of penalties, interest, or

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tax deficiencies themselves, but take the form of a money-back guarantee: if the particular issue on which the advisor gave an opinion ends up being challenged on audit and rejected by the Service and a court, the advisor agrees to refund some or all of the fees that were charged for the advice. Such an arrangement can be an explicit element of the service contract between the advisor and the taxpayer. It is more likely to be part of an implicit understanding, however.

In effect, these tax advisor warranties amount to a form of contingent fee arrangement for tax advisors. What is interesting is that the Treasury Department apparently regards such arrangements as presenting significant tax compliance concerns. This can be seen in Circular 230, the regulations governing the standards of practice before the Service, which specifically prohibits those admitted to practice before the Service from using contingent fee arrangements, except in circumstances in which the advisor is giving advice with respect to an amended return. Relatedly, the Treasury Regulations

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83 There may also be implicit arrangements under which tax advisors agree to indemnify the taxpayers against back taxes, interest, and penalties in the event the Service disallows a particular tax issue. Something like this was involved in Clark v. Commissioner, although that may have been a one-time spontaneous transfer and not part of an implicit indemnification contract. 40 B.T.A. 333 (1939), nonacq. 1939-2 C.B. 45; nonacq. withdrawn and acq., 1957-2 C.B. 3. I suspect, however, that such indemnification arrangements are rare. An alternative version of this type of tax advisor indemnification would be the existence of potential legal malpractice claims against tax advisors who issue advice that is below industry standards. Given how low industry standards have fallen, however, this coverage is largely illusory except in the most egregious shelter cases.

84 As far as I am aware, there is no published data on the prevalence of these arrangements. I have been told by some tax lawyers that it is common. Other lawyers have told me, however, that these arrangements are common only among shelter promoters, which would explain why the Treasury Department is so concerned about these arrangements. Again, the distinction between a tax shelter and mere tax planning is notoriously difficult to draw.

85 Most lawyers think of contingent fee arrangements as having the following structure: the lawyer gets paid a percentage of the favorable outcome, which in a tax case would be the "tax savings" from the transaction in question. However, such an arrangement could be structured as follows: the tax advisor charges an hourly rate or a set fee for given transaction, and if the tax characterization of the transaction is disallowed by the Service and Courts, the advisor must refund a portion or all of the fees. Either approach is a form of contingent fee arrangement and could be structured to provide identical incentives and risk allocation.

86 In those regulations, a contingent fee is defined as follows:

[A] contingent fee is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by
that define the category of tax shelter transactions that taxpayers are required to flag for the Service as so-called "reportable transactions" include transactions that have "contractual protection," which essentially means those involving contingent fee arrangements.\(^{87}\) These two sets of regulations — Circular 230 and the reportable-transaction regulations — seem to work together as follows: tax advisors who want to maintain their ability to practice before the Service and avoid Circular 230 penalties may not charge contingency fees or structure their fees in any way to provide contractual protection on a "reportable transaction," as defined under Code

\(^{31}\)C.F.R. § 10.27(b)(1) (2002). Circular 230 then provides:

A practitioner may not charge a contingent fee for preparing an original tax return or for any advice rendered in connection with a position taken or to be taken on an original tax return.

... A contingent fee may be charged for preparation of or advice in connection with an amended tax return or a claim for refund (other than a claim for refund made on an original tax return), but only if the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax return or refund claim will receive substantive review by the Internal Revenue Service.

\(^{87}\) Treas. Reg. § 1.6011-4 (2003) requires taxpayers to report transactions that involve "contractual protection," which is defined as follows:

A transaction with contractual protection is a transaction for which the taxpayer or a related party ... has the right to a full or partial refund of fees (as described in paragraph (b)(4)(ii) of this section) if all or part of the intended tax consequences from the transaction are not sustained. A transaction with contractual protection also is a transaction for which fees (as described in paragraph (b)(4)(ii) of this section) are contingent on the taxpayer's realization of tax benefits from the transaction. All the facts and circumstances relating to the transaction will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to the transaction have not designated as fees or any agreement to provide services without reasonable compensation.

\(^{Id.}\) § 1.6011-4(b)(4)(i).
section 6011, even if the transaction is reported to the Service by the taxpayer, unless the transaction involves a claim for a refund. If the transaction involves a claim for a refund, however, not only is a contingent fee arrangement allowed, there is an exception to the reporting requirement for the taxpayer as well. In any event, the Treasury Department seems to be concerned about contingent fee or warranty arrangements between tax advisors and taxpayers but is apparently not the least concerned about tax preparer warranties of the sort described above that promise, not reimbursement of fees, but coverage of back taxes, penalties, and interest. The difference in Treasury concern probably makes some sense, because of differences in the two markets. Tax return preparers are dealing with relatively simple returns for mostly low and middle income individuals and are less likely to be involved in aggressive shelter-type activity; whereas at least some tax advisors are actively working in the tax shelter market. Indeed, some lawyers have told me that the only tax advisors who use contingent fee arrangements are those involved in shelter activity. In any event, the concern with these regulations is that they are over-inclusive and require reporting, or have the effect of forbidding contingent fees, in circumstances in which there is no special concern about aggressive avoidance. I will return to this issue below after I have outlined the nature of and problems with the tax transaction or tax indemnity insurance market.

C. Tax Indemnity Agreements

Although tax preparer and tax advisor warranties have some aspects in common with tax indemnity insurance policies, if there is a single forerunner of the new market in tax insurance, it is the humble tax indemnity agreement, which is often structured as a special addendum to the standard “Representations and Warranties” section of most buy-sell agreements. So-called tax indemnity provisions have long been a part of contracts involving the purchase and sale of businesses; and it is not difficult to see why: Whenever one business acquires, merges with, or purchases another, there will always be some legal uncertainty that needs to be allocated. And one of the parties to the deal is likely to be in a better position to bear the risk. For example, the seller may, for whatever reason, be especially risk-averse and thus may wish to shed any risk of environmental liability that

88 See supra text accompanying notes 73–81.
89 Neither Circular 230 nor any other regulations address tax preparer warranties. See 31 C.F.R. § 10.27 (2002).
might accompany the business that it is selling. Indeed, that may be a main reason behind the sale. In that case, the seller might enter into a contractual arrangement shifting primary responsibility for environmental liability risks to the purchaser — in effect, making the purchaser the insurer of the environmental liabilities of the target business. Alternatively, the buyer may be more risk-averse and may want to avoid assuming any unknown environmental risks from the seller. Thus, the buyer may insist that the seller assume responsibility for those risks before closing the deal. Which of the parties will be the one to whom the risk is allocated will depend on a number of factors, including who is the better risk bearer — i.e., who has more assets over which to spread the potential loss or who has better access to capital markets — or who has better information about the risk. As mentioned, such indemnity agreements are common in transactions involving business purchases or mergers. Tax law risk is commonly allocated in the same way. Contracting parties frequently allocate between them the responsibility for potential tax liabilities through the use of tax indemnity agreements that become an integral part of the overall transaction.\(^90\)

As we shall see in the next Part, tax indemnity or tax transaction insurance policies can be viewed as the next logical step in the evolution of these contracts. That is, instead of shifting the legal risk from buyer to seller or vice versa the strategy now is to shift that risk to a third-party insurer. Especially interesting is that although such contractual efforts to shift legal risk between buyers and sellers have been around for a long time, they do not seem to have been a source of regulatory scrutiny. With regard to tax indemnity agreements specifically, nothing suggests that the Service or the Treasury has any

\(^{90}\) Lewis M. Horowitz, *Excludability of Tax Indemnification Payments Threatened by Recent Change in IRS Position: PLR 9014046, 49 TAX NOTES 799, 799* (Nov. 12, 1990) (observing that tax indemnity agreements are used when “one party represents to the other that certain tax benefits will be derived under the contract. Because the anticipated tax treatment usually affects the economic viability of the contractual arrangement, the representing party typically indemnifies the other in the event the represented tax benefits are not realized.”); Robert W. Wood & Dominic L. Daher, *Beating a Dead Horse: Tax Indemnity Payments to Ex-Spouses*, 101 TAX NOTES 875, 875 (Nov. 17, 2003) (“Tax indemnity payments are common features of many transactions, such as litigation settlement agreements, merger documents, purchase and sale agreements, leases, and so forth. Regardless of the context, in general, they say: ‘If you get taxed as a result of the transaction, I’ll cover it.’”). A sample of a tax indemnity agreement can be found online: FindLaw – Tax Allocation and Indemnity Agreement, http://contracts.corporate.findlaw.com/agreements/parkplace/hilton.tax.1998.12.31.html (last visited Oct. 5, 2005).
concerns about such transactions. The same cannot be said, however, for tax indemnity insurance.

