TEI/LMSB Financial Services Industry Conference

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I appreciate the opportunity to address this audience. As a private practitioner, I attended similar industry conferences sponsored by the IRS and industry groups. I found that such conferences greatly improved communication between the IRS and taxpayers and their representatives. Frank – but professional – discussion of issues and problems is good for tax compliance and tax administration. As a result of such discussions, we can identify areas of agreement and areas where we might respectfully disagree. Such exchanges also create appreciation of, and respect for, the other side's perspectives and concerns. Both my personal and my professional experiences tell me that honest and direct communication reduces conflict and controversy over time.

In keeping with this philosophy, I want to discuss today a concept that is sometimes called the "Wall Street Rule."

Even in Dallas, Texas – where I practiced law for 28 years prior to joining the IRS – we had heard of the Wall Street Rule. Some might say that is not surprising because Dallas is just Fort Worth trying to be New York. The truth is that the Wall Street Rule is widely known in the tax world and is not limited to issues that originate from, or arise on, Wall Street. The Wall Street Rule may often be cited with respect to publicly traded securities, but the underlying premises of the Wall Street Rule apply to the tax treatment of a variety of issues and transactions. Therefore, my comments today are not limited to the financial industry or to Wall Street.

There are at least two accepted versions of the Wall Street Rule. One version is that the IRS cannot attack the tax treatment of any security or transaction if there is a long-standing and generally accepted understanding of its expected tax treatment. This is the "golden oldie" version of the rule.

The second version of the Wall Street Rule is that the IRS is deemed to have acquiesced in the tax treatment of any security or transaction if the dollar amount involved is of sufficient magnitude. This version of the Wall Street rule is primarily premised on the dollars involved and the adverse economic or market impact of any challenge by the IRS. This is the "golden rule" version of the Wall Street Rule.

When I first started practicing law, a senior lawyer asked me if I knew the "golden rule." I mumbled something about "do unto others as you would have them do unto you." He immediately corrected me with the real golden rule. He said: "The person with the gold makes the rules." That pretty well summarizes the "golden rule" version of the

Wall Street Rule. If the dollars are big enough, the IRS cannot challenge the tax treatment of a transaction or security because the economic or market impact would be too large.

Sometimes, both versions of the Wall Street Rule are invoked simultaneously. But, any version of the Wall Street Rule ultimately is based on the principle of estoppel by laches. This is an equitable principle holding that a claim or right may not be enforced if the plaintiff delayed too long in making the claim or enforcing the right. One of the basic legal rules I learned in law school, however, was that there is no estoppel against the King. This basic legal rule applies under the tax law. There is no equitable principle of estoppel by laches against the Commissioner under the tax law. The failure of the IRS to issue published guidance on a transaction, and even the failure of the IRS to raise issues regarding a transaction in audits for many years does not prevent the IRS from questioning the tax treatment of the transaction. As a legal matter, there is no such thing as The Wall Street Rule.

As a lawyer, therefore, I must dismiss the Wall Street Rule, whether I represent the IRS or taxpayers. Taxpayers cannot rely upon the Wall Street Rule, since it is not equitably or legally binding on the IRS. Likewise, the Commissioner may challenge positions taken by taxpayers, however longstanding and however many dollars are at stake. While it is good tax policy and good tax administration to issue published guidance to inform taxpayers of the IRS's view of the tax consequences of their transactions, the IRS cannot be expected promptly to identify and respond to all transactions. There are institutional and practical limitations on the ability of the IRS to issue published guidance on each and every transaction or issue. That we aspire to issue more, and more timely, published guidance does not give any credibility to the Wall Street Rule.

Even though the Wall Street Rule is not legally relevant, we cannot ignore the widespread acceptance in the tax world of the Wall Street Rule. The widespread assertion of the Wall Street Rule also tells us something about the attitudes of taxpayers and tax practitioners regarding the self-assessment system.

