July 31, 2000

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
REPORT ON PROPOSED AMENDMENTS TO CIRCULAR NO. 230[1]

On May 5, 2000, the Department of the Treasury issued a notice of proposed rulemaking (the "Notice") to amend the regulations governing practice before the Internal Revenue Service, which appear in the Code of Federal Regulations (31 CFR, Part 10) and in pamphlet form as Treasury Department Circular No. 230. The Notice was prompted by the continuing debate over the proliferation of corporate tax shelters and the promulgation of regulations by the Treasury Department and the IRS requiring disclosure of certain transactions by corporate taxpayers, registration of confidential corporate tax shelters and the maintenance of lists of investors in certain tax shelters. The Notice seeks comments relating to the standards of practice governing tax shelters and other general matters. This Report responds to that request primarily as it relates to the standards of practice applicable to opinions issued in connection with corporate tax shelters. The Report also responds briefly to a few of the other matters raised by the Notice.[2]

As a preliminary matter, we are skeptical that changes in the standards of practice applicable to tax advisors will have any significant impact on corporate tax shelter

---

1 This Report was prepared by an ad hoc committee composed of Peter Canellos, Carolyn Lee, Richard Loengard, Harold Handler, David Hariton, Richard Reinhold, Michael Schler and Steven Todrys (who was the principal drafter). Helpful comments were received from Andrew Berg, Robert Jacobs, Erika Nijenhuis, Robert Scarborough and Willard Taylor.

2 While this Report is directed primarily to issues relating to corporate tax shelters, its observations and recommendations are also applicable to certain tax shelter products that are being marketed to wealthy individuals.

activity. It is not likely that any such changes will deter tax advisors from continuing to work with, and support, promoters in developing and marketing tax shelter products. As discussed below, we continue to believe that strict liability for increased penalties in tax shelter transactions and enhanced enforcement efforts would be more effective responses to the problem. Moreover, an approach that eliminated the reasonable cause exception to accuracy-related penalties in tax shelter transactions would also eliminate the need to adopt the standards of practice discussed below for opinions of tax advisors upon which taxpayers currently rely as the basis for that exception.

We also have some concern about Treasury and IRS regulation of the relationship between taxpayers and their tax advisors, even in connection with corporate tax shelters. However, to the extent that tax advisors are providing opinions upon which corporate taxpayers rely to avoid penalties, we believe it is entirely appropriate for Treasury and the IRS to articulate the standards such opinions must meet. We further believe that the standards of practice for rendering those opinions should be consistent with the substantive requirements of the applicable penalty provision. If the reasonable cause exception to accuracy-related penalties is retained for corporate tax shelters, we believe (i) the standards of practice for corporate tax shelter opinions under Circular No. 230 should be the same as the standards applicable to such opinions under the reasonable cause exception and (ii) the standards for satisfying the reasonable cause exception should be strengthened. As a result, a tax advisor providing an opinion intended to satisfy the reasonable cause exception would be subject to sanctions if the opinion failed to meet those standards.

We also believe that it may be appropriate to prescribe standards for material (in the form of memoranda or opinions) that tax advisors provide to promoters for use in marketing tax shelter products. However, because the nature of that material is varied and because the material is not directed at avoiding the accuracy-related penalties, it is more difficult to develop any workable set of applicable standards. Moreover, since these tax shelters are generally marketed to sophisticated taxpayers who will consult their own tax

advisors on the merits of the proposal, the concerns about misleading material in broadly-marketed shelters may not be present.

I. Background

In 1984, faced with another tax shelter problem, Treasury and the IRS amended Circular 230 to provide standards for the issuance of tax shelter opinions. At that time, individual tax shelters — broadly-marketed limited partnerships often engaged in real estate, equipment leasing, oil and gas, commodities or securities activities — were the subject of attention. The shelters were commonly packaged with "opinions" of tax counsel. Some of those opinions addressed only limited aspects of the shelter (*e.g.*, that the limited partnership would be classified as a partnership for tax purposes). Others, while describing the relevant tax issues, failed to express a view on how the issues would likely be resolved if litigated. Still others were based on assumed facts, with no meaningful due diligence performed by counsel providing the opinion.