IV. THE NEW MARKET IN TAX INSURANCE

Tax indemnity or transactional tax risk insurance policies differ from traditional tax preparer or tax advisor warranties and tax indemnity agreements in several respects. First, tax insurance policies are not warranties. Neither are they merely contractual agreements that allocate risks between two parties who are also contracting on other issues. Rather, tax indemnity policies are, as the name suggests, full-fledged insurance policies issued by real insurance companies that are regulated as such. Thus, when a tax insurance policy is purchased, certain tax risks are transferred to an insurance company, which then pools and distributes the risks across its other insureds and which sometimes reinsures some portion of those risks with other insurance companies. A second general difference between tax risk insurance and preparer warranties in particular is that the former are not mass-marketed in standardized forms to individuals for relatively small risks, as are tax preparer warranties. Rather, tax transaction insurance is a type of custom-designed and individually-negotiated insurance. It is sold exclusively to wealthy and commercially sophisticated, typically corporate taxpayers seeking to cover large tax-related risks — potential tax liabilities in the millions, tens of millions, and even hundreds of millions of dollars. That the policies are individually negotiated in this way may have consequences for how courts will interpret the language of the contracts, as courts sometimes treat standard form insurance contracts differently from individually negotiated ones. Finally, as already mentioned and as will be discussed further below, although tax preparer warranties cover an entire tax return, tax transaction policies are written on a transaction-specific basis. They generally cover the tax treatment of particular tax transactions; they generally are not written to cover entire tax returns.

A. The Content of Tax Insurance Policies

Because they are not standard form contracts, it is difficult to describe the typical tax insurance policy. Nevertheless, there are enough important features in common that some general descriptive comments are possible. 91 As already mentioned, tax insurance is a

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91 My knowledge of the tax indemnity insurance market and the content of the policies themselves derives from numerous conversations with individuals in the
form of liability insurance, where the liability risk is that of unexpected tax liabilities and penalties. Thus, tax insurance policies cover the risk that the Service will rule unfavorably with respect to some tax position that the taxpayer has taken or plans to take on its tax return. In this sense, then, tax insurance is a form of government sanction insurance. The policies typically cover the amount of the tax deficiency as well as any interest and penalties that are assessed up to the limits of the policy. These policy limits are set to equal a substantial fraction, sometimes all, of the potential tax liability, penalties, interest, and legal fees that might be incurred if the transaction in question is disallowed. Thus, for large corporate taxpayers, the policy limits can be in the hundreds of millions of dollars, although limits in the tens of millions are more common. The policies typically provide full "gross ups," which means that insofar as the insurance payouts themselves are considered income for tax purposes, the insurer will cover that additional tax as well and the resulting additional tax liability, and so on, "grossing up" the overall payment until the taxpayer is made whole on an after-tax basis. In this way the insurance aims to leave the taxpayer whole with respect to the risk of a negative tax ruling, with one exception: As do virtually all commercial liability insurance policies, tax indemnity policies include a substantial deductible, which is intended to help reduce moral hazard concerns.  

insurance industry who are involved in the design and marketing of these policies as well as with a number of tax lawyers who either have been hired to provide legal opinions to insurance companies or taxpayers regarding the purchase of such insurance. In addition, I have read many sample policies that were sent to me by insurers or by insurance brokers or that I downloaded directly from insurance-company websites. To view a description of the nature and function of tax risk insurance and to see a model policy, see Am. Int'l Group, Inc., M&A North America: Tax Liability Insurance, http://www.aigmergerrisks.com/northamerica_tax.html (last visited Oct. 5, 2005). For the best published source on the nature and content of tax risk insurance policies by a tax practitioner, see generally Wolfe, supra note 1.  

An interesting question, which cannot be answered fully in this Article, is whether a tax insurance premium is a deductible business expense and whether the proceeds from such policies are excludible from gross income. Commercial insurance premiums, including liability insurance premiums, paid by business taxpayers are generally considered ordinary and necessary business expenses under Code section 162. Thus, they are generally deductible, subject to the economic performance rules under Code section 461(h) and subject to capitalization rules for multi-year policies. But what about tax liability insurance? It might be argued that the insurance premiums ought not be deductible, since the insurance is to cover payments which, if made by the taxpayer, would not be deductible (i.e., income tax payments). My guess, however, is that most taxpayers that purchase tax risk policies are deducting
As with standard commercial liability insurance policies, tax transaction policies offer coverage for the legal and accounting costs of contesting the tax liability, although the language here is different from a standard commercial liability policy. For example, although the policies clearly provide for coverage of some of the legal costs of defending the tax position against government challenge, sometimes called "contest expenses," they also state clearly that "the insurer has no duty to defend" the insured, which is a standard part of most liability insurance policies. Tax transaction policies are written exclusively on a claims-made basis; that is, they cover only losses for which claims are made during the policy term, which is typically three years — or the length of standard statute of limitations for the Service to issue a "notice of proposed adjustment" — but can be longer. The policies also contain provisions requiring the insured-taxpayer to notify the insurer in the event of a claim and to cooperate with the insurer in the event of an insured loss — all standard terms in liability policies. The policies typically contain subrogation clauses, which transfer to the insurance company the taxpayer's potential malpractice claim against the tax advisor who rendered an opinion for the tax transaction in question.

As mentioned above, tax insurance policies are usually sold on a the premiums. As for the receipt of the insurance payouts in the event of an adverse decision by the Service, although Clark v. Commissioner, 40 B.T.A. 33 (1939), nonacq. 1939-2 C.B. 45; nonacq. withdrawn and acq., 1957-2 C.B. 3, might be cited in favor of exclusion, the Service would likely take the position that the payouts must be included. Clark involved a payment received by a taxpayer from a tax preparer to cover a tax liability that was, in effect, the result of the preparer's negligence; that is, the tax would not have been owed had the preparer not made the mistake. Tax risk insurance is different. With tax risk insurance, payments are made by an insurer to cover taxes that the taxpayer would have owed anyway. At least, that is the argument the Service would likely make. See, e.g., I.R.S. Priv. Ltr. Rul. 98-33-007 (May 13, 1998) (concluding that tax indemnity payments received by taxpayer from tax advisor's malpractice carrier must be included in gross income because reimbursement is for no more than the "minimum proper federal income tax liability based on the transaction for the tax year to which the tax reimbursement relates").

93 It is not entirely clear what the difference is between assuming a duty to defend, which is what liability policies typically do but tax insurance policies do not, and agreeing only to cover "contest expenses." This distinction may be an effort by insurers in drafting the policies to avoid state common law responsibilities that attach to the duty to defend. Relatedly, tax insurance policies typically give the insured taxpayer the right to choose the lawyer to contest the Service determination and to direct the case, but they impose a generally worded obligation on the insured-taxpayer to conduct the case as if there were no insurance in place, and they require consultation with the insurer on settlement negotiations.
transaction-specific basis — that is, to cover the tax risk associated with a single transaction, hence the term “transactional tax risk insurance.” Thus, such insurance is much less often sold to cover a corporate taxpayer’s entire tax return and all of the tax risks contained therein, although this does happen on occasion. This is another difference between tax indemnity insurance and tax preparer warranties, which, though much more modest in the amount of coverage, do apply to the entire return. Most commercial liability insurance policies, by contrast, cover the insured for a wide range of risks for given period of coverage. The rationale for the transaction-specific structure of tax insurance seems clear: to provide the insurer a way of limiting its exposure to particular tax positions that the insurer — and its tax law experts — have been able to examine, assess, approve, and ultimately price. These policies also contain a number of exclusions, including exclusions for fraud or for any false representations made by the insured to the insurer during the underwriting process. Premiums charged for tax insurance range between five and fifteen percent of the amount of the policy limits. Assuming this market is reasonably competitive, we should expect that the premium for any given insured would approximate that insured’s expected liability for back taxes, interest, and penalties, or the sum of those amounts discounted by the probability of prevailing on the merits, discounted further by the probability that the position being insured will avoid detection by the Service.