Over the years, I have concluded that taxpayers and their advisors subscribe to two major creeds. One creed views the tax law and the self-assessment system as a system for raising revenue. The Internal Revenue Code sets the basic principles and rules, and the Treasury regulations fill in the gaps with more refined principles and rules. Revenue Rulings and Revenue Procedures provide even more refinement through examples and safe harbors. Overlaying this system are judicial doctrines, such as the step transaction doctrine, the substance-over-form doctrine, and the economic substance doctrine. These and other court created doctrines require that the principles and rules must be tempered by reality, sound judgment, and common sense. Tax practitioners who adhere to this creed believe that these common law doctrines are as much a part of the law as the Code and Regulations, and that they must advise taxpayers to comply with all aspects of the law. Taxpayers who adhere to this creed ask

themselves whether the tax advice they receive makes any common sense in a system that is designed to raise revenue.

A second group of taxpayers and tax advisors subscribes to the creed that the self-assessment system is a game. Adherents to his creed argue that if judgment and common sense are part of the tax law then, because people exercise judgment differently, the law has no predictability and taxpayers can never really know the rules under which they must plan and report their transactions. Consequently, they view the Code and regulations as technical rule books to be read literally and without regard to common sense or the ultimate purpose of the system. Tax practitioners who adhere to this creed believe that unless there is a specific rule prohibiting a tax treatment, then that treatment is available. Taxpayers who adhere to this creed do not ask whether the tax result makes any common sense in a system designed to raise revenue.

The Wall Street Rule ultimately is part of the creed that views the tax law as a game. It says: "If I can do enough deals before the Commissioner finds out about them and reacts, then I win." This attitude simply is not acceptable from a tax administration perspective. That is why the Commissioner cannot recognize the Wall Street Rule or accept the premises upon which the Wall Street Rule is based. Acceptance of the Wall Street Rule would encourage taxpayers and their advisors to adopt aggressive tax positions and to promote those positions widely. Acceptance of the Wall Street Rule would mean that the IRS would be required to issue published guidance without adequate analysis or information, since a failure to react would be deemed to be approval.

There is another aspect of the Wall Street Rule that is disturbing. I have observed that the first transaction involving a new tax product is often structured and effected in a conservative manner, including terms and conditions that are required by tax advisors to support their opinions. With each successive transaction, however, these terms and conditions are dropped or adjusted as the "market" accepts the tax product. In my view, this type of "deal creep" occurs because of competition and not because tax advisors suddenly discovered that those terms and conditions were not important to their tax analysis. The tax consequences of a transaction may vary widely depending on its terms and conditions, so the Wall Street Rule encourages taxpayers and their advisors to walk closer and closer to the line. The tax product becomes more and more aggressive in each successive transaction because, under the Wall Street Rule, the conventional wisdom is that the IRS cannot challenge the product. When taxpayers and their advisors walk closer and closer to the line, it is not surprising that they are more likely to step over the line.

Call me a cynic, but I believe that market pressures play a significant role in shaping tax planning. This reminds me of what one of my former partners referred to as the "client's lament." When a lawyer advises a client that it cannot legally do what it wants to do, the client's uniform lament is: "Why not, everybody else is doing it." "I cannot compete if I don't do it." And, "I don't pay you to tell me what I cannot do; I pay you to tell me how to do it." The final phrase in the client's lament is the statement: "If

you can't tell me how to do it, I will find someone who can." The client does not always make the final statement, but it is always an unspoken part of the client's lament.

Good lawyers find legal means to achieve their client's realistic goals, but there are some goals that are not realistic and simply cannot be entirely achieved under the law. This is true for all types of legal advice, including tax advice. As the client's lament demonstrates, however, both taxpayers and their tax advisors are subject to market pressures. The existence of these market pressures does not excuse taxpayers or their tax advisors from complying with the tax law or justify the Wall Street Rule.

Since variations on the Wall Street Rule are accepted in all parts of the country and in all business sectors, why is it called the Wall Street Rule and not the Main Street Rule? Why are both versions of the rule so commonly associated with the financial sector?