Regardless of the quality of the opinion, the participation of counsel placed an imprimatur of validity on the shelter which facilitated its sale by promoters. Investors (who did not have an attorney-client relationship with counsel providing the opinion) were led to believe that counsel had "blessed" the shelter. To deal with the problem of misleading opinions, Circular No. 230 was amended to impose three specific standards for providing tax shelter opinions.[3] First, practitioners providing tax shelter opinions are required to exercise a degree of due diligence concerning the relevant facts underlying the shelter. Second, practitioners are required to provide an opinion whether it is more likely than not that an investor will prevail on each material tax issue or explain the reasons for the practitioner's inability to opine. Third, the practitioner must provide an overall evaluation whether the material tax benefits of the shelter in the aggregate more likely than not will be realized. While the changes in Circular No. 230 may have improved the

---

3 These standards are similar to the standards set out in American Bar Association Formal Opinion 346 (January 29, 1982).

quality of tax shelter opinions, it was the enactment of the passive loss rules in 1986 that largely closed down the types of tax shelter activity at which the amended rules were directed.

The issues raised by corporate tax shelter opinions stem from two sources. First, corporate tax shelters are often sold with "marketing opinions" — generic tax opinions or memoranda obtained by (and addressed only to) the promoter of the shelter. The issue raised by the use of these marketing opinions — in which a tax practitioner discusses the tax consequences of the shelter without relating the analysis to the particular facts and circumstances applicable to the taxpayer — is similar to the issue addressed in 1984 with respect to individual tax shelters. The practitioner's generic opinion lends legitimacy (which may not be justified on closer analysis) to the tax product being sold. However, unlike the broadly-marketed shelters of the 1970s and early 1980s, today's corporate tax shelters are promoted to sophisticated taxpayers who generally seek advice from their own tax advisors. Thus, corporate taxpayers are less likely to be confused or misled by the inclusion of marketing opinions with tax shelter promotional material.

Instead, the focus of the corporate taxpayer participating in a tax shelter transaction is on obtaining a "reasonable cause opinion" — an opinion provided to (and addressed to) the taxpayer to satisfy the reasonable cause exception to accuracy-related penalties contained in Treas. Reg. § 1.6664-4(e).[4] In the case of corporate tax shelter items, neither substantial authority nor disclosure of the item on the return protect the corporation from penalties under section 6662. Therefore, the only source of relief is the reasonable cause exception of section 6664. With respect to corporate tax shelter items, Treas. Reg. §1.6664-4(e)(2)(i) provides that a corporation may establish reasonable cause if (i) there is substantial authority for the tax treatment of the item and (ii) the corporation reasonably believed that the tax treatment of the item was more likely than not the proper

---

4 All section references are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder, unless specifically noted.

treatment. To satisfy the second requirement, a corporation may reasonably rely in good faith on the opinion of a professional tax advisor, if the opinion is based upon the advisor's analysis of the pertinent facts and authorities and "unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service."[5] Reasonable cause opinions are sometimes provided by the taxpayer's own tax advisor, but may also be provided by the tax advisor to the promoter who will tailor his or her generic opinion to the specific facts and circumstances of the taxpayer.

Most corporate tax shelters are based on some technical (and, often, unintended) application of statutory or regulatory provisions. While practitioners may argue whether the strict technical legal analysis contained in any corporate tax shelter opinion is correct, the most serious criticism of such opinions is that they may fail to properly analyze judicially-created doctrines, such as the business purpose and economic substance doctrines, that may be applicable to the transaction, especially in light of the facts that are relevant to the particular corporate taxpayer. For example, an opinion may assume an adequate business purpose (*e.g.*, the need to obtain financing), without weighing that business purpose (and any increased costs of the transaction) against the promised tax benefits. Or, a tax shelter opinion may reach a technical result that is unreasonable (*i.e.*, "too good to be true") in light of the purpose underlying the relevant statute or regulation.

We have previously recommended that penalties be applied to corporate tax shelters without regard to a reasonable cause exception.[6] We believe that strict liability for

---

5 Treas. Reg. §1.6664-4(e) further states, however, that satisfying these standards is the "minimum" required to establish reasonable cause. The regulations provide that satisfaction of the minimum requirements is not dispositive where, for example, the taxpayer's participation in the shelter lacked significant business purpose, the tax benefits are unreasonable in comparison to the investment, or the taxpayer agreed with the promoter to protect the confidentiality of the tax aspects of the shelter.