If tax risk insurance is primarily transactional insurance, one might reasonably ask what sorts of transactions are currently being insured. As it turns out, there is a wide range of tax situations, mostly — though not exclusively — involving corporations that have been the subject of tax risk policies, examples of which were described in Part I. One way of understanding this range of insurable tax transactions

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94 It is through this underwriting process that insurance companies can, at least in theory, assist in the enforcement of the tax laws. See infra Part V.
95 Wolfe, supra note 1, at 618.
96 In a competitive market, insurance premiums should be slightly greater than the expected value of total claim payouts. Because insureds are risk-averse, they will pay slightly more than the expected value.
97 At the web site advertising their tax risk product, AIG lists the following situations as “potential opportunities for tax liability insurance”:

- Protection of the tax-free status of corporate spin-offs, split-ups or split-offs (Section 355);
- Tax consequences resulting from a change in ownership (for example, tax-free mergers under Section 368);
is to divide them into two general categories: (1) insurance that is purchased to cover a taxpayer's own tax risks, and (2) insurance that is purchased to cover the tax risks associated with the purchase, sale, or exchange by the taxpayer of some entity or assets. Included in the first category would be the situation in which a corporation, prior to issuing its initial public offering of stock, decides to purchase a tax risk insurance policy to cover some previous transaction, on the theory that this move will maximize the offering price. The theory is that the capital markets need to be reassured about the tax position of the corporation in question. Recall, this is the risk-averse-investor story mentioned above. A different example of the first type of tax risk insurance is the policy that covers some tax issue that has already been raised by the Service, perhaps in a 30-day letter. What makes this type of insurance especially interesting is that it is a form of "retroactive insurance," a rare and highly specialized type of insurance that is, by definition, sold only after the loss event has occurred but while there is still substantial uncertainty as to the case's outcome. Thus, retroactive tax insurance is purchased only after the

- Successor liability issues in the context of M&A transactions where, due to joint and several liability issues, an acquirer is concerned about a historic tax position taken by the target company or its consolidated tax group;
- Tax liability arising from a potential loss of "S" corporation status;
- Certain tax issues arising from Section 1031 "like-kind" exchanges;
- Certain tax issues related to the determination of the allowable net operating losses in a "change of control" context (Section 382);
- Certain tax issues arising from golden parachute payments under Section 280G;
- Tax liability resulting from deferred compensation arrangements that may be subject to challenge via the constructive receipt doctrine;
- Tax liability arising out of an employee's use of non-recourse debt to finance a purchase of his employer's stock; and
- Tax liability arising from an employee's receipt of discounted compensatory stock options.


98 Wolfe, supra note 1, at 601-02.
99 See discussion supra Introduction.
100 Id. at 612. Example Four in the Introduction is based on the example in the Wolfe article.
101 The most famous example of retroactive insurance was the policy purchased by the MGM Grand Hotel following the catastrophic fire at their facility that killed hundreds of people. A few months after the fire, after the company had been hit with
Service has told the taxpayer that it plans to challenge some issues on the taxpayer's return; only then does the taxpayer shift the risk of a tax deficiency and penalties, along with the costs of a legal defense, to the insurer. The premiums for retroactive insurance generally are relatively high, since the probability of an adverse decision is relatively high in comparison with that covered under a standard liability insurance policy, where the loss event has not yet occurred. The same could be said of retroactive tax risk insurance. Retroactive tax insurance is also more expensive than regular tax insurance because with regular tax risk insurance the probability that the issue being insured will be detected is less than one, whereas with retroactive tax insurance the probability of detection is one.

As for the second general category of tax risk insurance, quintessential tax transaction insurance, there are numerous examples, many of which involve transactions that seek to gain the benefit of either tax deferral through the application of specific nonrecognition provisions or the avoidance of multiple layers of tax. The first three examples in the Introduction would fit into this category. In Example One, the taxpayer, an individual, is interested in investing in an existing partnership, but her research reveals that the partnership in question has a potential tax issue. The taxpayer could purchase a tax insurance policy to cover this risk. In Example Three, the taxpayer is a corporation that wants to purchase a subsidiary of a nearly insolvent parent company. When the taxpayer discovers that the subsidiary has a potential tax issue, it worries that there may be some successor tax liability in the event the case goes badly, and it is concerned that the parent corporation might not have sufficient assets, or might not even be around, to cover the potential tax liability associated with the target company's prior actions. In that situation, the purchasing company might decide to buy a tax indemnity policy to shift all or some of the tax risk to an insurer, rather than bear the risk itself. Numerous other examples include a whole range of tax-related issues, many of which involve the application of anti-avoidance standards to transactions whose structure is at least partially influenced by tax considerations.

over 450 lawsuits but when the size of the ultimate liability was still greatly in question, the owners of the property purchased a retroactive liability policy to cover the loss. See David Lauter, MGM Cases Still Smoldering; Settlement Fund Reaches $140M; Hotel Battles Insurers, NAT'L L.J., May 23, 1983, at 7.

102 MGM Grand paid $39 million in premiums for $170 million in retroactive coverage. Id.

103 Wolfe, supra note 1, at 614–15.
Probably the most highly publicized use of a tax insurance policy to date involved a transaction similar to the one described in Example Two in the Introduction. In 2001, the Georgia Pacific Company wanted to split off its timber operations in a transaction that would qualify for nontaxation under Code section 355. In the split-off transaction, Georgia Pacific in effect planned to distribute its stock in a wholly-owned subsidiary corporation which had substantially appreciated in value to Georgia Pacific's shareholders, in exchange for those shareholders' shares in Georgia Pacific. Without section 355, such a transaction would produce two levels of income tax: (1) tax at the corporate level to Georgia Pacific on what is effectively a sale of its subsidiary to its shareholders, and (2) a tax to the shareholders on the distribution of the shares in the subsidiary. Given the amount of appreciation that can be present in such a subsidiary, the resulting tax liability can be huge and would have been so in this case, large enough in fact to make the transaction not worth doing. Under section 355, however, if certain requirements are met, such split-off transactions can be treated as a nontaxable event. The problem is that one of the requirements is that the split-off be primarily motivated by a substantial nontax "business purpose" and cannot be merely a "device" for avoiding tax through a disguised dividend. The answer to the business purpose question, however, requires a very fact-intensive, ex post, standard-like inquiry. Although the Service had for years provided such rulings in section 355 cases, in the Georgia Pacific case the Service declined to do so, citing the heavily fact-intensive nature of the inquiry. As a result, the parties to the transaction faced a large amount of unanticipated tax-related legal uncertainty with respect to the transaction. In response, Georgia Pacific opted to purchase a tax insurance policy, with a policy limit of $500 million, to cover the possible corporate level tax. With the insurance in place, the deal then went through. After this highly-publicized transaction, the Service announced that it would no longer provide advance rulings on the business purpose part of proposed section 355 transactions. The Service stated that the issue was too fact-intensive and that, like other such fact-intensive issues, would henceforth be resolved only on examination. Thus, for section 355-related and many other types of transactions, corporate taxpayers are left with the choice of forgoing the transactions, going ahead with the transaction and bearing the risk itself, or purchasing a tax indemnity policy. These are among the costs of tax law uncertainty.

B. The Function of Tax Insurance

This brings us to the asserted function and alleged social benefit of tax risk insurance. Perhaps the best statement of the case is found in the comments submitted by an official at The Hartford Insurance Company in a written statement on proposed Treasury Regulations that would have required any taxpayer purchasing a tax insurance policy to treat the insured transaction as a “reportable transaction” under Code section 6011. The statement bears quoting at length:

Tax insurance provides a needed alternative to the expenses, limitations and uncertainties associated with private letter ruling requests. Purchasers of tax insurance tend to be conservative, highly risk-averse taxpayers (or their lenders or investors) who choose to reduce or transfer even a modicum of tax risk identified in their transactions in order to increase certainty. Tax insurance was created due to a market need for a financial product to facilitate extraordinary transactions that may not otherwise close within the desired time frame because of the uncertainty with respect to a tax issue. For example, an auction bid typically cannot be contingent upon or delayed until the receipt of a satisfactory private letter ruling or pre-filing agreement.