One possible reason is the nature of today's financial products and financial markets, where speed is an ever more important factor. Over the past 20 years, advances in computer technology and financial mathematics have enabled investment banks and other financial institutions to develop more and more complex products at an ever increasing rate. As a result, the IRS falls farther and farther behind in its knowledge of current products and transactions. This lag in knowledge, which is a natural result of the self-assessment system, is extreme in the financial sector and has made this sector an ideal place for the Wall Street Rule.

Another possible explanation for why the Wall Street Rule is commonly asserted to apply in the financial sector is that financial products and markets involve large dollars and large numbers of taxpayers. One might argue that both taxpayers and their advisors in this sector adopt less aggressive tax positions than in other sectors due to the risks involved. If that were true, then the Wall Street Rule would be justified simply because the tax positions taken in the financial sector would be inherently conservative. But that conclusion is flawed since the logical result of the Wall Street Rule is to encourage more and more aggressive positions over time.

If a taxpayer enters into a transaction based on a "should" opinion, the taxpayer has accepted the risk that a particular tax treatment might be successfully challenged. The Wall Street Rule perversely says that even though a taxpayer has willingly accepted a tax risk, the taxpayer may still disclaim responsibility. It says that if an issuer sells enough of a tax product, then both the issuer and the holders are immune from challenge by the IRS. Thus, the Wall Street Rule encourages the sale of products beyond the real level of acceptable risk. It encourages holders and their advisors to be less careful, and it encourages issuers and their advisors to be more aggressive.

As a practical matter, the widespread assertion of the Wall Street Rule reinforces the importance of guidance in the administration of the tax laws. Our tax laws are extremely complex and this complexity can breed disrespect for the law. If taxpayers cannot obtain clear tax advice from responsible tax practitioners, taxpayers lose their

ability to differentiate between good and bad tax advice. Encouraged by tax professionals, taxpayers also become adherents to the creed that says that the self-assessment system is a game and there are no common sense rules to the game. Therefore, good tax administration requires that the IRS provide timely and reliable information to aid taxpayers and their advisors to comply with the tax law.

The question is how should Treasury and the IRS respond to the Wall Street Rule and the messages it sends? We could ignore it. We have no legal obligation to issue guidance on any particular transaction or tax product. The IRS is not estopped from challenging a transaction or product, even if no published guidance has addressed the transaction or product. But, published guidance helps taxpayers plan transactions; it promotes compliance; it saves revenue agents time in examining returns; and it promotes the uniform application of the law throughout the country. As a result, published guidance reduces the likelihood of costly litigation and unintended results, which benefits both the public and the government.

With this in mind, when I joined the Office of Chief Counsel about 18 months ago, one of our priorities was to increase the amount of guidance. Published guidance provides a greater benefit per unit of cost than other types of guidance because each published item can be relied upon by hundreds, and perhaps thousands, of taxpayers and also serves as a guide for all revenue agents and appeals officers. Thus, the technical divisions in the National Office of Chief Counsel have reallocated their time away from certain other programs in order to increase the publication program. This resulted in a significant increase in the amount of published guidance over the past year. And, we will continue our efforts to provide increased amounts of timely and relevant published guidance in the coming year.

LMSB plays an import role in our efforts to increase published guidance for the financial industry. An LMSB Industry Director focuses on financial institutions and transactions, and a cadre of experienced financial products specialists and teams of technical advisors coordinate issues nationwide. With this expertise, LMSB can better see what the industry is doing and anticipate where the industry is going in the future. LMSB has been extremely helpful in bringing issues to our attention so that we can develop a business plan each year, and there are other things that LMSB can do.

First, although conferences such as this one are useful, organized presentations of issues and transactions to the National Office would provide us with additional information to use in published guidance. This is already being done on an ad hoc basis, such as in the areas of asset securitization and mark-to-market accounting. We would hope to expand this concept to other areas.

Second, LMSB has used Coordinated Issue Papers to assure uniform treatment of issues throughout the country. I believe that similar papers could also be prepared as “issues memoranda” to generate published guidance.