6 New York State Bar Association Tax Section, Report on Corporate Tax Shelters (April 23, 1999).

penalties in corporate tax shelters (and increased enforcement) would be an effective means of deterring abusive transactions. If the reasonable cause exception was eliminated for corporate tax shelters, a reasonable cause opinion would no longer shield the corporate taxpayer from accuracy-related penalties and the pressure on tax advisors to provide such opinions would be eliminated, as would the need to prescribe applicable standards of practice. Tax advisors could then be selected on the basis of their skills and experience, rather than merely their willingness to sign reasonable cause opinions.

However, for purposes of this Report, we assume that the reasonable cause exception is retained and that tax opinions will continue to play a role in determining whether accuracy-related penalties are imposed in connection with corporate tax shelters. If that is the case, we believe that the standards for reasonable cause opinions with respect to corporate tax shelters should be strengthened and that the same opinion standards should be applicable under Circular No. 230. As noted above, we do not believe, however, that changes in the standards of practice for practitioners (or even tougher standards under section 6664) are likely to have a significant impact on the proliferation of corporate tax shelters.

II. Summary of Recommendations

A. **Reasonable Cause Opinions.** We believe that the standards of practice applicable to tax advisors rendering reasonable cause opinions should be conformed to the standards applicable under the reasonable cause exception of section 6664. We also believe that the standards under section 6664 for relying on an opinion of a tax advisor in asserting the reasonable cause exception for a corporate tax shelter should be strengthened. In particular, we recommend:

1. A reasonable cause opinion should state that it is being provided for that purpose.

2. A reasonable cause opinion should be required to specifically address and opine on all applicable judicial doctrines, including the business purpose, step transaction, economic substance, substance over form and sham transaction doctrines, as well as applicable statutory and regulatory doctrines, such as clear reflection of income and anti-abuse rules. The practitioner should also address whether the tax benefits of the transaction are unreasonable, and whether the benefits are consistent or inconsistent with the purpose of the underlying statute and regulations.

3. In rendering a reasonable cause opinion, the practitioner should be required to undertake an adequate factual inquiry, including an inquiry into the business purpose and non-tax economic consequences of the proposed transaction. The practitioner should be entitled to rely on a certified statement of an authorized corporate officer concerning all of the facts relating to the transaction. However, the practitioner should not be entitled to rely on such a statement where (i) the facts asserted in the statement are unreasonable on their face, (ii) the practitioner has reason to know that the facts asserted in the statement are not correct or (iii) the certificate contains unsupported conclusions (*e.g.*, certifies that the transaction has a business purpose without describing that purpose in detail).

4. A reasonable cause opinion should advise the taxpayer whether the disclosure, registration or list maintenance requirements may be applicable to the transaction.

5. If the practitioner who is rendering the reasonable cause opinion is not a regular tax advisor to the taxpayer (*e.g.*, a practitioner initially retained by the promoter), this fact should be disclosed in the opinion.

B. **Marketing Opinions.** It is more difficult to regulate opinions and memoranda provided in connection with the marketing of corporate tax shelters. However, where a tax advisor has reason to know that a marketing opinion that he or she has prepared will be used to market a corporate tax shelter, we recommend that:

1. The marketing opinion should specifically state that a taxpayer may not rely on it for purposes of the reasonable cause exception under section 6664.

2. The marketing opinion should address all material tax aspects of the proposed transaction (as opposed to, for example, a single issue) and all judicial, statutory and regulatory doctrines that could apply to the transaction in the same manner as a reasonable cause opinion.

3. Since the marketing opinion cannot be based on a specific factual inquiry applicable to a specific taxpayer, the marketing opinion should be based on a detailed set of hypothetical facts upon which the tax advisor would be willing to favorably opine. It should also include a caveat that the tax consequences of the transaction will depend upon the facts and circumstances of the particular taxpayer.

C. **Contingent Fees, Confidentiality and Sanctions.** We separately address some of the specific questions raised in the Notice concerning contingent fees, confidentiality and sanctions.