Tax insurance is underwritten by or with the support of tax attorneys who carefully review a transaction to “weed out” weak tax positions and insure strong tax positions. In stark contrast to certain tax practitioners (and promoters) who generate fees by creative application of the Tax Code, tax insurance underwriters are “rewarded” for providing a conservative, prudent analysis of a proposed tax position.

Thus, tax insurance fills the “gap” caused by the cost, limitations, uncertainties and delays associated with private letter rulings. . . . Tax insurance allows customary commercial transactions (albeit complex transactions) to proceed timely and with certainty of the tax consequences. Most importantly, by refusing to insure tax shelters, abusive schemes and weakly supported tax positions, the tax insurance industry injects a distinctly conservative evaluation within the community of tax professionals and helps to cultivate a culture of compliance in which corporate tax
shelters are less often created.\textsuperscript{105}

These statements were intended to ward off government intervention in the tax insurance market and must therefore be taken with a grain of salt. But they also contain the basis of what turns out to be a pretty solid case in favor of allowing, and perhaps even encouraging, the purchase of tax risk insurance. The argument goes something like this: Notwithstanding the rule-based nature of the tax laws, there remains significant legal uncertainty in how the tax laws will be applied to many types of transactions. This uncertainty can inhibit various types of transactions or can result in unfair and costly risk-bearing, especially when taxpayers are for whatever reason highly risk-averse with respect to tax deficiencies or tax penalties. For many years, the normal source of tax law risk insurance has been the private letter ruling issued by the Service with respect to particular transactions. For whatever reasons, the Service is not able or willing to provide rulings in a timely fashion for many types of tax law risks, especially those that involve fact-intensive standard-like inquiries.\textsuperscript{106} Insurance companies can fill this gap. Moreover, because insurance companies have the resources to hire the very best tax lawyers in the world to assist in the underwriting process, they can do a better job of screening these transactions for excessively aggressive positions than the Service can. If all of this is true, we have the makings of a case for allowing or even encouraging the purchase tax risk insurance. So what's the catch? The next section explores the main concerns with tax risk insurance: the specter of tax shelter insurance.

\textbf{C. The Concern About Tax Shelter Insurance: Deterrence Undermined}

The problem with tax risk insurance is that it might be used to insure, and thereby to encourage, overly aggressive tax positions. To see this point, refer back to the tax-compliance continuum in Part II. This continuum illustrates conceptually the range of possible tax transactions for which an individual or corporate taxpayer might seek to purchase tax risk insurance. On the far right, to the right of Point B, there is no legal uncertainty. The taxpayer knows that it is entitled

\textsuperscript{105} See Insurance Group Comments, supra note 9.

\textsuperscript{106} The Service has a longstanding written policy of not issuing private letter rulings for such fact intensive questions. For a complete and recent list of the areas in which the Service states that it will not issue an advance ruling, see Rev. Proc. 2005-3, 2005-1 I.R.B. 118 (covering domestic tax issues), and Rev. Proc. 2005-7, 2005-1 I.R.B. 240 (covering international tax issues).
to the tax treatment in question, and there is no need for private insurance or a private letter ruling. On the far left, to the left of Point A, are transactions that amount to outright tax evasion where the taxpayer knows that the position being taken is illegal. For those transactions, too, there is complete legal certainty, since the illegality of the position is clear; there is only detection uncertainty — uncertainty as to whether or not the position will be caught by the Service. Although such transactions or such misuses of the tax code are the most undesirable of all from a social perspective (hence the criminal penalties), they are almost entirely irrelevant to the discussion of tax risk insurance, as there is virtually no possibility that any insurance company would ever insure such a transaction. Indeed, every tax risk insurance policy that I have seen has contained an exclusion for tax evasion. And although the policies do not provide a comprehensive definition of the term “evasion,” there is no doubt that cases involving criminal penalties would be excluded. There is also usually a separate exclusion for fraud, which would presumably exclude coverage for tax cases involving civil fraud penalties. What is even more important, no insurer would ever sell a policy without such an exclusion. The reasons are simple. First, an insurance policy sold to cover intentional wrongdoing would almost certainly be considered unenforceable.107 Second, the insurance company itself might be or become subject to separate penalties for in effect aiding and abetting a criminal activity. Third, and perhaps most important, no insurance company would be willing to risk the bad publicity that insuring tax evasion would bring. In sum, there is no serious concern that insurers would ever sell what would be considered pure detection risk insurance.

The problem is the range of tax positions represented by the middle section of the tax compliance continuum between Points A and B, with the most problematic area clustering around Point C. More precisely, the real concern, from a tax enforcement perspective, lies to the left (on the evasion side) of Point C. The reason Point C is so important is that infinitesimally to the right of it is the important more-likely-than-not threshold, the standard that must be satisfied in

107 SAMUEL WILLISTON & RICHARD A. LORD, 8 A TREATISE ON THE LAW OF CONTRACTS § 19:20 (4th ed. 1998) ("It seems quite clear that the doctrine that agreements to indemnify against negligence are valid should not be extended to intentional misconduct or willful wrongdoing involving personal volition, such as, for example, child molestation, or other intentional and inherently harmful activity.") (footnotes omitted).
order to acquire in effect an exemption from tax shelter penalties.\textsuperscript{108} That is, if a tax advisor provides an opinion that characterizes the taxpayer's position as being more likely than not to prevail on the merits if examined, the odds are very good that no penalties will ensue. More aggressive taxpayers and more aggressive tax advisors may attempt to defend positions that are in some objective sense to the left of Point C, on the belief that they can convince a judge, who is often not a tax expert, that the more-likely-than-not threshold had been met. Indeed, when we factor in the low probability of detection, the relatively low penalties for tax understatements, the increased market pressure on corporations to cut tax payments, and the general sentiment that structuring one's affairs to minimize taxes is a public right, the incentive for sophisticated taxpayers to push to the left of Point B becomes very strong indeed. Moreover, for transactions that do not qualify as tax shelters as defined by the Code, the relevant standard is to the left of C, since avoidance of penalties for substantial tax understatements for nonshelters requires only "substantial authority," which is something less than a fifty-plus percent chance of prevailing on the merits. Because of this lower standard, taxpayers presumably have an incentive to claim that their transactions are not shelters — that they do not have a "significant purpose" of avoiding or evading federal taxation — although for the most egregious shelters this strategy would be risky. Still, this phenomenon may tend to push some taxpayers to take positions even further to the left of Point C. For all of these reasons, an argument can be made that more and more taxpayers are choosing to take tax positions that lie to the left of Point C and closer to what might rightly be called tax evasion, where there is little substantive legal uncertainty (i.e., the positions will almost certainly be shot down if detected), and the only uncertainty is whether the taxpayers will be caught. Indeed, this is one way of restating the tax shelter phenomenon.

Now introduce tax risk insurance into the picture. It is one thing to allow taxpayers to insure substantive legal uncertainty, when it is anyone's guess how the law will be applied to a given transaction. But it is quite another to allow them to insure pure detection risk, when the position is probably illegal, in the sense that a court would likely reject it as being inconsistent with a reasonable interpretation of the Code, and the only uncertainty is whether the Service will catch them. If tax indemnity insurance was allowed for highly aggressive tax shelters, and Congress and Treasury did nothing about it, the

\textsuperscript{108} See supra text accompanying notes 38–39.
deterrence consequences could be profound. Those taxpayers who were considering whether or not to engage in an aggressive shelter but who were marginally deterred by the risk of tax penalties might be induced by the presence of tax shelter insurance to take the plunge. Or those already inclined to engage in such transactions may decide to increase the scope or aggressiveness of the shelter transactions, if part of the risk could be shifted to a third-party insurers. It is unrealistic, of course, to assume that lawmakers would not respond to this possibility. Thus, if tax shelter insurance began to be sold, lawmakers might simply increase dramatically the financial penalties for “abusive tax shelters,” which would presumably be reflected in tax insurance premiums, thus maintaining the deterrence effect that existed without the insurance. The main problem with that approach, besides the apparent political difficulty Congress experiences in raising tax compliance penalties generally, is that even if it adopted higher shelter penalties, they might be considered unfairly punitive for uninsured taxpayers. That problem could be addressed in turn by imposing special, higher penalties for those with shelter insurance, but then we have gone a considerable way toward banning the practice altogether. Alternatively, or in addition, the Treasury Department might shift away from using financial penalties, which would increasingly be insured, and toward uninsurable nonmonetary sanctions such as stiffer jail sentences. The problem with that response, however, is that jail-time may not always be a good substitute for monetary penalties, and the use of nonmonetary sanctions may also suffer from proportionality problems. The upshot of all of this is that, in a world with tax shelter insurance, it is certainly possible that the deterrence value of monetary penalties would be reduced and that, as a result, shelter activity would increase.