Finally, requests for Technical Advice are longstanding vehicles for presenting issues to the National Office. Technical Advice is particularly useful because it provides us with specific documentation, which ensures that we fully understand the mechanics of a particular product. Technical Advice does not respond to the Wall Street Rule, however, because it arises from examinations and comes long after the tax product has been marketed.

As the first tax advisors to review new products and transactions, TEI members are often the first to see gaps in existing guidance relevant to such products and transactions. Over the past year, some of your members have met informally with us in order to bring these problems to our attention. I urge those of you who have not participated in this way to consider doing so. I must caution, however, that even if we do not issue published guidance after being made aware these problems, the IRS is not prevented from challenging these products and transactions.

On a more formal level, you could submit written suggestions for our business plan. Now that we update that plan quarterly, I would urge you to submit suggestions throughout the year.

Finally, you should consider participating in our private letter ruling (PLR) program. In order to focus on published guidance, the National Office technical divisions are spending less time on their PLR programs by reducing the numbers of more routine rulings. In the Financial Institutions and Products division (FIP), we have published revenue rulings and procedures that make it unnecessary to request routine rulings. For example, in Revenue Procedure 2002-49, we addressed the securitization of certain stranded utility costs. As a consequence, FIP has very few routine PLRs and can entertain ruling requests on new products and transactions. By addressing new products rather than routine transactions, we hope to issue PLRs that we can convert to published guidance. For example, in Revenue Procedure 2002-11, we announced a program for securities futures contracts, under which an exchange can obtain a PLR on whether certain exchange participants qualify as dealers under section 1256(g)(9). And, we expect to convert those PLRs to revenue rulings. Thus, we are working with the exchanges, as well as the SEC and CFTC, to bring certainty to the markets before many of these new contracts are traded.

I understand that the normal PLR program often is not practical because of the very short time frames for marketing a financial product. To respond to this fact, we have been exploring ways to shorten the time for obtaining a PLR. And, over the past year, we have found that pre-submission conferences are helpful. A few days before a pre-submission conference, a taxpayer should submit a short, written description of the product and a very brief description of the legal issue under consideration. (Two or three pages are usually sufficient.) At the conference, we can be prepared to discuss the product, the possible tax analysis, and the time frame for issuing a PLR. We also will discuss what the taxpayer can do to facilitate the process.

We have had a number of these conferences over the past year. For some of them, formal PLR requests followed. For others, no request materialized. In all cases, both the taxpayers and the IRS found the conferences educational, productive, and cost effective. I should note, however, that neither the fact of such a pre-submission conference nor exchanges at such a conference protect a taxpayer or a financial product from challenge by the IRS. Pre-submission conferences do not give credibility to the Wall Street Rule.

Following that little commercial for FIP, I would like to summarize my comments regarding the Wall Street Rule.

The Wall Street Rule is not an acceptable legal principle, nor is it required by good tax policy or good tax administration. The IRS may determine not to challenge a particular transaction or product, but that decision is not based upon the Wall Street Rule. Neither the “golden oldie” nor the “golden rule” version of the Wall Street Rule binds or should bind the IRS. Acceptance of the Wall Street Rule by the IRS would encourage more and more aggressive tax positions over time, since the IRS cannot, as a practical matter, issue guidance as quickly as taxpayers and their advisors develop transactions and tax products. Therefore, reliance upon the Wall Street Rule is not justified.

The widespread acceptance of the Wall Street Rule in the tax world does say something about the self-assessment system. It reminds us of the importance of timely and relevant guidance from the tax administrator. But the absence of guidance on a particular transaction or product does not mean that such transaction or product cannot be challenged by the IRS. The tax law and the self-assessment system rely on both technical tax rules and principles – the Code and regulations and other forms of published guidance – and common law doctrines consistent with the purpose and intent of the Code. Therefore, even if the Treasury and IRS have not issued published guidance as to a particular transaction, issue or product, the IRS may challenge the taxpayer’s position. All concerned are better served, therefore, if taxpayers and their advisors plan and effect their transactions without regard to any alleged Wall Street Rule.