III. Discussion

A. **Reasonable Cause Opinions.** We recommend that, if the reasonable cause exception is retained, the standards of practice for the issuance of reasonable cause opinions be the same as the standards under the reasonable cause exception and that Treas. Reg. §1.6664-4(e) should be amended to strengthen the substantive standards required for taxpayers to rely on opinions of tax advisors.

As a preliminary matter, a reasonable cause opinion should state that it is being provided for the purpose of satisfying the reasonable cause exception under section 6664. We do not believe that this change would be particularly controversial, since practitioners who render reasonable cause opinions already know that those opinions are the basis for taxpayers asserting the reasonable cause exception.

On a more substantive note, we believe that a reasonable cause opinion should specifically address the applicability of judicially-created doctrines, and statutory and regulatory anti-abuse rules, to the corporate tax shelter transaction. The existing regulations under section 6664 already state that the minimum requirements for the reasonable cause exception are not dispositive if, for example, the taxpayer's participation in the shelter lacked significant business purpose, but they do not specifically require such issues to be addressed in an opinion in order for the minimum requirements to be satisfied. We believe that the application of the business purpose, economic substance, step transaction, substance over form, sham transaction, clear reflection of income and other similar doctrines, as well as statutory and regulatory anti-abuse rules, should be addressed by the opinion in order for the taxpayer to satisfy the minimum requirements under Treas. Reg. §1.6664-4(e)(2)(i)(B)(2). The opinion should also address the impact, if any, of the participation in the transaction of "tax indifferent" parties. We also recommend that the opinion specifically address whether the anticipated tax benefits are unreasonable, and whether the tax benefits are consistent or inconsistent with the purpose of the underlying statute and regulations.

In addition, we are concerned that reasonable cause opinions are being provided in cases where the practitioner has not undertaken an adequate inquiry into the facts relevant to the particular taxpayer and transaction, in part because the opinion may have been prepared on a generic basis for the promoter of the tax shelter. In particular, we recommend that both Treas. Reg. §1.6664-4(e) and Circular No. 230 require a practitioner issuing a reasonable cause opinion to undertake an adequate factual inquiry, including an inquiry into the specific taxpayer's business purpose for entering into the transaction and the non-tax economic consequences of the transaction to the taxpayer. An inquiry into the facts relevant to the particular taxpayer is necessary for the practitioner to reach the legal opinion that the transaction passes muster under the judicial, statutory and regulatory doctrines noted above.

In conducting this inquiry, we believe that the practitioner should be entitled to rely on a certificate from an authorized corporate officer concerning the underlying facts. However, the practitioner should not be entitled to rely on such a statement where (i) the facts asserted in the statements are unreasonable on their face, (ii) the practitioner has reason to know that the facts asserted in the statement are not correct or (iii) the certificate contains unsupported conclusions (*e.g.*, certifies that the transaction has a business purpose without describing that purpose in detail). Appropriate penalties might be imposed on a corporate officer who provides a false statement in support of a reasonable cause opinion.[7]

We also make two additional suggestions with respect to the opinion standards under Circular No. 230 that are not directly related to the reasonable cause exception under section 6664. First, in light of the new regulations dealing with disclosure, registration and list maintenance for corporate tax shelters, we believe that it would be good practice for practitioners providing tax shelter opinions also to advise taxpayers on the applicability of these requirements. Second, if the practitioner who is rendering the opinion is not a regular tax advisor to the taxpayer (*e.g.*, a practitioner initially retained by the promoter), this fact should be disclosed in the opinion.

B. **Marketing Opinions.** Marketing opinions come in a variety of forms. On the one hand, a practitioner may be asked by a tax shelter promoter to prepare a legal memorandum dealing with a discrete technical issue that is the basis for the tax shelter (*e.g.*, the regulations applicable to contingent payment installment sales that were the basis of the ACM transaction). Alternatively, the practitioner may provide the tax shelter promoter with a full-blown opinion analyzing all aspects of the tax shelter transaction, albeit based on a hypothetical set of facts.