In fact, for all of these reasons, everyone seems to agree that the sale of tax shelter insurance would be a bad thing. Even those who sell or promote tax insurance policies agree with that conclusion. Moreover, if tax insurance policies were currently being sold to cover pure detection risk, the risk created by the most egregious and indefensible shelter transactions, everyone would agree that some measure of regulatory intervention by the government would be warranted. How likely is it, however, that insurers would ever sell tax shelter coverage? We have already noted that they would never sell tax-evasion insurance, as it would be unenforceable and risky. What about tax shelters, however? In their promotional materials, tax insurers state emphatically that they do not insure tax shelters, which at least one such insurer defines in its promotional materials as
transactions “for the principal purpose of obtaining a tax advantage.” These statements could be pure propaganda disseminated for the benefit of tax and insurance regulators. Moreover, there is considerable wiggle room in the term “principal purpose.” However, the policies that I have seen do not cover tax transactions that fit the mold of the quintessentially abusive corporate tax shelter of the sort that has received attention recently in the tax and general business press and that has led to a regulatory crackdown. To the contrary, with the transactions that are currently being insured, although there is obviously an element of merits risk or legal uncertainty that could be a substantial concern for risk-averse taxpayers, the probability of winning on the merits is not so low as to call into question the good faith of the taxpayers. For example, consider the run-of-the-mill section 355 split-off transaction, similar to the one described above. Although there is clearly some risk that such a transaction could be disallowed by the Service under an existing anti-avoidance principle — such as the business purpose requirement — even the tax shelter police would have to admit that such cases present genuine legal uncertainty or significant merits risk. Moreover, because such transactions are identified on the taxpayers’ returns and are generally well publicized within financial circles, the detection risk for such transactions is quite high. The same could be said of many of the corporate reorganization transactions, such as those under Code section 368, that have become the bread and butter work of corporate tax lawyers and that despite presenting some prospect of disallowance — indeed, if there were no such prospect, the tax lawyers would not be needed — are not particularly aggressive tax plays. These transactions too are now being insured. Moreover, there are many other routine corporate acquisition and merger transactions being insured that do not involve the sorts of transactions that are of greatest concern to the Treasury Department. Certainly none of the examples of transactions that have been reported as being insured are transactions, or are substantially similar to those transactions, that appear on the Service’s official list of targeted shelter transactions.109 In addition, as discussed above, at least some of the tax risk policies seem to involve virtually no uncertainty as to detection, and thus only merits risk or substantive legal uncertainty, as the insurance is purchased after a ruling request has been submitted to the Service,

109 The Service’s most recent list of abusive tax shelters and transactions can be found online at Internal Revenue Service, Listed Abusive Tax Shelters and Transactions, http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html (last visited Sept. 17, 2005).
and hence after the probability of detection on audit has been increased to one.

Even if many of the tax transaction insurance policies written today cover legitimate substantive legal uncertainty — and these are the policies that insurers advertise to the public — it is possible that insurance policies covering more aggressive tax positions are being sold in secret, perhaps protected by confidentiality agreements. Alternatively, even if tax shelter insurance policies are not currently being offered, over time the competitive pressure could lead more aggressive insurers to begin covering more aggressive tax positions. So, what should be done about it? Should we ban such policies? That would throw the baby out with the bath water, since over-compliance with the tax laws as a result of substantive legal uncertainty can in theory be as much a source of wasteful distortion and unfair allocation as can under-compliance. Should we instead regulate privately provided tax risk insurance? Alternatively, should we expand the circumstances under which the Service will provide private letter rulings, thereby eliminating the need and the demand for private tax risk insurance? The next Part considers these and related questions.

V. REGULATORY RESPONSES TO TAX RISK INSURANCE

A. Compulsory Disclosure, Ex Post Penalties, and the Contrast with Tax Advisor Warranties

If regulators are concerned about tax transaction insurance morphing into tax shelter insurance, perhaps the simplest and most obvious regulatory solution would be compulsory disclosure, to require taxpayers who purchase tax indemnity insurance to disclose this fact to the Service, perhaps by attaching a copy of the insurance policy to their tax returns. Such a requirement (a) would reduce the possibility that the insurance was being sold for aggressive tax shelter positions — that is, being sold to cover pure detection risk, and (b) would allow the use of such policies to cover legitimate legal uncertainty. The benefit of including the policy with the tax return is that the policies themselves typically contain a detailed description of the tax position being insured. Indeed, such a detailed description is essential to the insurer's ability to underwrite the policy, because the insurer must carefully circumscribe the nature of the transaction it is covering in order to minimize moral hazard on the part of the taxpayer — which here would mean the taxpayer is taking a more aggressive position than the insurer agreed to cover. Hence, the policy itself must spell out the precise nature of the transaction being
insured. If the policy is then attached to the taxpayer’s return and the Service, upon reviewing the policy, determined that the return in question — especially the insured tax position — warranted auditing, they could do so. Compulsory disclosure therefore would largely eliminate the possibility that tax insurance would be sold for pure detection risk.

Interestingly, the compulsory disclosure idea was recently considered by the Treasury Department and was even included in one version of the Treasury Department’s temporary regulations governing so-called “reportable” transactions. Under those temporary regulations, the purchase of tax indemnity insurance was to trigger a filing requirement, although not a requirement to attach the policy. Rather, the taxpayer who purchased a tax insurance policy would have been required to file the standard “Disclosure Statement for Reportable Transaction” used for all reportable transactions. 110 Perhaps unsurprisingly, the insurance industry objected to the proposal, arguing that this reporting requirement would have a “chilling effect” on the tax insurance industry and thereby harm the economy, as on their view tax insurance was becoming a useful substitute for advance letter rulings and was thus important to continued mergers and acquisitions activity. 111 They argued further that tax insurance was not being sold for shelter transactions, was only being sold to taxpayers who were concerned about substantive legal uncertainty, and had the effect of improving tax compliance because only the most conservative tax positions would survive the insurers’ underwriting processes.

Although these arguments are obviously self-serving, they do have some merit, as I will explain. For now, it is worth noting that part of the risk currently being insured under tax risk policies is audit risk or detection risk. That is to say, when insurers currently sell tax risk insurance, they almost certainly price their policies to account for the possibility that the tax issue being insured will never be detected

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111 In particular, Dave De Berry of The Hartford testified as follows:

The Hartford, together with all other carriers that provide tax insurance, opposes the proliferation of corporate tax shelters and abusive tax avoidance schemes. Sound underwriting practices by insurance carriers and their respective reinsurance carriers precludes coverage for tax shelters or abusive tax avoidance schemes, as well as legitimate positions that seem to be only weakly supported by the facts . . . .

Insurance Group Comments, supra note 9, ¶ 9.
by the Service. They would be crazy not to do so, given the competitive nature of the insurance business. If an insurer considered only merits risk and in effect assumed that the issue being insured would be litigated, the premium the insurer would have to charge would be high — perhaps very high — relative to the premium that could be charged if detection risk (i.e., the possibility of avoiding detection) were factored in. Therefore, any insurer that ignored the possibility that the issue would go undetected would lose out in the competition for insureds, as another insurer could easily come along and under-price the first insurer for essentially the same product. Knowing this fact, insurers will be induced by competition to factor the chance of avoiding detection into their premiums. This conclusion assumes, however, that the Service does not require the policies to be disclosed when the return is filed. If disclosure is required, premiums would have to rise to reflect the increased probability of detection. The higher premiums would presumably deter some taxpayers from purchasing a tax insurance policy in the first place. This sort of direct chilling effect, however, is entirely for the good. Put differently, the chilling effect associated with increased prices due to increased probability of detection would deter precisely the types of tax insurance transactions that are of greatest concern. If after the adoption of a reporting requirement the tax insurance market were to dry up completely as a result of this effect, and insurers and taxpayers were not able to negotiate policies in ways that made them profitable for both sides, such an outcome would provide fairly convincing evidence that these products are providing more coverage for detection uncertainty than substantive legal uncertainty and are probably best eliminated. 112

This is not to say, however, that the chilling effect argument is wholly without merit. Compulsory disclosure may raise the cost of tax risk insurance even for those policies covering primarily substantive legal risk. This could happen, for example, if the taxpayer's disclosure of a tax insurance policy were to trigger or significantly increase the likelihood of triggering an audit by the Service of the taxpayer's entire return and not merely the single transaction being insured. Imagine that the Service were of the view that taxpayers who purchase tax insurance tended on average to be more aggressive on their returns

112 Indeed, some skeptics have suggested to me that there really is very little substantive legal uncertainty involved in the types of tax planning transactions that are currently being insured, thus implying that what is being insured is primarily detection risk. If that is so, then a disclosure requirement will likely cause the market for such insurance to disappear.
generally. If so, the Service might treat tax insurance as a proxy for overall aggressiveness and subject such taxpayers to increased scrutiny across the board. Were that to happen, it would be akin to placing an excise tax on the purchase of tax insurance, but worse — since it would be an uncertain tax, inasmuch as the likely outcome and cost of such increased scrutiny would be uncertain. The result at the margins would be that some taxpayers would be priced out of the market, and, at the extreme, the market for tax insurance might collapse entirely. What is more, even if the Service were to limit its increased scrutiny to the specific transactions being insured, on the speculation that those are likely to involve aggressive tax positions, that too would raise the cost of tax insurance and perhaps inhibit the market’s development. Assuming the Service is wrong that the purchase of tax insurance indicates a greater propensity for tax aggressiveness and wrong that the transactions being insured are themselves especially aggressive, this would be a bad result: a social-welfare-enhancing product would be forced off the market. This might be thought of as an indirect chilling effect of a compulsory disclosure requirement. How likely is it to happen? If tax insurance companies behave as they claim to, engaging in careful underwriting to make sure that the only tax positions they insure are ones that have a strong likelihood of succeeding on the merits, then the purchase of tax insurance need not signal hyper-aggressiveness in any respect. To the contrary, it may develop into a signal of tax-planning conservatism if some insurers over time can establish a reputation for only insuring fairly conservative positions. The real chilling effect problem, however, occurs in the short run, before the insurers have had a chance to prove themselves and when the Service may well be tempted justifiably to increase audit rates of insured returns, at least for a while. A possible solution to this problem would be to provide a modest and perhaps temporary subsidy to defray the extra costs of purchasing tax insurance caused by increased audit rates.

Compulsory reporting of tax transaction insurance raises other issues as well. For example, without stiff penalties for nonreporting, the incentive to report may be too low. Of course, if failure to report a tax insurance contract were made punishable by a criminal or stiff civil penalty, this problem could be substantially reduced. The other problem with the reporting solution is that, when a category of transactions is required to be reported in this way, taxpayers can sometimes construe the requirement so broadly, sometimes intentionally, as to deluge the Service with an avalanche of paper. That is, there could be such a large increase in information being
reported that the Service would be overwhelmed and could not separate the wheat from the chaff. If that were to happen, then the reporting response would not be helpful. Although the information avalanche scenario seems highly unlikely at present, given the small size of the tax risk insurance market, if the use of these policies were to expand considerably, the problem could be significant. The problem is not just that the Service may be overwhelmed, but also that the administrative reporting costs imposed on taxpayers would be increased. An alternative to compulsory reporting would be to do nothing for now and to wait and see what happens, which seems to be the path chosen by the government. If it turns out that some insurance companies are writing policies for highly or even marginally aggressive positions, action could be taken against that particular insurer and its clients. Penalties could be imposed on insurers who are found to have sold insurance for tax shelter positions. Those insurers could be required to disclose their clients to the Service, who would then be subject to a new and especially searching audit process and ultimately increased penalties as well. Also, if the Treasury Department determines that some categories of overly aggressive positions are being insured, a list of “uninsurable positions” could be promulgated, akin to the “listed transactions” category, positions that if insured would give rise to a special penalty for taxpayers and insurers alike. This approach would have the benefit of deterring tax shelter insurance without subjecting the policies covering true substantive legal uncertainty to any special penalties. Of course, with this approach, and especially without compulsory disclosure, there would always be the possibility that the aggressive taxpayer-insurer collaborations might escape detection. But that is the sort of possibility that again can be handled by increasing penalties ex post.

To date, the insurance industry has persuaded the Treasury Department that tax insurance is not a problem that warrants regulatory intervention. Thus, under the current reportable-transaction regulations, the purchase of tax insurance does not trigger a reporting requirement; there are no special penalties for tax insurers who insure tax shelter transactions.113 It is interesting to note, however, that other forms of “contractual protection” — such as money-back warranties provided by tax advisors — do trigger the reporting requirement. Thus, as discussed at the end of Part III above, if the insurance is provided by the tax advisor rather than by a separate insurance company and if the insurance is limited to a refund

of fees in the event that the tax position in question is rejected, then the taxpayer must flag the transaction for the Service. The exception to this rule is when the tax advice being given, and the money-back guarantee being provided, involves a claim for refund based on a return that was already filed prior to any fees being charged. Obviously, then, the concern here is that such guarantees or contingent fee arrangements will be used to cover mostly detection risk (i.e., aggressive shelter opinions), except in cases involving refund claims, where the probability of detection is significantly greater, though not necessarily equal to one. The interesting question is why this concern about detection risk or shelter insurance would be greater for tax advisor warranties and contingent fee arrangements than for tax insurance policies. The answer to this question might shed some light on what, if anything, should be done about tax transaction insurance.

The main differences between tax transaction insurance and tax advisor warranties are the involvement of insurance companies and the concomitant triggering of the states' insurance regulatory regimes. Insurance companies are notoriously conservative in their underwriting practices and must satisfy various regulatory reporting requirements that tax advisors need not satisfy. Moreover, whereas tax advisor warranties, which are generally oral and informal in nature, probably are not subject to the sort of public policy restrictions that would apply to formal, written insurance policies. Hence, one external regulatory force that would inhibit both the demand for and the supply of insurance policies for increasingly aggressive tax plays would be the possibility that such contracts might be deemed void as against public policy. Although it seems unthinkable that an insurance company would invoke this doctrine to avoid paying under such a policy, it is possible that an aggressive state regulator, insurance commissioner, or attorney general might make such a ruling. In addition, from what I am told, current demand for tax transaction insurance is being met by only a small number of large insurance companies. Given this fact, if a particular insurer decided to offer policies for aggressive tax shelter transactions and this were discovered, the Treasury Department could then take action against the aggressive insurer, in much the same way that it has already done with tax shelter promoters. The threat of such a possibility likely would deter insurers from overstepping the line. By contrast, in the absence of an official reporting requirement for other types of

114 See supra note 87.
contractual protection, presumably including tax advisor warranties, it seems unlikely that they would ever be discovered or made public. One can certainly imagine some especially aggressive tax advisors being willing to play the audit lottery along with their clients, whereas that possibility seems rather unlikely with insurance companies.