---

7 The regulations might require that the certificate be executed under penalties of perjury.

Where the practitioner has reason to know that the marketing opinion is going to be included in marketing material for the tax shelter, we believe that the standards of practice applicable to the opinion should be derived from the standards applicable to reasonable cause opinions. First, in order to distinguish marketing opinions from reasonable cause opinions, we recommend that a marketing opinion state explicitly that it may not be relied upon for the reasonable cause exception under section 6664. As a result, taxpayers will recognize that they must obtain a separate reasonable cause opinion that satisfies the requirements discussed above to avoid accuracy-related penalties.

Second, a marketing opinion should be in substantially the same form as a reasonable cause opinion, in that it should address all of the issues associated with the tax shelter. We do not believe that it is appropriate for a marketing opinion to be limited to a discrete technical issue, without an analysis of other issues raised by the tax shelter transaction. Opinions that are limited to a discrete issue will tend to mislead the taxpayer into concluding that the practitioner who has provided the opinion has passed on the entire transaction. Therefore, a marketing opinion should, for example, address the same judicial, statutory and regulatory doctrines that must be addressed in a reasonable cause opinion.

Finally, a marketing opinion, by its nature, cannot address the facts applicable to a specific taxpayer and, therefore, a requirement that the practitioner undertake an adequate factual inquiry before rendering the opinion cannot be imposed. As a substitute, we recommend that a marketing opinion include a detailed set of hypothetical facts upon which the practitioner would be willing to favorably opine. By setting out a detailed set of hypothetical facts, the taxpayer may be better able to assess whether its own particular facts and circumstances would support the conclusion reached in the marketing opinion (*e.g.*, whether it would have an adequate business purpose or profit motive). The marketing opinion should also contain a specific caveat that its conclusion depends upon the facts and circumstances of the specific taxpayer.

C. **Other Matters.** The Notice requests comments on a series of questions related to matters other than opinion standards. We respond only to a few of those items on which we have a view.

1. **Contingent Fees**

The Notice asks for comment on whether Circular No. 230 should prohibit a practitioner from charging a fee for an opinion relating to a position taken in an original return where the fee is contingent upon whether the tax treatment of the transaction is sustained, and whether Circular No. 230 should prohibit a practitioner from providing an indemnity to a taxpayer with respect to a position taken in an original return. The Notice also asks whether contingent fees should continue to be permitted for assisting a taxpayer in filing an amended return or claim for refund where it is anticipated that the return or claim will receive substantive review.

Fee arrangements of tax advisors in tax shelter transactions may include a variety of contingencies. In one sense, all fee arrangements have some transaction-related contingency because, even if a tax advisor bills on an hourly basis, the amount of fees will increase if the taxpayer consummates the transaction (*i.e.*, more work will be need to be done). Tax advisors may also bill on a "value" basis, adding a premium to their ordinary hourly rates for complex transactions.

The most extreme (and troublesome) example of a contingent fee arrangement is the case in which a tax advisor charges fees that are contingent upon whether the tax treatment of a transaction is sustained. Other contingent fee arrangements in tax shelter transactions could include fixed fees contingent on whether the transaction is completed, fees based on a percentage of the taxpayer's anticipated tax savings, or fees based on a sharing agreement with the promoter in the transaction. We believe that, where there is an explicit advance agreement for the taxpayer to pay a tax advisor fees based on any of these types of contingencies, the regulations under section 6664 should

prohibit the taxpayer from relying on the opinion of the tax advisor in establishing reasonable cause.

The proper treatment of success-based contingent fees for positions on original or amended returns logically might depend on the degree of substantive review the return is likely to receive. Since positions on original returns are less likely to receive substantive review than positions on amended returns, a fee that is contingent on a return position being sustained is more likely to be a bet on the "audit lottery" in the case of an original return than in the case of an amended return. Thus, we believe that success-based contingent fees raise greater concerns in the case of original returns than in the case of amended returns. To the extent, if any, that Circular No. 230 restricts use of success-based contingent fee arrangements, we believe that the arguments for doing so are weaker in the case of refund claims than in the case of original returns.

2. **Conditions of Confidentiality**

The Notice asks whether there are circumstances in which a practitioner should be prohibited from agreeing to conditions of confidentiality, other than confidentiality imposed by reasons of privilege, and whether a practitioner should be prohibited from asking a client to agree to conditions of confidentiality.