What is my bottom line? Is current Treasury policy fine as it is, or should more be done to reduce the risk of tax shelter insurance? It is difficult to offer a definitive answer to these questions, given that the dangers that tax insurance presents, if any, depend on the larger context of tax enforcement policy. Thus, if tax shelter activity was already adequately deterred by a combination of aggressive Service auditing and stiff penalties for tax underpayments — and I mean much stiffer than is currently the case — tax insurance policies as well as tax advisor warranties would likely be a nonissue. Either the detection risk would be high, meaning the insurance would cover only substantive legal uncertainty, or the penalties would be so high that the result would be the same. In the current regulatory climate, however, a climate in which audit rates are low, the Service staff is outgunned by highly paid tax advisors, and tax penalties are far below levels necessary to achieve optimal deterrence, some modest regulatory action would seem appropriate. Thus, the compulsory disclosure option mentioned above strikes me as a sensible step. Although the distinction the Treasury has drawn between private contractual-protection agreements and insurance policies is defensible, I am unpersuaded. That is, I would probably require taxpayers to disclose their purchase of tax insurance in the manner described above, although I would try to find some way to offset the cost of this disclosure in order to minimize the indirect chilling effect. Given the nature of the tax transaction policies currently being sold, it is highly doubtful that the market would be much affected by a disclosure requirement. Indeed, it could even be helped, as the public and the Service would be made aware of the nature of the policies and the types of transactions being insured. Furthermore, because of this publicity effect, it is conceivable that compulsory disclosure could ultimately lead to more corporate and wealthy individual taxpayers trying it. Assuming the Service has the resources to review all of these insurance policies and the transactions being insured by them, the spread of tax risk insurance would not necessarily be a bad outcome.
B. Private Versus Public Insurance for Tax Law Uncertainty

Before we can conclude definitively that a private market in tax risk insurance is a good thing, however, we must return to the comparison between private tax insurance and its most obvious alternative, government provided tax law uncertainty insurance. Given the reasonable assumption that Congress cannot possibly enact tax laws that cover every conceivable transaction in advance, there will always be some residual substantive tax law uncertainty. The primary means in the past of dealing with this uncertainty for risk-averse taxpayers has always been the private letter ruling. In general, if a taxpayer follows certain technical filing procedures, the Service will issue a ruling directly to the taxpayer that explains how it will apply the law to the particular transaction described in the ruling request.115 The Service will issue rulings on both proposed and completed transactions, assuming no return has yet been filed and the ruling-request procedures have been followed.116 If a favorable ruling is issued by the Service, the taxpayer may generally rely upon it.117 In that sense, then, a favorable letter ruling is akin to purchasing tax law uncertainty insurance from the government. Private letter rulings can be revoked retroactively under certain conditions, which also is similar to an insurance policy that can be rendered void if certain exclusions are triggered. For example, this could occur if the Service determines that the taxpayer misstated an important fact in its ruling request or determines that the factual circumstance of the transaction has changed dramatically from the facts that prevailed at the time of the request. That possibility is analogous to the exclusion in most insurance policies that eliminates coverage if the insured commits fraud or makes any materially misleading statement in the insurance application process. Private letter rulings can also be revoked by the issuance of a revenue ruling, the promulgation of final regulations, the enactment of federal legislation, or a decision of the U.S. Supreme Court that is directly on point.118 This possibility is akin to the

116 See id. § 5.01.
117 See id. § 11. Private letter rulings have no precedential value for other taxpayers. Taxpayers, however, will sometimes look to them as evidence of how the Service might handle particular issues that have not yet been addressed in more formal announcements, such as in a Revenue Ruling.
118 Id.
exclusion in tax risk insurance policies for changes in the law. If the taxpayer seeking a letter ruling wants even greater certainty from the government regarding the tax treatment of a particular transaction, he or she can enter into a “closing agreement” with the Service, which conclusively determines the issue in question and is binding on the Service unless there is fraud or material misstatement on the part of the taxpayer. The additional level of “coverage” provided by the closing agreement effectively eliminates the risk of retroactive revocation by revenue ruling, regulation, or congressional action, although the fraud and misrepresentation limitations remain. Of course, the Service does not charge a premium for this insurance in the same way that an insurance company does. It charges a nominal fee, and the taxpayer must incur the cost of hiring a lawyer to draft the ruling request, but the taxpayer is not required to make a payment to the government that approximates the expected value of the taxpayer’s tax liability, as there is with private tax risk insurance.

An important question is why the private-letter-ruling process is not itself sufficient to meet taxpayers’ need for tax law uncertainty insurance. If taxpayers are so concerned about the uncertainty of how the tax laws will be applied, why do they not simply apply for a ruling? This is what is done in other areas of law. As already noted, there are a number of circumstances in which the Service will not issue

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119 Id. § 2.02.

120 In other areas of law where there is similar transaction-specific or activity-specific legal uncertainty, individuals or corporations that are concerned about such uncertainty can request that the regulators render an opinion as to how the law would apply to a particular set of facts. For example, the Securities and Exchange Commission (SEC) upon request will issue so-called no action letters indicating that no criminal or civil action will be taken against the person engaged in a particular activity. The letters, typically issued from a particular division within the SEC, usually state that the division “will not recommend enforcement action,” with the following qualification:

This position is based on the representations made to the Division in your letter. Any different facts or conditions might require the Division to reach a different conclusion. Further, this response only represents the Division’s position on enforcement and does not purport to express any legal conclusion on the question presented.

Among them are whether a proposed or completed transaction “lack[s] a *bona fide* business purpose” or has as its “principal purpose the reduction of federal taxes.” In addition, the Service states that it will not “ordinarily” issue rulings (a) on “[a]ny matter in which the determination requested is primarily one of fact . . . [such as] whether an interest in a corporation is to be treated as stock or indebtedness,” (b) in “[s]ituations where the requested ruling deals with only part of an integrated transaction,” and (c) on issues that are “under [extensive] study” by the Service. Unfortunately, these are categories that could be construed to cover many transactions, and they are types of transactions that often involve the highest degree of legal uncertainty. Perhaps unsurprisingly, then, they are transactions for which private insurance has recently become available. The question now becomes why the Service is not willing to provide rulings under circumstances of profound substantive legal uncertainty — such as ones that involve the application of anti-avoidance standards — and why private insurers are willing to insure such transactions. As it turns out, there are a number of possible explanations.

Continuing the insurance analogy, one conceivable answer is that the Service simply does not have the resources to “underwrite” the risks. That is, they do not have a large enough or sufficiently capable staff to do the factual and legal analysis necessary to issue rulings on such fact-intensive questions without running a big risk of adverse selection and moral hazard. That is, if the Service were to issue rulings on such questions as whether there is a sufficient nontax business purpose in a particular transaction, or whether there was economic substance without having done a thorough and detailed analysis of all the relevant facts and law, there would be a tendency for relatively aggressive taxpayers to apply for such rulings. Moreover, because once a ruling is issued it is difficult for the Service to determine if it should be retroactively revoked — for example, because the actual transaction does not coincide with the described transaction — taxpayers who have secured an advance ruling have an

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121 *See* Rev. Proc. 2005-3, 2005-1 I.R.B. 118. The list of issues on which the Service will never or will not “ordinarily” give letter rulings is updated in the third revenue procedure of each year.

122 *Id.*

123 I do not know if there is a similar list of issues about which the SEC will not issue no action letters.

124 Underwriting is the process by which insurers determine whether a particular risk is insurable and, if so, under what contractual terms.
incentive subtly to alter the transactions so as to increase their tax-avoidance aspect. Of course, the Service is not without some defense mechanisms in dealing with this sort of adverse selection and moral hazard. The Service, as mentioned, does have the authority to revoke a ruling after-the-fact if it can show that there were demonstrable misstatements in the ruling request. Such misstatements, however, may be difficult to identify, much less prove; in any event, issuing such a retroactive revocation may be administratively and politically costly. Thus, because of the difficulty of combating such adverse selection and moral hazard on the part of taxpayers, the Service may have determined that it makes more sense for the agency simply to withdraw from providing this type of insurance coverage, just as private insurance companies sometimes temporarily or permanently withdraw from offering certain types of insurance coverage.

Yet private insurers seem to be willing to fill in some of the gaps in tax uncertainty insurance. Why? First, we should not forget that the reason may be that insurers are to some extent selling detection risk insurance, which the Service obviously has no interest in doing and which we want to discourage — hence the proposal to require disclosure of the tax risk policies. Putting that possibility to one side, which seems reasonable for many of the sorts of transactions currently being insured, perhaps the reason is that private insurers are better funded and better organized than the Service and have better access to exceptionally able tax lawyers to advise them on these issues.\textsuperscript{125} At least some of the largest insurance companies selling tax indemnity insurance policies, as a regular part of their tax insurance underwriting process, consult a panel of the very best tax lawyers in the business. That is, they use expert advisory panels to help them determine if particular transactions are likely to be rejected or approved by the Service on audit or more importantly by a court in litigation. In this way, perhaps private insurance companies are simply better at doing ex ante tax transaction risk assessments, which might be thought of as ex ante “mini-audits,” than is the government.