In light of the recently promulgated regulations requiring registration of corporate tax shelters marketed under conditions of confidentiality, promoters have, to a large extent, eliminated confidentiality conditions in order to avoid registration. Where conditions of confidentiality are still imposed, however, we do not believe it is appropriate for Circular No. 230 to restrict practitioners from agreeing to conditions of confidentiality. The propriety of such agreements is not a matter of tax enforcement, but is instead a basic ethical inquiry into the effects of such agreements on an advisor's broader ability to represent its clients.

A practitioner, whether an attorney, accountant, or other tax professional, has a duty to evaluate whether the confidentiality agreement may interfere with the practitioner's ability to represent his or her clients as required by the ethical rules applicable to that advisor. The specific client whose transaction prompts such an agreement would have ordinarily entered into a similar confidentiality agreement itself and, therefore, we would not expect that the practitioner's confidentiality agreement is likely to interfere with his or her representation of that client. We do note, however, that many practitioners are unwilling to enter into confidentiality agreements because such agreements may compromise the practitioner's representation of other existing or future clients. Tax advisors deal with similar issues for many clients and, therefore, must be cautious about undertaking confidentiality obligations that could even appear to affect their ability to provide complete advice to all of their clients. We believe tax advisors should be educated about, and sensitive to, the ethical implications of such agreements, but do not believe a Circular No. 230 restriction is an appropriate way to address these concerns.

In addition, we do not believe that practitioners should be prohibited from requesting confidentiality agreements from their own clients and potential clients. The business of tax advisors includes providing ideas for structuring transactions to their clients, and they should be permitted to protect those ideas through confidentiality agreements if they believe necessary. Again, we do not believe that prohibition of these kinds of contractual agreements by Circular No. 230 is appropriate.

3. Sanctions

The Notice asks whether there are circumstances in which a practitioner's failure to comply with the rules of Circular No. 230 should be attributed to the firm with which the practitioner is associated so that the practitioner and the firm may be subject to discipline under Circular No. 230. The Notice also asks whether Circular No. 230 should provide a broader array of sanctions for violation of its provisions.

There is a broad range of sanctions that could be applied to a practitioner and his or her firm for consistent violations of the opinion standards of Circular No. 230. At one extreme, the practitioner and the firm could be suspended from practice before Treasury and the IRS for some period. An alternative, but more limited, approach directed at the corporate tax shelter problem would be to prohibit taxpayers from relying on the opinion of a practitioner (or the practitioner's firm) to satisfy the reasonable cause exception of section 6664. In either case, the names of practitioners and firms that have been sanctioned should be published on the Treasury and IRS websites.

While we believe there must be properly-crafted safeguards to prevent the errors of one practitioner from unduly restricting the ability of others in his or her firm from pursuing their profession, we do generally believe that extending sanctions to the practitioner's firm could result in greater oversight of the opinion process, especially for large firms where the sanction could have a meaningful economic impact on their practice. We would impose such sanctions in cases where there is a pattern of abuse by members of the firm in providing tax shelter opinions. A firm which lends its imprimatur, in particular, to opinions which corporate taxpayers use to avoid penalties has an obligation to monitor the quality of those opinions; persistent lapses in such oversight are properly a cause for concern.

IV. Conclusion

Overall, changes in the standards of opinion practice are not likely to have a meaningful impact on corporate tax shelter activity. In particular, while opinion standards can be strengthened and coordinated with the reasonable cause exception under section 6664, we continue to believe that elimination of the reasonable cause exception to the accuracy-related penalties for corporate tax shelters (and increased enforcement) is a more effective approach to the problem. The proliferation of corporate tax shelters in recent years, and the profitability of these transactions for both taxpayers and their advisors, make it unlikely, in our judgment, that tightening opinion standards in Circular No. 230 will

have any noticeable impact on the problem. In our view, the most powerful deterrent is a material economic disincentive to the transaction, which meaningful penalties provide.

Nonetheless, if the reasonable cause exception is retained, we recommend that the opinion standards of section 6664 be strengthened and we believe that coordination of those standards with Circular No. 230 would help to reinforce the obligation that practitioners have to fairly assess the tax consequences of corporate tax shelter transactions. We also believe that raising the standards for practitioners who provide marketing opinions for tax shelter promoters may help to discourage advisors from participating in the sale of the more abusive products.