If the problem is merely the low quantity and quality of the Service’s tax lawyers, something could be done about it. Congress

\footnote{\textsuperscript{125} The conventional wisdom among tax practitioners is that Service lawyers are in over their heads or “out of their league” at least when it comes to dealing with complex tax shelters. Bankman, \textit{supra} note 7, at 1786 (“A persistent comment of private attorneys, speaking in their public-spirited capacity, is the inability of the [Service] field staff to correctly apply many of the more complicated tax provisions. Many private attorneys believe that auditors are completely out of their league in identifying and correctly analyzing tax shelter items.”).}
could simply allocate more money to the Service for hiring attorneys, whether they are brought in-house or hired on a contract basis. That may well be a good idea. It is possible, in other words, that if Congress were to increase the Service’s budget dramatically, earmarking money to hire more and better lawyers in the Service’s Chief Counsel’s and Deputy Chief Counsel’s offices, more private letter rulings would be forthcoming — that is, the Service might agree to issue rulings in areas of higher legal uncertainty such as those involving the application of fact-intensive anti-avoidance standards — and hence fewer taxpayers would see a need for private tax indemnity insurance. Moreover, if we added more and better lawyers to the field offices doing the audits, the rate of detection for tax shelter transactions might be dramatically increased, which would reduce some of our concerns about tax shelter insurance. If adding talented personnel were feasible, then it may be an improvement over the current state of affairs. We should note, however, that insofar as we conceive of the private letter ruling process as a form of government provided insurance, it has some of the problems and it lacks some of the benefits that we sometimes see with government provided insurance. One problem, which is found in most forms of government provided insurance, is that the government makes no attempt to charge a true premium to the taxpayer-insured, one that roughly reflects the risk being shifted to the government. Not charging a risk-adjusted premium further increases the chance of adverse selection of the sort described above.126 Sometimes government provided

126 Having the Service charge a risk-adjusted premium for issuing an advance ruling is not an entirely crazy idea. Whenever the Service settles a tax case and enters into a closing agreement, they are in a sense accepting a payment equal to something approximating the expected value of the taxpayer’s liability. Of course, this is not the same thing as, in effect, settling a case before there is a dispute, and doing so on a large scale. Even that is not without precedent in the tax area, as the Service already has a program for entering into so-called advanced pricing agreements with multinational corporations who are concerned about the uncertainty with respect to how the Service might resolve transfer-pricing issues, which themselves raise an especially fact-intensive set of questions. These advance agreements are a form of alternative dispute resolution under which the taxpayers or taxpayer groups avoid ex post audits of their transfer prices, and potentially large adjustments, by agreeing in advance to use a standard arms-length pricing method. I.R.S. Announcement 2005-27, 2005-16 I.R.B. 918 (statement by Matthew W. Franks, director of the Advance Pricing Agreement Program, explaining how the program works). Whether this system is working as it is supposed to for transfer-pricing issues is beyond the scope of this analysis. Whether a similar approach might be used more generally for other highly fact-intensive questions of income tax law, especially those involving corporations and partnerships, seems unlikely, at least any time soon. To undertake
insurance is able to combat adverse selection, in a way that private insurance cannot, by making coverage compulsory. Obviously, private letter rulings are entirely elective. For all these reasons, the adverse selection effect — of aggressive taxpayers trying to take advantage of under-priced and elective government-provided tax uncertainty insurance — may simply be too much to overcome.

Nonetheless, the idea of increasing the Service's funding to allow it to hire more and better-qualified personnel for conducting analyses of ruling requests — and perhaps helping to fund these new personnel by significantly increasing the fees that are charged, even if the fees are not linked to expected tax liability — might be worth trying. We might even consider allowing the Service to use outside tax experts to assist them, as insurers have done. Having said all of this, however, I still see no sound reason to object to a market in privately provided tax risk insurance for those domains of tax law uncertainty that insurers are willing to enter. Insurance companies are especially adept at combating adverse selection and moral hazard problems. Their use of detailed insurance application procedures, expert advisory panels, and the deductibles, policy limits, and numerous exclusions in their policies are evidence of this fact. Moreover, having private insurers cover these risks provides another advantage over government-provided insurance: the private insurers can also provide coverage for legal fees, which is no small part of the legal risk being insured and which the government cannot reasonably insure. The reason the government cannot cover the legal fees is the issue of conflict of interest: the government as insurer could not be responsible for hiring and supervising the taxpayers' attorneys in the tax dispute. The insurer, however, can.

such a project on a broader scale would require far more administrative resources than the Service has or ever is likely to have.

Other commentators have suggested that allowing the Service to retain elite tax lawyers on a contract basis to assist with complex tax shelter cases may be a useful, though politically unlikely, response to the problem of Service understaffing. See, e.g., Bankman, supra note 7, at 1787 (“In theory, the government could contract with private parties on an incentive-based fee structure to ferret out shelter activity. A related . . . proposal would be to hire outside experts on a non-incentive based fee arrangement to train auditors and, perhaps, advise on particular audits or audit-related issues.”).

There can be conflicts of interest between private insurers and the insured as well, especially in settlement negotiations, but these can usually be handled contractually or by application of state-law good faith standards and rules of professional ethics for lawyers.
VI. Conclusion

Despite the extraordinary length and specificity of the federal tax laws, many sophisticated taxpayers face uncertainty as to how their transactions will be treated by the Service and the courts. That is, although the Code is the quintessential rule-based system of law, as opposed to one that relies primarily on vague standards, there remain significant areas of legal uncertainty even for those taxpayers able to hire tax law experts. The reasons for this are simple enough. First, there are a seemingly infinite variety of transactions that taxpayers can enter, and the tax laws cannot deal clearly with all of them in advance. There will always be gaps and inconsistencies in the tax laws. Second, because of these inevitable gaps, the taxing authorities will have a strong incentive to use some type of background anti-avoidance standards — such as the business purpose or economic substance standards — to prevent abusive tax avoidance. Both of these facts combine to create significant legal uncertainty for the sophisticated taxpayer. Such uncertainty can lead to distortions in economic activity and is not ideal from a social welfare perspective, even though it can serve as a sort of second-best deterrent against excessively aggressive tax avoidance.

The better response to tax law uncertainty is (a) to increase penalties or the likelihood of detection to deter abusive tax positions and (b) to make available some form of tax law uncertainty insurance. Until recently, the only available insurance for this sort of uncertainty was the private letter ruling, which serves only a very small portion of taxpayers and is explicitly not available, probably for adverse selection and moral hazard reasons, for those transactions that involve the most legal uncertainty — the ones that involve highly fact specific standards-like analyses. A new market of private insurance has arisen to cover this category of legal uncertainty, and the question is whether it is a bad or a good thing. The concern is that such insurance will not be sold to cover positions about which there is legitimate legal uncertainty, but for positions that are more likely than not to be rejected by the Service and the courts if examined. For those positions, tax insurance would be, in effect, audit or detection insurance; that would be bad. To prevent this possibility, while at the same time allowing the benefits of a private market in tax law uncertainty insurance, the Treasury Department probably should compel taxpayers who purchase tax risk insurance from a private insurer to disclose that fact on their return. This will doubtless raise the cost of such insurance and may in the short run hinder the
development of the market. In the long run, however, if there is strong demand for tax law uncertainty insurance — not just for detection-risk insurance — the market should survive and grow. Indeed, given the potential efficiency gains from the use of legitimate tax law uncertainty insurance, the government should consider ways of subsidizing it, at least in the short run. Privately provided tax risk insurance not only allows risk-averse taxpayers to shift this uncertainty from themselves to risk-neutral insurers, it creates an incentive for insurers — and their paid expert tax advisors — to serve as a sort of privatized Service. By doing ex ante mini-audits in the form of tax risk underwriting, insurers can fill a void that the Service, through its letter ruling policies, is unwilling and probably unable to fill.